

October 2, 1998

Katherine A. England  
Assistant Director  
Division of Market Regulation  
Securities and Exchange Commission  
450 Fifth Street, N.W.  
Washington, D.C. 20549  
Mail Stop 10-1

Re: **File No. SR-NASD-98-75** - Rule Requiring Certain NASD Members to Conduct or to Participate in Year 2000 Testing

Dear Ms. England:

Pursuant to Rule 19b-4, enclosed herewith is the above-numbered rule filing. Also enclosed is a 3-1/2" disk containing the rule filing in Microsoft Word 7.0 to facilitate production of the Federal Register release.

If you have any questions, please contact Peter R. Geraghty, Office of General Counsel, NASD Regulation, Inc., at (202) 728-8227; e-mail [geraghpr@nasd.com](mailto:geraghpr@nasd.com). The fax number of the Office of General Counsel is (202) 728-8264.

Very truly yours,

Joan C. Conley  
Secretary

Attachment

**SECURITIES AND EXCHANGE COMMISSION**

Washington, D. C.

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Form 19b-4

Proposed Rule Change

by

**NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.**

Pursuant to Rule 19b-4 under the  
Securities Exchange Act of 1934

1. Text of Proposed Rule Change

(a) Pursuant to the provisions of Section 19(b)(1) under the Securities Exchange Act of 1934 ("Act"), NASD Regulation, Inc. ("NASD Regulation") is filing with the Securities and Exchange Commission ("SEC" or "Commission") a proposed rule change to require certain National Association of Securities Dealers, Inc. ("NASD") members to conduct or to participate in computer tests designed to address the Year 2000 problem. Below is the text of the proposed rule change. Proposed new language is underlined.

**1000. MEMBERSHIP,REGISTRATION AND QUALIFICATION REQUIREMENTS**

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**1150. Mandatory Year 2000 Testing**

[This rule will expire automatically on January 1, 2001]

(a) Members of the Association that determine their minimum net capital requirement according to paragraphs (a)(2)(i) and/or (a)(4) of Securities Exchange Act Rule 15c3-1, or are registered with the Securities and Exchange Commission as government securities brokers or dealers under Section 15C of the Securities Exchange Act of 1934 must conduct or participate in such testing of computer systems as the Association may prescribe.

(b) Every member required by the Association to conduct or participate in testing of computer systems shall provide to the Association such reports relating to the testing as the Association may prescribe.

(c) Every member of the Association that clears securities transactions on behalf of other broker-dealers must take reasonable measures to ensure that each broker-dealer for

which it clears securities transactions conducts testing with such member.

(b) Not applicable.

(c) Not applicable.

2. Procedures of the Self-Regulatory Organization

(a) The proposed rule change was approved by the Board of Directors of NASD Regulation at its meeting on August 5, 1998, which authorized the filing of the rule change with the SEC. The Nasdaq Stock Market has been provided an opportunity to consult with respect to the proposed rule change, pursuant to the Plan of Allocation and Delegation of Functions by the NASD to its Subsidiaries. The NASD Board of Governors reviewed the proposed rule change its meeting on August 6, 1998. No other action by the NASD is necessary for the filing of the proposed rule change. Section 1(a)(ii) of Article VII of the By-Laws permits the NASD Board of Governors to adopt NASD Rules or amendments to NASD Rules without recourse to the membership for approval.

(b) Questions regarding this rule filing may be directed to Peter R. Geraghty, Assistant General Counsel, NASD Regulation, Office of General Counsel, at (202) 728-8227.

3. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

**(a) Purpose**

The NASD is proposing that certain members conduct some form of Year 2000 testing and to report to the NASD on that testing. The rule would establish the NASD's specific authority to require these members to participate in Year 2000 tests and to require

reporting on the tests.<sup>1</sup> The NASD is proposing that the rule will expire in the year 2001, instead of the year 2000, so that the NASD will have specific authority to mandate testing, as necessary, to correct problems that are not resolved prior to January 1, 2000, or to correct problems that arise after January 1, 2000.

On January 1, 2000, the internal date in all the world's computers will roll-over from "12/31/99" to "01/01/00." At that moment, if corrective measures have not been taken, the program logic in the vast majority of these computer systems will begin to produce erroneous results because the systems will read the date as beginning in the year 1900. This problem, known as the "Year 2000 Problem," could cause significant disruption in the securities industry. There are several stages involved in correcting the Year 2000 Problem. These include: assessment of the problem, implementation of corrective measures, internal testing, point-to-point testing, integrated or industry-wide testing, and contingency planning.

The testing stage of correcting the Year 2000 Problem will be critical to ensuring that the markets will operate with minimal disruption after January 1, 2000. To facilitate testing on an integrated, industry-wide basis, the Securities Industry Association ("SIA") has undertaken the task of coordinating such a test. Test participants will include, among others, exchanges, registered clearing corporations and depositories, data processors, and broker-dealers. The first day of the integrated, industry-wide test is scheduled for March 6, 1999.<sup>2</sup>

The NASD believes it is essential that the firms that could cause the most disruption in

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<sup>1</sup> The proposed rule is not intended to limit the NASD's existing authority, by rule, contract, or otherwise, by which the NASD can mandate testing or require reports from members. For example, the Nasdaq Workstation II™ Subscriber Agreement, Section 1 states that Nasdaq agrees to provide services to a subscriber on the terms and conditions set forth in the agreement, which could include testing.

<sup>2</sup> The exact number of firms that will be able to participate in the SIA coordinated test has not been conclusively determined.

the market, if these firms have not corrected the Year 2000 problem, conduct tests of all of their critical computer systems that relate to their different types of businesses (*e.g.*, equities, options, government securities, mortgage-backed securities, etc.). Consequently, the NASD is proposing to require all market makers and clearing firms to conduct tests designed to address the Year 2000 Problem. The proposed rule also would require government securities brokers or dealers that are not subject to the SEC's net capital rule, but are NASD members, to conduct Year 2000 tests.

It is expected that some firms will be able to satisfy at least part of their testing obligations by participation in the SIA coordinated test, however, for example, testing for government securities is not included in the SIA test, but will be conducted by the Government Securities Clearing Corporation. In addition, testing for mortgage-backed securities are not part of the SIA test, but will be conducted by the clearing corporations that clear these instruments, namely, the Participants Trust Company, and MBS Clearing Corporation. Therefore, it is expected that portions of the members' testing obligations will be satisfied by participation in the tests offered by these clearing corporations. Once the number of firms that will be able to participate in the SIA test has been finalized, the NASD will issue a Notice to Members specifying members' testing obligations under the rule.

The rule would provide authority to require not only participation in organized, industry-sponsored tests, but also to conduct "point-to-point" testing between member firm and NASD or other systems, or internal tests of member systems. These other testing venues may be particularly significant for smaller market makers and clearing firms that may not be able to participate in the industry-sponsored tests. Following approval of this rule

proposal, NASD Regulation will issue a Notice to Members describing the types of tests that will be required for different types of market makers and clearing firms.

The NASD also believes that test results should be reported to the Association. These reports will enable the NASD to identify those members that have not adequately prepared for the Year 2000 so that appropriate action can be taken to address these members' deficiencies, including, for example, providing assistance to or easing the transition of business to other firms. Accordingly, the proposal would require members to file reports with the NASD about the tests. To simplify the reporting requirement, the NASD will design a standardized report that will be filed by firms required to report to the NASD. In addition, to limit the number of reports that a firm would be required to file, the NASD will coordinate its reporting requirements with the SIA and other self-regulatory organizations as much as possible. For example, it might be possible to exclude from the NASD reporting requirement those firms for which the NASD is not the designated examining authority. Again, once the number of firms that will be able to participate in the SIA test has been finalized, the NASD will issue a Notice to Members that will specify members' reporting obligations under the rule.

Although the NASD is not proposing to require all members of the Association (*e.g.*, introducing firms that do not make markets) to conduct some form of testing, this does not mean to suggest that the NASD believes these firms should not test their computer systems. NASD Regulation staff has held 35 Year 2000 seminars in 14 cities and has been told by introducing firms that their computer systems are dependent upon, and in some cases provided by, their clearing firms and that cooperation by and coordination with the clearing firms is necessary. Based on these comments, the NASD is proposing that clearing firms must take

reasonable measures to ensure that their introducing firms have an opportunity to test with them. The NASD expects that “reasonable measures” in this context would include providing reasonable notice of the existence of tests that are scheduled as well as such access to the systems and personnel of the clearing firm as may practically be necessary. The NASD would expect that the clearing firms report to Association the results of the tests conducted with the introducing firms.

Finally, there is no more significant issue confronting the financial industry than the Year 2000 Problem, and the NASD thus will respond decisively to members’ failure to respond to initiatives designed to determine their readiness. The NASD informed members that failure to respond to the NASD Year 2000 survey could result in disciplinary action. Similarly, disciplinary actions will be instituted against members that fail to file SEC Form BD-Y2K. In addition, members will be subject to disciplinary action if they fail to conduct the required tests, fail to report the results of the tests to the NASD, or fail to take reasonable measures to ensure that their introducing firms have an opportunity to test with them.

**(b) Statutory Basis**

NASD Regulation believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act, which requires, among other things, that the Association’s rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. NASD Regulation believes the proposed rule is necessary to protect investors and the public interest. The NASD rule requiring certain members to conduct or participate in Year 2000 tests, and to file reports about the tests, will enable



NASD Regulation, those participating in the tests, and others to evaluate the readiness of securities industry for the Year 2000. The firms that would be required to conduct testing perform critical functions in the markets and these firms' inability to perform these functions beyond January 1, 2000 could cause disruptions in the markets and cause harm to investors.

4. Self-Regulatory Organization's Statement on Burden on Competition

NASD Regulation does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act, as amended.

5. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

Written comments were neither solicited nor received.

6. Extension of Time Period for Commission Action

NASD Regulation does not consent at this time to an extension of the time period for Commission action specified in Section 19(b)(2) of the Act.

7. Basis for Summary Effectiveness Pursuant to Section 19(b)(3) or for Accelerated Effectiveness Pursuant to Section 19(b)(2)

Not applicable.

8. Proposed Rule Change Based on Rules of Another Self-Regulatory Organization or of the Commission

Not applicable.

9. Exhibits

1. Completed notice of proposed rule change for publication in the Federal Register.

Pursuant to the requirements of the Securities Exchange Act of 1934, NASD Regulation has duly caused this filing to be signed on its behalf by the undersigned thereunto duly authorized.

NASD REGULATION, INC.

BY: \_\_\_\_\_  
Joan C. Conley, Secretary

Date: October 2, 1998



**1150. Mandatory Year 2000 Testing**

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(b) Every member required by the Association to conduct or participate in testing of computer systems shall provide to the Association such reports relating to the testing as the Association may prescribe.

(c) Every member of the Association that clears securities transactions on behalf of other broker-dealers must take reasonable measures to ensure that each broker-dealer for which it clears securities transactions conducts testing with such member.

II. SELF-REGULATORY ORGANIZATION'S STATEMENT OF THE PURPOSE OF, AND STATUTORY BASIS FOR, THE PROPOSED RULE CHANGE

In its filing with the Commission, NASD Regulation included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. NASD Regulation has prepared summaries, set forth in Sections (A), (B), and (C) below, of the most significant aspects of such statements.

(A) Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

(a) **Purpose**

The NASD is proposing that certain members conduct some form of Year 2000 testing and to report to the NASD on that testing. The rule would establish the NASD's specific authority to require these members to participate in Year 2000 tests and to require reporting on the tests.<sup>1</sup> The NASD is proposing that the rule will expire in the year 2001, instead of the year 2000, so that the NASD will have specific authority to mandate testing, as necessary, to correct problems that are not resolved prior to January 1, 2000, or to correct problems that arise after January 1, 2000.

On January 1, 2000, the internal date in all the world's computers will roll-over from "12/31/99" to "01/01/00." At that moment, if corrective measures have not been taken, the program logic in the vast majority of these computer systems will begin to produce erroneous results because the systems will read the date as beginning in the year 1900. This problem, known as the "Year 2000 Problem," could cause significant disruption in the securities industry. There are several stages involved in correcting the Year 2000 Problem. These include: assessment of the problem, implementation of corrective measures, internal testing, point-to-point testing, integrated or industry-wide testing, and contingency planning.

The testing stage of correcting the Year 2000 Problem will be critical to ensuring that the markets will operate with minimal disruption after January 1, 2000. To facilitate testing on an integrated, industry-wide basis, the Securities Industry Association ("SIA") has undertaken the task of coordinating such a test. Test participants will include, among others,

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exchanges, registered clearing corporations and depositories, data processors, and broker-dealers. The first day of the integrated, industry-wide test is scheduled for March 6, 1999.<sup>2</sup>

The NASD believes it is essential that the firms that could cause the most disruption in the market, if these firms have not corrected the Year 2000 problem, conduct tests of all of their critical computer systems that relate to their different types of businesses (*e.g.*, equities, options, government securities, mortgage-backed securities, etc.). Consequently, the NASD is proposing to require all market makers and clearing firms to conduct tests designed to address the Year 2000 Problem. The proposed rule also would require government securities brokers or dealers that are not subject to the SEC's net capital rule, but are NASD members, to conduct Year 2000 tests.

It is expected that some firms will be able to satisfy at least part of their testing obligations by participation in the SIA coordinated test, however, for example, testing for government securities is not included in the SIA test, but will be conducted by the Government Securities Clearing Corporation. In addition, testing for mortgage-backed securities are not part of the SIA test, but will be conducted by the clearing corporations that clear these instruments, namely, the Participants Trust Company, and MBS Clearing Corporation. Therefore, it is expected that portions of the members' testing obligations will be satisfied by participation in the tests offered by these clearing corporations. Once the number of firms that will be able to participate in the SIA test has been finalized, the NASD will issue a Notice to Members specifying members' testing obligations under the rule.

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The NASD also believes that test results should be reported to the Association. These reports will enable the NASD to identify those members that have not adequately prepared for the Year 2000 so that appropriate action can be taken to address these members' deficiencies, including, for example, providing assistance to or easing the transition of business to other firms. Accordingly, the proposal would require members to file reports with the NASD about the tests. To simplify the reporting requirement, the NASD will design a standardized report that will be filed by firms required to report to the NASD. In addition, to limit the number of reports that a firm would be required to file, the NASD will coordinate its reporting requirements with the SIA and other self-regulatory organizations as much as possible. For example, it might be possible to exclude from the NASD reporting requirement those firms for which the NASD is not the designated examining authority. Again, once the number of firms that will be able to participate in the SIA test has been finalized, the NASD will issue a Notice to Members that will specify members' reporting obligations under the rule.

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introducing firms that their computer systems are dependent upon, and in some cases provided by, their clearing firms and that cooperation by and coordination with the clearing firms is necessary. Based on these comments, the NASD is proposing that clearing firms must take reasonable measures to ensure that their introducing firms have an opportunity to test with them. The NASD expects that “reasonable measures” in this context would include providing reasonable notice of the existence of tests that are scheduled as well as such access to the systems and personnel of the clearing firm as may practically be necessary. The NASD would expect that the clearing firms report to Association the results of the tests conducted with the introducing firms.

Finally, there is no more significant issue confronting the financial industry than the Year 2000 Problem, and the NASD thus will respond decisively to members’ failure to respond to initiatives designed to determine their readiness. The NASD informed members that failure to respond to the NASD Year 2000 survey could result in disciplinary action. Similarly, disciplinary actions will be instituted against members that fail to file SEC Form BD-Y2K. In addition, members will be subject to disciplinary action if they fail to conduct the required tests, fail to report the results of the tests to the NASD, or fail to take reasonable measures to ensure that their introducing firms have an opportunity to test with them.

**(b) Statutory Basis**

NASD Regulation believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act, which requires, among other things, that the Association’s rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect



investors and the public interest. NASD Regulation believes the proposed rule is necessary to protect investors and the public interest. The NASD rule requiring certain members to conduct or participate in Year 2000 tests, and to file reports about the tests, will enable NASD Regulation, those participating in the tests, and others to evaluate the readiness of securities industry for the Year 2000. The firms that would be required to conduct testing perform critical functions in the markets and these firms' inability to perform these functions beyond January 1, 2000 could cause disruptions in the markets and cause harm to investors.

(B) Self-Regulatory Organization's Statement on Burden on Competition

NASD Regulation does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act, as amended.

(C) Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

Written comments were neither solicited nor received.

III. DATE OF EFFECTIVENESS OF THE PROPOSED RULE CHANGE AND TIMING FOR COMMISSION ACTION

Within 35 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

- A. by order approve such proposed rule change, or
- B. institute proceedings to determine whether the proposed rule change should be disapproved.

IV. SOLICITATION OF COMMENTS

Interested persons are invited to submit written data, views, and arguments concerning the foregoing. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the NASD. All submissions should refer to the file number in the caption above and should be submitted by [insert date 21 days from the date of publication].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority, 17 CFR 200.30-3(a)(12).

Jonathan G. Katz  
Secretary