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Remarks to

The Group of Thirty U.S. Steering Committee

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REMARKS TO THE GROUP OF THIRTY U.S. STEERING COMMITTEE  
BY MARY L. SCHAPIRO, COMMISSIONER  
U.S. SECURITIES AND EXCHANGE COMMISSION

I appreciate this opportunity to speak to you today. On behalf of Chairman Breeden, let me extend his apologies for being unable to be here and assure you of his support of the Group of Thirty initiative.

As we look back on the past decade, it is obvious that the world today is a very different place than it was ten years ago, five years ago, or even one year ago. During that time, the political and financial landscapes have changed completely. On the political front, there has been a fundamental realignment of the traditional East versus West mentality as democratization has swept through the Soviet Union and Eastern Europe. At the same time, the European Community has taken major steps toward eliminating all internal trade barriers by 1992, and East and West Germany may unify their currencies as well as their political systems in the near future.

These events have been accompanied by equally significant developments in the world's financial markets. First of all, the emerging democracies in Eastern Europe have begun to establish and expand securities markets, which will lead to a corresponding increase in worldwide demand for capital as these economies start to absorb investment funds from around the world. Furthermore, as cross-border securities activity has grown, national boundaries have become increasingly irrelevant. For example, during the 1980s, the gross purchase and sale of U.S. securities by foreign investors grew by a factor of almost 20, while the portfolio

activity of U.S. investors in foreign stocks increased by a multiple of eight. At the same time, the world's financial markets have become increasingly interdependent, with events in one market having ripple effects across the globe.

As a result of these developments, regulators must devote increased attention to the international aspects and operations of markets. In response to the challenges of the 1990s, the ultimate goal of the world's major markets should be to promote simultaneous access by issuers and investors to the world's capital markets. Issuers should be able to proceed simultaneously with offerings to investors around the globe, using a single disclosure document. Similarly, investors should be able to participate fully in, and receive full benefits from, securities investments, regardless of the home of the issuer and the investor. Perhaps most importantly, regulators and securities industry participants must act cooperatively to ensure market stability. In no area is the urgency of this task greater than the effort to reduce risks and enhance the efficiency of international clearance and settlement.

Accordingly, I believe that the Group of Thirty recommendations provide a critically important framework for upgrading and harmonizing clearance and settlement systems in both fully developed and emerging markets. The Securities and Exchange Commission strongly supports these efforts by the Group of Thirty. As the Group's Report recognizes, clearance and settlement is not a glamorous topic. Nevertheless, the importance of efficient and safe clearance and settlement systems cannot be overstated. As the

experience of the last three years has demonstrated, weaknesses in the clearance and settlement system can create major risks for the entire global financial system. Improved and coordinated global clearance and settlement procedures will make our markets more efficient while reducing the risks that firms must undertake, thereby improving the growth and stability of the world's financial markets.

The Commission supports the work of the Group of Thirty in particular because we believe that, in the first instance, initiatives to upgrade the world's clearance and settlement systems should be undertaken by industry members and not by government regulators. Indeed, private industry has taken and should continue to take the lead in developing safe and efficient clearance and settlement systems for international markets. At the same time, however, the Commission, pursuant to its mandate under the Securities Exchange Act to foster prompt, safe, and efficient clearance and settlement, actively will monitor and, where appropriate, support progress in this area.

The Group of Thirty is now entering the most exciting phase of its project, the implementation phase. All of the work that has been done brings us to the point where we can finally discuss as a practical matter how we should go about upgrading clearance and settlement systems in the United States and the world to conform to the Group of Thirty's standards. Although the Commission and other regulators around the world will of necessity be taking a more active role in these matters as the focus shifts to

implementation of the Group of Thirty's recommendations, we look forward to working with you during this process and we are prepared, in cooperation with this group and others, to facilitate the implementation process when necessary.

#### The Implications of the Collapse of Drexel Burnham Lambert

Before turning to the specific G-30 proposals, however, it is important to underscore that a safe and efficient clearance and settlement system is built on a platform of financially responsible participants coupled with effective and secure methods of obtaining financing. In this connection, the recent events concerning Drexel Burnham Lambert Inc. highlight a variety of issues which have been of ongoing concern to the Commission.

At the most general level, the Drexel situation is only the most recent and most dramatic example of why the Commission believes there is a need to assess the risk of broker-dealer holding companies. Even the most sophisticated risk control procedures at the clearance and settlement level will be sorely tested by the collapse of a major money-center institution. Thus, in the first instance, we must endeavour to ensure that effective internal controls and risk management procedures are in place at the participant level.

Notwithstanding such controls, however, firms (even large firms) still may fail or encounter financial stress. Here too, Drexel is an example of what more can be done. Throughout the last several weeks, as most of you are aware, (1) Drexel was required

to surrender excess collateral to bank lenders and control of that collateral on an intra-day and overnight basis, (2) Drexel was unable to conduct business under routine business conventions and (3) counterparties were unwilling to deal with it. In part, these difficulties reflected uncertainties in state commercial law regarding pledge agreements; in other situations, they demonstrated the potential for a creeping gridlock in the settlement process.

In any case, these difficulties reaffirm the need for the market reform legislation proposed by the Commission after the 1987 crash. We need to strengthen the authority to facilitate a coordinated clearance and settlement system. We need the authority to clarify, where necessary, commercial law requirements to facilitate an efficient clearance and settlement process. To the extent that it is possible to achieve these results through private action, such as the Haydock Group, an advisory committee of the American Bar Association, the Commission welcomes these efforts. The way in which the result is reached, however, is not as important as that it be reached, and that it be reached quickly.

#### The Group of Thirty Report

Let me turn now to the specific recommendations of the Group of Thirty Report. As you know, the United States markets are already structured to comply with most of the Group of Thirty's recommendations. In addition, substantial progress has been made and will continue to be made this year in satisfying the Group's first recommendation, that trade comparisons be accelerated to the

day after the trade date, T+1. The remaining recommendations, which may require significantly greater efforts, are the settlement of trades by T+3 and the use of same day funds for settlement. Our ability, in a globally interconnected environment, to reduce risk is dependent in large part on our success in moving toward these goals.

#### T+3 Settlement by 1992

The Group of Thirty Report recommends that all trades be settled by the third day after the trade date, T+3. The Commission agrees with the Group of Thirty that shortening the settlement period could have a substantial positive impact in terms of reducing risk in the clearance and settlement system. A shorter settlement time period will reduce the number of outstanding trades, thereby reducing the counterparty risk and market exposure associated with unsettled securities transactions.

In order to achieve harmony with the Group of Thirty's recommendation to move to a T+3 settlement period, however, the U.S. markets need to shorten their current settlement cycle by two full days. The U.S. Working Committee's recent report on this subject preliminarily concluded that eliminating physical certificates in stock transactions is a necessary prerequisite to moving to T+3 settlement in the U.S. That view is based on a review of the current, varied settlement practices in two segments of the industry -- the institutional market and the retail market.

On the institutional side, a majority of transactions currently settle in automated, book-entry form at the securities depositories. The major obstacle to T+3 settlement for institutional trades, therefore, occurs in the current methods of trade confirmation and affirmation with institutional customers that precedes such book entry settlement. Currently, self-regulatory organization rules require that institutional clients who desire delivery- or receipt-versus-payment privileges must participate in trade confirmation and affirmation systems operated by the securities depositories, such as the National Institutional Delivery System ("NIDS"), managed by the Depository Trust Company ("DTC"). To accommodate an earlier settlement period, NIDS would need to be changed to an intra-day, interactive trade confirmation and affirmation system. Procedures and rules must ensure that an acceptable percentage of transactions are processed through this system and that sufficient resources are available to enforce compliance with the system.

On the retail side, the problems are more difficult. A retail transaction may involve physical presentation to the broker, often through the postal system, of the certificates to be sold. Moreover, customers often wait to receive confirmation of the transaction before mailing their payment checks to the broker. This reliance on the postal system, and other inherent delays in the procedures for retail transactions, led the U.S. Working Group to conclude that settlement on T+3 is not possible for the retail sector of the business without the dramatic change of taking the

certificate out of the system.

As you know, the Commission has addressed the question of eliminating stock certificates before. As part of our efforts in the 1980s to immobilize stock certificates in securities depositories, we began to explore the many issues raised by moving to a certificateless system. At that time, the Commission encountered significant resistance to its efforts. Some individual investors regard the ability to obtain a paper certificate as an important incident of securities ownership, and they will need to be convinced that sacrificing their certificates will not disadvantage them.

As a result of the Commission's experience during that process, we believe that a number of steps would need to be taken if certificates are indeed to be dematerialized or immobilized as part of the industry's efforts to achieve settlement by T+3. First, if investors are to be asked to give up their certificates, the industry must establish a workable system for custody and money transfer that is acceptable to individual investors. Direct registration of ownership interests, in a system that is either centralized (similar to the current Treasury Direct system for government securities) or decentralized among transfer agents but tied to securities depositories, should be considered seriously, and questions as to who will pay for the start-up and maintenance costs of such a system must be answered. As a corollary to this effort, there would be a need for an extensive educational program to persuade investors that they will not be harmed by the loss of

the ability to obtain paper certificates. In addition, the industry would need to take steps to protect the ability of issuers to have open channels of communication to their shareholders.

Government initiatives would also be necessary. There would need to be changes to some state laws concerning the physical issuance and custody of certificates. The ambiguities created by the lack of adoption in some states of the 1977 amendments to the Uniform Commercial Code concerning the transfer and pledge of uncertificated securities would need to be resolved. In this regard, the Commission's market reform proposal currently pending before Congress would give the Commission authority to adopt rules concerning the transfer and pledge of uncertificated securities, and to override state law (after consulting with the Federal Reserve Board and the Treasury and after considering the views of an advisory committee) to the extent necessary to promote safe and efficient clearance and settlement of securities transactions. Federal level changes, too, would be needed, such as the Commission's own rules governing the confirmation of transactions, and customer margin rules that are promulgated by the Board of Governors of the Federal Reserve System.

You have identified the important issues and created the momentum for change. It is now incumbent upon all segments of the U.S. securities industry and the Commission to devote careful thought and attention to these issues. If you find that it is necessary for the Commission to become more actively involved in this area and to take a leadership role in studying whether the

elimination of certificates is feasible, and in exploring various options, the Commission stands ready to do so.

#### Same-Day Funds Settlement of Securities Transactions

The Group of Thirty Report also recommended the adoption of a same day funds convention for settlement of securities transactions. Adoption of same day funds settlement would increase the efficiency of the accounting and payments systems, and may reduce risk, especially if all markets are consistent in their use of same day funds settlement. As a result, most industry participants, including a joint committee of the American Bankers Association ("ABA") and the Securities Industry Association ("SIA") that studied the issue in 1985, agree that settlement in same day funds should be the industry's long-term goal.

Nevertheless, same day funds settlement raises a host of complex questions, and the transition to same day funds may not be an easy one. Perhaps in recognition of the structural and operational difficulties of complying with the recommendation, the Group of Thirty did not recommend a target date for adopting the same day funds settlement convention.

The Working Committee has also recognized the benefits of same day funds settlement, but has recommended that a rigorous study of the issues be conducted before a definitive implementation schedule is established. The Commission agrees with these conclusions. We support the Working Committee's efforts to study ways in which to implement the same day funds recommendation, giving due

consideration to the factors noted and others that may yet be uncovered; and we will work with the Working Committee to complete the necessary study as swiftly as possible. It is our hope that, if insurmountable obstacles are not discovered, the Working Committee will be able to establish a reasonably prompt implementation schedule that is acceptable to industry members as well as individual customers.

### Conclusion

The Group of Thirty's efforts to establish universal principles for upgrading the world's clearance and settlement systems, in both established and emerging markets, are critically important to the long-term stability of the world's financial markets. The Commission strongly supports the Group's accomplishments as well as the work of the U.S. Steering and Working Committees to apply these general principles to the specific facts of the United States. Your efforts have focused the issues and developed broad support for the Group of Thirty's principles. The Commission applauds these results, and we hope that you will continue to work to make all of the Group of Thirty's recommendations a reality in the U.S. markets, so that the U.S. markets may continue to lead by example and to provide the safest, most efficient clearing and settlement systems in the world.