REMARKS OF

COMMISSIONER J. CARTER BEESE, JR.*
U.S. SECURITIES AND EXCHANGE COMMISSION

MARKET 2000, T+3 AND THE FUTURE OF U.S. CAPITAL MARKETS

SIA OPERATIONS UPDATE

NEW YORK
NOVEMBER 9, 1993

* The views expressed herein are those of Commissioner Beese and do not necessarily represent those of the Commission, other Commissioners, or the staff.

U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

I've been told by technology experts that the world's collective capacity to compute and to communicate increase by an average factor of <u>ten</u> from one decade to the next. In other words, in 1990 our computers and telecommunications systems were ten times faster than they were in 1980. All that is about to change, however. According to techies, the world now stands on the edge of a quantum leap forward. During the next ten years, our ability to compute and to communicate will increase by a factor of <u>one hundred</u>.

This explosion in new technology will have profound implications for the world's capital markets -- markets that are already inextricably linked. Technology now permits capital to move with the speed of a computer stroke in and out of new opportunities. The great surge in merger activity that Wall Street has been engaged in recently is a direct result of companies trying to position themselves for the next wave of this technological revolution.

From Shanghai to Budapest to New Delhi, market reforms are also taking hold and creating new demand for capital. This combination of new technology and increased market access provides investors with more opportunities than ever before, including an estimated $150 billion in anticipated privatizations around the globe. It also will lead to fundamental changes in how markets, *both in the U.S. and abroad, operate. And it may lead to changes in the way regulation operates, given the increased opportunity for "regulatory arbitrage" and the increased technological capability to synthetically circumvent regulation.*

__MARKET 2000__

At the SEC, efforts are underway to prepare for these changing markets. The centerpiece of our effort is our "Market 2000" study -- a study which I am pleased to report is nearing completion. As many of you know, Market 2000 is a comprehensive analysis of the competitive and market structure issues affecting the equity market. It is my hope that Market 2000 will deal not only with the current "hot issues," but also with how technology, institutionalization, derivatives and globalization are impacting the market and how these forces will change the marketplace by the year 2000. And perhaps most importantly, how the U.S. markets will be positioned versus other increasingly competitive world markets.

Market 2000 represents the first comprehensive study of our markets since the so-called "Institutional Investor Study" done in the mid-1970's. The Institutional Investor Study led to the un-fixing of commission rates; the development of consolidated quotation and transaction reports among U.S. exchanges; the Intermarket Trading System; and the initiation of transaction reporting for NASDAQ securities.

Since that time, the U.S. equity markets have undergone dramatic changes, not the least of which are the growth in trading volume, advances in trading technology, the increasing dominance of institutional investors, the introduction of standardized and OTC derivative products, and the explosion of cross border activity.

While these developments have resulted in significant cost savings, convenience, and variety to the investing public, they also raised important questions of market transparency, liquidity, efficiency, and domestic and international competition. As a result, the Commission, as well as market participants, have been confronted with issues such as payment for order flow, proprietary trading systems, the growth of third and fourth market trading, and fair competition between the exchanges and NASDAQ.

But that's enough about the big picture. Many people in this room are the ones responsible for making the "trains run on time" -- and you have much more practical concerns. Like, how does the industry keep pace with the changes in the markets that technology is bringing? And more importantly, is the industry using technology to lead the way, or is it being pulled along reluctantly?

T+3 CLEARANCE AND SETTLEMENT

One area that I know is of interest, is the adoption of a T+3 settlement timeframe for most broker-dealer securities transactions. Under new Rule 15c6-1, most transactions that now settle on T+5 will be required, effective June 1, 1995, to settle on T+3.

As you know, this was not an issue that proceeded without significant debate. All told, 1,941 comment letters were received, and many commenters opposed to the Rule raised legitimate concerns regarding the needs and preferences of retail investors.

After weighing these concerns, however, the Commission believed that it was important to proceed with T+3. As I mentioned earlier, the last 20 years have seen unprecedented changes in the world's securities markets. Not only has volume grown exponentially, but market participants now routinely operate in multiple markets -- foreign and domestic -- equity, debt and derivative. With this has come an unprecedented, but inevitable, linkage among the world's securities markets.

In light of these linkages, the clearance and settlement system must be prepared to absorb shocks from more remote sources than ever before. Since the 1987 Market Break there has been a near universally held view, first *expressed in the Brady Report, that improvements needed to be made in domestic clearance and settlement systems.*

Subsequently, the Bachmann Report quantified for the first time what we all knew intuitively about the clearance and settlement system: time = risk. Or, to put it another way, nothing good happens between trade date and settlement. After all, a five-day post-trade settlement cycle is like giving Mitch Williams of the Phillies five days to decide whether he would like to try again on that last pitch to Joe Carter of the Blue Jays in game six of the World Series -- even though the City of Toronto has already banked the transaction.

By adopting T+3 the Commission attempted to strike a reasonable balance between the needs of the retail customer and the structural changes necessary to adapt to the technological world we now live in.

As most of us who lived through October of 1987 know, the longer the settlement cycle, the greater the risk that a customer will not settle with a broker, that the broker will not settle with the clearing corporation, and that the clearing corporation itself will come under financial strain. Indeed, in October of 1987, while the rest of the industry breathed a collective sigh of relief as the market rebounded from the shock of October 16th and 19th, I'm sure many of you were still holding your breath to see if certain trades would settle.

In my view, quick and efficient clearance and settlement of securities transactions is vitally important to maintaining the long-term stability, efficiency and competitiveness of U.S. financial markets. And I personally hope that T+3 is merely a stepping stone to even further reductions in the settlement period. And for certain transactions, I would like to suggest that you start thinking along those lines now.

As we stated in the release accompanying Rule 15c6-1, the Commission believes T+3 settlement represents an important near-term goal. At any given point in time, there will be fewer unsettled trades subject to credit and market risk, and there will be less time between trade execution and settlement for the value of those trades to deteriorate. As most of you know, the Bachmann Task Force collected data indicating that moving settlement from T+5 to T+3 reduced the risk to National Securities Clearing Corporation by over 50% in the event of the failure of an average large member during normal market conditions.

In addition, we believe the rule will reduce the liquidity risk between the derivative and the cash markets and reduce financing costs by allowing investors that participate in both markets to obtain the proceeds of securities transactions sooner. With less time to exchange securities and funds, market participants *will also have a greater incentive to complete specific tasks more efficiently. In reality, this might not be as dramatic a change for many of you as is first perceived. Over the last few years, I've seen an increasing emphasis placed on the automation of the middle and back office. Consequently, for many firms, the move to a T+3 settlement cycle has already begun and therefore may be more "evolutionary" than "revolutionary."*

At the same time, I recognize that compliance with the new rule is going to be difficult for some industry members and their customers. Systems upgrades, loss of float and the need to finance customer securities purchases are all going to cost money, particularly for retail firms.

But, now is the time to start the educational effort that will be necessary to change the behavior of retail customers. Let your customers know that they may have to deposit securities or funds upon placing an order. In fact, retail customer behavior is changing dramatically already. Customers have adjusted to a shorter settlement cycle for many products including options, government securities and mutual funds not sold through a broker-dealer. To facilitate having customer funds on hand, you should think about expanding the services you offer where necessary -- such as cash management accounts.

You also need to start now to reduce customers' reliance on the confirmation -- we are moving down the road where the confirmation can no longer serve as the notice to remit funds. For those customers that simply will not pay for a purchase until it is verified in writing, the Automated Clearing House (ACH) system or overnight mail may provide a viable alternative to mailing a check to a broker through the U.S. mail.

On previous occasions I have spoken about a challenge facing today's regulators -- the tiering of global financial markets into increasingly separate institutional and retail markets. We treat institutions differently in a number of contexts -- Rule 144A is a prime example. In my view, clearance and settlement is another area where we should consider tiered regulation.

Of course, an Interactive Institutional Delivery (ID) system is a critical building block to successful implementation of Rule 15c6-1. As a result of the European initiative with respect to Electronic Trade Confirmation, systems such as LSE's Sequal, ISMA's TRAX, and Thomson Financial's OASYS GLOBAL are already being used for cross-border trading. I also understand that Depository Trust Company is targeting mid-1994 for full implementation of their interactive system. Participants will then be able to access the interactive system on a voluntary basis for both international and domestic business. Once this is operational, the process of trade data input, confirmation output, affirmation *and issuance of settlement instructions will be capable of being completed within a matter of minutes. Is there any good reasons why we couldn't settle these institutional trades on T+1 or even T+0?*

Of course, I know that this will require all ID <u>*users*</u> *to be interactive as well. So banks and other institutions involved in the custody and handling of securities may have to re-tool proprietary systems that capture, process and transmit confirmations to customers in a batch mode. However, in order to comply with T+3, the affirmation process will have to be completed by T+1 so parties accessing the ID system will need to be interactive, anyway.*

Moreover, there are benefits that justify the expense of investing in the automation and making the investment sooner rather than later. Many of the features built into DTC's interactive system will result in significant savings to system users. I've been told the advice-of-correction and trade matching features will save the industry several million dollars annually through reduced clerical functions and eliminated phone calls.

I know that during the debate concerning the advisability of moving settlement to T+3, a task force explored the feasibility of split settlement dates -- T+3 for institutional trades and T+5 for retail trades. This group found several reasons not to bifurcate the securities markets along these lines. For *example, there would be additional pressure on the equity capital base of retail broker-dealers who may be required to hold in inventory securities purchased from institutions and sold to retail investors. In addition, stock borrowing would be necessary to make institutional settlement where the securities were purchased from a retail investor. Even if the customer securities were held by the broker-dealer, possession and control requirements under Rule 15c3-3 would prevent broker-dealer access to those securities until customer settlement.*

Policy issues arise as well. Retail order flow is an important source of liquidity in volatile markets. We need to be careful not to create the perception that retail order flow doesn't interact with institutional order flow -- this could have serious implications for retail investor confidence in the fairness of our securities markets.

Nevertheless, I urge you to look at this issue again. If institutions account for over two-thirds of transaction volume on any given day, we can reduce the risk in the system by the same proportion by settling those transactions on trade date. The benefits may just outweigh the costs.

One final point related to T+3. The move to T+3 has brought into focus a question that I believe will need to be addressed in the future. As we shorten the settlement cycle, do we in fact deemphasize the significance of the *confirmation statement? And if that is a side-effect of our action, should we begin to look at front-loading more disclosure in account opening statements and annual statements? I don't have answers for these questions today, but I do think the Commission and the industry need to rethink the entire approach to providing certain types of disclosure, and the timing of that disclosure, to make it more meaningful to retail investors.*

<u>CONCLUSION</u>

Despite these, and other, practical concerns that the people in this room are confronted with, these are exciting times for securities professionals. The markets are at all time highs, new and innovative products are being developed that meet investor demands, individual investors are returning to Wall Street in record numbers, and capital is flowing relatively unimpeded across numerous international borders.

The current challenge for regulators and market participants is to validate this overwhelming vote of confidence that we have received from investors. Market 2000 is the SEC's primary effort in this regard, and hopefully will allow us to adapt to the new demands of tomorrow's markets. This is certainly no time to be complacent.

I'm reminded of the old Texas adage that "only a fool rolls up his pants before he gets to the creek." That's certainly true, and there is no need to be alarmist about the current state of U.S. capital markets, they truly are an American success story. By the same token, however, let's not wait until the water starts rising before we take action to relieve some of the "stress points" in our regulatory structure.

Working together, we will ensure that the United States continues to have the most efficient means of allocating capital in the world. And that investors know that our markets are liquid, transparent and fair.

In our efforts to achieve this goal, our choices are clear. We can either embrace change, and look to technology to facilitate that change, or we can resist change and be content with the status quo. In my view, we must not allow inertia to keep us from extracting unnecessary risk from the system. After all, we all have an interest in ensuring that the U.S. market system remains the model for the rest of the world.

Thank you very much.