REMARKS BEFORE THE SECURITIES INDUSTRY ASSOCIATION OPERATIONS UPDATE CONFERENCE

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

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Good afternoon. It is a pleasure to be here. I have been very interested to listen to this morning's discussions.

Today, I would like to discuss the progress of the Commission's efforts to increase the safety and efficiency of the clearance and settlement system, specifically with regard to the recommendations of the Group of Thirty. I would also like to talk a little bit about the role of individual investors in the U.S. securities markets of the 1990s and the 21st century. As you will see, although these two topics may seem unconnected, there is really a very important and direct relationship between them.

Individual investor participation is an extraordinarily valuable characteristic of our securities markets. Over 50 million Americans participate in the US markets today and the clearance and settlement system must continue to accommodate their participation.

Direct participation by individual investors in our nation's securities markets is smaller now than it was 20 years ago. In part, that is because their participation is now indirect -- through pension plans and mutual funds, for example. However, the decline in individual investor participation can also be traced to a decline in individual investor confidence in the securities markets. Put simply, some individuals who previously were investors no longer believe that the U.S. stock market is a safe place for the small investor.

Happily, the percentage of investors who feel so disenfranchised that they have withdrawn from the market is still small. But the trend is cause for concern, because we cannot afford to drive individual investors from our markets. We have to foster an atmosphere in which individual investors believe that their participation is important and valued.

Developing a safe and efficient clearance and settlement system that accommodates the interests of individual investors is one aspect of preserving investor confidence and investor participation in the markets. Although some members of the securities industry seem to believe that retail investors do not care about clearance and settlement, a failure of the clearance and settlement system would have a very destructive effect on investor confidence. To borrow a metaphor from the President of the Federal Reserve Bank of New

York, investors treat clearance and settlement just like plumbing. They don't know how it works, and they don't want to know how it works, but when they turn on the faucet, they want water to come out -- every time, and with no leaks.

Unpleasant as it would be to contemplate, a failure of our clearance and settlement system is not unthinkable. The market breaks of October 1987 and 1989 served to remind us that the value of securities positions can change suddenly enough, and drastically enough, to cause defaults on unsettled positions. As a result of the interdependence of financial intermediaries, the loss of funds or securities due from a defaulting financial institution could set off a chain reaction of defaults within the financial community. Fast and final settlement and clearance can reduce these risks.

Which brings me to the Group of Thirty recommendations. As you all know, the Group of Thirty is a non-governmental, international group consisting of the leaders of many of the world's largest financial institutions, and including some prominent U.S. members. It has no official status or role in any country, but it does have great credibility with many governments because of the high caliber of its members and the thoughtfulness and intelligence they bring to bear on a variety of financial and economic issues. By providing a credible private sector viewpoint on major issues of financial policy, the Group of Thirty performs a very valuable public service on what is essentially a pro bono basis.

One topic that the Group of Thirty has considered is the state of the world's clearance and settlement systems. At the original Group of Thirty Symposium on clearance and settlement in London, it was concluded by the nearly 100 participants from around the world that while "the development of a single global clearing facility was not practicable, agreement on a set of practices and standards that could be embraced by each of the many markets that make up the world's securities system was highly desirable." (G30 Report) Remarkably, an international group of considerable diversity -- and representing markets with considerably different volumes of trading and levels of sophistication -- was able to reach consensus on a wide-ranging set of recommendations. The subsequent report, issued by the Group of Thirty in March 1989, contained the following nine recommendations:

- Trade comparisons between brokers, broker-dealers and other exchange members by should be accomplished on T+1 by 1990.

- Institutional customers should be members of a trade comparison/confirmation system by 1992.
- Each country should have a centralized securities depository by 1992.
- If appropriate, each country should have a trade netting system in place by 1992. (high volume w/ high concentration among participants)
- Each country should develop a delivery versus payment system for settling all securities transactions by 1992.
- Securities transactions should be settled in same day funds.
- A rolling settlement system should be adopted with final settlement of all trades on the third day after the trade date (T+3) by 1992.
- Securities lending and borrowing should be encouraged.
- Each country should adopt the standard for securities messages, in particular the ISIN numbering system.

Since the Group of Thirty's recommendations were first reported, countries around the globe have formed working committees to explore implementation of the Group of Thirty proposals. In some countries, particularly those with emerging securities markets, compliance with the Group of Thirty recommendations within the strict timetable established by the Group initially seemed to be, and in most cases still is, a daunting task.

In the United States, however, unlike practically all developing markets and even other major markets, most of the Group's recommendations were already standard elements of the clearance and settlement system by the time the Group of Thirty recommendations were first issued. For example, the United States already employed rolling settlement on T+5, unlike the United Kingdom, which today still uses non-rolling settlement every fortnight. Likewise, the United States has long had a centralized system of securities depositories; Japan does not have such a facility yet. In short, when the Group of Thirty recommendations came out in 1988, the United States probably had less to do in order to bring its clearance and settlement system into compliance than almost any other country in the world.

The United States clearance and settlement system, however, was not, and still is not, completely in compliance with the Group of Thirty recommendations. In the United States, most transactions in corporate and municipal securities settle on the fifth day after the trade date -- T+5 -- in next-day funds. In order to comply with the

Group of Thirty recommendations, the settlement cycle would have to be shortened by two days, and settlement payments would have to be converted into same day funds. Therefore, the United States Working Committee has focused its attention on how best to achieve these recommendations.

As you have heard this morning, the U.S. Working Committee, after many long hours of hard work, has developed recommendations for attaining these two goals. Given that banks, broker-dealers, transfer agents, issuers, clearinghouses, self-regulatory organizations and trade associations are all represented on the Working Committee, its ability to reach agreement on a wide variety of issues and to generate coherent, thoughtful reports represents a remarkable achievement.

The Working Committee's efforts culminated in an SEC roundtable, held late last month, to discuss the Working Committee's recommendations as well as alternative ways in which we might improve the clearance and settlement system. I'd like to summarize for you the results of the Roundtable.

First, the Roundtable provided the Commission with a public forum to discuss the need to reduce risk in the clearance and settlement system. The Commission believes very strongly that the overall level of risk in the clearance and settlement system is unacceptable, and that steps must be taken -- in the short term -- to reduce that level of risk. Shortening the settlement cycle and converting to the use of same-day funds are certainly two steps that would help to achieve that goal.

Second, the Roundtable discussion proved that, despite outward appearances, shortening the settlement cycle by two days and converting to the use of same-day funds will be no simple task. These improvements are going to cost financial intermediaries real money, in terms of both operational changes and the loss of income from elimination of float.

Third, with respect to shortening the settlement cycle, it appears that the biggest obstacles exist on the retail side, where customers often take full advantage of the current five day settlement cycle. The largest part of the retail problem is on the purchase side, where many customers still pay by check mailed to the broker-dealer, after they have received a confirmation of the transaction through the mail. The unfortunate but unavoidable truth is that, if the mail must go from the broker-dealer to the customer and then back to the broker-dealer, the check will not arrive at the broker-dealer, much less clear, by T+3. If we are to shorten the settlement cycle, then, we must explore better ways of getting retail customer payments for the securities they have purchased to the broker-dealer by the settlement date.

Fourth, it seems that the emphasis on the problems caused by physical certificates is misplaced. While customers who choose to hold physical certificates must deliver those certificates to the broker-dealer prior to settlement, the vast majority have the appropriate incentive to do so, for the simple reason that they want the proceeds of the sale as quickly as possible. Indeed, about 90% of certificates are already in by T+3, even though settlement doesn't occur until T+5. Given that the biggest problem is on the payments side, and given that elimination of the physical certificate would not address that problem, it seems that there is no necessary link between achieving shorter settlement and discouraging, or even eliminating, the physical certificate.

Nevertheless, a reduction in the use of physical certificates would serve a number of important industry goals. First and foremost, it would save money. This group, which is composed of operations professionals, knows all too well the costs of handling physical certificates. Furthermore, while it may be possible to settle securities transactions on T+3 with physical certificates, further shortening of the settlement cycle would be progressively more difficult unless the physical certificate is immobilized prior to the trade. If we ultimately move, as I hope we will, to settlement on T+1 or even on T, certificate ownership will become less and less feasible.

The roundtable participants actively debated the elimination of the physical certificate as a means to save time and costs. Indeed, one very vocal constituency argued that there was no logic to creating a new system that would still accommodate certificates when in fact our ultimate goal was to see them completely immobilized. Others felt that elimination of certificates would scare the already skittish individual investors further out of the market.

The Working Committee's recommendation carves a sensible middle ground between these two polar positions. Under the Working Committee's proposal, investors would retain the ability to hold physical certificates, and would be permitted to sell shares represented by physical certificates. In other words, retail customers would not be required to be in book entry form to transact -- they could still obtain and sell physical certificates -- but they would have to convert those securities into book entry form for settlement. Indeed, settlement of all trades, whether or not they involve retail customers, would be required to take place in book-entry form. Also, all new issues of corporate and municipal securities would be required to be book-entry eligible.

Nevertheless, I think we all recognize that the costs of holding a physical certificate would likely increase in a T+3 environment. Specifically, I would expect that broker-dealers would have to borrow more securities in order to make settlement than they do today. While some broker-dealers will profit from increased securities lending, others will experience increased costs. The increased cost of securities borrowing likely would be passed on to the broker-dealer's customers, either through a direct charge for that service or through an increase in the broker-dealer's commission rates.

Reduced use of physical certificates would thus benefit both the industry and individual investors. The question is how we can best encourage investors to hold in book-entry form. Personally, I believe that we should use a carrot, rather than a stick. Although the reasons may not be entirely clear, a percentage of small investors have an emotional attachment to their securities certificates and loose talk about eliminating certificates only serves to scare those investors and to leave them feeling even further disenfranchised from the market.

The best carrot that comes to mind to encourage book-entry ownership is a system of direct registration that would allow individual investors to hold securities in book-entry form on the books of a corporate or municipal issuer, rather than in street name through a broker-dealer. Retail investors already use direct registration-type systems for mutual funds, government securities, dividend reinvestment plans, and bank accounts, and a direct registration system for other types of securities ownership could operate in a similar manner.

The concept of a direct registration system has a lot of appeal. A direct registration system, for example, would allow an investor to sell securities through the broker-dealer of its choice, without the hassles involved in transferring a brokerage account. Securities held in a direct registration system also would not be subject to the risk of broker-dealer insolvency. At the same time, the costs of book-entry ownership would be much less than the costs of safekeeping physical certificates or replacing them if they are lost. For these reasons, the Working Committee has devoted much time and attention to the feasibility of a direct registration system.

Despite the Working Committee's efforts, however, the difficult mechanical issues associated with direct registration have not yet been solved. For example, a mechanism that would allow easy transfer, but provide necessary safeguards against fraud, has not yet been perfected. And, perhaps most importantly, the Working Committee has not yet identified an industry group that is willing to foot the bill for building and operating a direct registration system.

The Commission would like to see a workable direct registration system developed. If we give investors an alternative that is better than holding either in street name or in physical form, they'll use it. However, the initiative for developing a direct registration system rests squarely on the shoulders of private industry. The Commission cannot design it for you, it cannot build it for you, and it certainly cannot pay for it.

Fifth, the roundtable participants discussed the Working Committee's recommendation with regard to converting to the use of same-day funds. As you know, the Working Committee recommended shifting to payment in same-day funds by 1992, including for dividends, interest, redemptions and reorganizations, but only on the institutional side. Institutions and financial intermediaries already are accustomed to using same-day funds in other markets such as, governments, commercial paper and derivatives. The Committee was not able to make a recommendation that retail payments be effected in same day funds at this time given the current state of the retail payments system. Instead, the Working Committee recommended that market forces govern the method of payment between broker-dealers and their retail customers.

Converting to the use of same-day funds for settlement payments would be a major step forward in reducing risk in the clearance and settlement system. Because payments in next-day funds are reversible under certain circumstances, market participants who receive a settlement payment in next-day funds incur the risk that the payment will be reversed, or that the settlement bank may be unable or unwilling to provide good funds. The use of same-day funds would also facilitate settlement of intermarket transactions between the securities markets and other markets that already use same-day funds for settlement purposes.

At the same time, however, conversion to the use of same-day funds will force market participants to alter their current business practices. For example, the use of next-day funds may provide an element of flexibility in the system that gives participants time to resolve liquidity concerns. In addition, many participants price their services based on the float that results when a payment is received in same-day funds but paid out in next-day funds. Loss of this float would require a re-pricing of the associated services.

I think it is fair to say, however, that operational issues may well present the largest challenge with respect to conversion to same-day funds. A same-day funds payments mechanism must be developed, and that system must satisfy Federal Reserve Board guidelines with respect to such payments systems. Developing the right mechanism will not be easy, although I am glad to say that the Depository Trust Company is now actively studying the matter and expects to submit a feasibility study to the Commission within the next three to six months.

The Working Committee has taken us a long way down the road toward implementing the Group of Thirty recommendations. I am also happy to tell you that the momentum built by the Working Committee has not evaporated in the wake of the Roundtable. The Working Committee is now developing a list of steps necessary for implementation of its recommendations, and a group of retail broker-dealers and others, led by Howard Shallcross of Merrill Lynch, is examining how to resolve the retail payments problems associated with shortening the settlement period. Indeed, at the end of the Roundtable, the Chairman asked all of the participants, and the audience as well, to vote as to whether we should continue to move forward on the Group of Thirty's recommendations. There was almost complete unanimity that we should move ahead <u>at this time</u> and not "back burner" the Group of Thirty process.

The Roundtable was something of a turning point in the Group of Thirty process, particularly with respect to the Commission's role in that process. To date, the Commission has refrained from active participation in the Working Committee's efforts, because we have felt that progress on the Group of Thirty goals could be achieved most expeditiously and most efficiently through a primarily private sector initiative.

However, the Commission cannot leave the matter entirely in the hands of private industry. Although private solutions to the problems of the clearance and settlement system are far preferable to governmental solutions, the level of risk that is built in to the clearance and settlement process cannot be ignored and indeed cannot be tolerated. As regulators, the Commission must do whatever is necessary in the first instance to assure the soundness and efficiency of the U.S. clearance and settlement system in order to protect the entire U.S. financial system from a failure associated with a weakness in the clearance and settlement process. We appreciate that it may be difficult for individual market participants to understand the need for action with respect to global risk reduction and to subjugate individual interests to the good of the whole. But, the Commission cannot afford to allow an internal industry disagreement over the appropriate ways of improving the clearance and settlement process to frustrate all efforts to improve that process. For this reason, the time has come for the Commission to become a more active participant in the U.S. Working Committee's process.

That is not to say, however, that the time has come for the Working Committee to pass on the torch. We hope and expect that the Working Committee will continue to function and will continue to work with us as plans for implementation move forward.

I would also not want to leave you with the misimpression that the Commission has reached a firm, final judgment on the Working Committee's recommendations. While it is probably fair to say that the Commission is favorably disposed toward the Working Committee's recommendations in theory, the practice may be somewhat different. The Commission may, for example, determine that different implementation dates are desirable, or that one of the recommendations should be implemented before the other. The Commission may even yet be convinced that other means of reducing risk in the clearance and settlement system are more appropriate than the Working Committee's recommendations. Our collective mind is still open on all of these issues.

The one issue on which our mind is not open is whether there is a need for swift action. Based on recent experience -- and I include the market events of both October 1987 and October 1989, as well as the failure of Drexel earlier this year -- it is the Commission's view that risk in the clearance and settlement system is unacceptably high. Steps must be taken to reduce the risks associated with clearance and settlement, and the recommendations of the Group of Thirty would be one path toward that goal.

Therefore, I think that you can expect much progress to occur in the next six months on these issues. The Commission looks forward to receiving the various reports that I have mentioned, and may determine to put one or more of those reports out for public comment. The Commission will also evaluate any alternative proposals that have been put forth for our consideration, and determine what the next steps must be. Beyond that, my crystal ball is a little dim. But, at the end of the day, I think you will find that the United States securities markets will have a clearance and settlement system that is faster, more efficient, and safer than the one we have today, and that we are better prepared to meet the challenges of the next century. Thank you.

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