CFA Consumer Federation of America

December 5, 2016

Brent J. Fields
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: File Number S7-22-16
Amendment to Securities Transaction Settlement Cycle

Dear Secretary Fields,

I am writing on behalf of the Consumer Federation of America (CFA)[1] regarding the Commission's proposed rule to shorten the standard settlement cycle for most broker-dealer transactions from three business days after the trade date ("T+3") to two business days after the trade date ("T+2"). While there is no doubt this proposal constitutes an improvement over the status quo, it is woefully insufficient to properly protect market participants from credit, market, and liquidity risks, safeguard the financial system from excessive and unnecessary threats, and ensure the timely processing of investors' transactions. The Commission must go further to mitigate these shortcomings, including by moving without undue delay toward a "T+1" standard based on straight-through processing. Doing so would spur a faster, safer, and more efficient 21st century clearing and settlement process.

I. Overview of the various risks inherent in the current settlement cycle

The settlement cycle begins when an investor's order is executed and ends when the securities are exchanged for cash and ownership of the securities is transferred. The longer this cycle spans, and the more money that is at risk during this cycle, the more there is that can go wrong for a variety of market participants and for the financial system as a whole.

First, the length of the settlement cycle can affect central counterparty (CCP) risk. Shortly after a transaction is executed, a central counterparty (in this case, the National Securities Clearing Corporation, or NSCC) novates the transaction, guarantying the terms of transaction and assuming liability for performing according to those terms if the buyer or seller doesn't perform. As a result, the CCP is exposed to any credit, market, or liquidity risk and resulting losses that arise from the transaction. The longer the cycle, the longer the CCP bears these risks. For example, a CCP assumes the credit risk that a broker-dealer that is a CCP member could default after the novation.

[1] CFA is a non-profit association of nearly 300 national, state, and local pro-consumer organizations. It was formed in 1968 to represent the consumer interest through research, advocacy and education.

In this scenario, the CCP would have to step in and perform instead, pursuant to the guaranty. In addition, a CCP assumes the market risk that a CCP member broker-dealer could default in a volatile market, with the value of securities suddenly moving against the CCP. In this scenario, the CCP would still have to perform at the agreed upon price and cover the difference. Moreover, the CCP assumes the liquidity risk that it could experience a sudden funding shortfall and not be able to make good on its obligations. Ultimately, the CCP assumes the first position of absorbing any losses from the time it novates the buyer and seller's transaction until ownership of the securities is finally transferred.

The length of the settlement cycle can also affect the liquidity risk of broker-dealers that are CCP members. CCP member broker-dealers are organized in a mutualized system and are subject to both daily and on-demand payments for the CCP's ongoing risk management purposes. If a broker-dealer defaults, the CCP is immediately responsible for covering any losses, as discussed above, and then those losses are mutualized among the CCP member broker-dealers. However, if a CCP member broker-dealer is assessed an unexpected payment pursuant to another broker-dealer's default, it could itself experience a sudden liquidity shortfall resulting in its own default. The longer the cycle, the more time there is for broker-dealers to default and the greater the number and value of transactions that are at risk of default.

Settlement shortfalls among CCPs and CCP member broker-dealers can create and proliferate systemic risk. Because risk is first centralized and concentrated within a CCP, a CCP could easily become a too-big-to-fail institution whose failure wreaks havoc on other market participants and the broader financial system. Former SEC Commissioner Steven Wallman has referred to this possibility as "a doomsday scenario."[2] Further, because CCP member broker-dealers are interconnected within a mutualized system, the failure of any one participant in the system could create a domino effect on others. For example, if a CCP or CCP member broker-dealer were to face a sudden liquidity demand and couldn't come up with that payment, it would default, triggering higher payments for the remaining broker-dealers. And if the remaining broker-dealers couldn't come up with those higher payments, they would default, which would trigger even higher payments among the remaining CCP member broker-dealers. Thus, a moderate amount of stress could have cascading and magnifying effects on others, spurring more and more defaults throughout the system.

The length of the settlement cycle can also affect how long it takes for investors' transactions to be processed. Under the current "T+3" standard, it can take three business days from when an investor's order is executed until the securities are exchanged for the cash. This means that, if an investor suddenly needs cash and decides to sell stock or an ETF in her portfolio on a Thursday, the investor would need to wait until the following Tuesday before she could gain access to the cash from that transaction. This lengthy waiting process can be frustrating and potentially very damaging for investors who are faced with immediate and unexpected financial obligations. Investors may respond to this lengthy settlement process by keeping larger buffers of cash on hand beyond their normal emergency fund, which can be costly and inefficient. Alternatively, they may borrow money short-term, often at very high interest rates, to bridge the

[2] Meeting of the Securities and Exchange Commission Investor Advisory Committee, Update on Possible Recommendations of the Market Structure Subcommittee on the Settlement Cycle, October 9, 2014, at 1:40, https://www.sec.gov/video/webcast-archive-player.shtml?document_id=iac100914

time gap, which can also be costly. Or, they may just have to wait until the transaction has settled, which can have other opportunity costs.

Other problematic scenarios relating to the lengthy “T+3” settlement process can cost investors money and impede basic transactions. For example, if an investor tries to sell an ETF and then tries to buy a traditional open-end mutual fund on the same day, her broker may not allow the trade due to the two-day difference in settlement between the ETF and mutual fund.[3] If an investor tries to make the trade, her account will be short of money for several days, which means at best, the investor would be charged interest; at worst, the buy order would not go through.[4] As a result of this delay in settlement, even relatively simple and commonplace transactions, such as the routine rebalancing of an investor’s portfolio or the modification of her asset allocation, can be turned into lengthy and complicated, multi-step processes.

II. Benefits of shortening the settlement cycle

Shortening the settlement cycle would better protect market participants from credit, market, and liquidity risks, reduce the threat of systemic risk, and hasten the processing of investors’ transactions. First, each individual trade would be at risk for a shorter amount of time, which would mean there would be less time for defaults and ensuing losses to occur. In addition, both the total number of trades and the total market value of trades that are at risk at any one time during the cycle would be reduced. This would benefit CCPs by reducing their initial overall exposure and CCP member broker-dealers by reducing the amount they would have to provide in additional resources for a CCP’s risk management purposes, both on daily and on-demand bases. Overall, shortening the settlement cycle would significantly improve financial stability by reducing the threat that sudden liquidity demands could have knock-on effects on a CCP, its member broker-dealers, and others within our highly interconnected system. Finally, shortening the settlement cycle would be greatly beneficial to investors who need access to cash in shorter turnarounds.

III. The Commission must go further than this proposal

While a “T+2” standard is certainly an improvement over the current “T+3” standard as far as shortening the settlement cycle and reducing time-related risks, “T+2” still constitutes an unreasonably lengthy settlement process in this day and age. Moreover, a “T+2” standard still effectively preserves other suboptimal processes within the settlement cycle. This is because the length of the settlement cycle is closely related to how the settlement cycle is structured. A longer cycle allows settlement processes to be structured in inefficient ways that are iterative, redundant, and error-prone. Take, for example, trade comparison and confirmation communications, which are often sent back and forth manually. A “T+2” timeframe doesn’t necessarily address these issues head on because, while it requires compression of time, it doesn’t necessarily require the fundamental overhaul of settlement procedures so that they are most efficient, automated, and least error-prone.

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[3] ETFs currently settle on a “T+3” schedule, while traditional open-end mutual funds already currently settle on a “T+1” schedule.

[4] *See, e.g.*, FIDELITY, The drawbacks of ETFs, https://www.fidelity.com/learning-center/investment-products/etf/drawbacks-of-etfs; Robert Schmansky, An ETF Quirk That Could Hurt Your Portfolio, FORBES, http://www.forbes.com/sites/feeonlyplanner/2011/05/16/an-etf-quirk-that-could-hurt-your-portfolio/#4a5a02f32054

Because the "T+2" does not fundamentally improve the settlement process, the Commission should instead move without undue delay toward a "T+1" standard based on straight-through processing. Requiring "the seamless integration of systems and processes to automate the trade process from end-to-end — trade execution, confirmation, and settlement — without manual intervention or the rekeying of data"[5] will ensure the most efficient settlement processes and decrease the potential for discrepancies to result in operational risk.

Despite the higher initial costs under this approach, those costs would be paid back in a relatively short amount of time. According to a 2012 Boston Consulting Group study, for example, it would take about ten years for the industry to recoup its initial costs, based on annual operational cost savings and reductions in clearing fund contributions, as well as other considerable economic benefits relating to reductions in exposure.[6] Indeed, these initial costs are well worth the long-term savings associated with moving toward a "T+1" standard.

Let's not forget that it was the Securities Industry Association (SIA), the predecessor to SIFMA, which originally published in 2000 the business case for shortening the settlement cycle to "T+1" and adopting straight-through processing.[7] In fact, that white paper is still housed on SIFMA's website, stating unequivocally on the landing page, "The case for moving to T+1 settlement for the U.S. financial services industry is strong and is based upon several factors."[8] The report details these factors:

> First, the move from T+3 to T+1 will dramatically reduce the settlement risk exposure of the U.S. securities industry. Second, it will enable the U.S. market to continue to maintain its global competitiveness by serving as the catalyst for enhancing the current post-trade processing and settlement process. The changes will result in a significant economic benefit to the industry. Third, the move to T+1 serves the interest of the U.S. investor by synchronizing the clearance and settlement process across asset classes, and enabling more fungible, flexible trading and investing. Finally, improving current trade process activities will make it possible for the U.S. market to support increased volumes.[9]

The report also makes the case that such a transition is eminently feasible. It states, "T+1 can be realized in three and one-half years of elapsed time. Assuming a start in the fourth quarter of 2000, T+1 could be realized by June 2004."[10] If such a transition was feasible in three and a

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[5] Securities Industry Association, Glossary of Terms, Kyle L Brandon, Prime Brokerage: Of Prime Importance to the Securities Industry (SIA Res. Rep., Vol. VI, No. 4, New York, N.Y.), Apr. 28, 2005, at 25-26, http://www.sifma.org/WorkArea/linkit.aspx?LinkIdentifier=id&ItemID=21718&libID=5884.

[6] The Boston Consulting Group, Cost Benefit Analysis of Shortening the Settlement Cycle (Oct. 2012), http://www.dtcc.com/news/2012/october/01/cost-benefit-analysis-of-shortening-the-settlement-cycle

[7] Securities Industry Association, T+1 Business Case Final Report (July 2000), http://www.sifma.org/issues/item.aspx?id=8589939820. While SIA was a leader in this regard, SIFMA, to our knowledge, has not advocated for "T+1" or straight-through processing in recent years. Instead, it has coalesced around the industry's position that they should move to a "T+2" standard and then pause to assess further assessment of industry readiness and appetite for a future move to T+1.

[8] *Id*. at 1.

[9] *Id*.

[10] *Id*.

half years in 2000, it should be much easier to adopt and implement more than 16 years later, given the significant advances in technology and automation in financial markets in the interim.

Unfortunately, notwithstanding the strong statements of support years ago for a “T+1” standard, the industry has since coalesced around the idea that the Commission should adopt a “T+2” standard and then pause for further assessment of industry readiness and appetite for a future move to T+1.[11] We strongly oppose such a tepid approach. The industry has already proven that it is either unwilling or unable to move collectively and in a timely manner toward a shorter and more automated settlement cycle, even one that is based on the less significant “T+2” timeframe. Thus, we fear that any pause after implementation of “T+2” is likely to be indefinite. At the very least, it is likely to extend until the Commission revisits this issue, which could be years away. Given these considerations, we urge the Commission to push forward with the near-term adoption of a “T+2” timeframe AND provide a concrete timeline by which the industry transitions to a “T+1” timeframe based on straight-through processing. In short, the Commission must not squander the opportunity that it has before it and must not defer to the industry, which has talked a big game but failed to achieve any progress on this issue.

IV. We can and must do better

The United States prides itself on having the most competitive and innovative securities markets in the world. Unfortunately, we are a laggard when it comes to securities settlement, and are now faced with the task of playing catch up to many other markets, including the 29 countries in the European Union that moved to a T+2 more than two years ago. Several of those countries, including some that were members of the Soviet Union not too long ago, have far less developed economies and securities markets than us. And yet they have leaped ahead of the United States when it comes to this important issue. Instead of playing catch up to these countries, we should be a leader. Unfortunately, the timid proposal put forward by the Commission would maintain our status as followers.

Conclusion

While this proposal clearly constitutes an improvement over the status quo, we can and should do far better. The Commission must move without undue delay toward a “T+1” standard based on straight-through processing, which would spur a faster, safer, and more efficient 21st century clearing and settlement process.

Respectfully submitted,

Micah Hauptman

Micah Hauptman
Financial Services Counsel

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[11] *See, e.g.,* DTCC Recommends Shortening the U.S. Trade Settlement Cycle; Shortening the Settlement Cycle: The Move to T+2, http://www.dtcc.com/news/2014/april/22/shortening-settlement-cycle.aspx. In collaboration with the financial services industry, The Depository Trust & Clearing Corporation (DTCC) formed an Industry Steering Committee (ISC) co-chaired by SIFMA and ICI. See also, SIFMA, Shortened Settlement Cycle Resource Center, which states: “SIFMA supports a move to shorten the settlement cycle for U.S equities, corporate bonds and municipal bonds to trade date plus two days (T+2) from the current T+3 in the third quarter of 2017.” http://www.sifma.org/issues/operations-and-technology/shortened-settlement-cycle/overview/