

Brian J. Woldow
Attorney

Direct: (202) 728-6927
Fax: (202) 728-8264

September 3, 2003

Katherine A. England
Assistant Director
Division of Market Regulation
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-1001

Re: File No. SR-NASD-2002-108 - Business Continuity Plans and Emergency Contact Information; Amendment No. 4 and Response to Comments on Second Notice of Proposed Rulemaking

Dear Ms. England:

NASD hereby submits Amendment No. 4 and its response to comment letters received by the Securities and Exchange Commission ("SEC" or "Commission") after the second publication of SR-NASD-2002-108 in the Federal Register on March 10, 2003.¹ The SEC received three comment letters, which are attached as Exhibit 2.² Upon consideration of the comment letters and discussions with staffs of the SEC and New York Stock Exchange ("NYSE"), NASD is proposing to amend the proposed rule change, as discussed below. A draft Federal Register release is attached as Exhibit 1.

Response to Comment Letters

I. Proposed Rule 3510

A. Requirement that Plans be Reasonably Designed to Enable the Member to Continue its Business

Proposed Rule 3510(a) requires that members create and maintain business continuity plans. Amendment No. 3 to the proposed rule change, filed on February 19, 2003, amended the language of the proposed rule to provide that each member's plan be

¹ 68 FR 11432 (Mar. 10, 2003).

² See Letter from Securities Industry Association and the Bond Market Association ("SIA/BMA") to Jonathan G. Katz, dated March 31, 2003; Letter from Thomas K. Heard, A.G. Edwards & Sons, Inc. ("A.G. Edwards") to Jonathan G. Katz, dated March 31, 2003; and Letter from Melvyn Musson, Edward D. Jones & Co., L.P. ("Edward Jones") to Jonathan G. Katz, dated March 28, 2003.

“reasonably designed to enable the member to continue its business in the event of future significant business disruption.” As explained in the original rule filing of August 7, 2002, NASD intended Rule 3510 to require that a member not only conduct a planning process to create a written business plan, but also that the resultant plan ensure that member’s ability to continue its business in the event of a significant business disruption.

One commenter expressed concern that the language added to proposed Rule 3510(a) creates a new obligation on a member to continue its business after a significant business disruption.³ This is not the intention of the proposal. The proposal does not deprive a member of its autonomy to choose to cease its operations at any time, provided it does so in a manner consistent with applicable laws and SEC and NASD rules. Nonetheless, to clarify that the rule does not create a new obligation for members to continue their businesses, NASD is amending the proposed rule. Specifically, the proposed rule text stating that “[s]uch procedures must be reasonably designed to enable the member to continue its business in the event of future significant business disruptions” is amended to read, “Such procedures must be reasonably designed to enable the member to meet its existing obligations to customers. In addition, such procedures must address the member’s existing relationships with other broker-dealers and counter-parties.”

The general principle that firms are not required to remain in business is further recognized in a related amendment that NASD is proposing to make with respect to the categories that a member’s plan must, at a minimum, address. In particular, following discussions with the SEC and NYSE staffs, NASD is proposing to amend proposed Rule 3510(c) to require a plan to address how a member will assure customers’ prompt access to their funds and securities in the event that the member determines it is unable to continue its business. If a member has customers, the member must detail the procedures it will employ to ensure customer access to funds and securities. This new category will help to ensure that if a member is unable to continue its business following a significant business disruption, those customers holding funds or securities through the member will be able to access their funds and/or securities.

B. Requirement to Update Business Continuity Plans

Proposed Rule 3510(b) states, “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 business continuity plan to determine whether any modifications are necessary in light of changes to the member’s operations, structure, business, or location.” One commenter suggested that the annual review should be required at the plan component level (either defined by business

³ See Comment Letter from SIA/BMA.

function or department), rather than the firm level.⁴ NASD continues to believe, however, that each member should annually review the contents of its business continuity plan at the overall firm level. Among other things, such a firm-level review will help to ensure that the business continuity plan continues to operate effectively as a whole notwithstanding any operational or business changes that may have occurred in a defined business area or department.

C. Senior Management Approval

Proposed Rule 3510(d) requires that “[m]embers must designate a member of senior management to approve the plan and he or she shall be responsible for conducting the required annual review.” One commenter requested clarification of whether the member of senior management must actually conduct the review or whether he or she must only ensure that the review was completed.⁵ NASD believes that it is the responsibility of the designated member of senior management to ensure an adequate, (at least) annual, firm-level review of the member’s business continuity plan. This does not require the member of senior management to personally conduct all aspects of the review; however, he or she must review the final plan, including any proposed changes to the existing plan, and have a reasonable basis on which to believe that any persons delegated to conduct the more detailed parts of the review have the appropriate levels of knowledge in their assigned areas.

D. Business Constituent, Bank, and Counter-Party Impact

The proposal requires a member’s business continuity plan to address “business constituent, bank, and counter-party impact.” In addressing this category, NASD stated 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 ongoing commercial relationship in support of the member’s operating activities), banks (lenders), and counter-parties (such as other broker/dealers or institutional customers). In addition, NASD stated 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.

The commenters expressed concern over this provision. Commenters contended that the requirement to provide for alternative actions or arrangements places an undue burden on members, might upset existing contracts, and presupposes that all such actions or arrangement are sufficiently critical to require consideration of alternatives.⁶

⁴ See Comment Letter from A.G. Edwards.

⁵ See Comment Letter from Edward Jones.

⁶ See Comment Letters from SIA/BMA and A.G. Edwards.

Another commenter suggested that the term “business constituent” should be limited to customer relationships.⁷

NASD disagrees with the commenters that the provision is unduly burdensome or that it might upset existing contracts. The provision requires only that a firm consider and include in its plan alternative steps that the firm will take in the event that a member’s critical business constituents, bank, or counter-parties are inaccessible. The rule does not mandate that a member enter into supplemental contracts or conditional agreements. For example, if a member were to determine that a telecommunications company is a critical business constituent, the member would then be required to create procedures or actions to follow in the event that this business constituent is unavailable. Alternatively, the member may enter into a supplemental agreement with another telecommunications service to provide back-up services. The rule permits each member to adopt an approach in dealing with its business constituents, banks and counter-parties that is best suited to the member’s particular operations, structure, business, and location. It requires a member only to assess the effect of a significant business disruption on its business constituents, banks, and counter-parties and decide appropriate actions if faced with any such situation.

NASD, however, recognizes that certain business constituent, banking, and counter-party relationships may not be critical to a firm’s business or operations. NASD therefore is amending the category of “business constituent, bank, and counter-party impact” in proposed Rule 3510(c)(6) to read, “Critical business constituents, banks, and counter-parties.” Members will be responsible for identifying those relationships that they deem critical for purposes of complying with the rule; NASD however, will consider, based on its experience in working with the rule following the rule’s adoption, whether to enumerate specific relationships that it views as critical to all members.

E. Disclosure Provision

Following discussions with SEC and NYSE staff, NASD is amending the proposed rule text to require each member to disclose to its customers how its business continuity plan addresses the possibility of a future significant business disruption and how the member plans to respond to events of varying scope. Furthermore, such disclosure must, at a minimum, be made in writing to customers at account opening, posted on the member’s Internet Web site (if the member maintains a Web site), and mailed to customers upon request. NASD believes that this requirement will enable investors to make an educated decision about whether to place their funds and securities at the specific member based on the firm’s business continuity planning and also will deter members from creating plans that do not adequately address contingency

⁷ See Comment Letter from Edward Jones.

planning. NASD, however, notes that members will not be required to disclose their actual plans; rather, each member need only create a summary of how its plan addresses the possibility of significant business disruptions and disclose the member's general planned responses to significant business disruptions. Members will not need to disclose such factors as: the specific location of any back-up facilities; any proprietary information contained in the plan; and the parties with whom the member has back-up arrangements. Members, however, would need to disclose the existence of back-up facilities and arrangements.

F. Technical Amendment

Two commenters questioned a technical amendment made by NASD to the proposed rule text. Originally, proposed Rule 3510(a) required that a member have a plan identifying procedures "to be followed in the event of an emergency or significant business disruption." In Amendment No. 3, NASD changed "to be followed in the event of an emergency or significant business disruption" to "relating to an emergency or significant business disruption." The commenters believed that this new language is less clear than the language originally proposed.⁸ This technical amendment, however, intends only to reflect that a plan might include more than a list of procedures to be followed by the member in the event of a significant business disruption. For example, a plan may reference an existing arrangement with another entity that permits the entity to perform services for the member in the event of a future business disruption. While this arrangement is not necessarily a procedure to be followed by the member in the event of a significant business disruption, it does reflect the member's procedures relating to a business disruption and should be included in the member's business continuity plan.

II. Proposed Rule 3520

A. Emergency Contact Information

Proposed Rule 3520 requires members to provide NASD with emergency contact information and to update any information upon the occurrence of a material change. Among other things, the proposed rule requires members to designate two emergency contact persons that NASD may contact in the event of a significant business disruption. Each emergency contact person must be a registered principal and a member of senior management.

One commenter asserted that the proposed rule should not require emergency contact persons to be members of senior management and registered principals. The commenter characterized this requirement as invasive and believed that NASD should

⁸ See Comment Letters from A.G. Edwards and SIA/BMA.

allow others to serve as emergency contact persons.⁹ NASD disagrees with this assessment. NASD proposed this requirement to address situations in which NASD wishes to contact a member in the event of a significant business disruption and believes that the emergency contact persons must be registered principals and members of senior management. Under such critical circumstances, NASD wants to ensure that it will be able to contact persons in senior management directly regarding the condition and operations of the firm. Moreover, NASD believes it is essential that the emergency contact persons be members of senior management with the authority, experience, and knowledge to make potentially critical and time-sensitive decisions regarding the firm.¹⁰

B. Review and Update of Emergency Contact Information

Proposed Rule 3520(b), as amended by Amendment No. 1, requires each member to promptly update its emergency contact information in the event of any material change. Because of the essential nature of this information, NASD believes that members also should review and update this information on a quarterly basis to ensure its accuracy. Consistent with the quarterly FOCUS reporting schedule, each member must review and, if necessary, update its emergency contact information within 17 business days after the end of each calendar quarter. Under this provision, the member's Executive Representative must perform the review and update. Finally, each member must have adequate controls and procedures to ensure that only the Executive Representative may perform the review and update of the firm's emergency contact information.

III. Effective Date of Rules

One commenter requested that upon SEC approval of the proposed rule, NASD announce in the Federal Register an effective date for the rule of 360 days after notice of SEC approval.¹¹ NASD, however, believes that business continuity plans, as required by proposed Rule 3510, should be implemented within 120 days after the publication of a Notice to Members announcing the approval of the rule filing. Furthermore, NASD believes members should designate emergency contact persons and provide NASD with their contact information, as required by proposed Rule 3520, within 60 days of publication of the Notice to Members.

⁹ See Comment Letter from A.G. Edwards.

¹⁰ NASD notes that the requirement that a contact person be a member of senior management and a registered principal is consistent with other NASD rules, including designation of a member's Executive Representative.

¹¹ See Comment Letter from SIA/BMA.

Text of Amendment

Below is the text of the current amendment to the proposed rule text published in the Federal Register on March 10, 2003. Proposed new language is 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 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] meet its existing obligations to customers. In addition, such procedures must address the member's existing relationships with other broker-dealers and counter-parties. The business continuity plan must be made available promptly upon request to NASD staff.

(b) No Change

(c) The 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) Critical [B]business constituents, banks, and counter-parties[y impact];
- (7) Regulatory reporting; [and]
- (8) Communications with regulators; and[.]

(9) How the member will assure customers' prompt access to their funds and securities in the event that the member determines that it is unable to continue its business.

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. If a member has customers, the member must detail the procedures it will employ to ensure customer access to funds and securities.

(d) No Change

(e) Each member must disclose to its customers how its business continuity plan addresses the possibility of a future significant business disruption and how the member plans to respond to events of varying scope. At a minimum, such disclosure must be made in writing to customers at account opening, posted on the member's Internet Web site (if the member maintains a Web site), and mailed to customers upon request.

(f) 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, the 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. Each member must review and, if necessary, update its emergency contact information, including designation of two emergency contact persons, within 17 business days after the end of each calendar quarter to ensure the information's accuracy. The member's Executive Representative must conduct such review and any update. Furthermore, members must have adequate controls and procedures to ensure that only the Executive Representative may perform the review and update.

* * * * *

NASD believes that this amendment furthers the purposes of the proposed rule change, as articulated in the original proposed rule change of August 7, 2002 and subsequent amendments. Given the nature of the revisions proposed by Amendment No. 4, NASD believes that this amendment should be published for comment to ensure that interested persons are given notice of the new rule requirements and an opportunity to comment.

If you have any questions concerning this submission, please contact me at (202) 728-6927; e-mail brian.woldow@nasd.com. The fax number of the Office of General Counsel is (202) 728-8264.

Very truly yours,

Brian J. Woldow

EXHIBIT 1

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

Self-Regulatory Organizations; Notice of Filing of Amendment No. 4 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. 4 to the proposed rule change, File No. SR-NASD-2002-108, as previously amended by Amendment No. 1 on December 11, 2002, Amendment No. 2 on January 8, 2003, Amendment No. 3 on February 19, 2003, and as described in Items I, II, and III below, which Items have been prepared by NASD. 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 proposed rule change was re-published for comment in the Federal Register on March 10, 2003.⁴ The Commission is publishing this notice to solicit comments on Amendment No. 4 to the proposed rule change from interested parties.

¹ 15 U.S.C. § 78s(b)(1).

² 17 CFR 240.19b-4.

³ 67 FR 57257 (Sept. 9, 2002).

⁴ 68 FR 11432 (Mar. 10, 2003).

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

NASD is proposing to notice interested parties of certain amendments to 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. Among other things, the new amendment clarifies that the proposed rule change does not mandate that members stay in business in the event of a significant business disruption. The new amendment also imposes a disclosure requirement on members. In addition, the amendment requires each member to review and, if necessary, update its emergency contact information. Below is the text of the proposed rule change. The base rule text is that proposed in Amendment No. 3, which was submitted on February 19, 2003. Proposed new language added by Amendment No. 4 is 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 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] meet its existing obligations to customers. In addition, such procedures must address the member's

existing relationships with other broker-dealers and counter-parties. 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 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) Critical [B]business constituents, banks, and counter-parties[y impact];
- (7) Regulatory reporting; [and]
- (8) Communications with regulators; and[.]
- (9) How the member will assure customers' prompt access to their funds and securities in the event that the member determines that it is unable to continue its business.

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. If a member has customers, the member must detail the procedures it will employ to ensure customer access to funds and securities.

(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.

(e) Each member must disclose to its customers how its business continuity plan addresses the possibility of a future significant business disruption and how the member plans to respond to events of varying scope. At a minimum, such disclosure must be made in writing to customers at account opening, posted on the member's Internet Web site (if the member maintains a Web site), and mailed to customers upon request.

(f) 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, the 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. Each member must review and, if necessary, update its emergency contact information, including designation of two emergency contact persons, within 17 business days after the end of each calendar quarter to ensure the information's accuracy. The member's Executive Representative must conduct such review and any update. Furthermore, members must have adequate controls and procedures to ensure that only the Executive Representative may perform the review and update.

* * * * *

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

NASD originally filed this proposed rule change with the SEC on August 7, 2002 and the SEC received three comment letters following publication of the Original Notice. NASD addressed these comments in Amendment Nos. 1, 2, and 3. The SEC re-published the proposed rule change for comment in the Federal Register on March 10, 2003.⁵ NASD incorporates the interpretations in the Original Notice and Federal Register release of March 10, 2003 to the extent that they are consistent with the interpretations contained in this release. In response the Federal Register release of March 10, 2003, the SEC received three comment letters.⁶

⁵ See 68 FR 11432 (Mar. 10, 2003).

⁶ See Letter from Securities Industry Association and the Bond Market Association ("SIA/BMA") to Jonathan G. Katz, dated March 31, 2003; Letter from Thomas K. Heard, A.G. Edwards & Sons, Inc. ("A.G. Edwards") to Jonathan G. Katz, dated March 31, 2003; and Letter from Melvyn Musson, Edward D. Jones & Co., L.P. ("Edward Jones") to Jonathan G. Katz, dated March 28, 2003.

The purpose of this amendment to the Original Notice and subsequent amendments dated December 11, 2002, January 8, 2003, and February 19, 2003, is to clarify that the proposed rule change does not mandate that members stay in business in the event of a significant business disruption. This amendment also requires each member to disclose to its customers how its business continuity plan addresses the possibility of a future significant business disruption. In addition, the amendment requires each member to review and, if necessary, update its emergency contact information on a quarterly basis.

A. Proposed Rule 3510

1. Requirement that Plans be Reasonably Designed to Enable the Member to Continue its Business

Proposed Rule 3510(a) requires that members create and maintain business continuity plans. Amendment No. 3 to the proposed rule change, filed on February 19, 2003, amended the language of the proposed rule to provide that each member's plan be "reasonably designed to enable the member to continue its business in the event of future significant business disruption." As explained in the Original Notice, NASD intended Rule 3510 to require that a member not only conduct a planning process to create a written business plan, but also that the resultant plan ensure that member's ability to continue its business in the event of a significant business disruption.

One commenter expressed concern that the language added to proposed Rule 3510(a) creates a new obligation on a member to continue its business after a significant

business disruption.⁷ This is not the intention of the proposal. The proposal does not deprive a member of its autonomy to choose to cease its operations at any time, provided it does so in a manner consistent with applicable laws and SEC and NASD rules. Nonetheless, to clarify that the rule does not create a new obligation for members to continue their businesses, NASD is amending the proposed rule. Specifically, the proposed rule text stating that “[s]uch procedures must be reasonably designed to enable the member to continue its business in the event of future significant business disruptions” is amended to read, “Such procedures must be reasonably designed to enable the member to meet its existing obligations to customers. In addition, such procedures must address the member's existing relationships with other broker-dealers and counter-parties.”

The general principle that firms are not required to remain in business is further recognized in a related amendment that NASD is proposing to make with respect to the categories that a member’s plan must, at a minimum, address. In particular, following discussions with the SEC and New York Stock Exchange (“NYSE”) staffs, NASD is proposing to amend proposed Rule 3510(c) to require a plan to address how a member will assure customers’ prompt access to their funds and securities in the event that the member determines it is unable to continue its business.⁸ If a member has customers, the member must detail the procedures it will employ to ensure customer access to funds and securities. This new category will help to ensure that if a member is unable

⁷ See Comment Letter from SIA/BMA.

⁸ The NYSE also is proposing a substantially similar rule.

to continue its business following a significant business disruption, those customers holding funds or securities through the member will be able to access their funds and/or securities.

2. Requirement to Update Business Continuity Plans

Proposed Rule 3510(b) states, “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.” One commenter suggested that the annual review should be required at the plan component level (either defined by business function or department), rather than the firm level.⁹ NASD continues to believe, however, that each member should annually review the contents of its business continuity plan at the overall firm level. Among other things, such a firm-level review will help to ensure that the business continuity plan continues to operate effectively as a whole notwithstanding any operational or business changes that may have occurred in a defined business area or department.

3. Senior Management Approval

Proposed Rule 3510(d) requires that “[m]embers must designate a member of senior management to approve the plan and he or she shall be responsible for conducting the required annual review.” One commenter requested clarification of whether the member of senior management must actually conduct the review or whether

⁹ See Comment Letter from A.G. Edwards.

he or she must only ensure that the review was completed.¹⁰ NASD believes that it is the responsibility of the designated member of senior management to ensure an adequate, (at least) annual, firm-level review of the member's business continuity plan. This does not require the member of senior management to personally conduct all aspects of the review; however, he or she must review the final plan, including any proposed changes to the existing plan, and have a reasonable basis on which to believe that any persons delegated to conduct the more detailed parts of the review have the appropriate levels of knowledge in their assigned areas.

4. Business Constituent, Bank, and Counter-Party Impact

The proposal requires a member's business continuity plan to address "business constituent, bank, and counter-party impact." In addressing this category, NASD stated 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 ongoing commercial relationship in support of the member's operating activities), banks (lenders), and counter-parties (such as other broker/dealers or institutional customers). In addition, NASD stated 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.

The commenters expressed concern over this provision. Commenters contended that the requirement to provide for alternative actions or arrangements places an undue

¹⁰ See Comment Letter from Edward Jones.

burden on members, might upset existing contracts, and presupposes that all such actions or arrangement are sufficiently critical to require consideration of alternatives.¹¹ Another commenter suggested that the term “business constituent” should be limited to customer relationships.¹²

NASD disagrees with the commenters that the provision is unduly burdensome or that it might upset existing contracts. The provision requires only that a firm consider and include in its plan alternative steps that the firm will take in the event that a member’s critical business constituents, bank, or counter-parties are inaccessible. The rule does not mandate that a member enter into supplemental contracts or conditional agreements. For example, if a member were to determine that a telecommunications company is a critical business constituent, the member would then be required to create procedures or actions to follow in the event that this business constituent is unavailable. Alternatively, the member may enter into a supplemental agreement with another telecommunications service to provide back-up services. The rule permits each member to adopt an approach in dealing with its business constituents, banks and counter-parties that is best suited to the member’s particular operations, structure, business, and location. It requires a member only to assess the effect of a significant business disruption on its business constituents, banks and counter-parties and decide appropriate actions if faced with any such situation.

¹¹ See Comment Letters from SIA/BMA and A.G. Edwards.

¹² See Comment Letter from Edward Jones.

NASD, however, recognizes that certain business constituent, banking, and counter-party relationships may not be critical to a firm's business or operations. NASD therefore is amending the category of "business constituent, bank, and counter-party impact" in proposed Rule 3510(c)(6) to read, "Critical business constituents, banks, and counter-parties." Members will be responsible for identifying those relationships that they deem critical for purposes of complying with the Rule; NASD however, will consider, based on its experience in working with the Rule following the Rule's adoption, whether to enumerate specific relationships that it views as critical to all members.

5. Disclosure Provision

Following discussions with SEC and NYSE staff, NASD also is amending the proposed rule text to require each member to disclose to its customers how its business continuity plan addresses the possibility of a future significant business disruption and how the member plans to respond to events of varying scope. Furthermore, such disclosure must, at a minimum, be made in writing to customers at account opening, posted on the member's Internet Web site (if the member maintains a Web site), and mailed to customers upon request. NASD believes that this requirement will enable investors to make an educated decision about whether to place their funds and securities at the specific member based on the firm's business continuity planning and also will deter members from creating plans that do not adequately address contingency planning. NASD, however, notes that members will not be required to disclose their actual plans; rather, each member need only create a summary of how its plan addresses

the possibility of significant business disruptions and disclose the member's general planned responses to significant business disruptions. Members will not need to disclose such factors as: the specific location of any back-up facilities; any proprietary information contained in plan; and the parties with whom the member has back-up arrangements. Members, however, would need to disclose the existence of back-up facilities and arrangements.

6. Technical Amendment

Two commenters questioned a technical amendment made by NASD to the proposed rule text. Originally, proposed Rule 3510(a) required that a member have a plan identifying procedures "to be followed in the event of an emergency or significant business disruption." In Amendment No. 3, NASD changed "to be followed in the event of an emergency or significant business disruption" to "relating to an emergency or significant business disruption." The commenters believed that this new language is less clear than the language originally proposed.¹³ This technical amendment, however, intends only to reflect that a plan might include more than a list of procedures to be followed by the member in the event of a significant business disruption. For example, a plan may reference an existing arrangement with another entity that permits the entity to perform services for the member in the event of a future business disruption. While this arrangement is not necessarily a procedure to be followed by the member in the event of a significant business disruption, it does reflect the member's procedures

¹³ See Comment Letters from A.G. Edwards and SIA/BMA.

relating to a business disruption and should be included in the member's business continuity plan.

B. Proposed Rule 3520

1. Emergency Contact Information

Proposed Rule 3520 requires members to provide NASD with emergency contact information and to update any information upon the occurrence of a material change. Among other things, the proposed rule requires members to designate two emergency contact persons that NASD may contact in the event of a significant business disruption. Each emergency contact person must be a registered principal and a member of senior management.

One commenter asserted that the proposed rule should not require emergency contact persons to be members of senior management and registered principals. The commenter characterized this requirement as invasive and believed that NASD should allow others to serve as emergency contact persons.¹⁴ NASD disagrees with this assessment. NASD proposed this requirement to address situations in which NASD wishes to contact a member in the event of a significant business disruption and believes that the emergency contact persons must be registered principals and members of senior management. Under such critical circumstances, NASD wants to ensure that it will be able to contact persons in senior management directly regarding the condition and operations of the firm. Moreover, NASD believes it is essential that the emergency

¹⁴ See Comment Letter from A.G. Edwards.

contact persons be members of senior management with the authority, experience, and knowledge to make potentially critical and time-sensitive decisions regarding the firm.¹⁵

2. Review and Update of Emergency Contact Information

NASD also is amending its proposed rule to include a requirement that each member review and update, if necessary, its emergency contact information on a quarterly basis. Proposed Rule 3520(b), as amended by Amendment No. 1, requires members to promptly update its emergency contact information in the event of any material change. Because of the essential nature of this information, NASD believes that members also should review and update this information on a quarterly basis to ensure its accuracy. Consistent with the quarterly FOCUS reporting schedule, members must review or update, if necessary, its emergency contact information within 17 business days after the end of each calendar quarter. Under this provision, the member's Executive Representative must perform the review and update. Finally, members must have adequate controls and procedures to ensure that only the Executive Representative may perform the review and update of the member's emergency contact information.

C. Effective Date of Rules

One commenter requested that upon SEC approval of the proposed rule, NASD announce in the Federal Register an effective date for the rule of 360 days after notice of SEC approval.¹⁶ NASD, however, believes that business continuity plans should be

¹⁵ NASD notes that the requirement that a contact person be a member of senior management and a registered principal is consistent with other NASD rules, including designation of a member's Executive Representative.

implemented within 120 days after the publication of a Notice to Members announcing the approval of the rule filing. Furthermore, NASD believes members should designate emergency contact persons and provide NASD with their contact information within 60 days of publication of the Notice to Members. NASD intends to publish the Notice to Members within 60 days following SEC approval of the proposed rule change.

(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.

(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

¹⁶ See Comment Letter from SIA/BMA.

September 9, 2002.¹⁷ NASD received 32 comment letters following publication of the Notice to Members. The SEC received three comment letters following publication of the Original Notice. NASD addressed these comments in Amendment Nos. 1, 2, and 3. The SEC re-published the proposed rule change for comment in the Federal Register on March 10, 2003.¹⁸ NASD incorporates the interpretations in the original notice and Federal Register release of March 10, 2003 to the extent that they are consistent with the interpretations contained in this release. In response the Federal Register release of March 10, 2003, the SEC received three comment letters.¹⁹ NASD's response to these comment letters are contained in Section II(A)(a) of this release.

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

¹⁷ See 67 FR 57257 (Sept. 9, 2002).

¹⁸ See 68 FR 11432 (Mar. 10, 2003).

¹⁹ See Letter from Securities Industry Association and the Bond Market Association ("SIA/BMA") to Jonathan G. Katz, dated March 31, 2003; Letter from Thomas K. Heard, A.G. Edwards & Sons, Inc. ("A.G. Edwards") to Jonathan G. Katz, dated March 31, 2003; and Letter from Melvyn Musson, Edward D. Jones & Co., L.P. ("Edward Jones") to Jonathan G. Katz, dated March 28, 2003.

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