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Via Airborne

Jonathan G. Katz; Secretary
Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20459-0609

Re: Securities Transactions Settlement: Proposed Rule; File No. S7-13-04.

Dear Mr. Katz:

The Depository Trust & Clearing Corporation ("DTCC")[1] appreciates the opportunity to respond to the request by the Securities and Exchange Commission (the "Commission") for comment on the above-indicated concept release regarding methods to improve the safety and operational efficiency of the U.S. clearance and settlement system, and to help the U.S. securities industry achieve straight–through processing ("STP").[2]

In short, DTCC believes that:

- Industry "best practice" is to complete agreement (through matching or affirmation) on institutional trades on trade date, although in some circumstances this is not possible. The industry should undertake a structured program over the next several years to dramatically improve the rates of agreement on such trades on trade date, relying on pricing disincentives and other actions to promote progress. Ultimately, once sufficient progress has been achieved, standards should be adopted that preclude automatic settlement for "un-agreed" or unmatched trades.

- The fixed income markets lag the equities markets in achieving higher rates of earlier trade agreement, and this is a significant obstacle for STP for transactions in fixed income securities. Active Government market professionals should be required to match data on trade date for all "regular way" trades on a real-time basis through FICC. This should be explicitly identified as part of the industry's overall STP objectives.

[1] DTCC is the parent of The Depository Trust Company ("DTC"), Fixed Income Clearing Corporation ("FICC"), National Securities Clearing Corporation ("NSCC"), and Emerging Markets Clearing Corporation ("EMCC"), clearing agencies registered with the Commission under Section 17A of the Securities Exchange Act of 1934 (15 U.S.C. 78q–1).

[2] As required, we are submitting this letter in triplicate.

- While DTCC has largely implemented the changes needed on its end to accommodate a shortened settlement cycle, DTCC does not endorse a move to T+1 at this point in time. This is because the necessary changes have yet to be made by regulators and industry vis-a-vis retail customers (including alternative payment mechanisms and revised prospectus delivery rules), matching or affirmation on trade date, and standardization of reference data, and because the costs that would be borne by industry and investors in both time and money may well, at the moment, outweigh the attendant benefits.

- A much more aggressive approach to the elimination of physical certificates should be pursued. Dematerialization should be explicitly adopted as the objective of these efforts.

I. Background.

Since 1999, DTCC has actively participated with the Securities Industry Association ("SIA") and other interested parties in developing industry solutions for STP, automating securities transactions clearance and settlement. The original SIA T+1 plan identified a series of "building blocks" required before T+1 could be implemented for equities and certain fixed income securities. DTCC subsidiaries were identified as being responsible for several. The eventual SIA decision to postpone the implementation of T+1 presumed, and the DTCC Board agreed, that DTCC subsidiary deliverables would for the most part be completed in any event.

The "DTCC building blocks" are listed below, along with their current status:

- Accelerate trade input to clearing.

  Status: Equity trade input from all trade sources has moved from end-of-day batch input to intra-day, with major markets submitting data real-time.

  FICC has implemented real-time trade matching for most fixed income security types, and will do so for the remaining fixed income security types on June 14, 2004.

- Where possible, lock all trades in at time of execution.

  Status: 99.9% of all equity trade activity is now locked in by the markets.

- Rewrite the NSCC Continuous Net Settlement ("CNS") system.

Status: The CNS system has been rewritten on a new technology platform that supports real-time processing, and the new system is scheduled for implementation in mid- 2004.

- Accelerate NSCC trade guarantee.

  Status: A possible revision to the timing of the NSCC trade guarantee has not been decided upon, with studies indicating that the additional collateral required for a trade date guarantee would be prohibitive in a 3-day settlement cycle.

- Immobilize/dematerialize certificates.

  Status: DTC has taken further steps to immobilize and dematerialize certificates, but strong regulatory and industry support will be crucial if these goals are to be completely achieved.

II. Trade Confirmation and Affirmation.

Institutional Trades. In its concept release the Commission discusses the possibility of a regulatory mandate requiring institutional trades to be agreed (*i.e.*, affirmed or matched) on trade date. While completing agreement on the details of a trade on trade date is not, strictly speaking, imperative for securities processing in a T+3 settlement environment, trade agreement on trade date does produce significant benefits to the industry. It increases settlement certainty, supports business resiliency, and paves the way for any potential future acceleration of the settlement cycle. Consequently, Omgeo, a joint venture between DTCC and Thomson Financial, has implemented both Central Trade Manager ("Omgeo CTM")[3] for agreement on cross-border institutional trades, and OASYS-TradeMatch for U.S. securities transactions. Omgeo intends to migrate all of its clients to the Omgeo CTM platform eventually. DTCC believes strongly that, given these benefits, achieving agreement regarding the details of trades on trade date should be a key industry objective in the near term. In limited circumstances this may not be possible (*e.g.*, for trades with counterparties in distant time zones), but for the vast majority of trades DTCC believes that this is a fully achievable objective.

[3] Omgeo CTM allows all counterparties to work simultaneously to match trades and to move trades from execution to settlement, leveraging existing technology and using industry–standard formats and automated settlement notification messaging.

Furthermore, the use of a "matching" process clearly is the preferable approach for achieving this agreement on institutional trades. Central matching improves the rate of "trade date" agreement on trades dramatically. The rate of agreement on trade date for centrally matched transactions is 77.8%, against 16.5% for those transactions processed via the traditional confirmation/affirmation process. The rate of agreement at noon of T+2 is also higher for centrally matched trades: 95.5% of centrally matched trades are agreed by that time, versus 85.7% of those transactions that are confirmed/affirmed.[4] Higher rates of agreement on trades are much more desirable for a variety of reasons. One key benefit is that trade agreement reduces the likelihood that a delivery may subsequently be reclaimed at DTC, and supports settlement finality – only 0.2% of deliveries on institutional trades are reclaimed if there was prior agreement on the trade, while 6.7% of deliveries on such trades are reclaimed if agreement was not formalized before the delivery was made. This exposure to subsequent reclamation of a delivery impairs achievement of settlement finality on "un-agreed" trades, and is a risk issue that must be addressed.

Consequently, DTCC endorses the SIA Institutional Trade Processing Committee's matching proposal. This step will reduce risk and add certainty to the settlement process.

DTCC recognizes that amending existing rules to make the extension of the "COD privilege" contingent upon achieving agreement on trade date is an approach that would be consistent with past regulatory practice in this area. We are concerned, however, based on past experience, that compelling full compliance with such standards is difficult and places the burden on a party (the confirming dealer) who has little leverage to use to "enforce" the standard; achieving the objective of high rates of trade agreement on trade date through such an approach would, at best, be a protracted exercise. Therefore, we suggest consideration of alternative approaches. Specifically, we suggest a multi-year phased approach in which subsequent steps would be taken as various milestones are reached. As the ultimate step, DTCC believes that rules should be adopted under which DTC would not permit deliver orders to be used to settle "regular way" trades until the trade has been agreed through a matching or affirmation process.

As an example, a phased approach similar to the following could be adopted:

1. DTCC could adopt severe financial disincentives for reclamations of trades processed after the original delivery date, with these disincentive fees becoming increasingly severe the longer after the original delivery date that the reclamation is delayed. This would immediately address the risk exposure and

[4] Source: Omgeo; March 2004.

impaired settlement finality attributable to delayed reclamations. The Board would consider including these disincentive fees as part of any fee changes made in January 2005.

2. DTCC would proceed with the implementation of modifications to the depository's Inventory Management System that would provide depository participants with a centralized mechanism to prioritize and control their delivery processing. The extensive and sophisticated capabilities that would become available through IMS would further advance the achievement of settlement finality, and increase the pressure on industry members to accelerate the trade agreement process.

3. DTCC, working with Omgeo, would begin to publicize on a periodic basis trade agreement statistics at various points during the post-trade process – for example, matching and affirmation statistics as of midnight on trade date (T), as of T+1 noon, as of T+1 midnight, and as of T+2 noon.[5] This would permit the industry to monitor progress against various milestones, and to continue to "raise the bar" as overall trade agreement processing improves (*e.g.*, as the T+1 midnight rate reaches certain levels, refocus on achieving agreement by T+1 noon).

4. As these statistics reflect the necessary progress, DTCC would consider using pricing disincentives to encourage firms to affirm or match trades. Specifically, settlements on institutional transactions without a related affirmation or match of the trade could be charged a substantially higher fee. While it may be somewhat difficult to ensure that the structure of such a disincentive applies these penalties appropriately (*i.e.*, that the higher "special charge" disincentive actually gets assessed against the party that failed to agree the trade), DTCC believes that, once appropriate progress milestones have been reached, disincentive fees would provide a powerful tool to accelerate further progress.

   To continue to encourage trade agreement, DTCC expects that the delivery fee for settlements of matched or affirmed trades processed through DTC will be reduced once again in January 2005.

[5] Statistics from other central trade matching/affirmation utilities recognized as such by the Commission could also be included in such reports, if provided.

5. DTCC believes that these steps should ultimately be followed by a regulatory requirement precluding "un-agreed" or unmatched trades from proceeding to automated settlement, with an effective date several years hence (*e.g.*, in 2008). Industry discussion suggests that consideration of this approach, originally advanced by the SIA's Institutional Trade Processing Committee, may now be timely. While the details of this approach would be finalized subsequently, identifying it now as part of the overall phased program would help focus industry members on the need to address the trade agreement issue rapidly and effectively.

Fixed Income Trades. DTCC supports the above steps for all institutional trades. It is important to note that there are additional issues relating to the matching of transactions in fixed income securities which also must be addressed. With regard to the sell side, since 2000, the Government Securities Division ("GSD") of FICC, which matches primarily broker/dealer-to-broker/dealer fixed income trades, has provided a Real-Time Trade Matching ("RTTM") service for the Government securities marketplace. RTTM facilitates the submission and comparison of trade data within minutes of execution. RTTM also allows participants to identify and resolve trade execution differences promptly, eliminates the need for a manual verbal "checkout" process, and provides an immediate legal and binding confirmation for trade executions.[6]

Inasmuch as the GSD guarantees settlement of a transaction at the time of comparison, the immediate submission and comparison of Governments buy-sell and repo activity on a trade-by trade basis is critical to: (a) reduce systemic risk (including not only counterparty credit risk, but also "9/11-type" risk; that is, the risk that some catastrophic event will occur after trade execution which will prevent a market participant from submitting that activity for comparison); and (b) ensure the safety and soundness of the Government securities clearance and settlement process. The GSD's ability to compare and guarantee eligible activity in a timely manner and, thus, reduce systemic risk is compromised by the lack of mandatory industry-wide trade matching. Unlike other markets, the Governments market has no SRO confirmation or price reporting requirements and, therefore, no mandate for market participants to submit

[6] 95% of all GSD trades are now submitted on an interactive basis by 82 members. FICC is also seeing a gradual increase in the number of Mortgage-Backed Securities Division (MBSD) trades submitted interactively (RTTM having been introduced for the MBSD in 2002).

In addition, FICC has developed a new STP institutional settlement model, outlined in its 2003 white paper, that would allow it to capture a dealer's buy-side trades without requiring institutions to join the clearing corporation (by treating the dealer and institutional sides of the trades discretely). Specifically, FICC would include the dealer side of the trade in its net settlement process, while the institutional side of the trade would not be netted but, rather, settled on a trade-for-trade basis. This trade-for-trade settlement would be based on settlement instructions provided by the institution's matching engine (*e.g.*, Omgeo).

trade data to the clearing corporation. In addition, given that the Governments market is an over-the-counter one, it is possible (as a practical matter) for a market participant – even an active one – not to participate in the clearing corporation's comparison, netting, and settlement processes.

DTCC therefore also supports, and believes that the industry would greatly benefit from, a regulatory requirement for active market participants to match data on trade date for "regular way" trades on a real-time basis (buy side entities through Omgeo or another central matching utility and broker-dealers through FICC). Such a broad mandate is essential to preserving the safety and soundness of the clearance and settlement process for the Government securities marketplace.[7]

III. Securities Settlement Cycles.

The concept release poses a number of questions regarding the benefits and costs of shortening the settlement cycle. As an active participant in the original Group of Thirty clearance and settlement project and the Bachmann Task Force that recommended shortening the settlement cycle from T+5 to T+3, DTCC acknowledges the Commission's perception that, all else being equal, a shorter settlement cycle provides certain benefits:

- It results in fewer unsettled trades and, therefore, may reduce credit and market risk;
- It may reduce liquidity risk and financing costs for firms to the extent that it helps to align the derivative and cash markets; and
- It may encourage efficiency in clearance and settlement.

DTCC also recognizes, however, that a further shortening of the settlement cycle cannot be achieved without a significant investment of time and money in changed systems and revised procedures. Further, in contrast to the past implementation of the change to T+3, a move to a still-shorter cycle would require significant reengineering of both processes and of the systems that support them, rather than a simple acceleration of the performance of those processes (which sufficed for the transition from T+5 to T+3). In addition, a shortening of the settlement cycle will necessitate changes to longstanding business practices. Sufficient lead time will be required to ensure a smooth transition with minimal disruption to the industry.

[7] In this regard, DTCC's Board is considering a rule change proposal along these lines for filing with the Commission. Any such trade submission mandate would be satisfied by submission to a centralized matching process such as those offered by Omgeo and FICC. This is, however, only a partial solution to the problem of active market participants' activity not being submitted to the clearing corporation, given that membership in FICC is voluntary

The benefits of moving to a shorter settlement cycle, then, must be considered against the background of the current market environment, and weighed quite carefully against the cost to market participants.

For the past five years, DTCC has focused on and completed a number of initiatives that promote STP and enable a shorter settlement cycle (described earlier in this letter). DTCC's systems are now fully capable of supporting a shorter settlement cycle for both "street-side" and institutional trades. DTCC is highly cognizant, however, of the broader requirements upon the financial industry that would be triggered by a move to a shorter settlement cycle. Significant work – and significant investment – remains before the financial industry will be ready to adopt a shorter settlement cycle.

While DTCC has largely completed its responsibilities for certain of the building blocks outlined in the SIA's T+1 business case as necessary to "close the gap" between T+3 and T+1, and is actively engaged in the effort to immobilize/dematerialize physical certificates, the building blocks affecting retail customers (including alternative payment mechanisms and revised prospectus delivery rules) are not yet in place. And, while significant progress has been made on the institutional side, work still needs to be done to achieve matching or affirmation on trade date, and to standardize reference data. Until all of these building blocks are in place, a shortening of the settlement cycle will likely fail to produce many of the anticipated and desired risk and cost reduction benefits.

Consequently, DTCC believes that the costs of a move to a shorter settlement cycle may well outweigh the attendant benefits at this time. Accordingly, DTCC does not endorse a move to a shorter settlement cycle.

IV. Immobilization and Dematerialization of Securities Certificates.

DTCC fully endorses aggressive initiatives aimed at bringing the industry's long struggle to immobilize and eliminate physical securities certificates to completion. We believe that it is essential that concrete steps toward this end be taken in the near term.

DTCC has worked closely with the SIA's STP Legal & Regulatory and Physical Securities Subcommittees to eliminate physical securities certificates. A recent study by the SIA estimates that the cost of handling and processing physical certificates approximates $250 million annually – a cost ultimately borne by investors and issuers. The cost of physical certificate handling at DTC alone exceeds $85 million annually. In addition to the costs associated with the manual processing and safekeeping of paper certificates, physical securities certificates introduce unnecessary risk of loss, theft, and fraud, as well as delays in transactional processing.

That the substantial costs reflected in the SIA study's statistics remain, illustrates clearly both the need for a continued focus on eliminating the use of certificates and the increasing difficulty of achieving further progress on this issue. Over the course of the past 30 years, recognizing the attendant significant gains in cost reduction, the industry – and DTCC itself – has expended substantial effort to eliminate the use of physical securities certificates in transaction processing. The success of these efforts has been most striking for mutual funds, U.S. Government and agency issues, money market instruments, options, and futures instruments, all of which have been fully converted to book-entry-only issues. Similarly, virtually all newly underwritten municipal debt offerings – a highly retail-oriented product – are distributed as book-entry-only issues, as are most corporate debt offerings.

With respect to equity securities, substantial progress has been made in immobilizing the overwhelming majority of these issues – DTCC estimates that more than 85% of all shares of issues listed on the New York Stock Exchange have been immobilized, and better than 80% of Amex and Nasdaq-listed issues. In a few instances, equity issuers have even embraced dematerialization – most visibly AT&T which, after its recent corporate reorganization, did not issue any physical certificates for its new stock. It remains the case, however, that equities are the only significant asset class that continues to follow the antiquated process of individual investors holding physical stock certificates to any significant extent. Decentralized individual state corporate laws, coupled with the tradition (peculiar in many ways to the U.S.) of holding paper stock certificates, have contributed to this unfortunate phenomenon.

<u>DRS</u>. Through the efforts of a joint industry committee of representatives of the SIA and the Securities Transfer Association, DTC cooperated with major transfer agents to introduce the Direct Registration System ("DRS") in 1996. DRS allows book-entry shares to be held directly on the books and records of an issuer, offering investors an alternative to "street name" and physical registration. Today, over 700 issues have joined DRS. With the addition of the Networking for Equities ("NFE") processing system to DRS, DTC now also supports the immobilization and dematerialization of non-traditional depository securities products such as restricted stock certificates, limited partnerships, and collateralized securities. The groundwork for a full book-entry environment for equity securities has unquestionably been established. Even with these improvements, however, and with some of the largest securities issuers participating in the DRS program, market utilization remains disappointingly low. DTCC is convinced that, notwithstanding the success in immobilizing equity securities certificates over the past decades, further progress in eliminating equity securities certificates will be increasingly difficult and increasingly expensive unless stronger steps are taken. More aggressive and definitive actions are needed, and the Commission's support here is crucial.

One key near-term step would be the adoption of appropriate requirements at the market level mandating that equity issuers listing their securities for trading on the market must arrange to have their issues participate in the DRS program. The Commission should act to ensure that all markets adopt such requirements concurrently, so that no market perceives a competitive advantage – as shortsighted and contrary to the national interest as that would be – in not providing for a mechanism to stem the continued issuance of certificates. DTCC agrees that this would be an appropriate next step in the effort to promote dematerialization of equity issues.

State Law Changes. Additionally, DTCC supports the lobbying of the six remaining state legislatures, most notably Delaware, to change their laws requiring the issuers incorporated within their states to make physical certificates available to investors.

Fee Changes. In support of immobilization and dematerialization, DTCC itself is prepared to propose sharply raised fees for certificated withdrawals in the near–term in order to create an economic disincentive for those requesting a physical certificate. These fee increases would disincent all withdrawals of certificates, but particularly focus on withdrawals for DRS issues where issuance of a certificate (as opposed to a DRS statement position) is requested.

As a potential further step, we are also prepared, at a later date after the above steps have been taken and certificate requests have fallen to an appropriate level, to eliminate the option of requesting a certificate through DTC's Withdrawal by Transfer ("WT") service for any WT on a DRS issue, effective once industry members have had sufficient time to make any necessary changes in their own systems.

Full Dematerialization. DTCC also strongly supports full dematerialization of securities issues. Under dematerialization, not even the one or more "global certificates" that are created for book-entry-only issues are necessary. Considering that DTC holds well over 2.2 million issues, the benefits here will be substantial in the aggregate.

DTCC strongly urges the Commission to support these and other immobilization and dematerialization efforts, both through its support of state law and regulatory changes, and through its communications with the public.

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DTCC appreciates the opportunity to comment on the concept release.

Very truly yours,

Jill M. Considine

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