



**REMARKS OF
COMMISSIONER MARY L. SCHAPIRO***

**SECURITIES INDUSTRY ASSOCIATION
REGIONAL CONFERENCE**

CHICAGO, ILLINOIS

MARCH 20, 1991

***The views expressed herein are those of Commissioner Schapiro and do not represent those of the Commission, other Commissioners or the staff.**

**U.S. Securities and Exchange Commission
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**REMARKS OF MARY L. SCHAPIRO, COMMISSIONER
U.S. SECURITIES AND EXCHANGE COMMISSION**

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Thank you for giving me the opportunity to join you today. I would like to discuss the Group of Thirty recommendations and the Commission's views on those recommendations. More importantly, though, I have been here today to listen to what you have to say about these proposals, and to learn how they will affect your business and your ability to serve your customers.

First, I would like to describe what I mean by the "Group of Thirty proposals." As you already know, the Group of Thirty, an international collection of business and financial leaders, originally made nine recommendations for upgrading the clearance and settlement systems in each of the world's securities markets. Most of these recommendations -- such as rolling settlement, creation of a securities depository, and automated affirmation of institutional trades -- are already fixtures in the United States clearance and settlement system. To set the record straight, it is also worth noting that the Group of Thirty did not recommend, and the U.S. Group of Thirty Working Committee is not pursuing, the elimination of physical

certificates. Therefore, only two of the original nine G-30 recommendations -- settlement on the third day after trade date ("T+3") and use of same-day funds for settlement of securities transactions -- are still at issue in the United States today.

These two recommendations are an important part of the Commission's regulatory agenda. In addition to our broad statutory mandate to serve the public interest and to protect investors, Congress has specifically instructed the Commission to ensure safe, efficient, prompt, and accurate clearance and settlement of securities transactions. To do that, the Commission must ensure that the U.S. securities markets are strong and stable and that the clearance and settlement system is free of unnecessary risks and inefficiencies.

Unfortunately, recent events have demonstrated the underlying fragility of the clearance and settlement system. The Market Breaks of October 1987 and October 1989 and the events surrounding the demise of Drexel highlighted that, despite the many strengths of our securities markets, significant systemic weaknesses and vulnerabilities still exist in the clearance and settlement system. In today's market environment, for example, the value of securities positions can change suddenly enough, and drastically enough, to cause a series

of defaults on unsettled positions that could threaten any participant in the U.S. securities markets. And, because of the interdependence of financial intermediaries, the loss of funds or securities due from a defaulting financial institution, particularly a major market participant, could set off a chain reaction of defaults within the financial community.

As a result, the Commission believes that improvements in the clearance and settlement system must be achieved, and they must be achieved in the short term. Given that the securities industry's profitability has been especially poor in the last two years, we recognize and understand that firms are reluctant to incur the costs associated with upgrading the clearance and settlement system. However, we cannot afford to expose U.S. investors to the risk that flaws or inefficiencies in the clearance and settlement process might cause the failure of a group of financial intermediaries or even the entire financial system. We cannot afford to continue to go about our business with nothing more than a sigh of relief that we managed to survive recent events. We have learned that the seawalls in our clearance and settlement system are not yet strong enough to handle the really big financial storms, and we must strengthen those seawalls before the next storm hits.

The Commission's efforts to improve the clearance and settlement system have received support from other influential financial regulators. Treasury Secretary Nicholas Brady, Federal Reserve Board Chairman Alan Greenspan, and Federal Reserve Bank of New York President E. Gerald Corrigan have all agreed that the clearance and settlement system must be strengthened, and their agencies are also examining methods of reducing systemic risk.

One element of risk in the clearance and settlement system is the length of the settlement cycle. The longer the settlement period, the greater the risk to the financial system, both because there are more unsettled positions open at any one time and because each position is unsettled (and thus subject to the risk of adverse market events) for a greater length of time. Fast and final settlement could reduce that risk substantially. Settlement of transactions in same-day funds also would reduce systemic risk by eliminating the existing element of uncertainty between settlement and actual payment as to whether a final movement of funds will take place as scheduled. Implementation of the Group of Thirty recommendations thus would reduce risk in the clearance and settlement system by a substantial amount.

As you probably know, the Group of Thirty U.S. Working Committee, after many months of hard work, has developed recommendations for attaining these two goals. The members of that Working Committee, and those of you who provided data or support to the Working Committee, deserve our thanks and our gratitude for the effort that was put into the Working Committee process.

The Working Committee's efforts culminated in an SEC roundtable, held last November, to discuss the Working Committee's recommendations as well as alternative ways in which we might improve the clearance and settlement system. The Roundtable discussion demonstrated that there is significant support across a broad spectrum of industry participants for implementing the Group of Thirty proposals. Indeed, at the end of the Roundtable, Chairman Breeden took a straw poll of all of the participants and all of the members of the audience as to whether we should continue to move forward toward implementation of these proposals. The consensus was virtually unanimous that we should continue to move forward.

However, the Roundtable discussion also proved that, despite outward appearances, shortening the settlement cycle by two days

and converting to the use of same-day funds will be no simple task. The changes contemplated by the Group of Thirty proposals will affect all participants in the U.S. securities markets and force them to modify their current settlement practices. These improvements also are going to cost financial intermediaries real money, in terms of operational changes and loss of float.

For example, most institutional investors currently are required to use automated clearing agency facilities for the confirmation and affirmation of institutional trades. Such automated systems permit institutions to settle these transactions through automated clearing agency systems on T+5. A move to T+3 settlement will force institutional investors, their brokers, money managers and custodians to confirm and affirm these securities transactions on an expedited basis. The clearing agencies who operate the automated confirmation and affirmation systems also will be required to make changes to their systems to accommodate the earlier settlement time frames.

Retail firms and retail investors also will be affected by the Group of Thirty proposals. Indeed, some representatives of retail firms have expressed serious reservations about the potential effects

of the Group of Thirty proposals. They have suggested that these proposals are prohibitively expensive, and that they will adversely affect retail customers. Of course, such criticisms depend on the particular approach taken to implementing the G-30 goals.

The Commission is aware of these concerns, and we take them seriously. Retail broker-dealers perform a critical role for our capital markets in general, and our securities markets in particular. Retail brokers, large and small, are the vital link between the U.S. securities markets and the investing public. The network of regional broker-dealers has contributed greatly to the breadth and depth of retail investor participation in our securities markets, which is one of the great strengths of the U.S. financial system. We do not want to interfere with your ability to serve your customers or, equally importantly, with their ability or desire to participate in the U.S. securities markets.

I believe, however, that we can shorten the settlement cycle and thereby reduce risk in the clearance and settlement system without such adverse effects. Certainly, we all recognize that retail investors would be poorly served by preserving a system that incorporates an excessive and unnecessary element of risk. Developing a safe and

efficient clearance and settlement system is one aspect of preserving investor confidence and investor participation in the markets.

Implementation of the Group of Thirty proposals will make our clearance and settlement system faster and more efficient and will make our securities markets safer for retail and institutional investors alike. Therefore, I believe that retail customers will be better off as a result of implementation of the Group of Thirty proposals.

Furthermore, I do not believe that shortening the settlement cycle will drive retail investors from our nation's securities markets. There is no particular magic to settlement on T+5. Indeed, retail customers already accept shorter settlement periods on some transactions -- on money market funds, on purchases of many mutual funds not through a broker-dealer, on purchases of options, and on dividend reinvestment plans. Furthermore, as many of you know, prior to 1968, equities transactions in the United States were settled on T+4 or earlier, without causing undue harm to retail customers.

It is even possible that many retail customers may benefit from compacting the settlement cycle. For example, with a shorter settlement cycle, retail investors will receive proceeds when they sell securities two days sooner than under the present system.

That is not to say, however, that retail firms do not have real and legitimate concerns about the effects of the proposed changes in the clearance and settlement process. From conversations I have had with some of you, I believe that the overriding concern seems to be that brokers will not receive payments from retail customers in time to make settlement on T+3. Under current practice, retail customers are accustomed to taking full advantage of the current five-day settlement cycle. In many cases, retail investors only mail a check to their broker-dealer after they have received a trade confirmation ticket. Some of you fear that brokers will incur significant financing costs because of the delay in receiving customers' payments beyond T+3. Another, lesser concern is that retail customers who choose to hold securities in physical form will be unable to get their certificates to their brokers before settlement day in a T+3 environment. Finally, some of you think that any change in the way retail customers are required to do business will be perceived as disadvantageous to them and will discourage them from the securities markets.

The Commission is committed to finding ways to address the problems that retail firms will face as we implement a T+3 settlement

period. We recognize that, given the current state of technology and systems within the securities industry, immediate implementation of the T+3 and same-day funds proposals might be difficult for some industry members and their customers. Therefore, Chairman Breeden at the Roundtable asked Howard Shallcross of Merrill Lynch to form a committee of large and small retail firms, including regional firm representation, to investigate the problems that implementing T+3 settlement will create for retail firms and to find solutions to those problems. We expect that committee to submit a report of its findings within the next month or two.

The Shallcross committee's prime task has been to identify better ways of getting retail customer payments for the securities they have purchased to the broker-dealer by the settlement date. As we all know, if a customer waits receive a confirmation through the mail before sending the broker-dealer his or her check, there is little chance that the check will be at the broker-dealer, much less cleared, by T+3. Therefore, I hope that the Shallcross committee will be able to recommend ways of getting customers to pay for securities prior to receiving a confirmation ticket, as well as ways of speeding up the payment process.

In comparison, the delivery of certificates to the broker-dealer in connection with sale transactions appears to be a minor problem. Preliminary surveys indicate that as many as 90% of all certificates are already in by T+3. Indeed, some broker-dealers have told us that the delivery of certificates is no problem at all, because the vast majority of customers have a great deal of incentive to send in their certificates -- they want the proceeds from their sales as quickly as possible. If our impression on this subject is incorrect, I hope that you will let us know, and that you will provide us with hard statistics.

As a result, I am very hopeful that the Shallcross committee will come up with answers that can help us overcome the retail obstacles to T+3 settlement in same-day funds. Nevertheless, we cannot lose sight of our primary goal, which is to reduce systemic risk. Accordingly, the Commission will not be satisfied with assertions that the retail problems are simply intractable. Solutions must be found, and they will be found, so that we can proceed together to strengthen our clearance and settlement system.

In this vein, I hope that every regional firm represented in this room will lend support to the implementation effort. Improvements to the clearance and settlement are essential to the long-term stability of

the U.S. securities markets, and they are going to happen. Therefore, I ask that each of you work with us and with the various industry committees to find the most efficient, least expensive, and least disruptive path toward these goals.

Toward that end, I hope that we can stop wasting time and effort debating the elimination of certificates. Let me put it plainly -- the elimination of certificates is no longer part of the G-30 agenda, and it simply isn't going to happen. With that said, I hope that we can put the question of certificates aside for now and that we can start focusing our energy on the real issues involved in making T+3 settlement in same-day funds a workable reality.

Finally, let me say a word about a subject that is near and dear to many of your hearts -- direct registration. As you have heard, the Commission is strongly in favor of the development a system that would allow individual investors to hold their securities in electronic form without putting those securities in street name at a financial intermediary. Such a system would allow an investor to sell securities through the broker-dealer of his or her choice, without the hassles involved in transferring a brokerage account. Securities held in such a book-entry system also would not be subject to the risk of

broker-dealer insolvency. At the same time, the costs of book-entry ownership would be much less than the costs of safekeeping physical certificates or replacing them if they are lost.

Despite our support for the concept of a book-entry system, however, no one has yet developed a workable industry-wide approach. More importantly -- and I guess that it needs to be repeated, since the certificate will remain a part of the system -- there is no need to have such a system in place prior to implementation of T+3 settlement. Therefore, the Group of Thirty U.S. Working Committee has recently decided to delink efforts to develop a system of book-entry records of ownership from its T+3 recommendation. The Working Committee will continue its efforts to develop a viable book-entry system, but that system will stand or fall on its own merits, regardless of what happens to the T+3 recommendation.

In closing, I want to re-emphasize that I believe that T+3 settlement and use of same-day funds for securities settlements will be implemented in the U.S. markets. I believe that the Commission and Federal Reserve will continue to view final settlements in a shorter time period as an important way to reduce the systemic risk that is so much on our minds. I am confident that the Commission

can and will develop an implementation program for the Group of Thirty proposals that minimizes any potential disruption to any segment of the securities industry, and in particular to retail firms and their clientele. And I will go even further and predict that, as advances in technology permit, the settlement period will be shortened even beyond T+3 in the future, with the ultimate goal being final settlement on trade date.

Your participation in the implementation process, however, is necessary to make sure that the concerns of retail firms are addressed fully prior to implementation. I hope you will continue to work with us constructively in this process, because I believe all participants in the U.S. securities markets will be better off as a result.