

John Ramsey
Vice President and
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December 3, 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** - Amendment 1 - Rule Requiring Certain NASD Members to Conduct or to Participate in Year 2000 Testing

Dear Ms. England:

Pursuant to a request by Sheila Slevin, Assistant Director, Division of Market Regulation, NASD Regulation hereby submits an amendment to File No. SR-NASD-98-75. The amendment provides additional information regarding the different means by which members may be able to satisfy their Year 2000 testing obligations. In addition, the amendment moves the proposed Rule from the Membership and Registration Rules section of the NASD Manual to the Conduct Rules section.

Please replace the text in Sections 1(a) and 3(a) of the proposed rule change and Sections I and II(A)(a) of Exhibit 1 to the proposed rule change with the text set forth in Attachment A.

NASD Regulation also requests that the Commission find good cause pursuant to Section 19(b)(2) for approving the proposed rule change prior to the 30th day after its publication in the Federal Register. Members that will be required to participate in the test coordinated by the Securities Industry Association must perform preliminary tests, therefore, it is necessary to have the rule effective as soon as possible.

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. The fax number of the Office of General Counsel is (202) 728-8264.

Very truly yours,

John Ramsay
Vice President and Deputy General Counsel

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.

3400. COMPUTER SYSTEMS

3410. Mandatory Year 2000 Testing

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

(a) Members of the Association that determine their minimum net capital requirements 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.

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.¹ 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.

¹ 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.

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, Nasdaq, 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, 1999.²

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. Testing for some types of business, however, will not be covered by the SIA test. 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 is not part of the SIA test, but will be conducted by the clearing corporations that clear these instruments, namely, the Participants Trust Company,

² The exact number of firms that will be able to participate in the SIA coordinated test has not been

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 require "point-to-point" testing between member firms and the 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.

Some members that fall within the category of firms required by the rule to conduct tests may be able to satisfy portions of their testing obligations without actually testing a particular system. For example, it is likely that market makers that are not clearing firms and that only use Nasdaq Workstation II[®] (NWII) terminals for their market-making activity will not be required to participate in mandatory testing because the NASD has completed testing of the NWII system. Also, members that utilize computer systems provided by service bureaus are not likely to have to participate in the SIA coordinated test as long as the service bureaus will participate in the SIA coordinated test, the members have conducted point-to-point testing with their service bureaus, the service bureaus have conducted point-to-point testing with the NASD, and the tests do not indicate any problems. In the circumstances described above, the NASD and service bureaus will act as proxies for the members for purposes of compliance with the rule. Following approval of this rule proposal, the NASD will issue a Notice to Members describing the types of tests that will

conclusively determined.

be required for different types of market makers and clearing firms, and the types of situations in which members will be able to satisfy the testing requirement by proxy.

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. 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.

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

NASD Regulation is proposing to add a new rule, Rule 3410, to the Conduct Rules of the National Association of Securities Dealers, Inc. ("NASD" or "Association"), to require certain 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 in italics; proposed deletions are in brackets.

3400. COMPUTER SYSTEMS

3410. Mandatory Year 2000 Testing

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

(a) Members of the Association that determine their minimum net capital requirements 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.

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

(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.¹ 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

¹ 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

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, Nasdaq, 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, 1999.²

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

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.

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

by participation in the SIA coordinated test. Testing for some types of business, however, will not be covered by the SIA test. 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 is 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 require "point-to-point" testing between member firms and the 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.

Some members that fall within the category of firms required by the rule to conduct tests may be able to satisfy their testing obligation without actually conducting tests themselves. For example, it is likely that market makers that are not clearing firms and that only use Nasdaq Workstation II[®] (NWII) terminals for their market-making activity will not be required to participate in mandatory testing because the NASD has completed testing of the NWII system. Also, members that utilize computer systems provided by service bureaus are not likely to have to perform any additional tests of the systems provided by the service bureaus as long as the service bureaus will participate in the SIA coordinated test, have tested their systems with other members,

and the tests do not indicate any problems. In the circumstances described above, the NASD and service bureaus will act as proxies for the members for purposes of compliance with the rule. Following approval of this rule proposal, the NASD will issue a Notice to Members describing the types of tests that will be required for different types of market makers and clearing firms, and the types of situations in which members will be able to satisfy the testing requirement by proxy.

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. 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.