

February 19, 2003

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

Re: File No. SR-NASD-2002-108 – Business Continuity Plans and Emergency Contact Information; Amendment No. 3

Dear Ms. England:

Upon consideration of comments noted by the staff of the Securities and Exchange Commission (“SEC”) concerning the proposed rule language of the above-referenced rule filing, NASD staff believes it is appropriate to amend the proposed rule change as described below to clarify the language in the text of proposed Rule 3510. A draft Federal Register release is attached as Exhibit 1.

The purpose of this amendment is to address concerns that a literal reading of proposed Rule 3510, as set forth in the proposed rule filing, could suggest that the Rule only requires members to create, maintain, and periodically review a business continuity plan, but does not obligate that members' plans be effective in enabling members to continue their business in the event of a future significant business disruption. NASD did not intend to propose a rule of such limited scope. In this regard, in its description of the purpose of the proposed rule change, NASD stated that “[t]he purpose of the proposed rule change is to help to ensure that NASD members will be able to continue their business in the event of future significant business disruptions.” NASD believes that members should be obligated to develop a business continuity plan that is reasonably designed, in light of particular characteristics of the firm, to allow the firm to recover as early as practicable in the event of a future significant business interruption.

To clarify that the language of proposed Rule 3510 is intended to require not only that a member conduct a planning process to create a written business plan, but that the plan that results from this process be reasonably designed to enable the member to continue its business in the event of future significant business disruptions, the staff proposes to amend the language of proposed Rule 3510(a) and 3510(c), as set forth in Amendment No. 2, as follows (additions are underlined; deletions are bracketed):

3510. Business Continuity Plans

(a) Each member must create and maintain a written business continuity plan identifying procedures [to be followed in the event of] relating to an emergency or significant business

disruption. Such procedures must be reasonably designed to enable the member to continue its business in the event of future significant business disruptions. The business continuity plan must be made available promptly upon request to NASD staff.

(b) No Change

(c) The [requirements of] elements that comprise a business continuity plan are flexible and may be tailored to the size and needs of a member. Each plan, however, must at a minimum, address:

(1) – (8) No change.

Each member must address the above-listed categories to the extent applicable and necessary to enable the member to continue its business in the event of a future significant business disruption. If any of the above-listed categories is not applicable, the member's business continuity plan need not address the category. The member's business continuity plan, however, must document the rationale for not including such category in its plan. If a member relies on another entity for any one of the above-listed categories or any mission critical system, the member's business continuity plan must address this relationship.

* * * * *

NASD staff believes that amending this filing to clarify the requirements of the rule furthers the purposes of the proposed rule change, as articulated in the proposed rule change. NASD staff notes that the amended rule language is consistent with NASD rules in other areas where reasonableness standards were adopted because the diversity of NASD's membership made specific standards impracticable. *See e.g.*, NASD Rules 3010 (Supervision) and 3011 (Anti-Money Laundering Compliance Program). In light of the SEC staff's concerns regarding the clarity of the proposed rule text, NASD believes this amendment to the proposed rule change should be published for comment to ensure that interested persons are given notice of the clarification and an opportunity to comment thereon.

If you have questions, please contact the undersigned at (202) 728-6927.

Very truly yours,

Brian J. Woldow

Attachment

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34- ; File No. SR-NASD-2002-108)

Self-Regulatory Organizations; Notice of Filing of Amendment Nos. 1, 2 and 3 to Proposed Rule Change by National Association of Securities Dealers, Inc. Relating to Business Continuity Plans and Emergency Contact Information

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹ and Rule 19b-4 thereunder,² notice is hereby given that on _____, the National Association of Securities Dealers, Inc. (“NASD”), filed with the Securities and Exchange Commission (“SEC” or “Commission”), Amendment No. 3 to the proposed rule change, File No. SR-NASD-2002-108, as previously amended by Amendment No.1 on December 11, 2002 and Amendment No. 2 on January 8, 2003, and as described in Items I, II, and III below, which Items have been prepared by NASD. The Commission is publishing this notice to solicit comments on Amendment Nos. 1, 2 and 3 to the proposed rule change from interested persons. NASD submitted the proposed rule change to the Commission on August 7, 2002, which was published in the Federal Register on September 9, 2002 (“Original Notice”).³ The Commission is publishing this notice to solicit comments on Amendment No. 3 to the proposed rule change from interested parties.

¹ 15 U.S.C. § 78s(b)(1).

² 17 CFR § 240.19b-4.

³ 67 Fed. Reg. 57257 (Sept. 9, 2002).

I. SELF-REGULATORY ORGANIZATION'S STATEMENT OF THE TERMS OF SUBSTANCE OF THE PROPOSED RULE CHANGE

NASD is proposing to clarify that the proposed rule change, which requires member firms to create and maintain business continuity plans and provide NASD with certain information to be used in the event of future significant business disruptions, also requires members' business continuity plans to be reasonably designed to enable members to continue their business in the event of a significant business disruption. Below is the text of the proposed rule change. The base rule text is that proposed in the original submission of August 7, 2002. Proposed new language added by Amendments Nos. 1, 2 and 3 are underlined; proposed deletions are in brackets.

* * * * *

3500. EMERGENCY PREPAREDNESS

3510. Business Continuity Plans

(a) Each member must create and maintain a written business continuity plan identifying procedures [to be followed in the event of] relating to an emergency or significant business disruption. Such procedures must be reasonably designed to enable the member to continue its business in the event of future significant business disruptions. The business continuity plan must be made available promptly upon request to NASD staff.

(b) Each member must update its plan in the event of any material change to the member's operations, structure, business or location. Each member must also conduct an annual review of its business continuity plan to determine whether any modifications are necessary in light of changes to the member's operations, structure, business, or location.

(c) The [requirements of] elements that comprise a business continuity plan are flexible and may be tailored to the size and needs of a member. Each plan, however, must at a minimum, address:

- (1) Data back-up and recovery (hard copy and electronic);
- (2) All mission critical systems;
- (3) Financial and operational assessments;
- (4) Alternate communications between customers and the member;
- (5) Alternate communications between the member and its employees;
- (6) Business constituent, bank, and counter-party impact;
- (7) Regulatory reporting; and
- (8) Communications with regulators.

Each member must address the above-listed categories to the extent applicable and necessary to enable the member to continue its business in the event of a future significant business disruption. If any of the above-listed categories is not applicable, the member's business continuity plan need not address the category. The member's business continuity plan, however, must document the rationale for not including such category in its plan. If a member relies on another entity for any one of the above-listed categories or any mission critical system, the member's business continuity plan must address this relationship.

(d) Members must designate a member of senior management to approve the plan and he or she shall be responsible for conducting the required annual review. The member of senior management must also be a registered principal.

[d] (e) For purposes of this rule, the following terms shall have the meanings specified below:

(1) "Mission critical system" means any system that is necessary, depending on the nature of a member's business, to ensure prompt and accurate processing of securities transactions, including, but not limited to, order taking, order entry, execution, comparison, allocation, clearance and settlement of securities transactions, the maintenance of customer accounts, access to customer accounts and the delivery of funds and securities.

(2) "Financial and operational assessment" means a set of written procedures that allows a member to identify changes in its operational, financial, and credit risk exposures.

3520. Emergency Contact Information

(a) Each member shall report to NASD, via such electronic or other means as NASD may require, prescribed emergency contact information for the member. Among other things, t[T]he emergency contact information for the member includes designation of two emergency contact persons. Each emergency contact person shall be a member of senior management and a registered principal of the member.

(b) Each member must promptly update its emergency contact information, via such electronic or other means as NASD may require, in the event of any material change[, but at a minimum must review the information contained therein twice a year to ensure its accuracy].

* * * * *

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 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 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 purpose of this amendment to the original rule filing dated August 7, 2002, and subsequent amendments dated December 11, 2002 and January 8, 2003, is to clarify that the language of proposed Rule 3510 is intended to require not only that members conduct a planning process to create a written business continuity plan, but also that the plan resulting from this process be reasonably designed to enable members to continue their business in the event of a future significant business disruption.

As described in detail in the Original Notice, following the tragic events of September 11, 2001 and after an extensive survey of the business continuity practices of members, NASD proposed two new rules, NASD Rules 3510 and 3520. Proposed Rule 3510 would require members to create and maintain business continuity plans. In developing this rule, NASD recognized the diversity in size, structure, operations, and business of its members. Each member's plan would be required, at a minimum, to address eight areas specified in the proposed rule change, which NASD believes are essential to a broker/dealer's business continuity plan.

Proposed Rule 3510 also would require members to update their business continuity plans based on any material change to the member's operations, structure, business, or location. In addition, members would be required to conduct an annual review of their plans to determine

whether any modifications are needed in light of any changes to the member's operations, structure, business, or location. Finally, members also must designate a member of senior management to approve the plan and conduct the annual review.

NASD's experience in the aftermath of September 11th also confirmed that NASD needs a fully reliable means of contacting firms in the event of an emergency. Proposed Rule 3520 would require members to file and keep current with NASD certain key information that would be of particular importance during significant business disruptions, including:

- emergency contact information for key staff;
- identification of two designated contact persons;
- location of books and records (including back-up locations);
- clearance and settlement information;
- identification of key banking relationships; and
- alternative communication plans for investors.

The purpose of Amendment No. 3 is to address concerns that a literal reading of proposed Rule 3510, as set forth in the Original Notice, could suggest that the Rule only requires members to create, maintain, and periodically review a business continuity plan, but does not obligate that members' plans be effective in enabling members to continue their business in the event of a future significant business disruption. NASD did not intend to propose a rule of such limited scope. In this regard, in its description of the purpose of the proposed rule change, NASD stated that “[t]he purpose of the proposed rule change is to help to ensure that NASD members will be able to continue their business in the event of future significant business disruptions.” NASD believes that members should be obligated to develop a business continuity plan that is

reasonably designed, in light of particular characteristics of the firm, to allow the firm to recover as early as practicable in the event of a future significant business disruption.

Therefore, NASD is proposing to amend proposed Rule 3510(a) and 3510(c) to clarify that the proposed rule is intended to require not only that members conduct a planning process to create a written business plan, but also that the plan resulting from this process be reasonably designed to enable the member to continue its business in the event of future significant business disruptions, NASD staff notes that the amended rule language is consistent with NASD rules in other areas where reasonableness standards were adopted because the diversity of NASD's membership made specific standards impracticable.⁴ In light of the concerns regarding the clarity of the original proposed rule text, NASD believes this amendment to the proposed rule change should be published for comment to ensure that interested persons are given notice of the clarification and an opportunity to comment thereon.

(b) Statutory Basis

NASD 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 NASD'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 believes that the proposed rule change as amended, which will help to ensure that members are prepared for significant business disruptions, is consistent with those purposes.

⁴ See e.g., NASD Rules 3010 (Supervision) and 3011 (Anti-Money Laundering Compliance Program).

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

NASD does not believe that the proposed rule change as amended 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 received in response to Notice to Members 02-23 (April 2002) and the original rule proposal filed August 7, 2002 and published for comment on September 9, 2002.⁵ NASD received 32 comment letters following publication of the Notice to Members. NASD also received three comment letters following publication of the Original Notice. In response to the comment letters, NASD identified the following issues that warranted amendments and/or further clarification.

Categories of a Member's Business Continuity Plan

Proposed Rule 3510(c) states that the “requirements of a business continuity plan are flexible and may be tailored to the size and needs of a member.” The rule requires that each plan must, at a minimum, address eight key categories. These categories are: (1) data back-up and recovery (hard copy and electronic); (2) all mission critical systems; (3) financial and operational assessments; (4) alternate communications between customers and the member; (5) alternate communications between the member and its employees; (6) business constituent, bank and counter-party impact; (7) regulatory reporting; and (8) communications with regulators.

In the original proposing release, NASD stated that “each member's business continuity plan will only be required to address the eight listed categories . . . to the extent applicable and

⁵ See 67 Fed. Reg. 57257 (Sept. 9, 2002).

necessary.” A commenter believed that Rule 3510 should specifically state this interpretation directly in the rule text. In response, in Amendment No. 2, NASD has proposed to amend proposed Rule 3510(c) to include the statement that “[e]ach member must address the above-listed categories to the extent applicable and necessary to ensure the continuity of its business in the event of a future significant business disruption. If any of the above-listed categories is not applicable, the member’s business continuity plan need not address the category. The member’s business continuity plan, however, must document the rationale for not including such category in its plan. If a member relies on another entity for any one of the above-listed categories or any mission critical system, the member’s business continuity plan must address this relationship.” NASD believes that the proposed language provided above will ensure that members understand that, if any of the categories are not applicable, the member would still be required to document the rationale for not including such category in its business continuity plan. For example, if a member’s books and records are kept at its clearing firm, the member’s plan must address this fact as well as the relationship with, including identity of, the clearing firm.

Requirement to Update Business Continuity Plans

Proposed Rule 3510(b) requires that each member conduct an annual review of its business continuity plan to determine whether any modifications are necessary in light of changes to the member’s operations, structure, business, or location. Some commenters believed that the yearly review requirement was inadequate. Although commenters cited different events that should trigger an update of a business continuity plan, most commenters who dissented believed that plans should be updated more frequently.

NASD believes that, at a minimum, an annual review of the plan is necessary. In response to member and industry comment, in Amendment No. 1, NASD has proposed to amend the proposed rule change to expand upon this requirement and include the following language: “Each member must update its plan in the event of any material change to the member's operations, structure, business or location. Each member also must conduct an annual review of its plan to determine whether any modifications are necessary in light of changes to the member's operations, structure, business or location.” This added language emphasizes that members must promptly update their business continuity plans whenever there is a material change in a member's operations, structure, business, or location that affects the information set forth in the business continuity plan. This requirement would be in addition to the yearly review requirement.

Business Constituent, Bank, and Counter-party Impact

One of the categories that members' business continuity plans must address is “business constituent, bank, and counter-party impact.” Commenters sought clarification of this category. Under this category, NASD believes that firms should have procedures that assess the impact that a significant business disruption has on business constituents (businesses with which a member firm has an on-going commercial relationship pertaining to the support of the member's operating activities), banks (lenders), and counter-parties (such as other broker/dealers or institutional customers). In addition, NASD believes that members should provide for alternative actions or arrangements with respect to their contractual relationships with business constituents, banks, and counter-parties upon the occurrence of a material business disruption to either party.

Category of Books and Records Back-Up and Recovery

One of the categories that members' business continuity plans must address is "books and records back-up and recovery (hard copy and electronic)." One commenter requested clarification of whether the rule creates a requirement that members have both hard copy and electronic books and records. While proposed Rule 3510 refers to the types of books and records that a firm might maintain, the proposed rule does not mandate that members keep book and records (and back-up books and records) in both hard copy and electronic formats. To determine what records (and in what format) firms must retain, members should refer to SEC and NASD rules and interpretative materials specifically addressing record retention requirements, such as Rule 17a-4 of the Exchange Act and NASD Rule 3110.

Application of Proposed Rule to Subsidiaries

In its original rule filing, NASD stated that it believes that a subsidiary member firm may satisfy its obligations under the proposed rule change by participating in a corporate-wide business continuity plan of a parent corporation that addresses its subsidiary member firms. As a result, a subsidiary member firm may rely on the corporate-wide business continuity plan of its parent corporation regardless of whether the parent corporation is a member or non-member. The original rule filing, however, stated that the parent corporation's business continuity plan must comply fully with proposed NASD Rule 3510 and address all requirements under the proposed rule change. In addition, it noted that the parent and subsidiary corporations both must comply with NASD rules on recordkeeping and supervision for purposes of proposed NASD Rule 3510, and that the parent corporation must grant NASD access to its business continuity plan upon request.

A commenter believed that it is not appropriate to subject non-member firms to these NASD requirements, nor is it necessary. NASD, however, believes that if a member chooses to participate in a parent company's corporate-wide business continuity plan, the record-keeping of that plan and any supervision of the creation, execution, or updating of that plan must comply with NASD rules on record-keeping and supervision. Participating in a corporate-wide business continuity plan is merely an alternative and is intended to give firms greater flexibility in complying with the proposed rule.

Senior Management Approval

NASD is proposing to amend the text of Rule 3510 to include new subsection (d) to conform NASD's rule with the NYSE's proposed business continuity rule. NASD agrees with the requirement set forth in the NYSE proposal that a member of senior management and a registered principal should approve a member's business continuity plan, including any updates to the plan, to ensure that the creation and maintenance of any plan is reviewed and approved by persons with appropriate expertise and seniority.

Emergency Contact Information

Proposed Rule 3520 requires members to provide NASD with emergency contact information and update any information upon the occurrence of a material change. A commenter suggested that NASD take a proactive role in gathering emergency contact information. Again, as noted in the Original Notice, NASD believes that this duty should lie with the member firm because the member will be best able to identify when a material change has taken place. In Amendment No. 1, NASD, however, has proposed to amend proposed Rule 3520(b) to require members to promptly update any changes to their emergency contact information. In addition,

NASD is eliminating the semi-annual update requirement from the rule text. Rather, to be consistent with other contact information required by NASD and periodic updates required by the NYSE, NASD will issue future guidance on a periodic update requirement. NASD also is amending proposed Rule 3520(a) to include the phrase “[a]mong other things” to emphasize that NASD is requiring other contact information in addition to designating two emergency contact persons.

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, including whether the proposed rule change as amended is consistent with the Act. 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 NASD. All submissions should refer to the file number SR-NASD-2002-108 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).

Margaret H. McFarland
Deputy Secretary