

things, that the NASD's rules 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. The NASD believes that the proposed rule change, as amended, which would 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

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

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 Notice. The NASD received 32 comment letters following publication of the *Notice to Members*. The NASD received three comment letters in response to the Original Notice. In response to these comment letters, the NASD identified the following issues that warranted amendments and/or further clarification.

Categories of a Member's Business Continuity Plan

Proposed NASD Rule 3510(c) would state that the "requirements of a business continuity plan are flexible and may be tailored to the size and needs of a member." The rule would require 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 Notice, the NASD stated that "each member's business continuity plan will only be required to address the eight listed categories * * * to the extent applicable and necessary." One commenter believed that NASD Rule 3510 should specifically state this interpretation directly in the rule text. In response, the NASD in Amendment No. 2 proposed to revise proposed Rule

3510(c) to include the following statement:

Each 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.

The NASD believes that this proposed language would 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 would be required to address this fact as well as the relationship with (including the identity of) the clearing firm.

Requirement To Update Business Continuity Plans

Proposed NASD Rule 3510(b) would require 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.

The NASD believes that, at a minimum, an annual review of the plan is necessary. In response to member and industry comment, the NASD in Amendment No. 1 revised the proposed rule language 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 would be required to address is "business constituent, bank, and counter-party impact." Commenters sought clarification of this category. The NASD believes that, under this category, 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, the 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 would create a requirement that members have both hard copy and electronic books and records. While proposed NASD Rule 3510 refers to the types of books and records that a firm might maintain, it 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 Commission and NASD rules and interpretative materials specifically addressing record retention requirements, such as Rule 17a-4 under the Act⁹ and NASD Rule 3110.

Application of Proposed Rule to Subsidiaries

In the Original Notice, the NASD stated that it believes that a subsidiary member firm may satisfy its obligations under the proposed rule by participating in a corporate-wide business continuity

⁹ 17 CFR 240.17a-4.