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Sent: Tuesday, June 15, 2004 12:10 PM
To: rule-comments@sec.gov
Cc: WilliamDuMond@aol.com
Subject: File # S7-13-04 Concept release-Securities Transactions Settlement

Attached is a summary analysis of the items addressed in the staff concept paper and my observations.

The Attachments are prepared in Microsoft Word ME edition.

I am a retired Senior VP for clearance, custody and capital markets operations for Marine Midland Bank(HSBC Bank USA). I served on the NY Clearing House Securities for 10 years. I have performed consulting work involving STP, Strategic Planning, Product Management, settlement etc for DTCC, PricewaterhouseCoopers and the Bank of China.

I managed a medium-sized bank through a one year liquidity squeeze as a result of the 1974 failure of the Bank Herstatt and also managed the custody business of Marine Midland Bank through the failure of Drexel Burnham and the other customer failures. Currently I am a full time faculty member of Metropolitan College of New York- School of Business. I am available to discuss any of the suggestions made in the attachments.

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**Observations and Comments Re SEC STP Proposals – William DuMond-
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- 1- Removal of institutional RVP/DVP privilege should only be undertaken in extremis. If such removal is administered broker by broker it will only result in trade movement across brokers or in split processing at the institutional level leading to increased operational risk.
- 2- A condition precedent to invoking new proposed T+0 completion of institutional confirm/affirm must be the development of independently verifiable intraday metrics that can be analyzed in multiple ways-by customer, by time slices, by instrument, by initiating broker/trader etc. The first principle of operational excellence is the gathering of the metrics which measure the hallmarks of excellence. Currently available metrics are inadequate.
- 3- T+0 completion of confirm/affirm is too ambitious in the near run and too lenient in the longer run. In the short run we should first use metrics to drive the industry towards T+0 confirm/affirm in steps---1st get improved statistics under the current time regime for matching e.g 95% by T+2 with 80% by T+0.

In the longer run, the requirement that all parties reach quick agreement on the Material details of the trades in order to take rapid corrective action on mis-communication. There must be intraday time elapsed standards running from Trade execution to trade agreement in ways that are documented and auditable. A principal intraday objective is assuring a meeting of the minds on the material details of the trade.

- 4- Proposed Basel Capital rules for institutions with above average operational risk will drive improvements. Consideration should be given to increasing capital requirements on regulated parties with poor meta customer confirm/affirm rates relative to industry standards rising along a reasonable timeline. Let the broker in turn manage his relationships with the customers.
- 5- An industry forensic should be immediately prepared that analyzes the best 20% and worst 20% of current affirming parties as per the improved metric reporting. What is each group doing right or wrong? Are the processes currently used by the best 20 % still available?
- 6- Timely Institutional Mutual Trade Agreement (MTA) should be subject to intraday processing and exception elapsed time standards set for all instruments exempt and non-exempt. In volatile markets, non-mutual agreement on the material terms of each trade must be identified in time for corrective action

without serious market risk attendant. The elapsed time from initial execution through NOE, provision of allocated trade detail, confirmation forwarding, affirmation and settlement should all be measurable against a standard to allow for exception handling of problem items and possible future charges for causing increased operational risk. We must have multiple fail rates along the entire process.

- 7- In designing our future procedures, we must think in terms of global, 24 hour trading , comparison and settlement especially for those securities traded on several international stock markets. Mutual Trade Agreement (MTA) must be in accordance with an intraday elapsed time standard.
- 8- MTA should not be limited to one channel or method. “Realer” time confirm/affirm, mutual counterparty match input, voice journaling or realtime counterparty acceptance (non-rejection) of intraday fund charges for detailed described instruments (eg money market processing for on-line custodian customers) should all be acceptable evidences of a meeting of the minds. All approaches must be documented and readily auditable.
- 9- Static Data for delivery instructions must not be allowed to serve as barriers to entry for new technology. Interoperability must be the rule.
- 10- The long term goal must be to have all instruments settle in a symmetrical manner so that fungible funds can move seamlessly across instruments without timing difference between instruments.
- 11- The full cost/benefit of moving settlement from T+3 to T+0 is close to impossible to measure. Many senior executives are not fully aware of the likely impacts. The 1974 failure of Bank Herstatt and it’s impact on the markets were analogous to what might happen in the case of a large broker failure. There were severe liquidity constraints caused by an immediate flight to quality and the continued

litigation entanglement risk that persists and ties up staff and resources. There should be detailed and on-going training of staff at all levels particularly those executive levels who have no direct experience. Reviews should cover all of the risk possibilities and uses the history of past problems to heighten risk awareness.

- 12- The risks inferred by T+3 settlement could and should be mitigated by the increased development of virtual T+1 settlement in a manner similar to the virtual T+1 mark to market system used in the CNS system. This Virtual T+1 effort should be undertaken by the individual firms because the risks go across multiple infrastructure entities globally and could not be co-ordinated by any one agency.

Larger firms are all subject to LTCM (Long Term capital Management Risk). This risk may be defined as time delayed consolidated counterparty risk. Currently, intraday changes/transactions with counterparties are buried in best of breed trading systems making it difficult to manage overall risk for counterparties dealing in multiple instruments. New consolidated journals which allow for the consolidation and marking to market of overall counterparty risk would mitigate delays in the movement away from T+3. They would also cover all instruments regardless of settlement venue. This calls for an evolution in the infrastructure with the intraday changes(transactions) being journalized centrally and then fed to all parties—settlement, internal users and external users in a format and via a channel that allows or them to immediately reprocess without re-handle. This is a evolutionary process already underway in leading firms.

- 13- STP can not be attained until we have better metrics which measure the extent of each firm's 3Fs Problem. The 3fs are faxing, phoning and physical re-handle. The 3Fs are the hallmarks of where the bottlenecks exist in each operation. Heavy reliance on any of the 3Fs as is the case in the allocations and especially in the area of providing instructions to multiple custodians and in the responses to corporate actions indicate points where volume increases do not easily scale. Metrics on the number of transactions passing through these 3F points is a condition precedent to reaching STP. The solution lies in evolutionary interim solutions which are designed to initially improve 3F volume handling but which can easily scale up to fuller blown STP as the users situation warrants.

- 14- A key stumbling point in moving to T+0 is the process in place to support securities lending and related processes supporting settlement and liquidity. An industry system that supported intraday recall or replacement of collateral is

needed. Additionally, there is a need for a system to support equity repos that provides for haircuts and flexibility to support the requirements of the various credit committees that must be satisfied before equity repo is widely accepted by the buy/invest-side. It should also have realtime intraday feeds from the rating entities that reflect any changes in ratings for the key listed companies. Such an equity repo system would in fact have to be able to handle mixed collateral repos where combinations of securities would support single repos.

- 15- In order to control and act on intraday changes in risk across a range of instruments there must be a movement towards a centralized journal that is first fed and that in turn feeds all best of breed systems. The individual trade data is thus captured in one consolidated site and should be forwardable to all bona fide users-settlement parties, internal users and external users in their preferred format and via their preferred communications channel in order to allow for immediate reprocessing.
- 16- It is politically unlikely to be able to require current holders of certificates that are registered in physical form to move to book-entry. An alternative approach would be to issue replacement certificates in a plain, unadorned generic paper form. Overtime all these certificates would look the same except for the issuing company's name. This "certificate" would have on its obverse side a detailed outline of the various drawbacks to keeping certificates in this form and clear instructions on how to convert certificates to bookentry. Additionally, the SEC should consider requiring the commissioning of an independent industry study to develop an equitable approach that can be followed by individual firms to develop what their cost of issuing and maintaining physical securities amounts to. Holders of these securities should be required to pay for any differential on cost for maintaining physical certificate forms versus the cost of bookentry. The costs should be developed according to a validated formula and subject to independent review. Customers must help pay for these impediments to STP.
- 17- Consideration should be given to the development of a central securities master that is constructed with a limited, flawless "golden copy" of descriptive material for every security listed on any major stock exchange plus US Treasuries and money markets. We would have flawless data centrally maintained for only those securities that were listed or US Governments. Each individual firm would be provided with a Private subset of this central security master which would be maintained by each individual firm. This would give a firm using the system the ability to set up new items that are not widely held on their own private portion of the data base. Overtime categories would be added to the golden list but with firms having to independently maintain their own flexible sub-master.

- 18- In attacking the impediments to external STP between firms we need to develop solutions that work economically for the smaller firms that provide for E-processing of the last 20% of volume. It is in the interest of the entire brokerage and buy-side community to move to T+0 for not only confirm/affirm but for settlement. This of course must be done in a cost effective manner. A targeted % of soft dollar spending should be spent on funding the elimination of faxing, phoning and physical re-handle projects between firms.
- 19- Technology and changes in trade practice must both be undertaken to develop alternatives to the current timing of the allocations process. Late day allocations and matching do not identify problems soon enough and give custodians notice of trades far to late for the process to be completed by T+0. Final custodian notice cannot be a post 5pm process and must be happening intraday with penalties for end day bunching of trade notice. This is primarily a shortened settlement period issue.

Response to SEC Request for Comments Re Staff Concept Release-Securities Transactions Settlement—June 2004.

**Submitted by Professor William J DuMond – Metropolitan College of New York
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The SEC staff paper solicits comments on suggestions for improving the safety and operational efficiency of the US clearance and settlement system and to help the US securities industry achieve STP. The staff paper addresses and seeks comment on three principal, related subsections

1- Improving Timely, Institutional Confirm/Affirm of US Equity Securities

The SEC is planning to require a tightening and compression of the current institutional confirm/affirm process calling for full completion on Trade Date (T+0). Counterparty institutions that have been granted Receive Versus Payment/Delivery versus Payment (RVP/DVP) settlement privileges would lose such privileges if they could or did not affirm by the close of Trade Date in accordance with a new proposed T+0 completion date for matching and locking the trades.

Under this newly proposed regulation, the current multi-day confirm/affirm process would have to be completed on Trade Date-(T+0) for all RVP/DVP institutional counterparties. Settlement would still initially be T+3 business days but would likely further compress (See 2 below). Industry input is only solicited on whether the implementation is done directly by the SEC or via the Self Regulatory Organizations (SROs).

2- Compressing T+3 Settlement--A request for comments on the pros, cons and cost/benefits of further compressing the US equity settlement from its current Trade Date plus three business days standard (T+3) to T+2, T+1 or T+0. This would be done to reduce the market, counterparty credit and liquidity risks inherent in the current settlement of institutional trades where an institutional counterparty enjoying RVP/DVP may fail to pay for securities at the end of what may be five calendar days during which the market value of the equities may have deteriorated materially.

3- Elimination of Physical Securities---A solicitation of opinions on what course of action, if any, is needed regarding retail clients continued ability to register securities in physical form. Such physical registration is an impediment to STP because of the time to receive and transfer such items.

