SECURITIES AND EXCHANGE COMMISSION

Concept Release: Securities Transactions Settlement

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Comments due on or before June 16, 2004

I. Summary

The SEC is looking into ways of improving the efficiency of the US clearing and settlement system and help move the financial industry toward the objectives of straight through processing. The basis for the inquiry is Section 17A of the Securities Exchange Act which directs the Commission to set up a clearing and settlement system for securities transactions. Section 17A says:

? The prompt and accurate clearing and settlement of securities transactions (including transfer of records and safekeeping of securities and funds are necessary to protect investors.
? Inefficient procedures for clearing and settlement add unnecessary costs to the process.
? New technologies are available to make clearing and settlement more efficient
? Linking clearing and settlement facilities and developing uniform standards and procedures will reduce costs and increase protection

This Concept Release stems from the previous Commission inquiry on the value of shortening the trade settlement date from T+3 to T+1. This shift is based on the SIA's recommendations that the industry needed to focus on STP before it could make the conversion to T+1 settlement. The goals of STP (reducing risk and increasing efficiency) have also been the focus of international initiatives including the Task Force organized by the Committee on Payment and Settlement Systems (CPSS) and the recommendations from the Group of 30.

The purpose of the SEC release is to build upon those initiatives and continue to look for ways to improve the operation and efficiency of the U.S. clearance and settlement system. Their rational is that people who invest in securities markets want to know that their product will be delivered on time, at the agreed upon terms, and that they will not lose their funds and securities because of insolvency, mismanagement, or operational difficulties. The particular focus of this release is on improving the trade confirmation/affirmation process, shortening the settlement cycle and reducing the use of physical securities.

II. Trade Confirmation and Affirmation

Confirm/Affirm Process

Prompt verification of trade details is essential to finding problems that can lead to settlement failures and errors in recording trades. The current process rules require a broker/dealer (B/D) to use a registered clearing agency or a qualified vendor for the confirm/affirm process -- when the B/D allows the customer to pay for the trade on delivery of securities or cash to the customer (known as receive-versus-payment (RVP) or delivery versus payment (DVP)). RVP/DVP privileges are usually for institutional customers and only available on agreement that the customer (on both sides) will affirm each trade as soon as they receive confirmation.

Once a B/D executes a trade for a customer with RVP/DVP privileges, the B/D provides trade details to the customer. This is called "notice of execution" or "NOE." If the customer submitted

the order on behalf of other parties, the customer will tell the B/D how to allocate the transaction among the participating entities. The B/D will reply to the customer by "confirming" each allocation. If the B/D has correctly allocated the trade, the customer will "affirm" the trade. In the US, the only entity currently offering confirm/affirm services is Omgeo.

B/D generally confirm trades with their institutional customers on T+0. Institutional customers affirm the majority of their trades after T+0. In the first half of 2003, 86% of trades submitted to Omgeo were confirmed on T+0, but affirmation rates were approximately 23% on T+0, 85% on T+1 and 88.5% on T+2.

SIA's ITPC Recommendation

In an effort to improve the clearing and settlement process, SIA formed an Institutional Transaction Processing Committee (ITPC) with the goals of evaluating the settlement process for institutional trades. The SIA white papers recommended the use of matching utilities as the way to improve the processing of RVP/DVP transactions.

According to the SIA, the current method of institutional transaction processing involve a series of sequential steps by the B/D and its customer – with only one participant reviewing and entering trade data at a time. This means that the processing swings back and forth between the customer and the B/D – and with each pass, one party provides additional trade data. They describe this as a reactive process because each participant waits for a trigger before executing the next step in the process. **The result is delay and redundant flows of non-essential data.**

According to the ITPC, another major cause of delay is that fact that many industry participants have to manually re-key trade data into several systems. The systems of B/D and their customers are not automated and don't use common message standards. **The lack of automation causes errors and discrepancies.**

The ITPC paper states that redesigning the institutional transactional settlement model to achieve STP would allow the industry to streamline operating processes, increase capacity, decrease the number off exceptions and reduce costs by eliminating redundant and manual steps. To address this, the ITPC envisioned an institutional transaction processing model in which the trade is matched by a matching utility (MU). The MU would match the data submitted by the B/D and its institutional customer and would submit the matched transaction information to the depository in real-time. **The ITPC model treats the trade cycle as a unit from post-execution to settlement, rather than a group of loosely related messages and processes.**

Industry Proposals for Rulemaking

According to the SIA, in order to achieve STP (all transactions to be confirmed/affirmed on T+0), the Commission should consider two SRO rulemaking alternatives. The first would require B/D to get agreement from their customers at the beginning of the relationship or at time of trade to participate in and comply with the operational requirements of interoperable trade matching systems as a condition of settling RVP/DVP trades. The second would be to require investment managers to participate in a trade matching system.

According to SIA, either alternative would result in the completion of the confirm/affirm process within minutes of the trade execution – providing time to resolve discrepancies before settlement date – thereby reducing fails.

CPSS/G30 Recommendations

Both the CPSS and G30 reports recommend that confirm/affirm should occur ASAP (preferably onT+0) for the same reasons as SIA – that early agreement on trade details will allow early detection of errors in trade data which could result in inaccurate books and records, increased credit/market risk and increased costs. In essence, the achievement of STP is essential to maintaining high settlement rates as volumes increase and for timely settlement of cross-border trades. Both CPSS and G30 urge the industry to develop compatible, industry-accepted technical and market practice standards to automate the confirm/affirm process.

Commission Options

The Commission believes that the goal of industry-wide trade matching is the best way to improve the confirm/affirm process and achieve STP – but they are concerned about imposing a requirement that all B/D use a matching service. They are particularly concerned that mandating matching might stifle competition and innovation – and might put undue burdens on small B/D and asset managers. The Commission is seeking comment on how to best achieve the confirmation/affirmation process on T+0 – and have suggested two approaches for consideration.

1. The SROs could amend their confirmation rules to prohibit B/D from extending RVP/DVP privileges to any customer unless all trades are confirmed/affirmed on T+0. The concern is that this would require the B/D to take action to help with compliance. B/D are reluctant to exert pressure on customers for fear that those customers will take their business elsewhere.

2. The Commission could adopt a rule that would require B/D to confirm and affirm trades on trade date.

The Commission likes these options because the preserve competition/innovation (do not require the use of a particular service or technology) and because they complement, rather than replace existing SRO confirmation rules. The Commission is seeking comment on the following issues:

1. What are the benefits and costs of same-day trade confirmation/affirmation?
2. What are the relative burdens of trade date confirmation/affirmation on the different market participants involved?
3. What effect would trade date confirmation/affirmation have on the relationship between a broker-dealer and its customer?
4. Do the benefits of trade date confirmation/affirmation accrue to all participants -- brokers, institutional customers, custodians, or matching utilities? Do they accrue to large, medium, and small entities?
5. Does trade date confirmation/affirmation introduce any new risks? If so, can they be quantified?
6. Would the modification of the existing SRO confirmation rules or the adoption of a new Commission rule be feasible approaches to having trades confirmed/affirmed by T+0? Are there alternative rule changes?
7. If rules mandating trade date confirmation/affirmation are adopted, what should be the time frame for implementing them? What factors should the Commission consider in determining the implementation period?
8. Would same-day confirmation/affirmation affect cross-border trading? If so, how would it do so? Should any confirmation/affirmation rule apply to all types of non-exempt securities?

9. Should all participants in institutional trades be required to use a matching service if the Commission were to require confirmation/affirmation on T+0?
10. What, if anything, should the Commission do to facilitate the standardization of reference data and use of standardized industry protocols by broker-dealers, asset managers, and custodians?

III. Securities Settlement Cycles

Overview

The essence of the settlement issue can be summed up as -- nothing good can happen between trade date and settlement, only bad things can happen. And the longer the settlement cycle, the greater the risk.

In 1993, the Federal Reserve Board noted that settlement systems for securities were a potential source of "systemic disturbance" to financial markets and the economy. In the Board's view, the ideal scenario was settlement immediately after execution and payment in same-day funds. The longer the period from trade execution to settlement, the greater the risk that one of the parties may default on the trade. In addition, the larger the number of unsettled trades, the greater the opportunity for prices of the securities to move away from the contract price – thereby increasing the risk that non-defaulting parties will incur a loss when replacing unsettled contracts.

The biggest concern of the Commission is **systemic risk** – or the inability of one market participant to meet its obligations when due, which will cause others to fail to meet their obligations. And while the Commission believes that the threat of a serious systemic disruption to the US financial markets from a settlement failure is small, it is still a serious concern.

It was this type of concern – propelled by the 1987 Market Break and the 1990 bankruptcy of Drexel Burnham – that caused the Commission to adopt **rule 15c6-1** – shortening the settlement time frame from T+5 to T+3. The implementation of T+3 is widely viewed as a success – but the Commission thinks it is important to further mitigate systemic disruptions and facilitate a more efficient clearance and settlement system for three primary reasons:

1. The size and growth of the markets since 1995 (the year Rule 15c6-1 became effective)
2. Tighter linkages between participants in multiple markets and multiple jurisdictions (failure of one has wide implications)
3. The potential of wide-scale regional disruption (i.e. 9/11/01 type disruption)

The Commission continues to agree with the underlying assumptions that led to the movement from T+5 to T+3. Fewer unsettled trades would exist (less market and credit risk) and there would be less time between trade execution and settlement for the value of trades to deteriorate. Shorter settlement cycles would also reduce liquidity risk among derivative and cash markets. And shortening the settlement cycle would encourage greater efficiency in clearing and settlement.

Rule 15c6-1

Rule 15c6-1 was adopted to move the industry to prompt and accurate clearance and settlement of securities transactions. It states that a B/D can't enter into a contract to buy or sell securities (except exempted securities) unless they can facilitate payment and delivery in three business days or less. The Commission adopted Rule 15c6-1 following reports by the G30 and others

recommending that markets shorten settlement cycles to T+3 to minimize counterparty risk and exposure. **The G30 report concluded, however, that same day settlement is the final goal.**

Coverage of 15c6-1

Rule 15c6-1 covers all securities except for government and municipal securities, commercial paper, bankers' acceptances, insurance and commercial bills. The Rule also specifically exempts sales of unlisted partnership interests and the Commission has exempted securities that don't generally trade in the US.

Rule 15c6-1 and IPOs

Rule 15c6-1 provides a T+4 settlement cycle for new offerings that are priced after 4:30 p.m. (eastern) to enable participants to meet their prospectus delivery requirements, Those requirements prohibit the sale of securities unless accompanied or preceded by a prospectus that meets the Commission's disclosure requirements. Those requirements state that a B/D must give customers written confirmation of purchase on or before the completion of the transaction – and communication after the effective date of the registration statement is not considered a prospectus. In essence a confirmation can not be a substitute for a prospectus.

The open question is whether it is possible to shorten the settlement cycle and still provide customers with a final prospectus prior to or simultaneously with the confirmation. If the Commission adopts a shorter settlement cycle, the industry says that it would be "Extremely challenging to accurate complete necessary due diligence and satisfy the physical prospectus delivery requirements."

To address this problem, the SIA has asked the Commission to consider eliminating the requirement that the final prospectus be delivered at the same time as the confirmation. In addition, the SIA wants the Commission to adopt an electronic access standard as a way of alleviating time pressures associated with meeting the prospectus requirement. Finally, SIA has asked the Commission to consider a T+3 settlement cycle for IPOs priced after 4:30 to allow participants time to complete their due diligence.

<u>Risk Reduction Benefits of Shorter Settlement Cycles</u>

The goal of shortening the settlement cycle is to reduce risks that can lead to systemic disruptions in the financial markets. The Commission is evaluating three types of risks – those prior to settlement, those at settlement and those associated with operations.

Risks Prior to Settlement

Pre-settlement risk is defined as the risk that a counterparty to a transaction for completion at a future date will default before final settlement. The resulting exposure is the cost of replacing the original transaction at current market prices. This is also known as **replacement cost risk**.

Pre-settlement risk is of concern because it involves a change in the value of the securities if one of the party's defaults. If the default is by a major player, it might suffer credit losses so large as to create systemic problems. If you reduce the time period from trade execution to settlement, you reduce pre-settlement risk.

A good example of this is the 1987 market break – where the settlement cycle was T+5. During those five days, ten of the 30 DJIA stocks declined 35% or more. A default by the buyer of one of those stocks would have exposed the seller to big losses. There are other examples … on October 27, 1997 the DJIA declined by 554.26 points … on August 31, 1998, the DJIA fell by 512.61 points. With sharp price movements, traders may be unwilling or unable to meet margin calls and default on their delivery obligations.

Risks at Settlement

Settlement risk means the risk that settlement in a transfer system will not take place as expected. This might be both credit and liquidity risk. This is also known as **principal risk** – the risk of loss of securities or payments made to the defaulting party before the detection of the default. In this scenario, both the buyer and seller are exposed to risk of loss of the full principal value of the securities or funds transferred.

In addition, both parties are exposed to **liquidity risk** on settlement date. Liquidity risk is the risk that the seller of a security who does not receive payment when due may have to borrow or liquidate assets to complete other payments. It also includes risk that the buyer does not receive delivery when due and may have to borrow the security in order to complete its own delivery obligation. The Commission believes that liquidity problems have the potential to create systemic disruptions.

Operational Risk

Operational risk is the risk that deficiencies in information systems or internal controls, human errors or management failures will result in unexpected losses. As clearing and settlement systems become more dependent on information systems, the reliability of these systems (errors or delays in processing, system outages, insufficient capacity, fraud) is a key element in operational risk.

Costs of Implementing a Shorter Settlement Cycle

SIA T+1 Business Case

In 2000, SIA published a T+1 business case that concluded the cost of moving to T+1 would be about $8 billion but would save the industry $2.7 billion per year and that moving to T+1 would reduce settlement exposure by 67% (or $250 billion). Since its publication, there have been a number of critics who have questioned the assumptions and conclusions.

Costs to Cross-Border Trading

Reducing the settlement cycle carries risk, particularly for markets with significant cross-border activity because of the differences in time zones and holidays as well as the involvement of multiple intermediaries. For most markets, a movement to T+1 would require reconfiguration of trade settlement processes and an upgrade of systems. Without upgrades, a move to shorter cycles could result in more settlement fails.

Request for Comment

The Commission is looking for comment on the current operation of Rule 15c6-1 and the costs/benefits of implementing a shorter settlement cycle. These are the specific questions in the concept release:

1. Should the securities covered by Rule 15c6-1 be expanded? If so, what securities should be added? Why should these securities be added?
2. Given the increase in cross-border transactions and dually-traded securities over the past eight years, are the conditions set forth in the Commission's exemption order for securities traded outside the United States still appropriate? If not, why not? If the exemption should be modified, how should it be modified?
3. Are the conditions set forth in the Commission's exemption order for variable annuity contracts still appropriate? If not, why not? If the exemption should be modified, how should it be modified?
4. If the Commission were to mandate a settlement cycle shorter than T+3, should the Commission s horten the settlement cycle for firm commitment offerings priced after 4:30 p.m. Eastern time from T+4 to T+3 or T+2?
5. How would a shortened settlement cycle affect processing newly issued securities?
6. What systems and operational changes would be necessary in order to settle newly issued securities in a shortened settlement cycle?
7. How much would it cost to shorten the settlement cycle beyond T+3?
    a. Is achieving 100% of confirmation/affirmation or matching on trade date a prerequisite for shortening the settlement cycle beyond T+3?
    b. If so, what are the additional costs of shortening the settlement cycle after achieving 100% of confirmation/affirmation or matching on trade date?
8. What parties will bear the costs of moving to a settlement cycle shorter than T+3 (such as broker-dealers, investment managers, custodians, investors, and other market participants)?
9. What are the benefits of shortening the settlement cycle beyond T+3? Are there economic benefits in terms of reduction in credit and liquidity risk associated with shortening the settlement cycle beyond T+3?
10. Who will benefit from shortening the settlement cycle beyond T+3 (such as broker-dealers, investment managers, custodians, investors, and other market participants)?
11. How would shortening the settlement cycle affect efficiency and risk?
    a. What are the risks associated with upgrading computer systems and transaction processing procedures to convert existing systems to new systems and the establishment of necessary linkages between other market participants?
    b. Would shortening the settlement cycle beyond T+3 encourage market participants to implement additional risk management procedures? What additional operational risks would result from shortening the settlement cycle beyond T+3?
    c. Would a shorter settlement cycle encourage market participants to invest in technology and automation that would enhance their operational efficiency? Would such investments improve market efficiency?
    d. Are there alternatives to shortening the settlement cycle that would increase efficiency in the clearance and settlement system?
    e. Are there alternatives to shortening the settlement cycle that would mitigate risks in the clearance and settlement process?
12. How would shortening the settlement cycle affect the information, benefits, and protections that investors have under present U.S. clearance and settlement arrangements?
13. How can the safety and soundness of the U.S. clearance and settlement system be increased while ensuring that investors can continue to obtain direct registration of their securities on issuer records in a less-than-three-day settlement environment?
14. What impact would a shortened settlement cycle for U.S. equities and corporate securities have on cross-border trading by non-U.S. entities of these instruments?