Draft Recommendation for the Market Structure Subcommittee of the IAC Concerning T+2 Settlement

IAC Recommendation: Shortening the Trade Settlement Cycle in U.S. Financial Markets

Introduction

- The Depository Trust & Clearing Corporation (DTCC) has proposed shortening the settlement cycle in the U.S. financial markets for equities, corporate and municipal bonds, and unit investment trust (UIT) trades to a two-day settlement period, which is commonly referred to as T+2. Currently, the securities industry completes settlement for these transactions on the third business day after a trade is executed, or T+3 (meaning that ownership of the security is actually transferred and money is exchanged between buyer and seller three days after the transaction occurs).

- The goal of shortening the settlement period is to reduce risks in the financial system. During the settlement period, market participants have credit exposure to each other. If one party defaults on either delivery of a security it sold or payment for a security it purchased, the counter party to the trade (frequently a clearing house acting for the industry) may sustain financial losses. Given the very large volume of daily trading in U.S. financial markets, the amount of credit exposure that financial market participants have, collectively, to each other is substantial; and the risk associated with this exposure is especially great during times of systemic financial stress. These changes will directly benefit retail investors (as well as other participants in the markets) through increased certainty, safety and security, resulting from lower levels of avoidable risk.

Recommendations

- The Committee believes that addressing this cause of systemic risk is critical.

- The Committee strongly endorses the direction of the recommendation by the DTCC to shorten the settlement cycle, and encourages the Commission and all market participants to move forward with the implementation of a shorter settlement period for all securities as soon as possible. Additionally, the Committee recommends that the shortened settlement period apply to any security-based swaps referencing the forgoing.

- Furthermore, the Committee strongly recommends the implementation of a <u>T+1</u> settlement period at least for U.S. equities and other US securities (corporate and municipal bonds, and UIT transactions) <u>as soon as possible</u>. The Committee believes that moving to a T+1 settlement period, matching the settlement period that already exists for Treasuries and many mutual funds, would greatly reduce systemic risk and benefit investors. We are concerned that an interim step to T+2 for all securities on the current, multi-year timetable involving relaxed study, consensus, planning and review with no apparent urgency or priority will delay unreasonably a move to T+1 for all securities and reduce the overall benefits to the financial system and investors.

- The Committee also recommends that the current industry/DTCC effort be strengthened with clear timetables and near term deadlines for action. The Committee believes that one of the causes for the current tentativeness is that this issue is being driven only by certain industry participants, without forceful Commission oversight and aggressive action for industry-wide coordination. Given the important systemic risk issues that longer settlement cycles pose, the Committee recommends that the Commission take a lead role in this process and not relegate this critical systemic risk issue to market participants or to the prudential banking regulators that do not have a central role in overseeing the critical market infrastructure that this change will impact. We understand that the Commission believes that priorities should be set based on overall impact and importance to the markets and investors. We agree. With perhaps only one or two exceptions, however, we cannot think of any other higher impact measure that is within reach, that does not potentially have other adverse consequences, and that can so substantially lessen what is otherwise significant systemic risk.

- To the extent the interim step of T+2 is nevertheless pursued, we recommend that the Commission work with industry participants to create a clear plan for moving to T+1 in an expedited fashion rather than pausing at T+2 for an indeterminate period of time.

Background

- The compelling justification for reducing the settlement period is to reduce the overall level of systemic risk in the financial system. Each day a purchaser of securities owes a seller money, the seller is exposed to the credit risk of the purchaser. In volatile periods when the market price of securities may change rapidly, the ability of a seller to recoup losses from a failed sale becomes more uncertain. Reducing the number of days of credit, liquidity, and counterparty risk in the system greatly benefits market participants collectively and the overall financial system generally, as well as investors that utilize the services of intermediaries or that are exposed to counterparty risk directly. These risks materializing in volatile times can become a serious contagion resulting in potentially enormous overall and systemic risk. Mitigating that risk should be a very high priority of the Commission. We have seen the results of this risk and fear of contagion at the beginning of the recent Great Recession – we believe there is no reason for letting it recur.

- The settlement period for various types of securities has been reduced over the years as technology advancements in both payment systems and transmission of investment documents have made it easier and cheaper for investors to receive information about potential purchases and to pay and receive funds for the purchase or sale of such securities. The settlement cycle for Treasury and other government securities and many mutual funds has been at T+1 for a number of years, to mention just a few examples. In addition, the current US stance is out of step with the rest of the world. After October of last year, when the settlement period for EU equities shifted to T+2, the US now stands basically alone among significant markets in not moving to a shorter settlement cycle.

The US markets should be leaders, not laggards especially when it comes to systemic risk mitigation measures.

A summary of some of the advantages of shortening the settlement period include:

- Reducing risk- A shortened cycle will mitigate overall operational and systemic risk in the markets and increase efficiency by reducing procyclicality.
    - In particular, a move to shorter settlement cycles will protect both the industry and individual investors by reducing credit, liquidity, and counterparty exposure risks since these risks increase with the passage of time.
    - In fact, DTCC's research suggests that many clients already request a shorter settlement period precisely to avoid the myriad risks associated with a three-day time lag and broker-dealers frequently oblige these requests. Making it a universal practice is obviously far more preferable.
- Optimizing capital- Shortening the settlement timeframe will reduce the amount of margin needed to settle broker-to-broker transactions.
- Cross-border harmonization- Reducing the time between execution and settlement will better align the U.S. settlement cycle globally.
    - In Europe, 27 markets migrated to a T+2 settlement cycle on Trade Date October 6th, 2014; only Liechtenstein has yet to set a migration date; Spain does not expect to make the change until this November; Germany already settled transactions on a T+2 cycle.
    - Many Asian markets are already on a settlement cycle shorter than T+3.
    - Harmonization across markets helps market participants better manage their cash flows by reducing and streamlining their financing needs in an increasingly global financial marketplace.
- Consistency for Derivatives- The shorter settlement period should also be extended, if possible and as applicable, to include security-based swaps referencing underlying U.S. securities. Having the settlement period for derivatives match the settlement period for the underlying reference asset helps ensure consistency in the marketplace and investors manage cash flows and operational issues.
- Retail investors will significantly benefit from a T+1 settlement cycle.
    - Retail investors will benefit from reduced overall risk to the system. Retail investors lost significant funds in the last financial meltdown due to liquidity freezes and systemic risk contagion caused by concerns for counterparty risk and settlement issues. Substantially reducing systemic risk greatly benefits retail investors.
    - Currently, the vast majority of mutual funds traded in the US are settled T+1. However, the other main asset classes used by retail investors, equities and ETFs, settle T+3. That difference causes confusion among retail investors, as well as failed trades when a retail investor wants to buy a fund upon selling an equity. It also causes funding issues when retail investors are told they need to pay for

their fund next day, but can't receive their money from an equity sale until days later.

- Moreover, unaware of the T+3 settlement period, many retail investors have funding "emergencies" when they sell a security to pay for some other purchase (such as a down payment on a house) only to find that the money will not be available for three days.
- Retail investors and even advisors who serve them also have difficulty rebalancing a portfolio of securities consisting of mutual funds, ETFs and equities because of the different settlement cycles.
- Nevertheless, some changes in retail behavior will be required. Although the number of transactions involving physical certificates has dropped to almost nothing over the last decade, some still occur, and retail client funding, such as the clearing of physical checks and ACH transactions, sometimes moves slower than even T+3. However, there are solutions (such as migrating customers of retail broker-dealers to funded trading accounts, for example) that many in the industry have already adopted and that retail investors are already used to.
- Shortening the settlement time could increase certain fails to deliver, which might impair some sophisticated investors' ability to cover short sales and implement certain investment strategies easily. The Commission, however, should act to eliminate any market-based incentives that may encourage some participants to fail.

- Technological and operational advances in the last two decades have made a move to T+2 generally and T+1, at least for US equities and ETFs and the minority of mutual funds that remain at T+3, both feasible and desirable for market participants.