

## ICI Comments on Efforts to Improve Clearance and Settlement System in U.S. Securities Markets, June 2004

June 16, 2004

Mr. Jonathan G. Katz  
Secretary  
U.S. Securities and Exchange Commission  
450 Fifth Street, N.W.  
Washington, D.C. 20549-0609

**Re: Securities Transactions Settlement (File No. S7-13-04)**

Dear Mr. Katz:

The Investment Company Institute (“Institute”)<sup>1</sup> appreciates the opportunity to comment on the Securities and Exchange Commission’s (“SEC”) concept release on securities transactions settlement.<sup>2</sup> The Concept Release requests comment on methods to improve the safety and operational efficiency of the U.S. clearance and settlement system and to help the U.S. securities industry achieve straight-through processing (“STP”).<sup>3</sup> Specifically, the Concept Release requests comment on: (1) changes to the confirmation and affirmation process; (2) shortening the securities settlement cycle; and (3) reducing the use of physical securities.

The Institute strongly supports the SEC’s efforts, of which the Concept Release is the latest example, as well as industry initiatives, to enhance efficiency and reduce risk in the operation of the U.S. clearance and settlement system.<sup>4</sup> As the Concept Release notes, the prompt and accurate clearance and settlement of securities transactions is necessary for the protection of investors and inefficient procedures for clearance and settlement impose unnecessary costs on investors. The issues raised by the Concept Release are therefore very important to our members.

While the Concept Release raises many important and complex issues relating to improving the U.S. clearance and settlement system and achieving STP, we will focus our comments on those issues that are most relevant to mutual funds and other institutional investors. Our specific comments follow.

## I. Trade Confirmation and Affirmation

### A. Accelerated Confirmation and Affirmation

The Concept Release requests comment on methods to improve the trade confirmation and affirmation process in order to achieve STP. In particular, the Concept Release sets forth two possible approaches: (1) adopting an SEC rule that would require broker-dealers to confirm and affirm trades on trade date (“T+0”) or (2) requiring the self-regulatory organizations (“SROs”) to amend their existing rules to prohibit broker-dealers from providing delivery-versus-payment (“DVP”) or receive-versus-payment (“RVP”) privileges to a customer unless all trades with that customer are confirmed and affirmed on T+0.<sup>5</sup>

The Institute strongly supports the goal of establishing STP in the securities markets and believes that a regulatory mandate will be necessary in order to compel market participants to achieve STP by improving the trade confirmation and affirmation process. We urge that any such regulatory mandate be implemented in a series of interim steps. For example, the first interim step could be a requirement that 90 percent of affirmations be received by noon on trade date plus one (“T+1”) in order for trades to settle on trade date plus three (“T+3”). After such a level is achieved, a second interim step could be a requirement that 90 percent of affirmations be received by 9:00 a.m. on T+1. Finally, the industry could then move to affirming all trades on trade date.

The Institute believes that implementing STP in steps would provide market participants with an opportunity to address a number of issues concerning an accelerated confirmation and affirmation process. In particular, we are concerned about the costs to mutual funds resulting from changes to the confirmation and affirmation process, especially to smaller fund firms that may currently allocate trades manually. These smaller firms may have to adopt new technology or rely on service providers to automatically generate affirmations. All mutual funds would likely incur increased costs due to extra staffing requirements that may be necessary to implement an accelerated confirmation and affirmation process (e.g., related to the handling and resolution of exceptions). In addition, an interim step approach could diminish the likelihood of an increase in failed trades that may result from a sudden shift in confirmation/affirmation or settlement deadlines. Finally, such an approach could address several other issues relating to the implementation of a faster confirmation and affirmation process, such as affirming trades in newly established brokerage accounts,<sup>6</sup> current time frames for reporting average prices by broker-dealers<sup>7</sup> and the need for increased automation of the allocation process.

The Institute also recommends that ample time, e.g., a minimum of 24 months, be provided for the implementation of changes to the confirmation and affirmation process. This is particularly important given the number of regulatory reform proposals currently underway that, if adopted, will present a

considerable implementation burden for industry participants.<sup>8</sup> Sufficient lead-time will also allow for multiple vendor solutions to emerge and mature, which could reduce the cost of implementation to market participants.<sup>9</sup>

## B. Trade Matching

The Concept Release states that the SEC preliminarily is of the view that the goal of industry-wide trade matching is the best method to improve the confirmation and affirmation process and to achieve STP. The Concept Release requests comment on whether all participants in institutional trades should be required to use a matching service.

While the Institute believes that the use of a matching service could provide a means to improve the confirmation and affirmation process and to achieve STP, we oppose mandating the use of a matching service by all participants in institutional trades. Instead, we believe that market participants should be allowed to choose alternative methods for the confirmation and affirmation of trades, as long as that process is completed in the requisite time frame. Many Institute members currently affirm trades on T+0 through automated methods other than the use of a centralized matching utility. We believe these firms should not have to incur additional costs to change systems and operational procedures to utilize a matching venue. In addition, requiring all entities to use a matching service may impose an unnecessary burden on smaller mutual fund firms due to high implementation costs. Finally, we are concerned that mandating the use of a matching service may stifle innovation and competition, making it virtually impossible for a service provider with new technology to compete, and has the potential to create a monopolistic situation in the event that only one vendor provides a central-matching solution.<sup>10</sup>

## II. Securities Settlement Cycle

The Concept Release requests comment on the benefits and costs associated with implementing a settlement cycle for most broker-dealer transactions that is shorter than T+3. Specifically, the Concept Release states that, due to the growth of the securities markets since T+3 settlement was implemented, the participation of financial firms in multiple markets, and the possibility of wide-scale regional disruption, the SEC believes that it is now appropriate to consider shortening the securities settlement cycle.

While the Institute supports the goals of shortening the settlement cycle (e.g., reducing systemic risk and increasing efficiency in the U.S. clearance and settlement system), we are not in favor of shortening the settlement cycle to less than T+3 at this time. Instead, we believe that the SEC's and the industry's focus should be on achieving industry-wide STP. STP is one of the building blocks for achieving a shorter settlement cycle and thus the implementation of STP will be necessary before the industry can move beyond T+3 settlement.<sup>11</sup> In addition, we do not believe that a shorter settlement cycle will produce significant benefits over and above those that will be realized by moving to a faster confirmation and affirmation process, and it could increase operational risk by reducing the time available to correct errors prior to settlement. Finally, we are concerned that the costs associated with

establishing a shorter settlement cycle could outweigh the related benefits.

### III. Immobilization and Dematerialization of Securities Certificates

The Concept Release requests comment on a number of specific issues relating to immobilization or dematerialization of securities certificates, including whether securities certificates should be completely immobilized or dematerialized.

The Institute strongly supports the immobilization or dematerialization of securities certificates and believes that there are many benefits to be gained by market participants and investors by such an initiative. For example, book-entry ownership reduces instances of lost or stolen certificates and replacement fees, eliminates the risk associated with catastrophic events, and offers increased portability and trading flexibility.

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The Institute appreciates the opportunity to comment on this concept release. If you have any questions or would like additional information, please contact the undersigned at 202-326-5850.

Sincerely,

Diane M. Butler  
Director – Transfer Agency & International Operations

cc: Annette L. Nazareth, Director  
Robert L.D. Colby, Deputy Director  
Jerry Carpenter, Assistant Director  
Jeffrey Mooney, Senior Special Counsel  
Division of Market Regulation

#### ENDNOTES

<sup>1</sup> The Investment Company Institute is the national association of the American investment company industry. Its membership includes 8,633 open-end investment companies ("mutual funds"), 622 closed-end investment companies, 126 exchange-traded funds and 5 sponsors of unit investment trusts. Its mutual fund members manage assets of about \$7.393 trillion. These assets account for more than 95% of assets of all U.S. mutual funds. Individual owners represented by ICI member firms number 86.6 million as of mid 2003, representing 50.6 million households.

<sup>2</sup> SEC Release Nos. 33-8398; 34-49405; IC-26384 (March 11, 2004), 69 FR 12922 (March 18, 2004) ("Concept Release").

- <sup>3</sup> “Straight-through processing” refers to the automation of the trade process, from the execution of the trade, through the confirmation procedure, until trade settlement, without any manual intervention.
- <sup>4</sup> Institute staff have served on several committees established by the Securities Industry Association examining the issues that are the subject of the Concept Release, in particular, the SIA’s STP Steering Committee, the STP Buy-Side Committee and the STP Legal and Regulatory Subcommittee.
- <sup>5</sup> Currently, SRO confirmation rules require a broker-dealer to use the facilities of a registered clearing agency, an entity that has received an exemption from clearing agency registration, or a qualified vendor for the confirmation and affirmation of securities transactions when the broker-dealer provides DVP or RVP privileges to the customer. SRO confirmation rules also require the broker-dealer to have obtained an agreement from each customer with DVP/RVP privileges that the customer will affirm each trade promptly upon receipt of the confirmation.
- <sup>6</sup> Current procedures for setting up new brokerage accounts are triggered by the placement of an initial trade with the broker-dealer and in many instances are not completed on trade date. In addition, the information that broker-dealers need to collect, review and retain when they set up a new account has increased since the enactment of the Patriot Act.
- <sup>7</sup> When a mutual fund places a large order or series of orders to buy or sell a security, pieces of the order(s) are executed over the course of the day at different prices. The broker-dealer then provides an average price for all of the trades executed in that security on behalf of the mutual fund that day. Currently, broker-dealers do not provide the average price until after 4:00 p.m. on trade date. Final trade allocations cannot be prepared and submitted by the mutual fund until the average price is received.
- <sup>8</sup> These include, for example, proposed new Rule 22c-2 under the Investment Company Act, which would require mutual funds to impose a two percent redemption fee on the redemption of shares purchased within the previous five days, proposed new Rules 15c2-2 and 15c2-3 under the Securities Exchange Act governing the content of confirmations and requiring point of sale disclosures, and proposed amendments to Rule 22c-1 under the Investment Company Act applying a “hard 4:00 p.m.” cut-off for processing mutual fund purchase and redemption orders.
- <sup>9</sup> Smaller mutual fund firms may rely more heavily on vendor solutions or service providers to achieve STP, as the costs to develop internal systems can be prohibitive. The availability of multiple vendor solutions would provide more flexibility to these organizations as they automate their confirmation and affirmation process.
- <sup>10</sup> The Concept Release requests comment on methods to facilitate the standardization of reference data and the use of standard industry protocols by broker-dealers, asset managers and custodians. The Institute supports the SEC’s continuing efforts to encourage interoperability, as interoperability

necessitates the use of standards, which, in turn, would promote more efficient and accurate processing.

<sup>11</sup> Other building blocks that the industry is currently working on include further automation of the securities lending recall process and the corporate action announcement process, which also will produce the benefits of increased efficiency and reduced risk.

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