

Chairman Laura S. Unger
February 16, 2001



Securities Industry Association

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February 16, 2001

The Honorable Laura S. Unger, Acting Chairman
United States Securities and Exchange Commission
450 5th Street, N.W.
Washington, D.C. 20549

Dear Chairman Unger:

I am writing on behalf of the Securities Industry Association's T+1 Steering Committee to review some of the key changes in existing rules we believe must be addressed before implementing next business day settlement in United States ("U.S.") securities markets. We believe this initiative is imperative if the U.S. is to maintain preeminence in the global securities markets for years to come. Our June 2004 target date for implementing next business day settlement of securities transactions in U.S. markets is ambitious, but we believe it is achievable. We appreciate your support and the assistance we have received from your staff, particularly Annette Nazareth, Bob Colby, Larry Bergmann, Jerry Carpenter, and Jeff Mooney and hope we may count on the valuable expertise of your staff in the future.

We believe next business day settlement is an essential and cost-effective public policy goal. A study¹ commissioned by the T+1 Steering Committee concluded that next business day settlement will reduce financial risk in our securities markets and increase investor confidence and projected that it will provide long-term cost savings (about \$2.7 billion in annual pre-tax direct savings). As noted in the study, some of these benefits come from reducing the settlement cycle by two business days; other benefits would result from the changes in securities transaction processing necessary for efficient and safe operations in a next business day settlement environment.

Next business day settlement requires significant changes to existing market mechanisms and transaction processes. Although moving to three-day settlement in 1995 reduced the number of tasks to be performed in connection with settling a typical trade, the process has changed little since then. Too much time is spent each day by too many people addressing yesterday's trades, instead of focusing on today's and future activity. To achieve efficient T+1 settlement, unnecessary tasks must be eliminated and the remaining tasks must fit within available timeframes. While this is a challenge, we are prepared

¹ A copy of our study, *T+1 Business Case Model*, is available at:
http://www.sia.com/t_plus_one_issue/pdf/BusinessCaseFinal.pdf

to meet it.

Enclosed is a Schedule of T+1 Regulatory Changes² that identifies some of the rules and regulations that must be reconsidered or revised to accommodate next business day securities settlements, and other rules and regulations that might warrant reconsideration in a next business day settlement environment. Some of these items are discussed in greater detail below, several of which may require action by or coordination with other governmental agencies and self-regulatory organizations (such as the national securities exchanges and the National Association of Securities Dealers, Inc. (“NASD”) (collectively, “SROs”). We recognize that some issues may be controversial, raise implications for public policies, and/or warrant further debate. Prompt and decisive action, however, is critical.

I. Critical Items

We believe the following items are critical to successfully implementing next business day settlement in U.S. securities markets by June 2004.

A. Coordinate a Shorter Settlement Cycle (SEC Rule 15c6-1)

Rule 15c6-1 currently establishes three business days as the standard settlement cycle in U.S. securities markets. Amending this Rule to establish next business day settlement as the standard settlement cycle is critical to achieving next business day settlement. We encourage the Commission to publish such an amendment early this year and to consider adopting the amendment before December 31, 2001. We recommend that the amendment as published for comment become effective in June, 2004. As was the case with the adoption of Rule 15c6-1 in October 1993, effective June 1995, setting the date for conversion to next business day settlement with considerable lead time provides greater certainty given the significant investments that must be made in resources, systems changes, and staffing.

² The Schedule reflects the Committee’s efforts to identify from a wide spectrum of legal and regulatory requirements those provisions substantially affected by the proposed change in securities settlement timeframes. There may be other regulatory provisions that have not yet been identified and there may be others that will be affected by changes to existing laws and regulations in the course of moving to a next business day settlement convention. The Committee intends to update the Schedule periodically to reflect those provisions.

B. Require a Trade-Match Process

1. Institutional Trade-Matching

Institutions account for a significant percentage of average daily trading activity in U.S. securities markets. The typical institutional trade involves at least three parties: a money manager or investment adviser who decides how the institution's assets should be allocated and what securities to buy or sell; a brokerage firm to execute the resulting trades; and a custodian bank to hold the institution's assets. After placing a trade with, and receiving an execution report from, a broker-dealer, the investment adviser must tell that broker-dealer for whom the trade was effected (assuming the investment manager acts on the behalf of more than one client account). The investment adviser must, then, accept the execution report and instruct the custodian to release funds and/or securities to the broker-dealer. The broker-dealer must issue a confirmation in accordance with SEC Rule 10b-10, which in many cases requires the broker-dealer to know to whom the trade was allocated. Overall, the current allocation/confirmation/affirmation process will not measure up in a next-day settlement environment.

In particular, the process and timing of allocating trades among an investment adviser's accounts must be streamlined. Ideally, investment advisers should be required to participate in a trade-match system, much the way broker-dealers participate in such a system through exchanges,³ so trades are "locked-in" within minutes of an execution report. This would provide time to resolve trades the investment adviser does not know and for the custodian to anticipate customer trade and settlement activity for the next business day.

Unfortunately, no single agency regulates all the entities that make investment decisions for institutional investors. Some investment advisers are registered with the SEC, some are registered in their home states, and some are subject to regulation by the Department of Labor. Accordingly, we encourage consideration of rules that require:

- broker-dealers to obtain agreement from their customers, at the outset of the relationship or at the time of the trade, to participate in and comply with the operational requirements of interoperable trade-match systems as a condition to settling trades on a delivery-versus-payment basis. This might best be accomplished through rulemaking by SROs; and
- registered investment advisers to participate in and comply with the operational requirements of one or more interoperable trade-match systems when opening

³ E.g., the New York Stock Exchange's ("NYSE") Overnight Comparison System or the NASD's Automated Confirmation Transaction system.

an account at a registered broker-dealer on behalf of a managed account and when executing a trade in such securities for a managed account. Although such a rule would not address all institutional trades because not all investment advisers are registered with the Commission, it would cover a substantial percentage of daily trading volume and establish a standard for the rest of the buy-side industry.

2. Fixed-Income Securities

The decentralized nature of the fixed-income securities markets represents an operational and organizational roadblock to efficient implementation of next business day settlement. Historically, these markets have relied on clearing corporations⁴ to provide centralized comparison of inter-dealer trades on an overnight basis. Those processes must be updated or restructured to provide real time comparison functions as soon after execution as possible. Accordingly, it will be critical to identify which systems and organizations will perform trade comparison functions for inter-dealer trades in these markets and mandate use of that system or systems through SEC or SRO rulemaking.

C. Revise the Prospectus Delivery Requirement

We need to reconsider the necessity of mailing to each purchaser a printed prospectus *before* settling syndicate trades. In many cases, it is not physically possible to generate a final, printed prospectus in sufficient quantities to dispatch a copy to each purchaser within 24 hours of pricing the offering.

We do not question the need for full disclosure as a predicate to investor decision making. Nonetheless, we believe new approaches to prospectus delivery should be considered, reflecting modern technology and widespread public acceptance of the Internet as a medium for accessing time-sensitive data. For example, one possible approach might be to adopt a rule under the Securities Act of 1933 to allow for “deemed delivery” of the final prospectus by filing with the SEC. This would be conditional on the managing underwriter posting the final prospectus to a Website it maintains, making copies of the final prospectus available free of charge upon request and notifying purchasers that they may obtain a copy free of charge upon request. Of course, other approaches might suffice.

D. Revise Secondary Trading in Initial Public Offerings

Consideration needs to be given on how to transition from syndicate settlements to secondary market trading of a security that has been the subject of an initial public offering. When it adopted Rule 15c6-1, the Commission recognized the special circumstances of settling an initial public offering and commencing secondary trading by

⁴ Clearing corporations include, for example, the Government Securities Clearing Corporation, the MBS Clearing Corporation, and the National Securities Clearing Corporation.

allowing an additional day to settle such transactions (see Rule 15c6-1(c)). We believe this flexibility should be retained in a next business day settlement environment.

II. Enhancements to Processing Securities Transactions

We have identified a number of regulatory initiatives or changes that would substantially enhance the efficiency of trade settlements or otherwise facilitate transition to a next business day settlement environment. These are identified in the enclosed Schedule of T+1 Regulatory Changes with priority codes of 2 and 3. A few examples are noted below:

A. Mandate New Issues in Book-Entry Form

During the last several decades the Commission has taken many critical and productive steps to encourage immobilization of securities certificates, significantly reducing the incidence of lost and stolen securities while facilitating unparalleled efficiencies in clearance and settlement of securities transactions. One such milestone was the development of automated links among, on the one hand, the recordkeeping systems maintained by transfer agents for corporate issuers and, on the one hand, the recordkeeping systems maintained by broker-dealers and banks for their customers. These automated links operate through a system established by the Depository Trust Company known as the Direct Registration System (“DRS”). Through DRS, a shareholder can direct, often with just a few phone calls, the movement of a securities position electronically from an issuer’s transfer agent to the shareholder’s account at a broker-dealer of their choice (“street name format”). DRS offers shareholders the convenience of fully-disclosed positions at the issuer or its transfer agent, as well as the convenience of book-entry transfer to a broker-dealer in the event the shareholder is inclined to sell his or her position or to consolidate his or her positions in one or more companies. The T+1 Steering Committee believes that consideration should be given to adopting a requirement under Section 12 of the Securities Exchange Act of 1934 (“Exchange Act”) requiring issuers who go public (or issue new classes of securities) after a future date (to be specified during the rulemaking process) to participate in DRS.

A few jurisdictions⁵ have not adopted the 1994 Revisions to Article Eight of the Uniform Commercial Code governing the transfer of investment securities. Also, some state corporate laws appear not to permit corporations organized under those laws to issue shares in uncertificated or book-entry form.⁶ Changing these laws will assure uniformity in all U.S. jurisdictions. Thereafter, consideration should be given to adopting a rule under Section 12 of the Exchange Act requiring issuers who go public after a future date (to be specified during the rulemaking process) to require issuance through DRS, bank, or street name format.

⁵ Of the 50 states, only South Carolina has not adopted the 1994 amendments. The amendments were introduced this year in the US Virgin Islands. See, www.nccusl.org/uniformact_factsheets.

⁶ See, Del. Code Ann. Tit. 8, Sec. 158(2000); LA. R.S. 12:57 (2000); W. VA. Code Sec. 31-1-87 (2000).

B. Amend the Timeframes for Turnaround of Items Presented for Transfer

The Commission has adopted rules regulating the time within which transfer agents must turnaround items presented for transfer. Although the Commission proposed to amend those timeframes in 1995 in connection with adoption of a three-business day settlement cycle, the Commission never took final action with respect to those amendments. We believe consideration should be given to the adoption of a next business day turnaround requirement for routine items, and that a specific timeframe for non-routine items, such as transfers involving securities subject to reorganizations and restricted securities, should be promulgated.

C. Encourage Electronic Payment

Banking payment systems that electronically move funds have the potential to significantly improve the speed and efficiency of payments in connection with securities transactions. Use of these systems will significantly facilitate efficient broker-dealer operations in a next business day settlement environment. The Committee believes more can be done to encourage brokerage firms and their customers to use electronic payment systems in place of paper checks and reduce the risk to brokerage firms using these systems. We have been working with the National Automated Clearing House Association to modify their Right of Return rule to reduce the credit exposure to broker-dealers inherent in that rule.

III. Rule Changes For Self-Regulatory Organizations

As you know, the Commission is responsible for overseeing the process by which each SRO promulgates policies and procedures (“rules”) that govern the trading and business activities of its members. The Schedule of T+1 Regulatory Changes identifies a variety of SRO rules we believe warrant re-evaluation in the event that securities markets migrate to next business day settlement. Some changes are critical for conversion to next business day settlement of securities transactions (priority code 1); other changes will substantially enhance the efficiency of trade settlements or otherwise facilitate transition to a next business day settlement environment (priority codes 2 and 3). A few examples are noted below:

A. Amend Default Contract Terms

Several SRO rules provide the terms of dealings among members in the absence of a specific agreement to the contrary. For example, NYSE Rule 64 specifies that, absent stated conditions, trading on the floor of the NYSE is “regular-way” or “for delivery on the third business day following the date of the contract.” These rules will need to be revised to reflect next business day settlement.

B. Revise Trade Comparison and Resolve Unmatched and Open Contractual Commitments

Some SRO rules establish time frames for comparing member trades and for the orderly buy-in and close-out of open contractual commitments. These rules will also need to be

revised to reflect next business day settlement.

C. Amend Trade Guarantee and Risk Management Rules

Some SRO rules establish the timeframes within which trades will be accepted for clearance and when the SRO's guarantee of a member's payment or delivery obligation attaches. Other rules establish mechanisms for protecting against or for allocating losses in the event of a member default or insolvency. Each of these will need to be reviewed in light of the changing time frames and risk profiles of a next business day settlement environment.

Because of the long lead times associated with the changes necessary to achieve next business day settlement, the SEC and/or other responsible agencies need to resolve these issues before the end of 2001. We look forward to meeting with you and representatives of other regulators and self-regulatory entities to discuss the next steps to be taken.

Sincerely,

Arthur Thomas
Chairman, T+1 Steering Committee

cc: Distribution

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The Honorable James E. Newsome, Acting Chairman, Commodity Futures Trading Commission
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