

**MEMO# 10800**

March 15, 1999

# **SEC PROPOSES YEAR 2000 OPERATIONAL CAPABILITY RULES FOR REGISTERED BROKER-DEALERS AND NON-BANK TRANSFER AGENTS**

1 Operational Capability Requirements of Registered Broker-Dealers and Transfer Agents and Year 2000 Compliance, Rel. No. 34-41142 (March 5, 1999); 64 Fed. Reg. 12127 (March 11, 1999) (the "Release"). 1 [10800] March 15, 1999 TO: ACCOUNTING/TREASURERS COMMITTEE No. 7-99 CLOSED-END INVESTMENT COMPANY COMMITTEE No. 11-99 COMPLIANCE ADVISORY COMMITTEE No. 9-99 ELECTRONIC COMMERCE ADVISORY COMMITTEE No. 2-99 INTERNAL AUDIT ADVISORY COMMITTEE No. 1-99 OPERATIONS COMMITTEE No. 9-99 SEC RULES COMMITTEE No. 19-99 TRANSFER AGENT ADVISORY COMMITTEE No. 21-99 UNIT INVESTMENT TRUST COMMITTEE No. 7-99 RE: SEC PROPOSES YEAR 2000 OPERATIONAL CAPABILITY RULES FOR REGISTERED BROKER-DEALERS AND NON-BANK TRANSFER AGENTS

The Securities and Exchange Commission recently proposed a series of rules under the Securities Exchange Act of 1934 ("Exchange Act") for broker-dealers and transfer agents regarding their operational capability related to Year 2000 compliance.<sup>1</sup> Specifically, the Commission proposed new Rule 15b7-2 and temporary Rules 15b7-3T and 17a-9T for broker-dealers, and new Rule 17Ad-20 and temporary Rule 17Ad-21T for non-bank transfer agents. The proposed rules would (1) establish operational capability standards for broker-dealers and non-bank transfer agents in the conduct of their business, and (2) require those broker-dealers and transfer agents that have, or are presumed to have, a material Y2K problem on or after August 31, 1999, to notify the Commission (and their designated examining authority ("DEA") in the case of broker-dealers) and cease operating their business. In addition, the proposed rules impose special recordkeeping requirements under conditions stated in the Release. The proposed rules are attached, and are discussed below. Comments on the proposals are due to the SEC by Monday, April 12, 1999. The Institute is considering whether to comment on the proposed rules. If there are issues you would like the Institute to consider addressing in a possible comment letter, please contact Barry Simmons by phone at (202) 326-5923, by fax at (202) 326-5839, or by e-mail at [simmonbe@ici.org](mailto:simmonbe@ici.org), or Kathy Joaquin by phone at (202) 326-5930, by fax at (202) 326-5853, or by e-mail at [kjoaquin@ici.org](mailto:kjoaquin@ici.org) by Thursday, March 24, 1999. Operational Capability Requirement 2 The Release notes that the proposed definition would not include a broker-dealer or transfer agent whose systems have minor technical problems regarding the reading of dates if these problems do not adversely affect the broker-dealer's or transfer agent's core business. In addition, under Rule 15b7-3T, "mission critical system" would be

defined as any system that is necessary, depending on the nature of the broker-dealer's business, to assure the prompt and accurate processing of securities transactions, including order entry, execution, comparison, allocation, clearance and settlement of securities transactions, the maintenance of customer accounts, and the delivery of funds and securities. Under Rule 17Ad-21T, "mission critical system" would be defined as any system that is necessary, depending on the nature of the transfer agent's business, to assure the prompt and accurate transfer and processing of securities, the maintenance of master securityholder files, and the production and retention of required records as described in paragraph (d) of the proposed rule. 3 The Release notes that the Commission and the SROs (as applicable) will conduct examinations of registered broker-dealers and non-bank transfer agents, including their automated systems and records, as are necessary to assess their operational capability and determine whether they have a material Y2K problem. 2 The Release proposes new Rule 15b7-2 under the Exchange Act, which would require registered broker-dealers to have and maintain operational capability, taking into consideration the nature of their business, to assure the prompt and accurate entry of customer orders, execution, comparison, allocation, clearance and settlement of securities transactions, the maintenance of customer accounts, and the delivery of funds and securities. The Release also proposes new Rule 17Ad-20 under the Exchange Act, which similarly would require registered non-bank transfer agents to have and maintain operational capability, taking into consideration the nature of their business, to assure the prompt and accurate transfer and processing of securities, the maintenance of master securityholder files, and the production and retention of required records. Definition of "Material Y2K Problem" The Release also proposes temporary Rules 15b7-3T and 17Ad-21T under the Exchange Act for broker-dealers and non-bank transfer agents, respectively. These rules would address what it means to be operationally capable in the context of Y2K, and outlines the procedures for those broker-dealers and transfer agents that are not Y2K compliant by August 31, 1999, but are in the process of remediating their Y2K problems. Under the proposed rules, a broker-dealer or a non-bank transfer agent would not be considered operationally capable if it has a material Y2K problem. Although recognizing that determining the existence of a material Y2K problem is based on the specific facts and circumstances of a particular case, the Release notes that a broker-dealer or a non-bank transfer agent would have a material Y2K problem if, at any time on or after August 31, 1999: (1) any of its computer systems incorrectly identifies any date in the Year 1999, the Year 2000, or in any year thereafter; and (2) the error impairs or, if uncorrected, is likely to impair, any of its mission critical computer systems.2 The proposed rules also would create a presumption that a broker-dealer or a non-bank transfer agent has a material Y2K problem (and therefore would be presumed not to be operationally capable) if, at any time on or after August 31, 1999, the broker-dealer or transfer agent: (1) does not have written procedures designed to identify, assess, and remediate any Y2K problems in its mission critical systems; (2) has not verified its Y2K remediation efforts through reasonable internal testing of its mission critical systems; (3) has not verified its Y2K remediation efforts by satisfying any applicable Y2K testing requirements imposed by a self-regulatory organization ("SRO"); or (4) has not remediated all exceptions contained in any public independent accountant's report prepared on behalf of the broker-dealer pursuant to Exchange Act Rule 17a-(5)(e)(5)(vi) or on behalf of the transfer agent pursuant to Exchange Act Rule 17Ad-18(f).3 4 The term "customer" would include a broker or dealer; thus, a clearing broker that handles orders from other brokers and carries their funds and securities would also be covered by the rule. 5 In the case of a broker-dealer, the certificate must state: (1) that the broker-dealer is in the process of remediating its material Y2K problem; (2) that the broker-dealer has scheduled testing of its affected mission critical systems to verify that the material Y2K problem has been remediated and specifies the

testing dates; (3) the date (which cannot be later than October 15, 1999) by which the broker-dealer anticipates it will have remediated the Y2K problem and will therefore be operationally capable; and (4) that, based on inquiries and to the best of his or her knowledge, the broker or dealer does not anticipate that the existence of the material Y2K problem will impair its ability, depending on the nature of its business, to ensure prompt and accurate processing of securities transactions, including order entry, execution, comparison, allocation, clearance and settlement of securities transactions, the maintenance of customer accounts, or the delivery of funds and securities. The certificate of a non-bank transfer agent would contain similar information. Moreover, the certification also would be made available to the public. 6 The Release notes, for example, that the Commission would take such action if the representations contained in the certificate were false. 3 SEC Notification The proposed rules also would require any registered broker-dealer or non-bank transfer agent that experiences, detects, or continues to have a material Y2K problem (or is presumed to have a material Y2K problem, as discussed above) at any time on or after August 31, 1999, to immediately notify the Commission (and, in the case of a broker-dealer, its DEA) of the problem. The Release notes that this notification would be made available to the public. Prohibition on Non-Compliant Broker-Dealers and Transfer Agents and Certification Under proposed temporary Rule 15b7-3T, if a broker-dealer is not operationally capable because it has a material Y2K problem, it would not be permitted, on or after August 31, 1999, to (1) effect any transactions in securities, (2) induce the purchase or sale of securities, (3) receive or hold customer funds or securities, or (4) carry customer accounts.4 Similarly, under proposed temporary Rule 17Ad-21T, if a non-bank transfer agent is not operationally capable because it has a material Y2K problem, it would not be permitted, on or after August 31, 1999, to engage in any transfer agent function, including: (1) countersigning securities upon issuance; (2) monitoring the issuance of securities with a view to preventing unauthorized issuance; (3) registering the transfer of securities; (4) exchanging or converting securities; or (5) transferring record ownership of securities by bookkeeping entry without physical issuance of securities certificates. The broker-dealer or non-bank transfer agent would be permitted to continue to operate its business, however, if, in addition to satisfying the notice requirement, it provides the Commission a certificate that is signed by its chief executive officer (or an individual with similar authority).5 The proposed rules further provide that, despite the filing of such a certificate, the Commission or a court of competent jurisdiction can order a broker-dealer to comply with proposed Rule 15b7-3T(d) (or a non-bank transfer agent to comply with proposed Rule 17Ad-21T(d)), and cease doing business, if it is in the public interest or for the protection of investors.6 Recordkeeping Requirements 7 The broker-dealers affected under this rule include only those broker-dealers that are required to maintain as of December 30, 1999 and December 31, 1999, minimum net capital of \$250,000. 4 The Release also proposes special recordkeeping requirements for broker-dealers and non-bank transfer agents. For broker-dealers, proposed temporary Rule 17a-9T would require certain broker-dealers7 to make a separate copy of their trade blotter and their securities record or ledger for the last two business days of 1999. These records must be stored in an easily accessible place for at least one year. This rule is intended to assist broker-dealers, the Commission, the DEAs, and the Securities Investor Protection Corporation in identifying all securities positions carried by the broker-dealer and the location of the securities in the event that a broker-dealer experiences Y2K problems. Similarly, for non-bank transfer agents, proposed temporary Rule 17Ad-21T would require every non-bank transfer agent to maintain a segregated copy of its database, file layouts, and all relevant files beginning August 31, 1999, and ending on March 31, 2000. The Release adds that the back-up copy of the database and file layouts must not be located with or held in the same computer system as the primary records. Furthermore, these records must be copied at the end of

each business day and stored in an easily accessible place for five business days. Barry E. Simmons Assistant Counsel Attachment

---

Copyright © by the Investment Company Institute. All rights reserved. Information may be abridged and therefore incomplete. Communications from the Institute do not constitute, and should not be considered a substitute for, legal advice.