

Beyond Business Continuity Planning

Critical Concepts and Considerations in the Business Resumption Process of Broker/Dealers

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Introduction

In the wake of the disastrous events of September 11, 2001, the securities industry showed an impressive ability to recover and continue their business operations. Given the events of this period, industry regulators examined the industry's recovery capability in greater detail to determine whether any regulatory action was needed to assure swift recovery in the event of any future significant business disruptions.

On August 30, 2002, the NASD filed a proposed rule change relating to business continuity plans and emergency contact information pursuant to the provisions of *Section 19(b)(1) of the Securities Exchange Act of 1934*.¹ The NASD initiated such a proposal to ensure that its member firms would be adequately prepared in the event of a significant business disruption through the creation and proper implementation of a well-drafted business continuity plan. In addition, the proposed rule change would also require NASD member firms to supply NASD with specified information to be used by NASD in the event of future significant business disruptions.

Based upon these findings and recommendations, broker/dealers firms alike are encouraged to create and maintain a business continuity plan and certain emergency contact information.

The purpose of the plan is to help to ensure that the broker/dealer or investment adviser firm will be able to continue its business in the event of future significant business disruptions.

A significant business disruption can be any situation that may temporarily disrupt a firm's operations which may cause a firm to quickly resume its operations at an alternate off-site facility. Examples of a significant business disruption can range from man-made disruptions, natural disasters, to any circumstantial occurrence that may temporarily disrupt the on-going operations of a broker/dealer.

Proposed NASD Rule 3510. Emergency Preparedness

Rule 3510. Business Continuity Plans

Written Business Continuity Plan. The rule states that each member firm must create and maintain a written business continuity plan identifying procedures to be followed in the event of an emergency or significant business disruption. The business continuity plan must be made available immediately upon request to the NASD staff. In addition, other regulatory agencies such as the SEC may also request to review such information.

Annual Review. Each member firm must conduct an annual assessment on the efficacy and functionality of its business continuity plan to determine whether any modifications are necessary in light of changes to the firm's operations, structure, business and/or location.

¹ Release No. 34-46444; File No. SR-NASD-2002-108

Business Continuity Plan Requirements.

Although each member firm may prepare a business continuity plan that is customized to its own size, scope and operational function, there are still a minimum set of requirements that must be addressed (please see Minimum Standard Test below).

NASD Rule 3520. Emergency Contact Info.

Emergency Contact Information. Each member firm shall report to NASD, via such electronic or other means as NASD may require, prescribed emergency contact information for the member. 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.

Updating Contact Information. Each member firm must update its emergency contact information in the event of any material change, such as adding or deleting key contact personnel, but at a minimum must review such information twice a year to ensure its accuracy.

Minimum Standards Test

The general requirements for the creation of a firm's business continuity plan are flexible enough to allow for certain customization based on a firm's size, scope and operational function. However, in accordance with NASD proposed Rule 3510, Release No. 34-46444 and Notice to Members (NTM) 02-23, NASD is proposing that all member firms meet a minimum of eight basic standards. The following is a list of the eight (8) categories for addressing critical issues in the preparation and implementation of business continuity planning and procedures:

1. Data Back-Up and Recovery (hard copy and electronic)

Location of Books and Records

Broker/dealer firms should disclose all relevant locations where a complete and/or partial set of books and records are currently being maintained.

At a minimum, firms should include the principal place of business and any ancillary offices that may be maintaining partial sets of records. Additionally, in the event of a significant business disruption, a firm should disclose any back-up copies that are being maintained at any designated alternate or off-site facility.

As a matter of general practice, a firm is encouraged to retain copies of such books and records as trade blotters, corporate records, customer new account information, customer statements, and any relevant correspondence in hardcopy and/or electronic format for immediate access.

Alternate Back-up Location(s)

The secondary (back-up) location of a firm's books and records should be maintained at an office location that is relatively close in proximity to the principal place of business for immediate access purposes. This should reduce response time for resuming business operations and minimize confusion as the main location for business resumption.

Description of Record keeping System

Financial transactions should be documented and recorded at the time of the transaction and all such documentation should be initialed and dated by the person responsible for reviewing each transaction (unless utilizing an electronic or other paperless trading and/or document retention format). Whenever possible, documents should be numbered and recorded to assist in document accountability.

Data Back-up Process

The process and frequency under which the firm conducts back-up copies of its critical customer data should be properly disclosed. A firm should set clear frequency guidelines for conducting back-up copies of all relevant client information on a daily, weekly, quarterly and/or annual basis, based on its size, scope and operation function. All client data should be stored on a firm's computer server/tape or through other electronic format. Firms are encouraged to save back-up tape that should be appropriately labeled and serialized for proper recording and organization of each back-up file.

Recovering Lost Data

In the event a firm experiences a significant business disruption, it should obtain the most recent copy of its back-up files from the server or from the latest tape copy from one of the designated back-up locations.

2. Mission Critical Systems

Under the proposed rule, the definition of, "mission critical systems" is defined as "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

Resource Planning for Operating in Emergency Preparedness Mode

In the event that a firm experiences a significant business disruption, the firm should consider several mission critical systems for operating in emergency preparedness mode such as core and ancillary business facilities and accommodations, scheduling and staffing issues, firm supplies and materials:

Business Facilities

When describing the business facilities, it is imperative to disclose critical variables that may affect the resumption of business operations. For example, firms should assess whether their principal place of business is located in an office building that is near a well established business area, or near a major metropolitan city, with access to major freeways. This is important due to access methods needed to reach a designation point, such as the alternate or off-site facility, for critical business resumption processes.

Additional considerations may include whether the office has all appropriate business facilities and amenities to include telephone and fax communication capabilities, as well as access to the Internet via modem, cable, DSL, T-1 or other high-speed Internet connectivity.

Scheduling and Staffing

Broker/dealer firms should also consider detailing the number of associated and non-associated personnel, as well as direct/indirect owners and/or shareholders of the firm.

Further consideration should also be given to specific staffing and scheduling issues based on the firm's relatively size, scope and operational function. For example, a firm should have an allocation schedule or some equivalent plan for essential/non-essential staff to handle the continued processing of customer transactions and other critical business operations. The proper implementation of a succession plan for executive officers could compliment the allocation schedule needed to resume a hierarchical structure of leadership and management direction within the organization.

Personnel Lists

Firms should consider the preparation and distribution or accessibility of key personnel lists that would extend beyond the two-person requirement of proposed NASD Rule 3520 for emergency contact information. The objective of these lists would be to provide critical contact information to and for executive officers, staff members, and key support personnel in the event of a major business disruption.

Administrative Supplies and Materials

Broker/dealer firms should conduct an internal assessment of the required supplies and materials needed for any off-site facilities in the event of an immediate transition from a primary location to an alternate site for continuity of business operations. For example, a firm may consider maintaining blank account forms and other relevant document supplies, duplicate books and records, supervisory procedures, stationary supplies and other relevant supplies and materials at both locations.

Temporary Hardware and Software

In the event that a firm experiences a significant business disruption, it should properly plan for the

² 17 C.F.R. § 240.15b7-3T(g)(1) (2001); NASD Notice to Member 02-23

use of back-up hardware and software systems that are located at a designated off-site facility. Firms should list the number and type of desk-top and/or laptop computers, to be used as temporary hardware for the designated back-up facility.

Firms should also consider the type and version of operating software to be used with each system to accommodate incoming files and documents as well system capacity and compatibility issues. Additionally, detailed consideration should be given to the type of electronic trading systems that are currently being used and the possibility of continued service or other relevant accommodations at an alternate or off-site facility.

3. Financial and Operational Assessment

Based upon comment letters received in response to NTM 02-23, NASD has amended the definition of "financial and operational assessment." Although the previous definition of "financial and operational assessment" was "a procedure created by a firm to test and determine the firm's capability to conduct business," the revised definition is "a set of written procedures that allows a member firm to identify changes in its operational, financial, and credit risk exposures."³

The term "operational risk" should focus on a firm's ability to maintain communications with customers and its ability to retrieve key activity records through its mission critical systems. The term "financial risk" should focus on the firm's ability to continue to generate revenue, and obtain new or retain adequate financing and sufficient equity. In addition to the possibility of experiencing operating losses, the value of a firm's investments may decrease due to the lack of liquidity in the broader market, which may prevent the firm's counter-parties from fulfill their obligations. Therefore, firms are encouraged to periodically review for changes in these areas, and act to promptly correct any exposure that may be evident. Each firm's business continuity plan should be written and implemented to reflect the correlations and interdependencies between these risks.

Financial Controls

Firms should designate a primary and alternate financial and operations principal (FINOP) to ensure the continued duties and responsibilities associated with the preparation and maintenance of its financial records. Each firm should review its software for producing financial records and other relevant financial information that will be maintained at a firm's main office and alternate location(s). All of the firm's financial information should be maintained on one or more specific computer systems, and should not be stored on any shared server or other shared environment accessible by restricted personnel. Moreover, all financial files should be password protected for security purposes, and only authorized persons such as will have access to a firm's financial information.

4. Alternate Communications between Firm and its Customers

General Communications and Operation Systems

To ensure the continued use of the Internet in accordance with common practices for communicating with clients and general business contacts, firms should assess the utilization of current and back-up computer systems and Internet access to assure the most reliable and efficient means of facilitating communications between the firm and its customers. These include, but are not limited to personal desktop computers, server hardware, PC uninterrupted power supply, anti-virus software, encryption software, and DSL data connections.

Firms should also employ the use of a local telephone system as its primary telecommunications system to communicate with clients and other business contacts. Several back-up connections should be in place throughout each firm in the event of extended power outages or other disruptions in the use of the primary system. Cellular phones may also act as an alternate communications device in the event that the primary system is inoperable.

³ Release No. 34-46444; File No. SR-NASD-2002-108

All such communication systems should be employed by firms to ensure fluid business continuity, including but not limited to, system capacity issues, to handle the anticipated level of usage; back-up communications systems in the event of system problems or failures; system redundancies; and system security issues.

Alternate Communications between Firm and its Customers

Broker/dealer firms should employ the use of a local telephone systems as its secondary (back-up) telecommunications system to communicate with clients and other business contacts. Cellular phones may also act as an alternate communications device in the event that the primary and/or secondary (back-up) telephone system is inoperable. A back-up connection should be located at the alternate off-site facility in the event of extended power outages or other disruptions in the use of the primary system. In the event of a significant business disruption, firms should contact all clients within a certain period of time to notify them of the alternate contact information and the location of the off-site facility (time requirement may depend on the size, scope and operational function of the firm).

5. Alternate Communications between Firm and its Employees

Broker/dealer firms should ensure that all key or essential personnel have the proper means of communication, such as cellular phones or other acceptable electronic and/or mobile communications, to facilitate the communication process in the event of a significant business disruption. Email lists and cellular phone numbers and other relevant contact information pertaining to all key and essential personnel will be programmed and documented to facilitate access and enhance connectivity between critical staff and key personnel. Some of the various methods of communication can be e-mail, two-way text messaging, instant messaging, and/or portable messaging devices.

6. Business Constituent, Bank and Counter-Party Impact

In this category, a firm should adequately address and analyze the potential impact of a significant business disruption might cause to a firm's existing business constituents (i.e. any business entity that maintains a business relationship with the firm regarding the support of the firm's operational activities), banks, and counter-parties (i.e. other broker/dealers or institutional customers).

In addressing such an impact assessment, the firm should also consider alternative strategic arrangements for handling any contractual obligations or other similar issues between the firm and its existing business relationships in the event of significant business disruption to any of the involved parties.

7. Regulatory Reporting

Central Registration Depository (CRD) Reporting Obligations

With the CRD system, each firm should prepare for the continued regulatory filings of Form BD, Form U-4/U-5 through the CRD system.

All filings are maintained on the CRD system for future use and retrieval purposes. In the event that a firm experiences a significant business disruption, it may attempt to access the IARD system through its User Name and Password information within a certain time period to ensure the CRD system is in operating order. Each firm should also maintain copies of each current Form BD, U-4/U-5 and other relevant filings appropriate schedules for future use.

Regulation Form Filing System

Firms should consider cross-training key personnel to ensure the continued use of NASD's Web-based form filing applications. These applications permit NASD member firms to submit filings via the Internet. The following is a list of the regulation form filing applications:

- Web-Based FOCUS;
- Customer Complaints (NASD Rule 3070);
- Regulation T/15c3-3 Extension Requests;
- Short Interest Reporting (NASD Rule 3360);
- Blue Sheets (NASD Rule 8210, 8211, 8213);
- INSITE (NASD Conduct Rule 3150);
- Advertising Regulation Electronic Files

8. Communication with Regulators

Each firm should maintain telephone and Internet access capabilities at the main office and the designated off-site facility. This may facilitate any required communications with federal, state and/or self-regulatory organization (SRO) agencies. As an alternate method, firms should also maintain an electronic (CD) and hardcopy list of all SEC Regional Offices, State Securities Agencies and any other regulatory agencies that firms may be affiliated with such as the NASD, CFTC, etc.

Regulatory Inquiries

In the event of a formal or informal inquiry made by any federal, state, self-regulatory organization (SRO) or other regulatory agency, an appropriately designated supervisor of the firm should be responsible for receiving all calls and/or other requests for further review.

Review and Updating Requirements

In accordance with proposed NASD Rule 3510(b), each firm will be required to review its business continuity plan on an *annual basis* to determine if it adequately addresses all relevant areas of the firm and whether any updating amendments or revisions are required to align it with the firm's current status. Any material change in the firm's size, structure and operational functions would generally require an updating amendment to the firm's existing business continuity plan. Additional changes might include any change in the firm's principal place of business and/or branch office locations, reorganization issues that may affect key contact personnel. The requirement for firms to "promptly" update their continuity plan may vary based on each firm's size, organizational structure, and other relevant factors.

Emergency Contact Information

In the initial proposal, NASD originally required that only one contact person was required as a means for contacting a broker/dealer firm. However, based on the number of comments in response to NTM 02-23, NASD has

amended its original position to include two contact persons in the event of an emergency. The NASD's decision to increase the number of emergency contact persons was in an effort to increase the chance of accessing one or more of the firm's designated contact persons in the event of a severe business disruption.

Pursuant to Article IV, Section 3 of the NASD By-Laws, NASD members are already required to appoint an executive representative to represent, vote, and act of behalf of the member firm in the affairs of NASD. As such, NASD will initially collect all relevant emergency contact information through the Member Firm Contact Questionnaire on the NASD Web-Site in order to ease the burden imposed by the proposed rule change.

Additionally, the proposed rule requires NASD members to update their emergency contact information in the event of any material change, and at a minimum to review the information twice a year, to ensure its accuracy.

This Report was prepared by Financial Registrations, Inc., a compliance management consulting firm providing registration and compliance advisory services to the financial services industry. Our clients range from "introducing" broker/dealers and market-making firms, to state and SEC registered investment advisers.

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