ICAA

June 11, 2004

Via Electronic Filing

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

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

Dear Mr. Katz:

The Investment Counsel Association of America (ICAA)[1] appreciates this opportunity to respond to the Commission's concept release[2] on securities transactions settlement issues. We commend the Commission and its staff for issuing the concept release and giving all interested parties an opportunity to discuss the important issues outlined in the concept release.

We believe the *goal* of achieving same-day affirmation of trades (SDA) and/or shortening the current T+3 settlement cycle – both of which would require significant improvements and investments in automation and straight-through-processing (STP) – is laudable. However, we strongly believe that a *regulatory mandate* requiring SDA or shortening the current T+3 settlement cycle is not warranted by any objective cost/benefit analysis and that such regulations would be ill advised, counterproductive, costly, and difficult to implement and monitor. The better approach is to encourage the development of *market-driven initiatives* to promote advances in STP that ultimately will be embraced by the vast majority of market participants.

The ICAA previously has expressed a number of concerns to the Commission regarding a regulatory mandate shortening the settlement cycle to T+1.[3] As noted in our

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[1] The ICAA is a non-for-profit association that represents the interests of SEC-registered investment advisory firms. Founded in 1937, the ICAA's membership today consists of more than 300 firms that collectively manage in excess of $4 trillion for a wide variety of individual and institutional clients. For more information, please visit www.icaa.org.

[2] *Concept Release: Securities Transactions Settlement*, Release No. 33-8398; 34-49405; IC-26384; File No. S7-13-04 (Mar. 11, 2004).

[3] *See Letter from David G. Tittsworth, ICAA Executive Director to The Honorable Harvey L. Pitt, Chairman, Securities and Exchange Commission* (Oct. 9, 2001); *Letter from David G. Tittsworth, ICAA*

INVESTMENT COUNSEL ASSOCIATION OF AMERICA, INC.
1050 17TH STREET, N.W., SUITE 725 WASHINGTON, DC 20036-5503
(202) 293-ICAA FAX (202) 293-4223

previous letters, the ICAA and representatives of its member firms have for some time participated in the so-called Buy-Side Committee organized by the Securities Industry Association (SIA), the association that represents broker-dealer firms. In addition, the ICAA has sponsored conferences designed to inform and educate investment advisory firms about such issues. In this vein, the ICAA believes that additional informational and educational efforts are desirable and necessary in order to build awareness, increase knowledge, and to gain additional input relating to STP issues. We strongly urge the Commission to use its resources and its public platform to encourage similar efforts in the future. Clearly, much more work needs to be done to ensure that investment advisory firms – including the thousands of smaller firms – understand issues related to STP. We believe that additional informational and educational efforts will – over time – help to promote and ultimately achieve the goals outlined in the concept release.

Following are a few issues that the ICAA urges the Commission to consider with respect to same day affirmation (SDA) and shortening the settlement cycle (for purposes of this comment letter, we will use the term "T+1" to encompass all proposals to shorten the current settlement cycle). Based on these and other considerations, the ICAA strongly opposes a regulatory mandate requiring SDA or T+1.

There is no evidence that current settlement and confirm/affirm processes and the accompanying regulatory framework are broken. The concept release correctly notes that the "implementation of a T+3 settlement cycle is widely viewed as a success, and the U.S. clearance and settlement system continues to be one of the safest and most reliable in the world."[4] The ICAA wholeheartedly agrees with this statement. The current clearance and settlement systems in the United States, including regulations governing such activities, are sound and effective. In fact, there are no major gaps or imminent threats that justify a regulatory overhaul of the current system. The current systems and accompanying regulatory framework, including the T+3 cycle, have clearly demonstrated their value in a wide variety of circumstances, including increased globalization of the securities industry, dramatic increases in U.S. trading volumes, and unforeseen catastrophic events such as the September 11, 2001 attacks. Throughout all of these diverse and extremely volatile circumstances, the current system has worked well. Accordingly, the concept release does not identify any systemic risks or any significant investor losses that would have been prevented had SDA or T+1 requirements been in place.

While it is certainly justifiable and appropriate to consider whether additional improvements can and should be made, we commend the Commission for recognizing that the current system is not broken. This reality should be considered carefully and given appropriate weight as the Commission balances the perceived need for any regulatory changes in this area. This is not to say that improvements cannot or should not be pursued. In fact, a number of financial services firms, including members of our organization, are engaged in a wide variety of activities to streamline and automate their

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Executive Director to The Honorable Harvey L. Pitt, Chairman, Securities and Exchange Commission (Jan. 14, 2002). A copy of each letter is attached and incorporated herein.

[4] Release at 9.

processes in order to gain efficiencies and reduce errors. The ICAA strongly supports these market-driven initiatives. However, we do not believe that current information supports the imposition of new and costly regulatory requirements at this time.

Faster is not necessarily better. An oft-repeated phrase is that "nothing good happens between trade and settlement." Similarly, the concept release states that it is "generally accepted that a substantial portion of the risks in a clearance and settlement system is directly related to the length of time it takes for trades to settle . . . [i]n other words, 'time equals risk.'"[5] These statements have an inherent appeal. However, they are at best misleading. The fact of the matter is that many good things happen between trade and settlement – specifically, that the vast majority of trades do in fact settle within the current T+3 framework. A recent analysis reached the same conclusion:

> There is an old adage that says nothing good can happen between execution and settlement date. While it is a catchy phrase, it is also patently wrong. Many vital risk management activities occur in the days between trade and settlement date: Trade obligations are netted, funding for settlement is arranged, and trading errors are detected and reconciled. The reason for a waiting period before buying a gun is to give the seller a chance to confirm that the buyer doesn't have a criminal history. As with guns, once the trade transaction is settled, it's too late.
>
> In a T+1 environment, risk is increased when an institution doesn't have time to correct internal posting errors that become costly external errors when trades actually settle. A T+3 environment also allows the foreign investor time to calculate net currency requirements and execute foreign exchange transactions on the morning of T+1, when rates are more attractive. In the haste to settle, custodians and brokers will be tempted to accept delivery of everything with the hope that they'll find the right account to post the securities. When they don't find one, expect a lot of trades to be reversed in the market, leading to both losses and profits.[6]

Speeding up the settlement cycle and/or confirm/affirm requirements will not necessarily result in a better system. In fact, some have suggested that such changes will actually increase operational risks for the markets.[7] Particularly considering all of the complexities of the U.S. markets – including the wide array of securities that can be bought and sold, as well as difficulties related to settlement involving non-U.S.

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[5] Release at 8.

[6] *The Sequel to T+1: Will the SEC Mandate Operational Efficiency?* Tim Lind, TowerGroup (May 2004).

[7] "The move from T+3 to T+1 would decrease credit or settlement risk, but the question is whether this reduction is significant enough to justify the massive technology and other costs the industry would be forced to bear *and the increased operational risk it could subsequently face*. Indeed, if reducing risk associated with securities settlement is the industry's goal, there are better ways to go about it." (emphasis added) *"T+1: Settling for more – higher priorities than T+1."* Andrew Tinney, Michael Patterson, and Reuben Khoo. Global Exchange (2002).

exchanges – the current regulatory framework works well. It provides sufficient flexibility for identifying, addressing, and resolving a number of problems that may arise while at the same time protecting the interests of investors. Speeding up confirm/affirm requirements and/or shortening the settlement cycle will not necessarily result in greater efficiencies and reduced risks.

While market-driven initiatives during the past few years have yielded advances in STP*, neither SDA nor T+1 are achievable today for many types and classes of securities transactions*. Unless and until greater progress is made toward achieving STP on a broad scale, it would be unwise for the Commission to adopt new regulatory requirements that involve significant costs but do not produce demonstrable benefits for most market participants.

<u>The costs associated with a regulatory requirement imposing SDA or T+1 are not justified.</u> The concept release correctly states that "the Commission must determine whether benefits of establishing a shorter settlement justify the costs of implementing it."[8] Portions of the concept release clearly indicate that the Commission and its staff believe that SDA and/or T+1 will reduce risks associated with clearance and settlement. We believe, however, that any objective analysis of the evidence clearly indicates that the potential risk reductions have been overstated relative to the costs of mandating SDA and/or T+1. With respect to the risks associated with the current clearance and settlement system, we believe the following statements from an analysis on the subject are instructive:

> [T]he suggestion that eliminating two days from the settlement cycle will reduce settlement risk by 67% is fundamentally flawed. The risk arguments for T+1 consider the absolute value of outstanding settlements and the extra time for price divergence and counterparty default found in a T+3 environment. What is not considered by the theory that time equals risk is the actual probability of default of a given counterparty. The calculation of risk is far more complex than a linear calculation based on the number of days between execution and settlement. Risk is a function of how well capitalized the market participants are, the volatility in the underlying markets, the effectiveness of internal controls within the firm, the legal certainty provided by national securities regulations, the integrity of the settlement infrastructure, and how well they measure, manage, and remedy risk between participants.[9]

Based on these and other arguments, the authors of the analysis concluded as follows:

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[8] Release at 10.

[9] *T+1: Cost, Risk, Benefit, and Other Urban Legends,* Timothy Lind and Dushyant Shahrawat, TowerGroup (June 2002).

> T+1 is not currently a priority for the global securities industry and is unlikely to become a priority for the foreseeable future. . .
>
> [T]he United States has one of the most robust settlement infrastructures in the world. The strength and maturity of the infrastructure, combined with the legal certainty of US securities regulation, eliminate principal risk between market participants and provide an adequate remedy against nonperforming counterparties. . .
>
> [C]ounterparty risk is effectively mitigated by use of a central counterparty between dealers and that delivery vs. payment mechanisms between dealers and custodians provide finality of settlement of cash and securities.[10]

On the flip side, everyone is in agreement that achieving SDA/T+1 will involve very significant costs. Many knowledgeable observers have noted that implementation of these initiatives necessarily involve costly and fundamental changes for all major segments of the securities industry.[11] For example, the SIA Business Case Report published in July 2000 (cited in the concept release[12]) estimated costs of $8 billion in moving to T+1 and predicted future annual industry-wide savings of $2.7 billion. The report also noted that the anticipated costs and predicted future savings will not fall evenly across all types of market participants. Of obvious interest to the ICAA, the report estimated that asset managers as a whole will incur costs of $1.7 billion and could expect future annual benefits of $402 million, resulting in a "payback" period of approximately 4.2 years (compared to payback periods of 2 – 2.5 years for broker-dealers and custodians). We have previously expressed our view that the assumptions used in the report are fundamentally flawed with respect to the investment advisory profession and that it underestimates the costs that will be required of investment advisers while overstating expected benefits. The SIA assumed that the entire investment adviser industry consisted of 238 firms, broken down as follows: 21 firms with more than $200 billion in assets under management (AUM), 42 firms with AUM of $50 – 200 billion, and 175 firms with AUM of less than $50 billion (which SIA categorized as "small" advisory firms).

In fact, there are thousands of registered investment advisory firms. In a recent report published by the ICAA and National Regulatory Services,[13] we reported that there

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[10] *Id.* at 1.

[11] For example, many knowledgeable observers have noted the difference between moving from T+5 to T+3 compared to moving from T+3 to T+1. The former essentially involved speeding up processes whereas the latter involves fundamental changes that require significant costs, the development of new or improved technologies, and the development of new protocols.

[12] Release at 14.

[13] *Evolution/Revolution: A Profile of the U.S. Investment Advisory Profession* (May 2004). The report is derived from filings required by the SEC from registered investment advisers. A copy of the complete report is available on the ICAA web site: www.icaa.org.

are 7,165 SEC-registered investment advisers that manage in excess of $25 million. Of these firms, *only 98 firms manage in excess of $50 billion and 7,067 firms manage less than $50 billion*. Clearly, the SIA report drastically understated the actual number of investment advisory firms. It also assumed that 70 percent of all "small" advisory firms (*i.e.*, firms that manage assets of less than $50 billion) would not need to make any investments in order to comply with a T+1 mandate. We certainly believe this is an erroneous assumption. In fact, the vast majority of investment advisory firms will incur one-time as well as ongoing costs in order to achieve either SDA or T+1.

We believe it is critically important for the Commission to understand that the vast majority of investment advisory firms are truly small businesses. Our recent report, for example, notes that there are 5,783 firms that manage more than $25 million but less than $1 billion in assets. Similarly, 5,683 SEC-registered entities reported that they employ 10 or fewer employees.[14] We strongly urge the Commission to take steps to examine the relative costs and benefits on the thousands of smaller investment advisory firms prior to considering regulations requiring SDA or T+1.

If SDA and/or T+1 would produce the benefits and efficiencies that their advocates have claimed, we submit that the vast majority of investment advisers would be willing to incur the necessary costs. To date, however, it is clear that neither SDA nor T+1 have proven their market worth for most investment advisory firms.[15]

Accordingly, we conclude that the costs of SDA and T+1 far outweigh any purported benefits for most investment advisory firms. While future innovations and developments may cause us to reevaluate this conclusion, we do not believe that it would be prudent for the Commission to impose broad and costly regulatory mandates based on the current reality. At a minimum, we strongly urge the Commission to conduct an appropriate cost/benefit analysis of the investment advisory profession *before* contemplating any major regulatory action such as mandating SDA or T+1.

Market-driven initiatives have produced improvements in STP. During the summer of 2002, SIA announced that it was re-directing its efforts away from conversion to T+1 toward straight-through-processing (STP), stating that, "The overall goal of SIA's earlier STP/T+1 program to convert from T+3 to T+1 settlement by 2005 has been replaced by a set of challenging straight-through processing goals to be accomplished over the next two years. . . This will result in significant benefits to firms and

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[14] *Id.* at 5 and 7.

[15] The same argument also applies to other market participants. One report, for example, underscored that a small percentage of brokerage firms had taken even the most basic of steps in preparing for T+1, finding that only 16 percent of brokerage firms had completed an inventory of processes, and 12 percent an inventory of affected applications. *T+1: State of the Industry.* Gartner, Inc. (D. Furlonger, T. Parker; Feb. 2002). Such information certainly begs the question: if T+1 and SDA will supposedly produce such dramatic benefits and efficiencies, why are so many firms reluctant to take the necessary steps and incur the costs that are required to achieve such desirable results?

investors."[16] Last month, SIA iterated its commitment to STP efforts, noting that: "We will continue to work to gain the full support of all the industry for straight-through processing, buy side and retail, through communication and education. It's in our clients' best self-interest to automate."[17] The ICAA strongly supported SIA's decision to refocus its resources and efforts toward STP initiatives and we wish to take this opportunity to commend SIA again for the leadership role it has assumed in this important area. We strongly believe that SIA's decision in 2002 clearly underscores the need for the Commission to evaluate carefully whether it should impose requirements via regulatory fiat that the vast majority of market participants find to be costly and premature.

In fact, improvements in STP have occurred during the past two years. For example, in 2001 same-day affirmation rates were about 13 percent. Today, they are at about 23 percent. Similarly, the percentage of unaffirmed trades have declined from about 15 percent in 2001 to 12.8 percent today. The significance of these statistics is heightened when considering market conditions during the relevant time period. While these statistics show major improvement, they also demonstrate that the industry has a long way to go before SDA or T+1 can be accurately characterized as any type of prevalent industry practice – even among the more sophisticated firms. Certainly, the Commission at this time cannot justify imposing SDA and/or T+1 on the basis that such regulations are needed to "close the gap" in prevailing market practices.

The ICAA is aware of other market-driven initiatives that have been developed to provide incentives to the investment advisory profession (including smaller firms) for automating trade-related activities. For example, several major brokerage firms have worked with Omgeo to develop a product designed to automate allocation instructions between the investment adviser and the broker. As contemplated, the allocation manager product would be provided free of charge for investment adviser firms. We believe that these and similar market-driven initiatives ultimately will produce better results than a regulatory strait jacket. In fact, it is difficult to imagine that any such initiative would ever have been developed if the Commission had imposed SDA or T+1 via regulation.

A recent white paper[18] developed by the SIA STP Buy-Side Committee highlights the need for market-based efforts that emphasize an adequate return on investment rather than a regulatory mandate that will stifle innovation and impose significant costs. Based on interviews with a small sampling of diverse advisory firms, the paper recommends that the return on investment for buy-side firms should be improved in the following ways: (1) the SIA should revisit the concept of centralized matching to determine if it is essential in order to achieve the underlying industry STP goals; (2) allow market forces

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[16] *SIA Board Endorses Program To Modernize Clearing, Settlement Processes for Securities,* SIA Press Release (July 18, 2002).

[17] *SIA Board Approves Continuation of STP Efforts,* SIA Press Release (May 5, 2004).

[18] *Buy-Side Straight-Through Processing White Paper,* SIA STP Buy-Side Committee (Dec. 2003). The white paper was cited in the SIA's recent press release as one of the most significant examples of progress in the STP arena during the past year.

and not new regulations to drive the move to STP and the innovation in solutions that will drive costs down and improve benefits; and (3) the SIA should consider adjusting the scope of the STP program to include international securities, since the SIA has focused on domestic securities due to the de-emphasis of T+1 settlement.

The ICAA heartily endorses the recommendations set forth in the Buy-Side White Paper. Accordingly, we urge the Commission to refrain from imposing costly and unworkable regulations mandating SDA or T+1 and instead to foster market-driven initiatives to improve STP.

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If SDA and/or T+1 will result in greater efficiencies, risk reduction, and a reasonable return on investment, there is no doubt that the various participants in the securities industry – including the investment advisory profession – will take steps to achieve these positive benefits. Based on market-driven initiatives, discernible improvements in STP have been achieved during the past 2-3 years and will continue in the future. While we believe that the goals of SDA and T+1 are commendable, we do not believe that a regulatory mandate is justified at this time, either in terms of the alleged benefits or the major costs involved. In fact, we believe that imposing SDA and/or T+1 at this time potentially may stifle innovations, reduce competition, and lead to increased operational risk.

The ICAA appreciates the opportunity to provide these comments and we stand ready to provide additional information to the Commission or its staff.

Respectfully,

DAVID G. TITTSWORTH
Executive Director

Cc: The Honorable William H. Donaldson
The Honorable Cynthia A. Glassman
The Honorable Harvey J. Goldschmid
The Honorable Paul S. Atkins
The Honorable Roel C. Campos

January 14, 2002

The Honorable Harvey L. Pitt
Chairman
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Re: Costs and Other Concerns of T+1 Implementation for Investment Advisers

Dear Mr. Chairman:

By letter dated October 9, 2001, the ICAA[19] expressed various concerns to you regarding costs and other problems associated with implementing next business day settlement for the investment advisory profession. Some of the issues involved potential problems with trade matching utilities. Based on our concerns, we strongly urged the SEC to take appropriate action to be vigilant in its continuing oversight of such entities.

> *By letter dated December 18, 2001, the General Counsel of Omgeo wrote to you to respond to the ICAA's concerns. Omgeo is a trade matching utility and a for-profit entity wholly owned by the Depository Trust & Clearing Corporation and Thomson Financial. We take issue with various statements in Omgeo's letter and feel compelled to outline the following points in response:*

Composition of Omgeo's Board of Directors. The letter notes that Omgeo's Board includes "representatives of the global securities industry who are not officers or employees of Omgeo's corporate parents, DTCC and Thomson Financial, or their affiliates," and that the "industry representatives on Omgeo's Board will undoubtedly pay close attention to Omgeo's policies on the matters about which the ICAA is concerned." It is simply a fact that the industry representatives on Omgeo's Board do *not* bear any resemblance to the vast majority of investment advisers registered with the SEC nor are their interests aligned with the investment advisory profession in general.[20] While we do not suggest that Omgeo has any responsibility to ensure representation of the advisory profession, it is curious to suggest that the current composition of its Board is designed to

[19] The ICAA is a not-for-profit association that consists exclusively of SEC-registered investment advisory firms. Founded in 1937, the ICAA's membership today consists of about 300 firms that collectively manage in excess of $3 trillion for a wide variety of individual and institutional investors. For more information, please visit www.icaa.org. The full text of our October 9, 2001 letter is posted on our web site under "Comments & Statements."

[20] According to its web site, Omgeo's industry representatives are employed by the following companies: Goldman Sachs & Company, FMR Co., The Bank of New York, Merrill Lynch Investment Managers, Deutsche Bank, and Morgan Stanley Dean Witter. By contrast, for an overview of the composition of the SEC-registered investment adviser industry, see "Evolution/Revolution: A Profile of the U.S. Investment Advisory Profession," published by the ICAA and National Regulatory Services (July 2001).

ensure that the interests of investment advisers will be safeguarded. If in fact Omgeo and its Board have paid "close attention" to our concerns, we request that it provide relevant documentation, such as minutes of Board meetings, to demonstrate: (a) that our concerns have been discussed by Omgeo's Board, and (b) what actions have been taken to address our concerns.

Need to Monitor Fees. Omgeo's letter states that all of our concerns were thoroughly addressed by the SEC when it issued an order last year exempting Omgeo's subsidiary from registering as a clearing agency[21] and that until "experience indicates a problem with the conditions and limitations of the exemption, there is no reason for the ICAA to call for increased Commission oversight of those matters." It goes on to discuss "misleading" statements in our letter relating to the 625% increase in fees assessed for software associated with Omgeo's "TradeSuite" services for investment advisers. Omgeo claims the increase in fees was justified because: (1) no new fees were imposed during the initial four-year launch of the software, even though many new features were added to the software during that period; (2) the fee increases in 2000 were "cost-based" and were approved by DTC's Board of Directors; and (3) the software "made investment managers' interaction with the TradeSuite services more efficient."

The ICAA and our member firms simply have no way of knowing whether the first two justifications have any basis in fact. With respect to the third justification, we can report that some ICAA member firms have informed us they have *not* experienced any increased efficiencies as a result of the changes outlined in Omgeo's letter. At any rate, we continue to believe that the Commission has a responsibility to assess whether fees imposed by Omgeo and other trade matching utilities are reasonable and appropriate. Particularly in view of the fact that Omgeo is a for-profit entity and that it has been granted an exemption from regulation as a clearing agency, it is incumbent upon the Commission to guard against predatory and unfair pricing practices.

Most important, Omgeo's letter also states that "investment managers generally do not pay transaction fees for use of TradeSuite services." This is an accurate statement. However, we are well aware of proposals to impose transaction fees on investment advisers in an effort to help defray T+1 costs for brokers and others involved directly in trade, execution, and settlement services. Similar proposals were made – and properly rejected – when the move to T+3 was considered and approved. *The ICAA strongly believes that investment managers should not pay transaction fees, as such matters are related directly to trade execution and thus should be borne by brokers and custodians.* If the Commission mandates T+1, we believe it has a duty to be vigilant in its oversight of such matters and we strongly urge the Commission to scrutinize carefully any effort to impose transaction fees on investment advisers in an effort to help pay for costs associated with T+1 implementation.

Privacy. In our October 9, 2001 letter to you, we noted that Omgeo does not appear to fall within the definition of "financial institution" within the coverage of the Gramm-Leach-Bliley Act nor is it covered under the Commission's Regulation S-P.

[21] Release No. 34-44188 (April 17, 2001).

Omgeo states that it is "committed to maintaining the confidentiality of its clients' information" and that "[t]here is no basis for suggesting, as the ICAA Letter does, that action by the Commission at this time is needed to safeguard client information." Frankly, we are somewhat mystified by Omgeo's assertion that it should be exempt from privacy laws and regulations. All investment advisers, broker-dealers, and investment companies must comply with the mandates of the Commission's privacy rule, Regulation S-P.[22] Omgeo will have unfettered access to what could be the largest repository of information about investors, investment advisers, and others ever assembled.[23] Given this fact, is it unreasonable to suggest that trade matching utilities should be subject to strict privacy laws and regulations and should be subject to frequent inspections for potential violations?[24] We strongly urge the Commission to act promptly and decisively to safeguard client information provided by investment advisers to trade matching utilities.

Requiring Investment Adviser Participation in Trade Matching Utilities. Omgeo states that the ICAA criticized the SIA's proposal to require customers of a broker-dealer to participate in trade matching systems. While we believe our letter to you accurately conveys our concerns in this regard, we wish to emphasize that there is a significant difference between free market initiatives to achieve straight-through processing (STP) and a regulatory fiat that requires T+1 participation by investment advisers and others. The ICAA is not opposed to STP – indeed, many of our member firms are involved in working with the brokerage industry to achieve greater trading and settlement efficiencies. As indicated in our prior letter, business necessity – as opposed to a Commission or SRO rule – may actually "require" some investment advisers to participate in systems and protocols that are designed to achieve STP. Nor is the ICAA necessarily opposed to T+1. However, we feel strongly that much more information is needed before the Commission mandates T+1.

At a minimum, the Commission should seek appropriate and accurate cost/benefit data. At a recent meeting with SEC staff, we again noted the flawed methodology in SIA's Business Case Final Report[25] and suggested that the SEC should request SIA to

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[22] Rel. Nos. 34-42974, IC-24543, IA-1883: File No. S7-6-00 (June 22, 2000). In written comments filed with the Commission, we emphasized that there certainly is no evidence that investment advisers have failed to safeguard investor information. The ICAA's *Standards of Practice* have always stated that client information is confidential; further, we note that client lists and other client information are in fact jealously guarded by investment advisory firms.

[23] The Commission's April 17, 2001 exemptive order notes that both DTC's Standing Instructions Database (SID) and Thomson's ALERT databases will be transferred to Omgeo's Global Joint Venture Matching Services. Both are described as a "database of customer relationship information and settlement data that is shared by institutions, broker-dealers, and custodians."

[24] The Commission conducts routine examinations of investment advisers at least once every five years and attempts to examine newly formed investment advisers within their first year of operation. The Commission also conducts targeted examinations or sweeps of investment advisers.

[25] For example, the SIA study assumed that the entire investment advisory industry consists of 238 firms. In fact, there are more than *7,000* SEC-registered investment advisers. The SIA study classified advisory

correct its report relating to estimated costs and benefits for investment advisers by basing it on appropriate data that reflects the actual composition of the investment advisory profession. The Commission should have accurate cost/benefit information before it considers effectuating T+1 – a move some have described as a fundamental restructuring of the U.S. securities markets. We believe that such a study will serve to illustrate the basic problem with mandating T+1 for investment advisers: the benefits (including enormous costs savings and operating efficiencies) will accrue to the brokerage industry while the vast majority of investment advisers will bear substantial costs while realizing few, if any, significant benefits.

Commission Support of T+1 Initiative. Finally, we note that, by letter dated October 19, 2001, SEC staff responded to our earlier letter to you stating in part that: "We support the T+1 initiative and believe that it is important to improving the infrastructure of our securities markets." Similar statements have been made in past speeches by SEC Commissioners and staff. We hope these statements are intended to indicate approval of private enterprise efforts to achieve STP – *not* to indicate approval of any particular regulatory regime needed to implement T+1. Further, we hope that any such regulatory decisions will be made only after a full opportunity for notice and comment. We trust that the Commission under your leadership will conduct any proceedings relating to STP/T+1 in a fully transparent manner and we look forward to participating in discussions on these important issues.

Sincerely,

David G. Tittsworth

DAVID G. TITTSWORTH
Executive Director

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firms into large, medium, and small firms, with small firms categorized as firms with less than $50 billion in assets under management (AUM). According to the SIA study, there are only 175 firms in the "small" category; further, the study assumed that 70% of all such small firms "would not need to make [T+1] investments (e.g., due to outsourcing or low volumes)." In fact, there are more than *5,500* SEC-registered investment advisers with less than $50 billion in AUM. Further, we have no idea how the SIA study came to the conclusion that 70% of such firms will not need to make *any* T+1-related investment. To our knowledge, we are unaware of any firm that would *not* have to make a significant investment to achieve T+1 compliance – most smaller firms at least will be required to purchase appropriate software that permits the exchange of settlement data.

Cc: The Honorable Laura S. Unger
Annette L. Nazareth, Director, Division of Market Regulation
Larry Bergmann, Senior Associate Director, Division of Market Regulation
Paul F. Roye, Director, Division of Investment Management
Carl H. Urist, Esq., General Counsel, Omgeo
Marc E. Lackritz, Securities Industry Association

October 9, 2001

The Honorable Harvey L. Pitt
Chairman
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Dear Mr. Chairman:

The Investment Counsel Association of America[26] is writing on behalf of its member investment advisory firms to express our views on certain matters relating to the implementation of next business day settlement of securities transactions in U.S. securities markets (T+1), currently scheduled to occur in June of 2004.

As you know, a leading role in the planning for implementation of T+1 has been undertaken by the Securities Industry Association, a trade association that represents broker-dealer participants in the securities industry. We believe SIA's leadership role is appropriate because most of the procedural changes in securities transaction processing that will be necessary to implement T+1 must occur within the broker-dealer community. We applaud SIA for its leadership in researching the relevant issues and moving the process forward.

Representatives of ICAA member firms and our staff are participating in the Buy-Side Committee formed under the auspices of the SIA to identify and resolve T+1 issues that pertain to investment advisers and other buy-side participants. The ICAA will continue to work cooperatively with the SIA, the Buy-Side Committee, and others to ensure that the interests of the investment advisory profession are considered fully and to help inform investment advisers of developments in this area. The ICAA is currently in the process of planning regional buy-side T+1 workshops to be held during the first quarter of 2002 that will be open to all investment advisers.

In our preliminary assessment of issues involved in the T+1 initiative, we have identified a number of areas of concern to our member firms. We wish to highlight these issues for the Commission's consideration as it contemplates rulemaking and other regulatory initiatives that would be required to implement the migration to T+1 by the securities industry.

Competition and Regulation of Trade Matching Utilities

[26] The Investment Counsel Association of America is a not-for-profit organization that exclusively represents the interests of SEC-registered investment advisory firms. Founded in 1937, the ICAA's membership today consists of about 300 federally registered advisory firms that collectively manage in excess of $3 trillion for a wide variety of individual and institutional clients. For more information about the Association, please see our Web site at *www.icaa.org*.

As you know, the Depository Trust Clearing Corporation (DTCC) and Thompson Financial, Inc., a for-profit vendor of trade matching and related services and information, have created a global joint venture (GJV) that, through its wholly owned subsidiary, Omgeo, would perform various trade matching and electronic confirmation functions critical to the implementation of T+1.

The GJV applied to the Commission for, and ultimately was granted, a conditional exemption from registration and regulation as a clearing agency under the Securities Exchange Act of 1934.[27]

Issues of access to and pricing of DTCC's services, and of interoperability among Omgeo and other potential vendors of competing services, raised by the formation of the for-profit GJV were thoroughly addressed in the submissions of the various commenters in connection with the GJV's exemptive application. We believe the Commission and its staff were appropriately mindful of these issues in reviewing and acting upon the application and we applaud the Commission's efforts to address these issues in establishing the conditions of the exemption ultimately granted.

Our principal remaining concern is that, given the expected reliance of a substantial portion of the advisory industry on outsourcing of trade comparison and matching functions to third-party vendors, each of which will require access to DTCC to provide a complete outsourcing solution, the degree to which the DTCC/Omgeo combination is able – despite the important safeguards contained in the conditions of the exemption – to exert monopoly power in the marketplace will likely have a significant and continuing impact on the costs incurred by investment advisers in implementing T+1. DTCC/Omgeo appears to bear similarities to a public utility and its costs and operations need to be monitored carefully by the Commission. We urge the Commission to be vigilant and aggressive in its continuing oversight of DTCC, Omgeo, and other trade matching utilities. In particular, we urge the Commission to monitor the fees and charges they impose on investment advisers and other market participants.

We note, for example, the dramatic increase in the cost of access to DTCC's "TradeSuite" service, as an example of the power of the monopoly position DTCC has occupied in the industry. A small ICAA member firm reports that its annual fee for access just five years ago was $500. The same firm's most recent invoice for annual access was $3,125, representing a startling price increase of 625%. The "TradeSuite" service is among those operations that DTCC has transferred to the for-profit Omgeo under its joint venture agreement with Thompson Financial, Inc.

<u>Privacy of Client Information</u>

A related concern is the privacy of investment advisers' client information that now resides in DTCC's Standing Instruction Database (SID), which also has been transferred by DTCC to the for-profit Omgeo under the joint venture agreement. SID is a database of customer information (including, among other information,

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[27] The conditional exemption was granted in Release 34-44188 (April 17, 2001).

names, addresses, taxpayer identification numbers, and custodial account numbers and custodian addresses of an investment adviser's clients) that is accessible by broker-dealers and custodians. It is our understanding that other trade matching utilities, such as the Global Straight Through Processing Association (GSTPA) and others yet to be created, will require bulk access to SID, or will need to create their own similar databases.

Clearly, the information regarding investment advisers' clients contained in SID or other comparable databases could be extraordinarily valuable to a person or organization wishing to identify, for example, high net worth individual investors to whom various products or services could be marketed, much less for identity theft or other illicit purposes. As well, trading information is valuable and proprietary, and can be used to the detriment of investment advisers and their clients by other market participants that may use or sell such information for their benefit.

Despite the obvious value and sensitivity of such information, we are unaware of any present statutory or regulatory restraint on the ability of Omgeo, GSTPA or others to make commercial use of investment advisers' client information either directly or by sale of such information to third parties. In fact, a clearing agency such as Omgeo, whether registered or exempt from registration under the Securities Exchange Act of 1934, does not even appear to fall within the definition of "financial institution" within the coverage of the privacy provisions of the Gramm-Leach-Bliley Act of 1999,[28] nor is it included within the Commission's Regulation S-P.

We strongly urge the Commission to take appropriate action to safeguard important and confidential client information provided by investment advisers to trade matching utilities. Such safeguards, for example, could include requiring Omgeo and other trade matching utilities to undergo a strict privacy audit.

<u>Costs and Benefits to Advisers of T+1</u>

While the broker-dealer community has taken the lead, implementation of T+1 also will require significant changes in transaction processing procedures among investment advisers and almost certainly will impose substantial initial and continuing costs on advisers. A study[29] commissioned by the SIA last year estimated the initial cost to all securities market participants of moving from T+3 to T+1 processing would be approximately $8 billion, but could result in future annual industry-wide savings of approximately $2.7 billion. The SIA's study acknowledges that these anticipated costs, and the predicted future savings, will not fall evenly across all types of market participants, but will vary based on the nature of each participant's business.

[28] Pub. L. No. 106-102.

[29] A copy of that study, the *SIA T+1 Business Case Model-Final Report-Release 1.2,* is available at the SIA's Web site at www.sia.com/t_plus_one_issue/pdf/BusinessCaseFinal.pdf.

The SIA's study estimates that asset managers as a whole will incur costs of $1.7 billion, and could expect future annual benefits of $402 million, for a "payback" period of approximately 4.2 years (compared to payback periods of 2 to 2.5 years for the costs estimated to be incurred by broker-dealers and custodians).[30]

We believe that, due to flaws in data, methodology and assumptions, the SIA's study very dramatically underestimates the costs that may be incurred by investment advisers, especially by smaller firms, and may also overestimate the future benefits.

The study's methodology divided asset managers into size categories, based on assets under management, of "large" (over $200 billion), "medium" ($50 – 200 billion), and "small" (under $50 billion). It indicates that, based on data used for the purposes of the study, there are 21, 42 and 175 firms in these categories, respectively. In other words, the study assumed that the entire investment advisory industry consists of just 238 firms.[31] As the Commission is well aware from its own registration data collected via Form ADV, there are in fact thousands of SEC registered investment advisers,[32] not 238. While not every registrant is an asset manager that will be affected by T+1, we believe the vast majority – numbering in the thousands, not a few hundred – are and will be.

The ICAA and National Regulatory Services (NRS) recently published a report based on filings of Form ADV, Part 1 made earlier this year by SEC-registered investment advisers.[33] Among the findings in this first-ever report is a breakdown of investment advisers by asset size. Of the 6,649 advisers that made electronic regulatory filings on the Investment Adviser Registration Depository as of May 1, 2001, the report notes that there are 45 investment advisers with discretionary assets of more than $100 billion; 35 advisers with discretionary assets of between $50 billion and $100 billion; 231 advisers with discretionary assets of between $10 billion and $50 billion; 190 advisers with discretionary assets of between $5 billion and $10 billion; 705 advisers with discretionary assets of between $1 billion and $5 billion; 2,297 advisers with discretionary assets of between $100 million and $1 billion; 2,381 advisers with discretionary assets of between $25 million and $100 million; and 765 advisers with discretionary assets of less than $25 million.

The SIA study clearly understates the total number of SEC-registered advisers and, in particular, severely understates the number of smaller federally registered advisers.

Having dramatically undercounted the number of "small" investment advisers that will be affected by T+1, the SIA study then estimates costs for these advisers at an average of $8 million per firm, but assumes only thirty percent of small firms counted in

[30] Ibid., pp. 3, 37, 43.
[31] Ibid., Appendix D, "Investment Model Approach," p. 26.
[32] In fact, more than 6,600 federally registered investment advisers filed Part 1 of Form ADV electronically using the new Investment Advisor Registration Depository during the first four months of 2001.
[33] *Evolution/Revolution: A Profile of the U.S. Investment Advisory Profession* (July 2001). A copy of the complete report is available on the ICAA's web site: www.icaa.org.

the study (*i.e.*, 53 out of 175 firms) would need to make such an investment, saying "…it was assumed that the remaining seventy percent of the small firms would not need to make investments (*e.g.*, due to outsourcing or low volumes)." The basis, if any, for this assumption is not clear from the study. It is clear, however, that the study ignores any initial or ongoing costs resulting from outsourcing of trade comparison, matching and reconciliation functions by advisers to "industry utilities," while at the same time projecting savings to the advisory industry as a result of this outsourcing because the "…industry utilities will be a more efficient processor…".

It is not our purpose here to denigrate the SIA's study, which we believe represents a genuine and helpful effort to identify the important changes in transaction processing procedures that will be required in order to implement T+1. We do not profess to know what the ultimate costs and benefits to the advisory industry will be. Our purpose is only to point out that the aggregate costs estimated in the SIA's study, based on a dramatic undercount of asset managers and apparently arbitrary and unsupported assumptions regarding the impact of T+1 on the thousands of smaller advisers, quite likely are far too low, and the projected future benefits may be illusory.

As to ongoing costs, it is our understanding that GSTPA has proposed to representatives of investment advisers and institutional investors a "buy side" per-transaction fee of $0.10. Such a per-transaction fee (which might be assessed to broker-dealers or custodians by GSTPA, Omgeo or other trade matching utilities) could be passed along easily by those institutions directly to their customers, as their compensation arrangements are based wholly or partially on the number or value of transactions. In contrast, advisers' compensation arrangements with clients generally are based solely on the value of the clients' assets under management, without regard to the number or value of transactions. As a result, short of negotiating increases in the overall levels of their asset-based fees, investment advisers would be unable to pass this added cost on to their clients.

We urge the Commission to weigh the costs and benefits of mandating T+1 for the investment advisory profession carefully. Apart from the legal requirement to conduct a cost-benefit analysis in conjunction with any proposed rulemaking, we believe the Commission should take appropriate steps in the near future to begin to quantify and consider the anticipated costs and benefits of T+1 for the investment advisory profession.

Requiring Advisers by Rule to Participate in Trade Matching Systems

The SIA has proposed to the Commission "…consideration of rules that require: … broker-dealers to obtain agreement from their customers … to participate in … trade-match systems as a condition to settling trades on a delivery-versus-payment basis …and … registered investment advisers to participate in … one or more interoperable trade-match systems when opening an account at a registered broker-dealer on behalf of a managed account and when executing a trade in … securities for a managed account."[34]

[34] Letter of Arthur Thomas, Chairman, SIA T+1 Steering Committee, to The Honorable Laura S. Unger, Acting Chairman, United States Securities and Exchange Commission, February 16, 2001.

The SIA premises the need for such rules on the notion that implementation of T+1 requires that "…the process and timing of allocating trades among an investment adviser's accounts must be streamlined … so trades are 'locked-in' within minutes of an execution report."

We agree that the process of allocating trades among an adviser's accounts, and especially the process of submitting the allocation information to the other parties to the trade, must be streamlined to accomplish implementation of T+1. But we do not believe that it is necessary, or desirable, to attempt to accomplish these goals by adopting new Commission or SRO rules.

Based on a survey of a number of mostly large advisers, the SIA's *T+1 Business Case Model* reported that 96% of respondents used standard allocation algorithms in generating allocations, and that 99% of respondents indicated allocations are usually known on the morning of the trade date.[35] These findings are consistent with our understanding of the allocation procedures used by most advisers which – given an adviser's fiduciary duty to allocate transactions among client accounts on a fair and equitable basis – generally rely on algorithms (although often with flexibility to alter the allocation to achieve sensible results in cases of partial executions, oversubscribed issues, or other unusual circumstances).

Accordingly, we do not believe substantial change is needed with respect to advisers' internal trade allocation procedures. Rather, the focus must be on the *process of communication* of the allocation information to the other parties to the trade, where significant change will be required for most, but not necessarily all, advisers. Here the SIA's *T+1 Business Case Model* reported, again based on survey of a limited number of mostly large advisers, that advisers "…maintain a significant number of connections to external [broker and custodian] parties, via a variety of methods …each link frequently requiring its own type of connectivity and method of interaction ..." and proposes that "industry utilities will set the messaging standards, leveraging existing standards to communicate, and reduce operational communication links by requiring only a single connection to the utilities."[36]

We believe many investment advisers will wish to participate, either directly or through service vendors, in automated trade matching and electronic confirmation systems for exactly these reasons and may realize significant benefits in efficiency through such participation. Indeed, business necessity – as opposed to a Commission or SRO rule – actually will "require" their participation, as they will find it impossible to operate in a T+1 environment in any other way.

> *However, we also believe that some advisers – particularly smaller advisers – find that neither the benefits of increased efficiency nor business necessity justify their participation in automated trade matching and electronic confirmation*

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[35] SIA *T+1 Business Case Model*, note 4 above, at p. 24.
[36] *Ibid*.

systems, either currently or in a T+1 environment. In fact, we believe it is possible that some advisers, because of a limited number of client, broker-dealer, and custodian relationships, could continue to operate efficiently in a T+1 environment relying on existing or enhanced proprietary communication links, and would see little or no benefit from increased efficiency – and certainly no business necessity – of participation in "industry utility" trade matching and electronic confirmation systems.

Accordingly, we believe that the enormous diversity within the investment advisory profession must be fully considered if the Commission contemplates adopting a rule to require advisers to participate in trade-match systems.

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We truly appreciate your consideration of our preliminary views on this important subject. We would be pleased to discuss these issues with you or Commission staff and trust that you will not hesitate to contact us if we may provide any additional information to you regarding these or any other matters of mutual concern.

Sincerely,

David G. Tittsworth

DAVID G. TITTSWORTH
Executive Director

Cc: Hon. Laura S. Unger
Hon. Isaac C. Hunt, Jr.
Annette L. Nazareth
Paul F. Roye
Cynthia M. Fornelli
Robert E. Plaze
Marc E. Lackritz