Comment Letter on Improvements to Existing Settlement System, August 2002

August 12, 2002

Mr. Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
450 5th Street, N.W.
Washington, D.C. 20549-0609

Ms. Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551

Re: Interagency White Paper on Structural Change in the Settlement of Government Securities: Issues and Option (File No. S7-15-02 (SEC) and Docket No. R-1122 (Fed)

Dear Mr. Katz and Ms. Johnson:

The Investment Company Institute [1] is pleased to provide comment on the concept release issued by the Securities and Exchange Commission ("SEC") and the Board of Governors of the Federal Reserve System ("Fed") (collectively, the "Agencies"). [2] We commend the Agencies for undertaking this initiative. In light of the central role settlement systems [3] play in providing liquidity to various markets, such a discussion is important.

A. Introduction

The Institute supports the Agencies' efforts to address the vulnerabilities in the clearance, settlement and financing of government securities that were revealed as a result of the terrorists attacks of September 11th. Like other market participants, mutual funds have a significant vested interest in ensuring the success of the government securities and the repurchase agreement markets. On behalf of their approximately 89 million shareholders, mutual funds directly own approximately $900 billion of US Government securities and daily provide approximately $350 billion of liquidity to the repo market. Efficient, low-risk settlement processes are essential for mutual funds to maintain sufficient liquidity in order to satisfy their statutory obligation under the Investment Company Act of 1940 to be able to redeem their shares at net asset value on each business day.

The Institute shares the Agencies' concerns regarding the operational, financial and structural risks that exist within the current clearing processes. Nonetheless, we do not believe that the creation of a central utility to clear and settle US Government securities is necessary at this time. Absent extreme events such as those that occurred last September 11th, the Institute believes that the current system works well each day and that the benefits of it should be preserved. In addition, we believe the costs associated with a conversion to a central utility would be significant, and it is quite possible that a detailed analysis would show that the costs to create, test, and convert to a utility will exceed the benefits that would be derived. Furthermore, we believe that a central utility could increase risk by creating a single point of failure and possibly do more harm than good, particularly with respect to its effect on competition, innovation and liquidity.

In the event the Agencies choose to continue to evaluate a utility, an in-depth study of how the private sector might respond to the exit of a clearing bank, and the cost or likelihood of the exit of one of the clearing banks, versus the cost and benefits of strengthening the existing system should be completed.

We believe that the risks identified in the White Paper can be addressed by enhancing the current structure. The best way to accomplish this is to form an advisory group of all market participants to seek ways to address these risks, to improve communication in times of disruption, and to enable market participants to more easily utilize each provider's capabilities, as necessary, in the event of either a disaster or exit from the market by of one of the clearing banks.

These points are addressed more fully below.

B. The Current System Works Well and Should be Maintained

A discussion of changing the settlement systems should begin with the status of the current situation and an evaluation of how it could be strengthened. In our view, absent the market disruptions resulting from September 11th, the existing settlement system for the government securities market is very effective. The system enables an efficient and unimpeded flow of significant amounts of money and securities between buyers and sellers and dealers and institutional investors. Even given the magnitude of the disruption that occurred after September 11th, the system recovered very well in a relatively short period of time. The recovery was greatly aided by the creativity and cooperation of the various market participants and the regulators, and the existence of a second clearing bank that could transact some settlement and financing business in the days following September 11th.

Competition in the current system between the two clearing banks [4] has promoted innovation, creativity and cost-effectiveness within the settlement and financing market. The tri-party repo transaction, upon which institutional investors, particularly mutual funds, and dealers rely to meet their short-term investing and financing needs was created as a response to a market need. We believe that maintaining and, where appropriate, improving a market that encourages innovation and cooperation is essential to reducing risk and recovering from future contingencies. For these reasons, we believe that steps to address the vulnerabilities described in the White Paper should be accomplished within the current market structure. Part D of this letter identifies several suggested steps to reduce the vulnerabilities within the current system.

C. Creating a Central Utility May Not be Necessary at this Time and Could Have Significant Adverse Consequences

We believe the creation of a utility is not warranted at this time for two reasons. First, we believe the operational risks are manageable. The next section of our letter offers suggestions to reduce the operational vulnerabilities encountered after September 11th.

Second, we believe it is likely that the costs that would be incurred from the exit of one of the two clearing banks would be less than the costs incurred from creating a utility and eliminating the benefits of the current market structure. If an institution decided to voluntarily exit the clearing and financing business, such a decision would most likely be implemented in an orderly manner over a period of time, so as to enable the exiting institution to capture the value of this line of business by selling it to another service provider.

An orderly exit significantly mitigates and possibly eliminates the risk from a voluntary exit. In the event of an involuntary exit, the core clearing and financing functions would be exposed to disruption. An insulated utility that provides financing could minimize this risk. However, we believe that the disruption from an involuntary exit can be satisfactorily contained without a utility by advance planning to provide for a quick and orderly assumption of these functions by another institution. We suggest that the Agencies work with all market participants to develop plans to minimize the risks of involuntary exit that could be quickly implemented, if needed, and that would be less costly than the creation of a utility.

The Institute is also concerned that a central utility would create several significant new risks. First, a central utility would have an adverse impact on the operational risk in the system by creating a single point of failure. In the current system, there are two clearing banks that provide critical settlement and financing services. As noted earlier in our letter, having at least one clearing bank available to transact business in the days following September 11th proved very beneficial for market participants as it enabled mutual funds to turn to another clearing bank to generate liquidity and invest cash flows.

Second, a central utility would eliminate or substantially reduce the innovation and efficiency present in the current system, and could add unnecessary layers of control to the process. We believe that notwithstanding how the governance structure of the utility is designed, there will remain serious concerns related to innovation and efficiency. The evolution of the financing market has included innovations, such as tri-party repos and specialized information reporting, that resulted from banks, dealers and institutional investors seeking more timely, efficient, and less risky processes. In our opinion, a utility can neither be governed nor incented to seek innovation and efficiency and to provide responsive service to all market participants reliant on it. The clearing and financing market has benefited greatly by developing into a system that is flexible and that encourages responsiveness, creativity, and cooperation among its participants. It is in the market's best interests to maintain and encourage such attributes.

Third, creating a central utility would be a costly, time-consuming, and untested process. Significant conversion costs will be incurred to modify systems and practices to comport with the requirements of the new utility and to modify existing contractual arrangements with all participants, including custodial and tri-party repo agreements. These costs will be substantial, especially when accumulated for all market participants. Also, the time required to create and convert all participants to the utility will most likely be lengthy. Recent attempts to coordinate the efforts of many companies to convert systems and practices by a common date have been difficult. For example, the efforts to prepare for Y2K and the recently abandoned conversion to T+1 have shown that industry-wide projects are expensive, time consuming and prone to delay. During the creation and conversion time period, the system continues to be exposed to the structural risks identified in the White Paper. We therefore believe that strengthening the existing system will reduce overall risk in a less costly and more timely manner than creating and testing a new utility and putting it into full service.

Fourth, depending on its structure, a utility could have adverse effects on liquidity. Mutual funds strongly believe that the financing function should not be separated from the core clearing functions. One of the primary reasons the current financing market is extremely efficient is that core clearing and financing occur in one place. To separate these activities creates another point in the settlement process at which securities could become lodged. The most likely effect of this would be to reduce liquidity rather than increase it because transactions that would have otherwise settled will not and must be financed. The after-hours repo market would not work as well. Separation of the functions might cause participants to attempt to transact more delivery-versus-payment repos, which would be much less efficient and contrary to current market trends.

D. Improving the Current System

As noted above, we believe that additional analysis by all affected participants is necessary to determine if the formation of a utility to address the risk of exit is the best course of action. Such an analysis could quite possibly conclude that a utility is unnecessary. We believe that it is preferable to minimize the vulnerabilities described in the White Paper by concentrating on improving the existing system through the cooperative efforts of all market participants. In this regard, we suggest several steps we believe would enhance operational resiliency and reduce systemic risk.

First, there should be established minimum standards for the business continuity capabilities of the clearing banks. Such standards should require multiple functioning locations that are geographically dispersed so as to reduce infrastructure dependencies. Second, the clearing banks should coordinate their continuity capabilities. This would prevent them from being wholly dependent on the same infrastructure at all operating locations. Third, there should be periodic regulatory examinations of the business continuity capabilities. This would ensure that clearing banks have plans in place to address potential issues that could arise. Finally, there should be mandatory periodic testing of the capabilities with all market participants, to ensure that the business continuity capabilities are up to date and responsive to changes that have occurred.

The Institute notes that these suggestions are not new. Indeed, in preparation for the millennium crossover to the Year 2000, virtually the entire financial services and securities industries, including mutual funds, dealers, custodian banks, and other participants, engaged in extensive contingency planning and testing measures over several years to make sure that critical systems and operations were prepared for Y2K. During that time, industry participants and market regulators worked together to take the appropriate steps to ensure the market’s readiness. As a result of these coordinated efforts, the market was very prepared and well positioned to face the challenges of Y2K. Many observers believe that the Y2K preparations were a significant reason that the financial industry was able to recover so quickly from the events of September 11th. This type of coordination and planning can be applied to the risks described in the White Paper.

One problem that the White Paper did not address is communication among market participants during times of crisis. In the days following the events of September 11th, the financial system faced unprecedented challenges. One of the more difficult challenges was re-establishing communications with all the parties who needed to adjust to changing market policies and practices as decision makers determined how market operations, such as opening and closing times, would be adjusted in response to the attack. The Institute and its members found it extremely difficult, and at times impossible, to communicate with key market participants and regulators about ongoing changes to market operations. Because mutual funds are required to accept investor orders when markets are open and to price their securities every business day in order to give investors liquidity, having access to accurate and timely information and being able to engage in the discussions about appropriate responses is critical to meeting investors needs. Accordingly, we urge the Agencies to seek ways to strengthen the communication channels and broaden the network of market participants that are communicated with during crises. Additionally, it would be helpful if there were a process by which market participants shared their contingency contact information so that communications could be promptly re-established in an emergency.

The Institute believes that the cooperative efforts of all market participants could substantially mitigate, and in some cases eliminate, the operational, financial and structural vulnerabilities in the government securities market and help guide future improvements to the system. Therefore, we recommend the creation of an advisory group, under the auspices of the Agencies, which would consist of all market participants, including dealers, institutional investors and clearing banks. The purpose of the advisory group would be to, among other things: (a) identify and analyze the costs and benefits of various solutions to reduce risks, including the risk of exit; (b) monitor contingency capabilities to ensure ongoing responsiveness to market developments and new risks; (c) explore for ways to strengthen communications among market participants; and (d) recommend common market practices that would enhance the ability of the system to respond to various threats and risks. [5] Such a group could be modeled after the advisory groups sponsored by the Federal Reserve Board of New York and the Treasury's advisory group on debt structure.

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The Institute appreciates the opportunity to discuss these important issues. If you have any questions, or would like additional information, please contact the undersigned at (202) 326-5857.

Sincerely,

Lawrence R. Maffia
Executive Vice President–Administration

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ENDNOTES

[1] The Investment Company Institute ("Institute") is the national association of the American investment company industry. Its membership includes8,990 open-end investment companies ("mutual funds"), 504 closed-end investment companies, and six sponsors of unit investment trusts. Its mutual fund members have assets of about $6.615trillion, accounting for approximately 95 percent of total industry assets, and over 88.6 million individual shareholders.

[2] SEC Release No. 34-45879; File No. S7-15-02; Docket No. R-1122 (May 6, 2002); 67 Fed. Reg. 32043 (May 13, 2002) (the "Concept Release").

[3] The White Paper uses the terms "settlement" and "core clearing" interchangeably to mean: (i) settling trades; (ii) providing intraday credit; and (iii) providing software for position management services for primary dealers. Also typically included as part of the settlement process is the provision of overnight and term financing through tri-party repurchase agreements ("repos").

[4] The Release points out that two banks—JPMorgan Chase (Chase) and Bank of New York (BONY)—provide the full panoply of services required by major market participants. See Concept Release at 32044.

[5] The Concept Release notes that a complementary interagency group is working with private-sector firms and utilities to improve the resiliency of financial market participants' backup arrangements. Goals of the group include developing guidance on business continuity issues, organizing industry testing, and addressing telecommunications issues, particularly switching and routing diversity. See Concept Release at n. 7. The Institute applauds such efforts and would welcome any opportunity to participate in that process.