



Request for Comment

SEC Concept Release

Securities Transactions Settlement

March 16, 2004

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

Dear Mr. Katz:

Re: Concept Release: Securities Transactions Settlement
[Release No. 33-8398; 34-49405; IC-26384; File No. S7-13-04]

BMO Financial group appreciates the opportunity to comment on the SEC STP Concept Release: Securities Transactions Settlement dated March 16, 2004.

BMO Financial Group is a highly diversified financial services provider. It offers clients a broad range of personal, commercial, corporate and institutional financial services across Canada and in the United States through [BMO Bank of Montreal](#), [BMO Nesbitt Burns](#), [Harris Nesbitt](#) and its Chicago-based subsidiary, [Harris Bank](#).

BMO performs a multitude of roles in the securities marketplace including that of broker dealer, investment manager and custodian. As such, it is well positioned to comment on the SEC Concept Release dealing with Securities Transactions Settlement published on March 16, 2004.

BMO is supportive of a Commission rule mandating matching on T+0, which should be accompanied with clear roles and responsibilities for participants. In light of the limited progress the industry has made to date, BMO is in favor of phasing in matching on T+0 but at an accelerated pace. BMO is not supportive of mandating participant use of a matching utility and believes that participants should be able to utilize technologies and processes suitable to their business model and size.

BMO is supportive of full dematerialization but not immobilization, which we believe would perpetuate inefficiency.

BMO believes that the Commission should introduce a rule to advance the settlement cycle to T+1. This would remove systemic risk from the system and enable clients to have accurate information about their assets with finality the next trading day.

BMO strongly encourages the SEC and CSA to align matching and settlement rules.

BMO offers the following additional comments on the SEC STP Concept Paper.



Trade Confirmation and Affirmation:

1) What are the benefits of same-day trade confirmation and affirmation?

As per published SIA STP white papers, BMO believes that same day confirmation/affirmation will reduce systemic risk and permit debits and credits to be realized in a timely fashion for brokers and clients. It will also result in the equities and fixed income marketplaces harmonizing with derivatives, money markets and the banking industry. These markets have been processing securities transactions on T or T+1 for years with complete acceptance by the client community.

2) What are the relative burdens of trade date confirmation/affirmation?

The burdens and benefits will be relative to the business model and technology solutions adopted by the participant.

It is essential that all participants (investment managers, broker-dealers and custodians) comply with the same goal of matching on T and with the relevant sections of the ITP Code of Practice dealing with electronic counterparty communications conforming to the specified ISO 15022 data elements. For some, this may be considered a burden, for others an opportunity. As long as all participants have the same goal and are subject to the same rule, it will be a level playing field.

3) What effect would trade date confirmation/affirmation have on the relationship between and broker-dealer and its customer?

Until an industry matching rule is introduced (for Canada and the US), with clear roles and responsibilities defined, the relationship between the broker-dealer and customer will continue to be one of a waiting game with only gradual progress towards this goal. The broker-dealer is unlikely to put pressure on its client to introduce optional systems to promote STP since it would put them at a disadvantage to their competitors. In addition, the broker-dealer is finding it increasingly difficult to recover these investment dollars as clients put downward pressure on commissions believing it costs less for the broker-dealer to process STP trades.

Introducing matching rules will make the evolution to STP and readiness for T+1 more palatable and easier to promote.

4) Do benefits of trade date affirmation/confirmation accrue to all participants – brokers, institutional customers, custodians or matching utilities? Do they accrue to large, medium, and small entities?



The current SIA ITP model appears to benefit matching utilities and custodians over of the investment manager and broker-dealer. Based on BMO experience, current marketing efforts of Omgeo have been to encourage the custodians to “white label” their matching applications at no cost to the investment managers. This does, however, represent additional costs to the broker-dealer that may not be recovered.

The introduction of technologies or utilities to the trade and settlement process should eliminate costs not add to them. Although broker-dealers, investment managers and custodians are currently required to have connectivity with DTC, if connectivity with a matching utility service is mandated then there will be net new costs to support STP trade processing. Communication requirements, system interfaces and application costs are expected to increase. Of particular concern are the transaction costs levied by the MU, service bureau and DTC with intra day processing through a matching utility service. Since these charges are transaction based with no trade compression benefits¹, the cost impact of a matching utility could be significant.

Given the low level of adoption of a central matching solution by all sizes of investment managers and broker-dealers to date, it would appear as though the costs of matching utilities out-weigh the benefits.

While the perception may exist that only the small players will find the costs associated with central matching onerous, all players, regardless of size, are concerned about the cost to trade, clear and settle transactions.

5) Does trade confirmation/affirmation introduce any new risks? If so can they be quantified?

No.

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 rules changes?

A Commission rule is considered the most effective and expeditious approach to ensuring industry matching on T+0 in a timely fashion. It is unlikely that SROs would be able to introduce coordinated rules and policies that would ensure STP compliance without gaps or overlaps in time to meet the SIA industry target of a mid 2005 implementation. BMO is concerned that without Commission involvement, the industry will continue to move toward a soft date that will ultimately cost the industry unnecessary effort and expense.

¹ Trade compression benefits exist when trades for the same security, same side and price are grouped together for pricing.



BMO believes that a matching rule should also contain clear participant roles and responsibilities for matching. For ITP, BMO believes that responsibility for trade execution and delivery of NOEs rests solely with the broker based on orders received from the investment manager. NOE information includes ISO 15022 compliant data elements containing broker-dealer trade and settlement information². Based on the NOE, the broker-dealer and the investment manager would address errors and exceptions³ before allocations are sent out. Since the investment manager is the **only** party to determine how trades are to be allocated and settled it should be the sole responsibility of the investment manager to ensure trades are matched **prior** to communicating allocation information to the brokers and custodians.

7) If rules mandating trade confirmation/affirmation are adopted, what should be the time frame for implementing them? What factors should the Commission consider in determining the implementation period?

BMO acknowledges that the industry is not moving at a pace that would allow it to meet the original 2005 STP implementation target of 100% matching on T+0. BMO supports phasing in matching on a fairly tight implementation schedule that builds on current matching rates. If progressive increases are established on a quarterly basis then the industry would progress faster and be in a better position to understand why trades aren't matching since all participants would be matching based on a clear rule.

Based on information publicly available, the U.S. STP infrastructure will be in place in 2004. Participant connectivity will then be a matter of budget and scheduling with a third party vendor for connectivity to DTC and its STP hubs.

BMO believes that if a Commission rule is introduced and well defined roles and responsibilities that are communicated to the industry then a phased in approach would have a greater likelihood of success.

As with the SEC and SRO audit trail requirements, the rule should specify the specific data elements necessary for matching and settlement.

It would be beneficial if the Commission identified those countries that are moving towards STP and/or an advanced settlement. This will allow firms to understand where they are in relation to global marketplaces. For example, Canada's STP program is aligned with U.S. program and has proposed NI 24-101 for trade matching on T+0. The U.K. has introduced Crest Settlement as a mechanism to promote timely settlement.

² The SIA Code of Practices identified ISO 15022 data elements of which a subset is the sole responsibility of the broker to provide.

³ Exceptions and errors could be handled intraday with or without the use of a matching utility.



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?

Yes. BMO strongly encourages the SEC and CSA to introduce and align matching on T+0 rules.

Currently, over 20% of BMO's trading business is comprised of cross border trading which involves equity and fixed income trading with FX processing and end-of-day file transfers of US trading to ADP Canada, BMO's official Book-of-Record. If the regulators align rules for matching on T+0 it will ensure efficient and cost effective processing by service bureaus and depositories that support cross border trading.

Yes, all types of non-exempt securities should be included.

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?

No, use of a matching service should not be mandated. Third party technology vendors are now coming to market with STP solutions. It is anticipated that with the publication of the SEC STP Concept Paper and the CSA proposed NI 24-101, more vendors will commit financial resources to research and development now that there is a clearly defined goal.

BMO is not supportive of the regulators mandating how a rule is to be met or what technology or business processes are used to meet that rule.

Small participants may not have sufficient order flow to justify the cost of using a matching utility service to support trade matching and they should be able to meet the target using existing or modified systems or processes. Mandating use of a matching service utility would put negative pressure on the profitability and business model that a firm chooses to employ and discourage technology innovation.

Matching on T can best be accomplished by mandating what is to be performed, not how it is to be performed.

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?

The greatest challenge participants face in the processing of trades is incorrect or incomplete data. As with the SEC and SRO audit trail requirements, the rule should identify the specific ISO 15022 data elements that participants are required to conform to for counterparty communications. Currently there is no requirement that a participant adopt the SIA Code of Practice, which are guidelines for the industry to follow.



Specific input on Securities Settlement Cycles:

- 1) Should the securities covered by Rule 15c6-1 be expanded? If so, what securities should be added?**

No. These securities covered under 15c6-1 are appropriate. They should maintain alignment with the CSA proposed NI 24-101.

- 2) Given the increase in cross border transactions and dually-traded securities over the past eight years, are the conditions set forth in the Commissions exemption order for securities traded outside the US still appropriate? If not, why not? If an exemption should be modified, how should it be modified?**

BMO is of the view that the current exemption does not need to be modified at this time. There is no compelling requirement to make changes since retail and institutional clients are able to trade in any global marketplace either through their global trading operations or through counterparty arrangements.

- 3) Are the conditions set forth in the Commission's exemption order for variable contracts still appropriate?**

No position.

- 4) If the Commission were to mandate a settlement cycle shorter than T+3, should the Commission shorten the settlement cycle for firm commitment offerings priced after 4:30 p.m. EST from T+4 to T+3 or T+2?**

BMO believes that new commitment offerings should settle on the same cycle as secondary market securities. The credit exposure for new commitment offerings is different since the broker cannot make the client pay for these securities ahead of time. If the client reneges on the purchase then the exposure goes back to the broker's balance sheet. Aligning the settlement cycle with secondary market trading would reduce this exposure.

- 5) How would a shortened settlement cycle affect processing of newly listed securities?**



If the industry moves to a shortened settlement cycle and stays with certificated trading then it would negatively impact market efficiency. Delays through manual processing and additional costs would result. Introducing electronic access to prospectuses and certificateless trading would improve the timeliness of processing client transactions and expand the reach of information via the Internet. Shortening the settlement cycle should motivate participants to further move to non-physicality. Once this occurs, savings should make their way up the chain as a savings to the customer.

6) What system and operational changes would be necessary in order to settle newly issued securities in a shortened settlement cycle?

It is essential that physical delivery by the issuer be eliminated. Credits need to show in DTC on the same night using electronic record keeping. If this operational change is not made then delays in crediting accounts at DTC will continue.

If the settlement cycle were advanced to T+1 then corporate actions events would need to be provided in advance of T+0 to ensure accurate and timely calculation of NAV. This will require new timings for availability of information and standards that apply to issuers, custodians, dealers, fund companies, investment managers, etc.

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 pre-requisite for shortening the settlement cycle beyond T+3?

No, although the level of non-matched trades must be reasonably small (less than 5%). BMO suggests that participants be required to report to DTC (either directly or through a third party) the reason why trades did not match. This will enable DTC, and the industry, to monitor the types of issues that are impeding matching on T. New reason codes may need to be developed to support this suggestion. As noted above, if progress targets are set and measured against a rule then the industry will be better able to understand impediments and address them in a timely fashion.

b) If so, what are the additional costs of shortening the settlement cycle after achieving 100% confirmation/affirmations or matching on trade date?

It is anticipated that there will always be justifiable reasons why trades cannot be matched or settled on time. The UK, with its Crest Settlement Discipline and Matching Rules, has been able to successfully introduce incentives for timely settlement through substantial penalties that are applied to participants that do not meet depository settlement targets. DTC (and Canada's CDS) should adopt similar incentives.



8) What parties should 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)?

All parties should bear a proportional cost of advancing the settlement cycle based on a competitive environment where the Commission does not dictate *how* a participant should meet a target. An open environment will promote survival of those participants who compete based on sound technology and business decisions.

9) What are the benefits of shortening the settlement cycle beyond T+3? Are there economic benefits in terms of reductions in credit and liquidity risk associated with shortening the settlement cycle beyond T+3?

Apart from those benefits already outlined in SIA White Papers, it is important that the SEC make a clear and definitive decision regarding its intention to require matching on T+0 and or advance the settlement cycle. A tremendous amount of resources have been expended to date to analyse this issue without industry conformance to industry standards and codes of practice. There will always be issues that distract participants from investing in change. If the Commission is serious about promoting these changes and eliminating systemic risk from the system then it should assist the industry with rules to that end. This ensures that all participants take the issue seriously and invest the resources towards a common deadline.

10) Who will benefit from shortening the settlement cycle beyond T+3 (such as broker-dealers, investment managers, custodians, investors and other market participants)?

Ultimately, the end client will benefit since it will have an accurate and timely record of its assets and net worth in near real time and be able to access its assets on T+1. Advancing the settlement cycle closer to the trade date permits the client to have certainty of his net worth and be able to access it. In addition, the client, broker dealers and custodians do not bear the systemic risk of delays in settlement for trades that are matched or locked-in at an exchange on T+0.

11) How would shortening the settlement cycle affect efficiency and risk?

One of the lessons learned from 9/11 is that there are immense costs associated with incurring a disastrous event within a 24-hour period. Anytime there is an unsettled item and an event occurs, the risk is greater than the dollar value of the trade itself. Legal fees from lawsuits, public relations damage, reputation, etc., all compound the costs of the



unsettled trade. Efficiency and risk would be enhanced, as risk would be reduced as manual processing is significantly reduced and risk is limited to a 24-hour period between trading and settlement.

12) How would shortening the settlement cycle affect the information, benefits, and protections that investors have under present U.S. clearance and settlement arrangements?

Customer information access would be improved with real or near real time delivery of information. Individual bankruptcy will be identified within 24 hours and counterparty exposure to credit risk or bankruptcy would be reduced significantly.

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?

Accelerating the point in time for finality of a transaction through the removal of manual processing and paper enhances the certainty of finality. DRS for issuer records provide that certainty of finality of data since identification of the client or owner (name, address, etc.) is available in the DRS systems⁴.

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?

Currently DTC and CDS have systems and timings that are integrally linked for trading and settlement. BMO cross border trading relies on end-of-day file transfers including FX conversions that will need to be processed by our service bureau to meet DTC/CDS processing times. BMO encourages the regulators to align rules for matching on T+0 to maintain and improve efficient and cost effective processing. BMO believes it would be detrimental to the health of the Canadian capital markets and the US, if matching rules and settlement cycles are not aligned.

⁴ The U.S. brokerage database structures have not been designed to include client or counterparty name and address information behind the trade infrastructure.



BMO encourages the SEC and CSA to align matching and settlement T+0 rules. BMO is supportive of competitive factors driving trading in a marketplace rather than different regulatory processing rules and cycles for the same securities.

Immobilization and dematerialization of Securities Certificates:

1) Should securities be completely immobilized or dematerialized in the U.S.? If so, which would better serve the market – complete immobilization or dematerialization? Why?

BMO supports the move to full dematerialization and removal of barriers to accepting electronic signatures and electronic guarantees to eliminate ink signatures. It is believed that dematerialization is “low hanging fruit” that can yield substantial benefits and savings with limited negative impact. Investor demographics indicate that this problem will resolve itself over time. It is recognized that there will be operational issues that would need to be addressed, e.g. large brokerage firms must ensure that dematerialization is coordinated with electronic credits of positions. The SEC should not develop rules to support immobilization of securities, which it believes perpetuates manual processing and inefficiencies in the system.

Most of the financial services sector has already moved to electronic representation of assets with appropriate guarantees in place. For example, all age groups have accepted this level of electronic representation of assets in the banking industry. Commercial entities are beginning to offer electronic signatures for credit card transactions.

The securities industry should move towards dematerialization as quickly as possible by requiring new issues and IPO's to be in electronic form with electronic access over the Internet. This is expected to reduce costs, improve timeliness of information to clients and expand the reach of information over the Internet.

2) What are the costs and benefits of complete immobilization or dematerialization?

The transition to dematerialization and associated costs of customer education, introduction of systems to support dematerialization and conversion of certificates to book-based form will be short lived if a deadline is imposed.

It is not believed that there are any benefits to immobilization. It is estimated that over 20% of BMO's operational staff are assigned to supporting certificate processing and management. This cost would be eliminated with dematerialization.

3) Are there operational, legal, or regulatory impediments to immobilization or dematerialization?



The current concepts of non-objecting beneficial owner (NOBO) and objecting beneficial owner (OBO) need to be eliminated. The current legal requirement that individual client/counterparty information must be passed to the issuer is a constraint that a broker currently faces. If issuers are required to communicate directly to the shareholder this will eliminate the broker dealer from the role of intermediary.

4) What advantages might certificates have over book-entry? What regulatory initiatives should be considered to address the advantages if the market were to move away from certificates?

None. Banking is the best example of all types of customers accepting electronic representation of assets. The securities industry should move in the direction of electronic processing as quickly as possible and, ideally, no later than when an advanced settlement cycle is introduced.

5) Should the existence of a viable, widely available direct registration system that preserves the benefits of holding securities in the form of physical certificates be a prerequisite to complete immobilization or dematerialization?

No, the use of physical securities should be eliminated. An issuer should be able to use a third party contractor to act as the record keeper of shareholder information. A DRS is not required to preserve the benefits of certificates or shareholder anonymity. It is considered a requirement that issuers are responsible for maintaining customer/shareholder records.

6) What should be done to increase the availability and use of DRS or to otherwise improve DRS?

A registration scheme should be introduced to ensure that any entity wishing to become a DRS understands the qualifications, responsibilities, etc.

7) What are the back-office costs at broker-dealers to process securities certificates? What are the costs to transfer agents to process securities certificates? How do these costs compare to book-based entry securities?



Current rules and broker-dealer to issuer arrangements support the perpetuation of certificates as brokers profit from getting out the proxy vote. This may change as dematerialization is adopted.

8) What should be done to encourage more companies to issue their securities in a completely immobilized or dematerialized format? Should public companies be required to do so?

Listing rules should be introduced to require all new listings to be in dematerialized form. The success of the NYSE rule and AT&T Corporation's elimination of physical certificates is an example of how successful and cost effective such a move can be. While this change was not without some challenges, overall it was beneficial to all parties.

9) What can broker-dealers do to facilitate complete immobilization or dematerializations on both the issuer and investor level?

Customer education programs should be introduced to increase the client comfort level with dematerialization. Brokers should review existing revenue streams to shift processing from manual processing and inefficiency to STP value added services.

At the issuer level, protocols should be introduced to prevent the use of physicals.

10) What can transfer agents do to facilitate complete immobilization or dematerializations on both the issuer and investor level?

Transfer agents could provide a mechanism or system that would allow for direct verification of shareholder holdings without going through a broker.

11) What incentives or disincentives can be employed to discourage shareholders from requesting certificates? Will investors be less inclined to request a certificate if they were required to pay more to obtain, transfer, and trade certificated securities than book-based securities? Should investors who choose to hold securities bear a greater amount of the overall costs associated with producing and processing those certificates?

There should be automatic default of securities in electronic form. Certificates and printed statements should be costly. Customers should be required to bear the complete cost burden of requesting certificates or the transfer/replacement of them. Ultimately the true cost of processing physicals will result in a change in behavior and expectations.



12) Are there any rules or regulations needs to enhance the safety of book-entry systems operated by transfer agents or broker-dealers?

Given the importance DRS systems play in maintaining client holdings, it is essential that they be viewed as essential infrastructure participants, such as a matching utility service or depository is currently. This would entail some degree of oversight and compliance to industry code of practices.

13) What can be done to engender public confidence in certificate-less systems?

Regulatory, SRO rules and listing requirements of marketplaces requiring dematerialization will all engender confidence by the customer in certificate-less systems.