

AUTOMATED CLEARANCE AND SETTLEMENT
IN THE
MUNICIPAL SECURITIES MARKET

A Report to the Securities and Exchange Commission

March 31, 1988

MSRB

Municipal Securities Rulemaking Board

Introduction

The Municipal Securities Rulemaking Board is a self-regulatory organization created in 1975 by the enactment of section 15B of the Securities Exchange Act ("the Act").¹ Section 15B of the Act delegates to the Board primary responsibility for adopting rules that govern the municipal securities activities of brokers, dealers and municipal securities dealers ("dealers") and sets forth a number of areas appropriate for Board rulemaking.² One important task delegated to the Board is to write rules for dealers which

foster co-operation and coordination with persons engaged in . . . clearing, settling, processing information with respect to, and facilitating transactions in, municipal securities.³

The Board's role in facilitating clearance and settlement of municipal securities transactions is given additional direction by section 17A of the Act, which mandates the creation of a national system of automated clearance and settlement of securities transactions and the elimination of the physical movement of securities certificates between dealers.⁴ Enacted in 1975, section 17A expressly includes municipal securities. Although Congress delegated the central authority to facilitate the purposes of section 17A to the Securities and Exchange Commission, it made clear that the Board, subject to Commission oversight, was intended to be primarily responsible for addressing the special clearance and settlement problems of municipal securities within the national clearance system.⁵

After its formation in 1975, the Board began the process of adopting rules to standardize industry operational practices and to facilitate the safe and efficient processing of municipal securities. In April 1983, the Board furnished the Commission with a comprehensive report on these efforts entitled *Prospects for Automation of Municipal Clearance and Settlement Procedures* (the "1983 Report"). The 1983 Report described the traditional physical processing and delivery of municipal securities used in the industry. The 1983 Report also discussed the existing impediments to integrating municipal securities into the automated clearance and settlement systems then available for corporate securities and the Board's efforts to lead the industry toward automation as envisioned under section 17A of the Act.

In July 1983, the Board adopted rules requiring dealers to use automated clearance and settlement systems for certain transactions. Since the adoption of those rules, industry members and registered securities clearing agencies⁶ have worked hard to implement automated systems for municipal securities.

¹ Securities Acts Amendments of 1975, P.L. 94-29, 89 Stat. 155, 131-137 (1975), *codified at* 15 U.S.C. §78o-4.

² The Board is composed of 15 members who serve staggered three year terms and who are divided equally into three categories—persons representing bank dealers, securities firms and the public. Of the five public representatives, at least one must represent investors and at least one must represent issuers.

³ Section 15B(b)(2)(C) of the Act, 15 U.S.C. §78o-4(b)(2)(C).

⁴ 15 U.S.C. §78q-1.

⁵ Section 15(c)(6) of the Act, 15 U.S.C. §78o(c)(6), grants the Commission authority to adopt rules applicable to dealers to effect the purposes of section 17A, but specifically exempts municipal securities transactions from this grant of authority. The legislative history of this provision states that the Board is intended to be the "primary medium for regulation of the municipal securities industry and should be furnished with ample opportunity to develop responsible rules for the industry." *Report of the Senate Committee on Banking, Housing and Urban Affairs*, Senate Report No. 94-75, 94 Cong., 1st Sess. (April 14, 1975), at 48.

⁶ The term "registered securities clearing agencies" refers to those clearing corporations and depositories registered with the Commission under section 17A of the Act.

The Board has supported these efforts by providing its expertise to the clearing agencies and by using its resources to inform and educate municipal securities participants about the systems. In addition, when appropriate, the Board has adopted additional rules or interpretations to facilitate the use of the systems. As a result of these efforts, the Board believes that today a majority of inter-dealer and institutional customer transactions in municipal securities are being processed in automated clearance and settlement systems.⁷

Notwithstanding the considerable progress achieved since 1983, the transition to automated clearance and settlement of municipal securities is not complete. Many industry members have not obtained the efficiencies and cost savings that automation is capable of providing. This report summarizes the progress that has been made in automating the clearance and settlement of municipal securities transactions since the 1983 Report. It also discusses the developments necessary to complete the industry's transition to automated systems.

⁷ Because there is no reliable estimate of the total number of municipal securities transactions, it is not possible to provide exact statistics on the percentage of total transactions that are cleared through automated systems.

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I Background

Automated Clearance and Settlement Systems for Municipal Securities

Today, automated clearance and settlement of municipal securities transactions is achieved through three automated systems offered by registered securities clearing agencies: comparison of inter-dealer transactions, confirmation/affirmation of institutional customer transactions, and book-entry settlement of inter-dealer and institutional customer transactions.

Automated comparison of inter-dealer transactions replaces the expensive and cumbersome process of confirming transactions by mailing and physically matching paper confirmations. To use the automated comparison system, dealers submit transaction data to a central processing facility operated by National Securities Clearing Corporation ("NSCC") by the day after trade date. The transaction data is matched ("compared"), indicating that the dealers agree on the terms of their trades. Compared trades are reported back to dealers the next day on "contract sheets," which are written memoranda of transactions containing the same information as paper confirmations. The contract sheets also list transactions that have not compared in the system, allowing the parties to utilize additional automated procedures to obtain a comparison or other resolution of each of the uncomparing trades. Dealers obtain access to the automated comparison system through membership in NSCC, Midwest Clearing Corporation, Stock Clearing Corporation or through clearing agents that are members of these organizations.¹

The confirmation/affirmation system allows dealers to confirm transactions with institutional customers without mailing confirmations. In this system, a dealer (or its clearing agent) submits data on a customer transaction to a depository through a computer link. The next day, the depository electronically provides the customer and the customer's clearing agent with a confirmation of the transaction.² If the confirmation is correct, the customer (or its clearing agent) acknowledges ("affirms") the transaction through the system and this affirmation is reported to the dealer. This system allows dealers to confirm transactions to customers by use of electronic media and thus avoid delays associated with mailing paper confirmations. In addition, the affirmation process greatly increases the probability that the customer's transaction will be settled by ensuring that the customer's clearing agent is aware of the transaction and is prepared to accept or make delivery. The affirmation process also allows depositories to set up book-entry deliveries automatically on affirmed transactions, saving dealers additional processing of the transactions.

The Depository Trust Company ("DTC"), Midwest Securities Trust Company ("MSTC") and Philadelphia Depository Trust Company ("Philadep") offer automated confirmation/affirmation services to their members. These services are linked together in the National Institutional Delivery System ("NIDS"), for which DTC functions as the central processor. Dealers and institutional customers participate in automated confirmation/affirmation systems by joining one of the depositories directly, or by using a clearing agent that is a depository member.

¹Dealers that are NSCC members also can make arrangements to submit transaction data through The Depository Trust Company.

² The customer and/or its agent can use printers to provide a "hard copy" of the confirmation for their records.

Book-entry settlement of inter-dealer and institutional customer transactions eliminates the need for costly and time-consuming physical delivery and handling of securities certificates. In a book-entry delivery system, securities certificates of eligible issues are deposited with DTC, MSTC or Philadep. Inter-dealer and institutional customer transactions then are delivered and transaction monies settled via bookkeeping entries at the depository. Instructions to the depository to make book-entry settlements normally are made through electronic communication links between the depositories and their members. Dealers and institutional customers participate in book-entry settlement systems by becoming direct members of depositories or using clearing agents that are members. The book-entry systems operated by DTC, MSTC and Philadep are linked through interfaces, allowing deliveries to be made between members of different depositories.

Preparation of the Municipal Securities Industry for Automation

The Board's preparatory work for automation began soon after the Board was created in September 1975, through the adoption of rules standardizing the regionalized trading, clearance and settlement practices that were prevalent in the industry. The adoption, in 1976, of Board rule G-12 on uniform practice established, for the first time, uniform national standards for confirming, delivering and settling inter-dealer municipal securities transactions.³ The adoption of rule G-15 in the same year established uniform procedures for confirming customer transactions.⁴ The Board continuously has refined these rules to require increasing uniformity in physical clearance and settlement practices. Obtaining uniformity was an essential first step toward automation, which requires standardization of operational practices.

The Board also mandated that the CUSIP numbering system be used to identify municipal securities.⁵ In May 1977, the Board amended rule G-12 to require that inter-dealer confirmations include the CUSIP number of the security traded if one was assigned to the issue.⁶ In 1981 and 1982, the Board adopted amendments to rule G-12 to require that securities delivered on a transaction be identical to those identified by the CUSIP number, if any, on the confirmation of the transaction. The Board also adopted

³ Approved September 8, 1977, Securities Exchange Act Release No. 13939. Rule G-12 also standardized inter-dealer reclamations, close-outs and certain other practices relating to clearance and settlement of transactions. In 1985, amendments were added to standardize interest payment claim procedures. *MSRB Reports*, Vol. 5, No. 5 (August 1985), at 13-15; approved October 15, 1985, Securities Exchange Act Release No. 22534.

⁴ Approved September 9, 1977, Securities Exchange Act Release No. 13942. Rule G-15 was amended in 1984 to set standards of delivery for customer transactions. *MSRB Reports*, Vol. 4, No. 2 (March 1984), at 17-20; approved May 29, 1984, Securities Exchange Act Release No. 21000. In 1986, rule G-15 was amended to standardize interest payment claim procedures. *MSRB Reports*, Vol. 5, No. 5 (August 1985), at 13-15; approved October 15, 1985, Securities Exchange Act Release No. 22534.

⁵ The CUSIP numbering system is an alpha-numeric securities identification system developed in 1967 by the American Banker's Association's Committee on Uniform Security Identification Procedures and is used to identify corporate and municipal securities. In general, the system provides for a six-digit number identifying the issuer of securities and a three-digit suffix identifying the specific issue, including, in the case of municipal securities, the specific maturity, interest rate and dated date of the security.

⁶ SR-MSRB-76-12 Amendment No. 1; approved September 8, 1977, Securities Exchange Act Release No. 13939 (effective January 1, 1979). A similar requirement was adopted for customer confirmations in April 1983. *MSRB Reports*, Vol. 3, No. 2 (April 1983), at 13; approved May 9, 1983, Securities Exchange Act Release No. 19742.

delivery standards providing that different issues of securities are not interchangeable for purposes of delivery unless identical with respect to the criteria used for CUSIP number assignment.⁷

The rules adopted in 1981 and 1982 concerning use of CUSIP numbers for clearance and settlement applied to all securities that were assigned CUSIP numbers, but not all issues of municipal securities were being assigned CUSIP numbers at that time. In June 1982, the Board addressed this problem by adopting rule G-34, which requires dealers underwriting new issues of municipal securities eligible for CUSIP number assignment to apply for and obtain number assignments.⁸ The rule became effective on July 8, 1983, and ensures that virtually all municipal securities issued after that date can be identified by a CUSIP number. In September 1984, the Board amended rule G-34 to require dealers also to apply for new CUSIP numbers for an outstanding issue of municipal securities if the issue is advance refunded to different dates or prices, or made subject to certain other security enhancements in the secondary market which create differences within the issue.⁹

Rule G-34 and the amendments to rule G-12 effectively require dealers to identify municipal securities by CUSIP numbers. This development was crucial to the implementation of automated systems, which use CUSIP numbers to identify specific issues of municipal securities.

Another area of Board activity in preparation for automation related directly to automated clearance systems.¹⁰ Because the automated clearance systems in existence prior to 1983 were designed primarily for corporate securities, few transactions in municipal securities were submitted to the systems.¹¹ The Board sought to ensure that its rules did not prevent use of the automated systems then available when the parties to a transaction wished to use them. In May 1977, the Board amended rule G-12 to exempt inter-dealer transactions compared, cleared and settled through the facilities of a registered clearing agency from the applicable provisions on confirmation and delivery.¹² Amendments adopted in April 1981 clarified that transactions compared through the facilities of a clearing agency were exempt only from the confirmation provisions of the rule and that transactions cleared and settled through a clearing agency were exempt only from the delivery provisions.¹³ The amendments also stated that delivery

⁷ *MSRB Reports*, Vol. 2, No. 6 (August 1982), at 11-13; approved March 14, 1983, Securities Exchange Act Release No. 19599. Prior to these amendments, there were a variety of practices in the municipal securities industry regarding the types of securities that were interchangeable for purposes of delivery. For example, securities with the same interest date and maturity date, but with different call provisions and dated dates were considered interchangeable in some cases. The amendments adopted by the Board require, among other things, that the securities delivered on a transaction be identical with respect to call provisions and dated date.

⁸ *MSRB Reports*, Vol. 2, No. 6 (August 1982), at 7-10; approved May 9, 1983, Securities Exchange Act Release No. 19747.

⁹ *MSRB Reports*, Vol. 5, No. 4 (June 1985), at 9-11; approved August 9, 1985, Securities Exchange Act Release No. 22308.

¹⁰ The Board, of course, does not have rulemaking authority to mandate changes in automated systems, but may adopt rules for dealers to facilitate use of the systems.

¹¹ Municipal securities transactions could be submitted to confirmation/affirmation systems for customer transactions prior to 1983, but no significant numbers of transactions were submitted. There were, in addition, pilot programs for automated comparison of inter-dealer municipal securities transactions and eligibility of bearer municipal securities in depositories at that time. It was not until the Board actually adopted its automated clearance rules in 1983 that implementation of full-scale automated systems specifically for municipal securities began.

¹² SR-MSRB-76-12 Amendment No. 1; approved September 8, 1977, Securities Exchange Act Release No. 13939.

¹³ *MSRB Reports*, Vol. 1, No. 1 (July 1981), at 17-18; approved June 22, 1982, Securities Exchange Act Release No. 18829.

through the facilities of a registered clearing agency was an acceptable alternative to the traditional "over-the-window" physical delivery at the purchaser's premises,¹⁴ and exempted transactions involved in netting programs from the provisions in rule G-12 against partial deliveries.¹⁵

The Board also began working with the registered securities clearing agencies in modifying existing automated clearance systems to accommodate municipal securities. In 1982, the Board concluded an agreement with NSCC concerning the standards for physical deliveries of municipal securities made by dealers through NSCC facilities.¹⁶ In January 1983, the Board reviewed and supported a DTC proposal to revise its automated confirmation/affirmation system to allow the entire municipal securities description required on customer confirmations by rule G-15(a) to be included on confirmations generated by the system.¹⁷ The Board also provided its expertise on municipal securities to the registered clearing agencies to assist in the modification of the systems that were necessary for municipal securities processing.

¹⁴ This provision was added to accommodate physical deliveries of certificates through such facilities as NSCC's envelope delivery services.

¹⁵ Rule G-12(e)(iv) states that, except for this exemption, partial deliveries on municipal securities transactions may be rejected. This rule reflects a longstanding practice in the municipal securities industry of not accepting partial deliveries.

¹⁶ February 16, 1982, letter from Jean J. Rousseau, Chairman, MSRB, to Jack Nelson, President, NSCC, and March 16, 1982, response from Mr. Nelson.

¹⁷ The Board also provided DTC other interpretive guidance on the requirements of Board rules relative to customer confirmations. In July 1983, the Board amended rule G-15(a) to delete the requirement to include the address and telephone number of the dealer on confirmations generated by automated systems. The Board noted that the automated systems were not capable of providing this information and that the types of institutional customers receiving such confirmations generally did not need this information on each confirmation they received. See *MSRB Reports*, Vol. 3, No. 5 (September 1983), at 25; approved September 30, 1983, Securities Exchange Act Release No. 20243.

II

Adoption and Implementation of the Automated Clearance Rules

Adoption of the Automated Clearance Rules

In 1982 and 1983, two events occurred which accelerated the Board's actions on automated clearance and settlement. First, the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") was enacted, requiring all municipal securities over one year in maturity issued after July 1, 1983, to be in registered form.¹⁸ Practically all outstanding issues of municipal securities issued since that date have been issued in registered form. In considering this impending development in 1982, the Board observed that registered securities are more difficult and costly to settle physically than are bearer securities, in part because of varying record dates on issues and transfer delay problems.¹⁹ The lack of regulation of some municipal securities transfer agents²⁰ and the inexperience of many industry members with registered securities raised the likelihood of substantial cost increases and delays in the physical settlement of municipal securities transactions. The Board observed, however, that immobilization of certificates in a depository minimized the problems associated with registered securities. In addition, the Board noted that registered securities are less expensive to immobilize than are bearer securities.²¹

The Board also was influenced by the proposal and adoption in 1982 of rules by the New York Stock Exchange ("NYSE"), the National Association of Securities Dealers, Inc. ("NASD") and other self-regulatory organizations which required most institutional customer transactions in depository-eligible corporate securities to be cleared and settled through automated systems.²² These rules were aimed at reducing the number of transactions that fail to settle on settlement date ("DKs") by greater use of the automated confirmation/affirmation process and book-entry delivery. The adoption of the rules by the NYSE and NASD raised the issue whether similar rules might be used to reduce DKs in the municipal securities industry. The Commission, which found the direction being taken in the corporate securities industry to be consistent with the mandate of section 17A of the Act, suggested that the Board consider

¹⁸ Pub. Law 97-248, section 310(b), 96 Stat. 324, 595-600 (1982).

¹⁹ In October 1982, the Board sponsored a conference for interested persons to discuss the problems created by registered securities culminating in a *Report of the Conference on Registered Municipal Securities*, which was published by the Board in 1983.

²⁰ Most transfer agents providing corporate securities transfer services are required to be registered with the Commission under Section 17A of the Act, 15 U.S.C. §78q-1, and are subject to the requirements of SEC rules 17Ad-1 through 17Ad-14. In general, these rules require most transfer agents to complete ("turn around") 90 percent of all routine transfer requests within three business days of receipt. These standards, however, apply to municipal securities transfer agents only if they are required to be registered because of corporate transfer activity. In 1982, many municipal issuers acted as their own transfer agents or utilized non-registered transfer agents.

²¹ This has been borne out by experience. In a comment letter on a recent Board proposal, DTC estimated that savings of approximately \$1.00 per year would accrue for each bearer certificate that could be changed into registered form. DTC currently immobilizes approximately 20 million bearer certificates. See SR-MSRB-87-12, filed October 6, 1987.

²² See, e.g., amendments to NYSE rule 387 ("COD Orders") and amendments to the NASD's Uniform Practice Code, section 64 ("Acceptance and Settlement of COD Orders"). These rule changes were approved by the Securities and Exchange Commission on November 9, 1982, in Securities Exchange Act Release No. 19227.

what steps would be required to bring the municipal securities industry into parity with the corporate securities industry.²³

1. July 1982 Proposal. In contrast to the corporate securities industry, which at the time was largely automated, practically all municipal securities transactions in 1982 still were being confirmed and settled physically. Moreover, certain unique characteristics of the municipal securities market made the use of automation more difficult than for the corporate securities markets.²⁴ The Board recognized, however, that a large number of securities firms handle both corporate and municipal securities and that the NYSE and NASD requirements for corporate securities transactions could have a positive effect in assisting the municipal securities industry toward automation if the Board adopted similar rules.

In July 1982, the Board published an exposure draft of an amendment to rule G-15 on customer transactions which essentially was the same as the NYSE and NASD rules.²⁵ The draft amendment would have applied to delivery vs. payment ("DVP") and receipt vs. payment ("RVP") customer transactions in securities eligible at a depository. It would have required such transactions to be confirmed/affirmed and settled through the book-entry settlement systems offered by the depository if both parties to the transaction were participants in the depository ("direct participants") or used clearing agents that were participants in the depository ("indirect participants"). Of the 24 comments received on the draft amendment, 15 generally agreed that automation would achieve cost savings and other efficiencies in clearance and settlement of municipal securities. Several commentators, however, expressed concern over difficulties and costs that would be experienced by dealers making the internal processing changes necessary for the use of automated systems.

A number of the commentators suggested that the Board expand its proposed requirements to include inter-dealer transactions.²⁶ The Board concluded that including inter-dealer transactions in automated clearance systems would reduce settlement delays and associated costs that would occur if inter-dealer transactions continued to be settled with physical certificates and book-entry delivery were required for customers. A number of commentators also urged that, unlike the rules adopted for corporate securities transactions, the automated comparison system for inter-dealer transactions and confirmation/affirmation systems for institutional customer transactions should be used for all municipal securities with CUSIP numbers, rather than the relatively limited number of depository-eligible municipal securities issues at that time.

2. March 1983 Proposal. In March 1983, the Board re-published a modified draft amendment to rule G-15 on customer transactions which extended the proposed requirement for use of automated

²³ Securities Exchange Act Release No. 18737 (May 13, 1982).

²⁴ These characteristics include the lack of a centralized trading market and a wide variety of dealers, including securities firms and banks. The municipal securities market also has approximately two million different outstanding issues. The huge number of issues has discouraged the development of systems capable of processing all potential transactions. The variety of different issue types also necessitates much longer securities descriptions than needed for corporate securities, presenting another technical difficulty that hinders incorporation of municipal securities into the automated systems developed for corporate securities.

²⁵ *MSRB Reports*, Vol. 2, No. 6 (August 1982), at 3-5.

²⁶ The corporate securities markets already were characterized at the time by widespread use of automated systems for inter-dealer transactions. The NYSE and NASD proposals therefore did not refer to inter-dealer transactions.

confirmation/affirmation systems to all securities with CUSIP numbers.²⁷ In addition, the Board published a new draft amendment to rule G-12 to require inter-dealer transactions to be compared in an automated comparison system if the transaction was between direct participants in a registered clearing agency offering comparison services and the securities were eligible for automated comparison.²⁸ The draft amendment to rule G-12 also would have required book-entry settlement of such transactions if depository-eligible securities were involved and the parties to the transactions were direct depository participants.

The Board received 27 comments on this proposal, 14 of which supported one or both draft amendments and only two of which opposed the draft amendments in concept. Some commentators continued to express concern that the automated clearance systems were not ready to incorporate municipal securities and that industry members did not have experience with the systems. The majority of commentators, however, again emphasized that the draft amendments were essential to bring clearance of municipal securities into parity with the corporate securities market and would provide the industry with significant efficiencies and cost savings. Several commentators stated that if any economies were to be realized from automation, all dealers should be included in the system. They urged the Board to extend the inter-dealer requirements to include indirect as well as direct participants in registered securities clearing agencies.

The comments received on the July 1982 and March 1983 proposals persuaded the Board that use of automated systems for municipal securities transactions was feasible and would (i) greatly reduce the costs of producing, mailing and processing physical confirmations; (ii) reduce the costs of delivering, processing, and safekeeping securities certificates; and (iii) reduce the number of "DK'ed" transactions. While the Board was mindful that the draft amendments would entail costs to municipal securities dealers that were not using or were not familiar with automated systems, it concluded that the potential benefits to be derived from automation by municipal securities market participants outweighed the inevitable transition burdens.

Accordingly, in July 1983, the Board adopted the draft amendments, with a revision in the draft amendment to rule G-12 to include indirect participants.²⁹ The Board's automated clearance rules included provisions for delayed implementation in two phases, allowing sufficient time for the industry to prepare to use the automated systems. The first phase, which began on August 1, 1984, required use of automated comparison and confirmation/affirmation systems. The second phase, which began on February 1, 1985, required use of book-entry delivery systems. The SEC approved the amendments on November 14, 1983.³⁰

After adopting the automated clearance rules in July 1983, the Board received a number of inquiries from dealers that were indirect participants in registered securities clearing agencies. It was brought to

²⁷ *MSRB Reports*, Vol. 3, No. 2 (April 1983) at 3-5. The draft amendment to rule G-15 also included requirements that certain information be obtained from DVP/RVP customers, including information regarding the customer's clearing arrangements, that would be helpful in the use of automated clearance systems. These requirements were written to apply to all DVP/RVP transactions with customers, including transactions not subject to the automated clearance requirements. The requirements ultimately were adopted as rule G-15(d)(i).

²⁸ *MSRB Reports*, Vol. 3, No. 2 (April 1983), at 7-8.

²⁹ *MSRB Reports*, Vol. 3, No. 6 (November 1983), at 19-26.

³⁰ Securities Exchange Act Release No. 20365, reprinted in *MSRB Reports*, Vol. 3, No. 7 (December 1983), at 7-12. A copy of the Commission's order approving the rules is attached.

the Board's attention that many of these dealers self-cleared transactions for local delivery and used clearing agents only for transactions that were settled in "money center" cities such as New York. These dealers expressed concern that the rules might require them to use clearing agents on all transactions in securities eligible for automated systems, which would be considerably more expensive than if they continued to self-clear their local transactions. The Board agreed that such transactions should not be required to be cleared through automated systems, at least during the transition to automation. Thus, in April 1984, prior to the first phase of implementation, the Board adopted amendments to clarify that the automated clearance rules would apply to a transaction by an indirect participant only if the indirect participant uses a direct participant clearing agent on the transaction.³¹

3. Summary of Automated Clearance Rules. As finally adopted, the automated clearance rules implemented in August 1984, make the following requirements. Rule G-12(f)(i) states that all inter-dealer transactions eligible for automated comparison must be compared through an automated comparison system if each party to the transaction is either a member of a registered clearing agency offering automated comparison services or uses a clearing agent for the transaction that is a member of such a registered securities clearing agency. Rule G-15(d)(ii) requires that DVP/RVP customer transactions eligible for automated confirmation/affirmation systems be confirmed/affirmed through such a system if each party to the transaction is a member of a registered clearing agency offering confirmation/affirmation services or uses a clearing agent for the transaction that is a member of such a clearing agency.

The rules implemented in February 1985, make the following requirements. Rule G-12(f)(ii) states that an inter-dealer transaction must be settled by book-entry delivery in a registered clearing agency if the transaction has been compared in an automated comparison system and each party is a member of a depository that makes the securities eligible for deposit or uses a clearing agent for the transaction that is a member of such a depository. Rule G-15(d)(iii) requires a DVP/RVP customer transaction to be settled by book-entry delivery if each party to the transaction is a member of a depository making the securities eligible or uses a clearing agent for the transaction that is a member of such a depository. Both rules on book-entry delivery state that, if the parties to a transaction are not members of the same depository, book-entry delivery is required only if both depositories make the securities eligible for deposit and the depositories are linked for inter-depository delivery.

Implementation of the Automated Clearance Rules

When the Board adopted the automated clearance rules in July 1983, most members of the municipal securities industry were not familiar with automated clearance systems and the automated systems then available would accommodate only secondary market transactions. At the outset, the Board's efforts largely were educational. In 1983 and 1984, representatives of the Board participated in a number of educational seminars sponsored by the Public Securities Association ("PSA") and other industry groups to prepare the industry for implementation of the rules.³² These seminars focused on the requirements

³¹ *MSRB Reports*, Vol. 4, No. 4 (June 1984), at 17-18; approved May 10, 1984, Securities Exchange Act Release No. 20952.

³² The Board obtained and continues to obtain information on the operation of the automated clearance systems at various meetings of municipal securities dealers sponsored by the Board and other industry associations such as the PSA, the Cashiers' Association of Wall Street, Inc. and the Bank Capital Markets Association. The Board

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of the Board's rules as well as the proper use of the systems. Once the rules became effective and the industry gained experience with the systems, the Board published notices in *MSRB Reports* to alert dealers to specific problems being encountered with the use of the systems and methods to avoid such problems.³³ As the industry gradually adjusted to the automated systems in 1985, the Board began discussing with the enforcement agencies the need to improve industry compliance with the automated clearance rules and the Board's view of appropriate enforcement priorities.³⁴

1. Automated Comparison System for Secondary Market Transactions. When the Board adopted the automated clearance rules, the NSCC system for municipal securities comparison was still in a pilot phase. Implementation of this system required a number of actions by the Board. During late 1983 and early 1984, prior to the August 1, 1984, effective date for use of the system, representatives of the Board had numerous meetings with NSCC to discuss system developments. One important topic of these discussions was the securities description appearing on the contract sheets that are produced by the system in lieu of paper confirmations. The Board strongly urged NSCC to include a complete securities description as required under the Board's rule governing physical inter-dealer confirmations, rule G-12(c), rather than a shorter description. NSCC incorporated the longer securities descriptions in the system in July 1984.

The industry quickly gained experience with the automated comparison system after the August 1, 1984, effective date of the automated comparison requirements and certain problems in the use of the system became clear at that time. It became apparent, for example, that many dealers were not using the appropriate features of the comparison system to resolve transactions that did not compare in the original comparison cycle and instead were using physical confirmation procedures for resolving such transactions. In December 1984, the Board amended rule G-12 specifically to require that dealers use the "post-original" comparison procedures offered by a registered securities clearing agency to resolve uncomparing transactions submitted to the automated system.³⁵ In February 1985, the Board published an interpretive letter to resolve problems that some dealers had experienced in determining the appropriate settlement date of a transaction compared through post-original comparison procedures.³⁶ In that interpretive letter, the Board also urged dealers to discontinue sending unnecessary physical confirmations of transactions submitted to the automated comparison system.

A significant compliance problem has been the persistence of some dealers treating certain inter-dealer trades (predominantly trades with small firms and bank dealers) as customer transactions.³⁷ This

also obtains information from comments on proposed rule changes and through telephone inquiries from industry members concerning the requirements of Board rules. In addition, the Board's Operations Advisory Committee, which is composed of industry representatives actively engaged in municipal securities clearance and settlement, has provided technical expertise on use of automated systems since 1985.

³³ The notice on inter-dealer versus customer transactions and the interpretive letter on settlement dates on post-original comparison transactions, discussed *infra*, are examples of such notices.

³⁴ The Board does not have inspection or enforcement authority with respect to its rules. This responsibility rests with the NASD, the Office of the Comptroller of the Currency, the Federal Reserve Board, and the Federal Deposit Insurance Corporation for each of their respective constituents.

³⁵ *MSRB Reports*, Vol. 5, No. 2 (February 1985), at 7-8; approved March 18, 1985, Securities Exchange Act Release No. 21859.

³⁶ *MSRB Reports*, Vol. 5, No. 2 (February 1985), at 17-18.

³⁷ This problem apparently originated because of the compensation policies of some firms, which treat certain inter-dealer transactions as customer transactions for purposes of sales commissions.

practice prevents the timely comparison of the transaction in the automated comparison system. In February 1985, the Board published a notice warning dealers against erroneous submission of inter-dealer transactions to the institutional customer confirmation/affirmation system and instructing dealers how to distinguish inter-dealer from customer transactions in the particular situations in which problems had been reported.³⁸ The Board also later communicated with enforcement agencies concerning this problem.

In some cases, industry experience with the automated comparison system revealed that additional system modifications were needed to accommodate the characteristics of the municipal securities markets. Municipal securities dealers, for example, often execute trades with special conditions attached, e.g., that an expected "AAA" rating will be given to an issue. During 1985, the Board received complaints from dealers that the automated comparison system could not provide notation of special conditions on contract sheets provided by the system.³⁹ This made it necessary for dealers to send duplicate physical confirmations of these trades to ensure a written record of the condition. In September 1985, the Board asked NSCC to develop a procedure allowing notation of special conditions and to require that transactions be submitted to the system with the same special condition designated for a comparison to occur. NSCC implemented such a feature in January 1987.

2. Automated Comparison System for When-Issued Transactions. As initially implemented, one problem with the automated comparison system was that it did not accommodate when, as and if issued ("when-issued") transactions. The inability of dealers to submit primary market transactions, which are a major segment of the municipal securities market, into the comparison system caused many dealers to delay using the system and to continue to rely on physical confirmations.

When the automated comparison provisions of rule G-12 went into effect in August 1984, the Board urged NSCC to develop when-issued capability quickly and discussed the design of the system with NSCC. In July 1985, the Board insisted that the when-issued comparison system not exclude transactions between syndicate managers and syndicate members, as was originally proposed by NSCC. The Board noted that the efficiencies of automated comparison and the purposes of section 17A required that all transactions in securities with CUSIP numbers be included in the system.

The Board also adopted several amendments to its rules to accommodate automated when-issued trade comparison. In July 1985, the Board amended rule G-12(b) on inter-dealer settlement dates to ensure that NSCC or its agent is notified of the initial inter-dealer settlement date of a new issue at least six days prior to its occurrence.⁴⁰ This provides NSCC with information necessary to compute transaction monies on when-issued trades and time to provide final contract sheets once a settlement date is established.

In September 1985, the Board amended rule G-34 on CUSIP numbers to require that CUSIP numbers be assigned to a new issue by the date that the contract for sale is executed with the issuer or

³⁸ *MSRB Reports*, Vol. 5, No. 2 (February 1985), at 9-10.

³⁹ *See, e.g., MSRB Reports*, Vol. 5, No. 2 (February 1985), at 17-18.

⁴⁰ *MSRB Reports*, Vol. 5, No. 5 (August 1985), at 7-8; approved October 25, 1985, Securities Exchange Act Release No. 22559. The settlement date of a when-issued transaction often is not known by the parties to a transaction at the time the transaction is executed.

the formal award is made by the issuer.⁴¹ In December 1985, the Board added a provision to rule G-34 requiring managing underwriters to disseminate the CUSIP numbers and the initial trading date in a new issue to all syndicate and selling group members.⁴² These amendments ensure that dealers have information necessary to submit transactions in new issues to the when-issued comparison system no later than the day following the day trading begins in an issue. NSCC's when-issued comparison system became operational on February 28, 1986, but, as discussed below, is not providing a satisfactory means of comparing when-issued transactions.

3. Book-Entry Settlement Systems. As the book-entry delivery requirements of the automated clearance rules were implemented in February 1985, the Board began receiving comments from dealers that they often did not receive adequate advance notice of the depository eligibility of a new issue from DTC and thus could not make appropriate arrangements to accept book-entry delivery. In February 1985, the Board requested that DTC publish a timetable for the submission of information by underwriters seeking to make a new issue depository eligible, allowing DTC to provide the industry with at least five days advance notice of an issue's eligibility. DTC proposed such a timetable to its participants in March 1985 and adopted it in October of that year.

The Board also received complaints from a number of dealers in 1985 that the interfaces linking depositories presented a number of problems in making book-entry deliveries from members of one depository to another. These problems were caused by inefficient computer links between the depositories, a lack of uniform eligibility standards and differing lists of eligible securities at the various depositories. In 1985 and 1986, the Board asked each of the depositories to improve the interfaces and to establish more uniform eligibility lists. Since that time, the Board has continued to press for improvements in these areas.⁴³

⁴¹ *MSRB Reports*, Vol. 5, No. 6 (November 1985), at 13-14; approved December 19, 1985, Securities Exchange Act Release No. 22730.

⁴² *MSRB Reports*, Vol. 6, No. 1 (January 1986), at 15-16; approved February 24, 1986, Securities Exchange Act Release No. 22938. The initial trade date for an issue is defined, for competitive issues, as either the date of award or the first date allocations are made to syndicate or selling group members, whichever date is later; and, for negotiated issues, as either the date on which the contract to purchase the securities from the issuer is executed or the first date allocations are made to syndicate or selling group members, whichever date is later.

⁴³ *E.g.*, November 5, 1985, Letter from MSRB Chairman Ralph Horn to William Dentzer, Jr., Chairman, DTC; January 2, 1986, Letter from MSRB Chairman Ralph Horn to Andrew Anderson, President, MSTC.

III

Recent Board Actions on Automated Clearance

1986 Board Review of Automated Clearance and Settlement Rules

During 1985 and early 1986, after the industry had gained some experience with the automated systems, the Board undertook an extensive evaluation of how its rules and the automated clearance systems were working. The Board reviewed the use of automated systems through detailed interviews conducted by Board staff with a number of dealers using a variety of clearance and settlement procedures. Although some dealers reported that they were achieving substantial cost savings from use of the systems, others reported that they were not. Most of the savings from the systems were reported to be derived from the use of book-entry deliveries. A small number of dealers actually reported increased costs from use of automated comparison of inter-dealer trades because physical confirmations continued to be sent and processed by many dealers, reducing all dealers' reliance on automated comparison.⁴⁴ In addition, many dealers were not submitting transactions to the system by the day after trade date and were relying on the more costly post-original comparison procedures. The Board's review also revealed that the benefits of automated confirmation/affirmation of customer trades in municipal securities were substantially lower than for corporate securities because of the low percentage of affirmed transactions.

In essence, inefficiencies were being caused in two ways. First, a number of dealers reported system inadequacies, such as the inability of the systems to handle certain types of transactions, *e.g.*, when-issued and special condition transactions, problems with inter-depository interfaces, lack of uniform depository eligibility standards, and delays in obtaining physical withdrawal of securities from depositories. These inadequacies resulted in increased costs for dealers attempting to use the systems. Second, it was clear that a number of dealers, institutional customers and their clearing agents had not made the "in-house" equipment and technical changes and other preparations necessary to use the automated systems efficiently.

In considering this information, the Board was concerned that it might have attempted to bring about the industry's transition to automation too rapidly. The Board debated whether it would be advisable to establish certain priorities for the completion of the industry's transition to automation. In December 1985, the Board published draft amendments to the automated clearance rules designed to allow dealers first to concentrate their efforts on completing their conversion to automated comparison, then to focus on book-entry settlement of inter-dealer transactions and finally to devote their full efforts to automated confirmation/affirmation and book-entry settlement of institutional customer transactions.⁴⁵ The draft amendments would have permitted physical delivery of inter-dealer transactions when agreed to by both parties and would have required use of automated confirmation/affirmation and book-entry delivery for customer transactions only if requested or agreed to by the customer. The Board stated that, if the proposed amendments were adopted, the full requirements of the automated clearance rules would be reinstated in the future, once the industry was better able to focus on the book-entry and confirmation/affirmation systems. The Board asked for comments on whether this plan would facilitate the transition to automated systems.

⁴⁴ The review was conducted prior to NSCC's implementation of the automated when-issued comparison system.

⁴⁵ *MSRB Reports*, Vol. 6, No. 1 (January 1986), at 7-10.

Eighty-five commentators opposed the amendments, while 24 commentators supported them. The commentators supporting the amendments cited higher costs, settlement delays or other inefficiencies that they were experiencing with the automated systems. Most of the commentators, however, indicated that many municipal securities market participants already were deriving cost savings from using the automated systems and resisted what was perceived as a step back from the Board's commitment to automated clearance. The majority of commentators argued that the draft amendments would act as a disincentive for dealers to convert to automation, would sanction physical settlements and would increase clearing costs for dealers already using the automated systems.

The Board was persuaded by the comments that the entire industry would experience cost savings offered by automation once the necessary "in-house" preparations were accomplished by dealers and that it was appropriate to continue to press for automation of the municipal securities market. The Board, therefore, reaffirmed its commitment to the automated clearance rules as drafted and withdrew the draft amendments in April 1986.⁴⁶ In its notice of withdrawal of the amendments, the Board urged dealers to make the internal modifications and other necessary commitments to obtain efficient and cost-effective automated clearance. The Board also stated that additional action would be needed by registered clearing agencies to facilitate the transition to automation and urged industry members with suggestions for improvement of the systems to contact the clearing agencies directly.

During the 1985–86 evaluation, it became apparent that some indirect participants were experiencing great difficulty with the automated systems. In many cases, the policies, practices, procedures and fees of the registered clearing agencies were not being adequately communicated to indirect participants. This resulted in unnecessary delays in processing or settling transactions and other time-consuming problems for indirect participants as well as dissatisfaction with automated clearance systems. In some cases, the costs of services provided by depositories is combined with other services so that indirect participants cannot determine the actual costs charged by the registered securities clearing agencies.⁴⁷ The Board requested from each registered clearing agency offering municipal securities services a list of personnel and telephone numbers that could be used by indirect participants to obtain information on the automated systems. The Board published this list along with its notice on the withdrawal of the draft amendments in *MSRB Reports*.⁴⁸

Recent Board Actions on Automated Clearance Issues

Since the Board's 1985–86 evaluation of the automated clearance rules, the Board has taken a number of additional actions designed to promote further progress in the automated clearance of municipal securities transactions.

1. Clearance and Settlement Fees. The Board has been very sensitive to the costs of the transition to automation by the industry, particularly for dealers that had not participated in automated systems prior to the adoption of the automated clearance rules in 1983. The Board has carefully scrutinized fee

⁴⁶ *MSRB Reports*, Vol. 6, No. 3 (June 1986), at 3-5.

⁴⁷ There are no regulatory standards applicable to the performance of those clearing agents not required to be registered with the Commission as dealers or as registered clearing agencies. The Board believes that the vital role of such clearing agents in the national clearance system should be acknowledged and that the Commission should consider whether certain minimum standards are needed for all clearing agents.

⁴⁸ The list was first published in June 1986. The Board continues to publish the list periodically.

proposals by registered clearing agencies and, on several occasions, has commented on proposed fee changes. Although the Board understands that clearing agencies have the authority to set fees based on participants' needs and an evaluation of the costs and benefits of various services, it believes that consideration also should be given to the effect of the fees upon the municipal securities industry's transition to automated clearance systems. The Board believes that proposed fees should be examined carefully by clearing agencies and by the Commission to ensure that they do not impede use of the systems by municipal securities market participants.

2. Amendment to Rule G-34 on CUSIP Numbers. In July 1987, the Board adopted an amendment to its rule G-34 on CUSIP numbers which effectively requires that new CUSIP numbers be assigned whenever necessary to reflect distinctions created within municipal issues in the secondary market.⁴⁹ This ensures that securities that obtain credit enhancements in the secondary market or which are remarketed with various put features can be identified accurately by their CUSIP numbers.

3. Confirmation/Affirmation Programs. In January 1986, DTC proposed to change the manner in which it provides securities descriptions on confirmations generated by its automated confirmation/affirmation system. At that time, the securities description appearing on a confirmation had to be entered by the dealer submitting the transaction to the system. DTC proposed a system which would print automatically on confirmations securities descriptions provided by a private vendor, but also would allow dealers to add a limited amount of information to augment the securities description provided. The Board commented that, even under the proposed revision, dealers ultimately would be responsible for ensuring that the securities description provided to the customer is accurate and in compliance with the customer confirmation disclosure requirements of rule G-15(a). The Board also pointed out several disclosure requirements of rule G-15(a) not generally met by commercially available standard securities descriptions. DTC implemented the revision in July 1987, for both its own confirmation/affirmation system and NIDS.

The Board also has monitored a DTC program for processing when-issued customer transactions in its automated confirmation/affirmation system. The program allows when-issued confirmations to be generated by the system at the time of trade, based on available information about the issue. This confirmation is informational only and cannot be affirmed. Once the settlement date and other necessary information about the issue are available, the dealer submits it to the system in the form of a final confirmation, which can be affirmed by the customer. This allows DTC to deliver DTC-eligible securities automatically for such affirmed trades on the settlement date of the new issue. Although DTC made the program available to all participants in 1987, it has received, thus far, limited use by dealers.

4. Book-Entry Settlement Systems. The Board recently adopted certain amendments on the delivery of securities that may be issued in either bearer or registered form ("interchangeable securities") which will offer great benefits to automation. In March 1987, the PSA requested that the Board consider amending its rules on delivery of interchangeable securities to allow such securities to be delivered in bearer or registered form, ending the former requirement that such securities be delivered in bearer form. The Board published draft amendments to rules G-12 and G-15 incorporating this suggestion in June 1987⁵⁰ and received 18 comments, the majority of which were positive.

⁴⁹ *MSRB Reports*, Vol. 7, No. 4 (September 1987), at 7-9; approved October 14, 1987, Securities Exchange Act Release No. 25020.

⁵⁰ *MSRB Reports*, Vol. 7, No. 3 (June 1987), at 9-10.

The comments on the draft amendments persuaded the Board that revision of the Board's rules on delivery of interchangeable securities would allow depositories to convert much of their inventory of bearer certificates into registered form, which may be safekept at substantially lower costs. The lower costs for safekeeping these securities should allow depositories to lower the costs of depository services for municipal securities and to increase municipal securities issues that are eligible for deposit. The Board also was convinced that the amendments would reduce the number of failed transactions because dealers obtaining registered certificates of an interchangeable issue will not be required to convert them to bearer form prior to delivery. For these reasons, the Board adopted the draft amendments in September 1987.⁵¹ The amendments will become effective on September 18, 1988. As noted by some commentators, the effect of the amendments may make it more difficult to obtain bearer securities for physical delivery to customers. The Board, therefore, has stressed the need for dealers to educate customers on the benefits of registered ownership and safekeeping of securities in depositories.⁵²

The Board also has taken actions to facilitate the operation of a DTC pilot program offering depository services for securities settling in federal ("same-day") funds. A number of short-term municipal securities pay interest and redemption proceeds in same-day funds.⁵³ Because transactions in these securities also generally are settled in same-day funds, depositories historically have not made these municipal securities eligible for deposit. In April 1987, at the request of DTC, the Board adopted amendments providing an exemption from the automated clearance rules until June 30, 1988, for book-entry delivery of securities that settle in same-day funds.⁵⁴ This exemption permits dealers to participate in the DTC pilot program and become familiar with its procedures on a transaction-by-transaction basis. The Board is reviewing the operation of the system to determine whether it would be appropriate to extend the sunset date of the amendments.

5. Netting Systems. Netting systems generally require dealers to accept partial deliveries that occur in the netting process. The historical practice in the municipal securities industry, however, is not to accept partial deliveries and this is reflected in rule G-12(e)(iv).⁵⁵ As a result, netting programs have been slow to develop as a means of clearing and settling municipal securities transactions. The Board, however, currently is monitoring a voluntary pilot program begun by NSCC in September 1987, for the netting of certain municipal securities issues. As of year-end 1987, approximately 38 dealers were participating in the pilot program and transactions in two new issues had been netted.⁵⁶ To reduce the possibility of short positions and partial deliveries, NSCC has limited the pilot program to when-issued transactions in book-entry-only securities. The pilot program appears to have worked successfully for the issues chosen. The Board plans to continue to monitor the pilot program and examine whether a wider application of netting municipal securities transactions will be feasible in the industry.

⁵¹ *MSRB Reports*, Vol. 7, No. 4 (November 1987), at 3-6; approved on March 18, 1988, Securities Exchange Act Release No. 25489.

⁵² *Id.* at 4.

⁵³ Most transactions are not settled in federal funds, but rather by check in "next-day" funds.

⁵⁴ *MSRB Reports*, Vol. 7, No. 3 (June 1987), at 7-8; approved June 30, 1987, Securities Exchange Act Release No. 24661.

⁵⁵ This practice arose because of the general inability of dealers to obtain securities in the market to fill short positions created by partial deliveries. In 1983, the Board proposed amendments to rule G-12(e) that would have allowed partial deliveries in certain cases. The comments on the draft amendments were predominantly negative and the Board decided not to adopt these amendments. See *MSRB Reports*, Vol. 3, No. 6 (November 1983), at 15.

⁵⁶ These two issues had a total of 43 various maturities that are distinct for purposes of trading, delivery and settlement.

IV Remaining Issues to Be Addressed

In the last four years, the municipal securities industry has made tremendous strides in its transition to automated systems of clearance and settlement. However, to achieve further progress, a number of problems must be addressed. As discussed below, some problems fall outside of the Board's regulatory authority. The Board, nevertheless, is committed to supporting improvements in automated clearance and settlement and will assist efforts by the Commission and other groups to overcome impediments to the goals of section 17A of the Act.

Compliance with the Board's Automated Clearance Rules

In general, the Board believes that the majority of municipal securities dealers have sought to comply with the Board's automated clearance rules. However, as revealed in the Board's 1985–86 evaluation, many dealers, including a number of dealers that are strong supporters of automated clearance, still have not made the internal technical changes, training and supervisory commitments necessary to use automated systems efficiently and to comply with the automated clearance rules.

1. Inter-Dealer Secondary Market Comparison. The percentage of secondary market inter-dealer trades compared in the initial comparison cycle is a good indicator of general industry compliance with the automated comparison requirements of rule G-12.⁵⁷ The initial comparison rate has risen slowly, from approximately 60 percent when the rule first became effective in August 1984, to only 75 percent as of February 1988.⁵⁸ Obtaining further efficiencies from the comparison system requires that this percentage be much closer to 100 percent.

The primary reason that secondary market transactions do not successfully compare in the initial cycle is the failure of dealers to submit transaction data to the system correctly by the day following trade date. This may result from inadequate internal procedures for transmitting transaction data from trading personnel to operations personnel, delays in obtaining transaction data from regional offices, or clerical errors in coding or submitting data to the system. Some dealers, however, consistently submit almost 100 percent of their transactions correctly and in a timely manner. This demonstrates that, if sufficient resources were dedicated by other dealers, the automated comparison system could be used with great efficiency.

The Board has discussed compliance with its automated comparison requirements with the various enforcement agencies responsible for enforcing Board rules. In 1986, at the Board's request, NSCC assisted the enforcement agencies in their compliance activities by supplying information on the

⁵⁷ Transactions compared in the initial comparison cycle (on the evening of the day following trade date) represent comparisons achieved with the least amount of manual processing and indicate that both parties submitted their transactions in a timely manner (no later than the day after trade date), as required by rule G-12. However, if post-original comparison procedures must be used to compare a trade, much of the efficiency offered by the automated system is lost.

⁵⁸ In contrast, the comparison rate for corporate securities transactions in the initial comparison cycle is close to 100 percent.

performance of individual dealers in the automated comparison system. The enforcement agencies used this information to conduct special programs to address noncompliance, which sparked an improvement in comparison rates from approximately 63 percent in mid-1986 to approximately 74 percent by April 1987.⁵⁹ Since then, comparison rates for secondary market transactions have remained relatively stagnant. The Board believes that additional vigorous enforcement efforts are necessary to improve compliance with the automated comparison provisions of rule G-12.

2. Inter-Dealer When-Issued Comparison. The initial comparison rate for inter-dealer when-issued transactions in February 1988 was only 43 percent.⁶⁰ This low comparison rate seems to indicate that the system, as currently operating, does not provide an efficient means of comparing when-issued transactions. Moreover, there does not appear to be any trend of steady improvement in the when-issued comparison rate⁶¹ and the low number of transactions submitted to the system suggests that a substantial percentage of when-issued transactions are not being compared in an automated manner.⁶²

The poor when-issued comparison rate may reflect a tendency of trading personnel to withhold when-issued trade data from operations personnel and thus delay processing. It also may reflect the complexity of the when-issued comparison system, which requires one procedure for inputting a trade in which a syndicate manager allocates securities to a syndicate member and a different procedure for other when-issued trades. In addition, the when-issued comparison system is a separate system from the secondary market comparison system. As a result, operations personnel may erroneously submit when-issued and secondary market transactions into the wrong systems, causing uncomparing trades. The relatively complex procedures for when-issued comparison also increases the possibility of clerical errors in the coding and submission of trade data.

The Board believes that the continued problems in the when-issued comparison system are unacceptable if the industry is to move forward with automation. It is concerned over an apparent lack of attention to the operation and usage of the when-issued comparison system. Accordingly, the Board is undertaking an extensive evaluation of automated when-issued comparison. The review will focus on the design of the when-issued comparison system, dealer compliance with the automated comparison requirements of rule G-12 and enforcement efforts. The Board will share the results of the evaluation with the Commission and other interested parties.

3. Institutional Customer Confirmation/Affirmation Systems. The rate of customer affirmation of DTC-eligible municipal securities transactions submitted in the NIDS confirmation/affirmation system was only 64 percent for the month of February 1988.⁶³ Many dealers report that they now submit

⁵⁹ The NASD also conducted a similar program to address compliance with rule G-12(b)(ii)(C), which requires syndicate managers to notify NSCC of the initial settlement date of a new issue to facilitate when-issued comparison.

⁶⁰ This percentage excludes transactions in which syndicate managers allocate new issue securities to syndicate members, which are submitted only by the syndicate manager and recorded automatically as compared trades on the day following submission.

⁶¹ For example, the June 1987 initial when-issued comparison rate was 45 percent—higher than the 43 percent rate experienced eight months later in February 1988. In the interim, the rate fell to 31 percent in July 1987, and then to 29 percent in December 1987.

⁶² In December 1987, for example, the total number of when-issued transactions submitted to the system averaged less than 600 transactions per day. In light of the total \$5.61 billion volume of new issues which came to market in that month, this figure seems to be low.

⁶³ The rate for non-DTC eligible municipal securities was much lower—approximately 25 percent.

substantially all of their municipal securities transactions with institutional customers for automated confirmation/affirmation, but that such confirmations routinely are not affirmed by their customers. There may be a number of reasons for the failure of customers to affirm trades. The clearing agent for a municipal securities institutional customer often is responsible for affirming transactions for the customer and must receive instructions from the customer prior to affirming the transaction. Affirmation of the transaction thus depends in part upon the communication links established between the customer (or the customer's investment advisor), the customer's clearing agent and the depository. Dealers cannot control these factors and generally are reluctant to jeopardize business relationships with customers by insisting that improvements be made.⁶⁴

The Board has asked DTC to work with all of its participants, including those serving as clearing agents for customers, to improve the affirmation rate. In 1986, DTC initiated an ongoing program of visiting its participants to discuss ways to improve performance; however, the affirmation rate for municipal securities continues to lag behind that for corporate securities.⁶⁵ Although the Board recognizes the difficulties that dealers face in improving their customers' affirmation performance, these efforts ultimately must be made if the automated systems for clearance and settlement of customer transactions are to be used efficiently. Improving affirmation rates will require industry-wide efforts, involving dealers, customers and clearing agents and, to be effective, also must be coordinated with enforcement activities.

Investor Education on Benefits of Immobilization

Significant numbers of municipal securities investors, including some institutional customers, continue to require or prefer physical possession of securities certificates.⁶⁶ Some dealers encourage this preference and promote delivery of physical securities certificates to their customers. To provide physical securities to customers, however, dealers must utilize the expensive and time-consuming procedure of withdrawing securities certificates from a depository. The preference for physical certificates by customers thus far has limited the potential cost savings of automation and has discouraged the transition of the municipal securities industry to immobilization of certificates.

The decreased risks of loss, theft and missed call notices offered by depository immobilization provide strong incentives for investor acceptance. Continued progress in the immobilization of municipal securities will depend, in part, on educating dealers and customers about these benefits. A number of dealers have advised the Board that customers who previously preferred physical securities generally have responded positively to such educational efforts. As part of its 1985–86 review of automation and its adoption of amendments on interchangeable securities, the Board urged dealers to educate their

⁶⁴ Automated confirmation/affirmation systems may provide some advantages over physical confirmations, even when transactions are not affirmed. For example, in the automated system, both the customer and the customer's clearing agent usually receive electronically a confirmation giving advance notice of the settlement of a transaction, eliminating the risk of postal delays in paper confirmations.

⁶⁵ The affirmation rate for corporate transactions in the month of January 1988 was 90 percent compared to the 64 percent rate for municipal securities.

⁶⁶ When the Board adopted the automated clearance rules in 1983, several states also had requirements that securities purchased for certain purposes, *e.g.*, insurance reserve requirements, be safekept physically within the state. Most of these requirements have been altered to allow immobilization of securities certificates in out-of-state depositories. The Board understands that the state of Wyoming, however, continues to have insurance requirements that limit the ability of insurance companies to safekeep securities in an out-of-state depository.

customers on the benefits of securities immobilization.⁶⁷ A successful educational campaign will require coordination of efforts by dealers, depositories and industry organizations.

The number of book-entry-only municipal securities issued in recent years also has highlighted general investor concerns about immobilization.⁶⁸ Many customers are reluctant to purchase book-entry-only securities because of fear that it would be difficult to trade and recover securities in the event of a dealer insolvency. The increase in book-entry-only issues has led some investors to express concern that the protection offered by Securities Investor Protection Corporation ("SIPC") may not be adequate to cover their municipal securities accounts. Therefore, the Commission may wish to determine whether SIPC coverage continues to be adequate given the increased immobilization of municipal securities.

Issuers undoubtedly will increasingly prefer book-entry-only issuance since this allows them to reduce the costs associated with printing certificates, recording and transferring registered ownership, processing interest checks and redemptions of principal.⁶⁹ The costs of recording ownership and processing interest and redemption payments, however, often are shifted to dealers that safekeep such securities for investors. Municipal securities dealers that have not previously offered safekeeping services may face additional recordkeeping and financial responsibility requirements under Commission rules if they offer such services. It would be appropriate for the industry and the Commission to discuss in more detail the implications of these new responsibilities in light of the anticipated growth of book-entry-only municipal securities.

Issuer's Trustees, Paying Agents and Transfer Agents

Issuers of municipal securities generally contract with separate, nongovernmental entities to fulfill various ongoing administrative functions with respect to the securities they issue. In a typical callable issue, a trustee is selected that must conduct any lotteries necessary to allocate partial calls among securities holders, notify the securities owners affected by a call and generally supervise the redemption of called securities.⁷⁰ The issuer also selects a paying agent responsible for paying interest and principal to securities owners and, in issues of registered securities, a transfer agent responsible for recording record ownership.⁷¹ Because depositories have become such large holders of municipal securities,⁷² problems in trustee, paying agent and transfer agent performance have become major depository problems. Depository participants who receive late credit for redemption payments because of inadequate call notices or who are delayed in receiving securities because of transfer problems first look to the depository to address such matters. The problems, however, are industry-wide and affect all holders of municipal securities.

⁶⁷ *MSRB Reports*, Vol. 6, No. 3 (June 1986), at 4; *MSRB Reports*, Vol. 7, No. 4 (November 1987), at 6.

⁶⁸ Securities certificates are not available to investors in book-entry-only issues. In most book-entry-only issues, securities owners must hold the securities through a depository, either directly as a depository member or through a safekeeping arrangement with a securities firm, bank or clearing agent that is a depository member.

⁶⁹ New book-entry-only issues grew by 250 percent in 1987 and comprised approximately 28 percent of the par value of new issues. See "Depositories Report Book-Entry-Only Municipal Sales Rose by 250% in '87," *Credit Markets*, January 25, 1988, section 2, page 1.

⁷⁰ Not all issues of municipal securities have trustees and it is possible for an agent of the issuer other than a trustee to have responsibilities concerning call processing. In most cases, however, it is the trustee that is responsible for these functions.

⁷¹ In many issues, the paying agent and the trustee are the same entity.

⁷² DTC, for example, had over \$500 billion in par value of municipal securities on deposit in 1987. MSTC had over \$200 billion in par value of municipal securities on deposit.

1. Trustees and Paying Agents. The Board routinely receives complaints from investors concerning the duties performed by trustees and paying agents.⁷³ The complaints often concern the manner in which call notices are written or transmitted to securities owners, inadequate identification of securities on call notices, improper performance of call lotteries and late payment of interest by paying agents. Since no governmental entity regulates these functions, there is little that the Board can do to assist such investors. In November 1986, representatives from industry organizations, regulatory agencies, depositories, the Commission and the Board met to discuss these problems and recommended that trustees and paying agents observe certain voluntary standards when providing call notification. The depositories have advised the Board that, after the December 1986 publication of the standards by the Commission⁷⁴ and subsequent re-publication by the Board and other industry organizations, call notification improved during the first three quarters of 1987. Voluntary observance of the standards, however, began to decline in the fourth quarter of 1987 and compliance with some of the standards continues to be low.

The Board believes that, as a first step in resolving call notification and interest payment problems, issuers should specify within an issue's official documents, such as the trust indenture or paying agent agreement, clear standards that must be met by the parties performing these functions, including the 1986 recommended standards for call processing. In addition, the Board believes that issuers should monitor the performance of their agents to ensure that the standards are being met. Since the entities performing these functions are almost exclusively banks, it may be appropriate for banking regulatory agencies to include oversight of these activities in bank examinations. If these suggestions are not practicable, it may be necessary, as the Board noted in a 1986 letter to the Commission, to seek legislation providing regulation of municipal securities call notification.⁷⁵ The Board strongly supports the statements of Commission Chairman Ruder that the logical focus of any regulation in this area should be on trustees and paying agents and that a direct grant of authority to the Commission would be appropriate to provide such regulation.⁷⁶ The Board urges the Commission to act quickly upon Chairman Ruder's statements so that these problems, which continue to affect clearance and settlement of municipal securities and present serious investor protection concerns, may be addressed.

2. Transfer Agents. The Board received a considerable number of complaints concerning transfer delays in the years immediately following the adoption of TEFRA in 1982. In May 1983, the Board, the Commission, and the Government Finance Officers Association published a joint statement recommending that municipal securities issuers choose transfer agents which meet the same three-day turnaround standards applicable to most corporate transfer agents.⁷⁷ Today, the problem of transfer

⁷³ The Commission also apparently receives similar complaints. Commission Chairman Ruder recently noted that, in fiscal year 1987, questions about lack of notice on called bonds were raised in over 200 investor complaints to the Commission. Text of Remarks of David Ruder, Chairman, Securities and Exchange Commission, Before the Public Securities Association, October 23, 1987.

⁷⁴ Securities Exchange Act Release No. 23856 (December 3, 1986). The Board endorsed these standards in December 1986. *MSRB Reports*, Vol. 7, No. 1 (January 1987), at 11-15. The Board also urged the Government Finance Officers Association ("GFOA") to incorporate the standards as a part of its recommended procedures for municipal issuers. The GFOA included the standards in its 1988 *Disclosure Guidelines for State and Local Government Securities* as Procedural Statement No. 7.

⁷⁵ November 14, 1986, Letter from MSRB Chairman Keith Brunnemer to Richard Ketchum, Director, Division of Market Regulation.

⁷⁶ See Text of Remarks of David Ruder, Chairman, Securities and Exchange Commission, Before the Public Securities Association, October 23, 1987.

⁷⁷ *MSRB Reports*, Vol. 3, No. 3 (May 1983), at 3-4.

delays does not appear to be as serious as it once was, due in part to the increasing immobilization of municipal securities.⁷⁸ The Board, however, continues to receive occasional complaints about extraordinary transfer delays and it is apparent that a number of transfer agents, including those subject to the standards set forth in Commission rules 17Ad-1 through 17Ad-14, do not complete routine transfers within three business days, as generally required by those rules.

The Board believes that all parties conducting transfers for publicly held securities, either municipal or corporate, should be subject to the same standards. The Board strongly agrees with the recent statements by Commission Chairman Ruder that the Commission should be given statutory authority to regulate transfer agents for municipal securities, even when such agents do not provide corporate transfer services.⁷⁹ The Board also believes that it would be appropriate to emphasize increased enforcement of the existing standards for transfer agents already registered with the Commission.⁸⁰

Interfaces and Eligibility Standards

Although the Board understands that improvements have been made in the interfaces linking the various securities depositories, it is concerned that interface problems continue to limit use of the automated clearance systems by municipal securities dealers. These problems have led dealers that are members of several depositories to withdraw from certain depositories or otherwise limit their participation rather than accept deliveries through the interfaces.⁸¹ This, in turn, discourages participation in the automated systems by dealers that are members of those depositories through which deliveries will not be accepted. The Board believes that, for the transition to automation in the municipal securities industry to continue, the Commission must require depositories to implement interface policies and procedures which promote, rather than discourage, use of the interfaces.

The Board realizes that the large number of issues and complex features of municipal securities currently make depository eligibility for all municipal securities impractical. However, if municipal securities are to reach a parity with corporate securities in automated clearance and settlement, it is critical that eligibility in the various depositories be as broad and uniform as possible. This will allow a steady reduction in the number of transactions that must be processed physically, outside of automated systems. In this regard, it is incumbent upon depositories to maintain a certain degree of flexibility in their eligibility policies concerning municipal securities, even, for example, if immobilizing a particular issue may be more costly or difficult than normal for the depository. Progress has been made in this area in recent years; DTC's pilot program to make eligible securities that settle in same-day funds is one example. The Board, however, believes that additional efforts are necessary, especially in the area of securities that

⁷⁸ By allowing changes in the ownership of securities to be accomplished through depositories, rather than by changes in record ownership, immobilization reduces burdens on transfer agents. This promotes better performance by transfer agents when transfers are requested.

⁷⁹ See Text of Remarks of David Ruder, Chairman, Securities and Exchange Commission, Before the Public Securities Association, October 23, 1987. The Board also notes that the need for such regulation has been endorsed by the Stock Transfer Association, a 500-member association of transfer agents.

⁸⁰ The Board notes that the recently adopted legislation bringing associated persons of transfer agents under Commission regulation may assist the Commission in its enforcement activities. Securities and Exchange Commission Authorization Act of 1987, Pub. Law 100-181, 101 Stat 1249 (1987).

⁸¹ See, e.g., "Phlx Hits Merrill Lynch Action as Anti-Competitive," *The National Securities Processing Report*, Vol. 1, No. 3 (December 1, 1987), at 2.

are advance refunded by certificate number, for the full benefits of the automated systems to be realized by municipal securities participants.⁸²

Exemption for Indirect Participants in the Board's Automated Clearance Rules

When the Board adopted amendments to the automated clearance rules allowing indirect participants to self-clear transactions physically, it stated its intention that indirect participants ultimately should participate fully in the automated systems. Experience has verified that the benefits of automated systems increase as a greater percentage of total industry transaction volume is processed through the systems. In light of the problems discussed in this Report, however, the Board does not believe that it is appropriate at this time to require all municipal securities transactions by indirect participants to be included within automated systems.⁸³ Because of a variety of factors, indirect participants are paying more for the use of automated systems than are direct participants.⁸⁴ For many dealers, indirect participation in a registered securities clearing agency is the only feasible means of using automated clearance facilities.

The Board will continue to monitor the participation of indirect participants with a view to bringing them fully into automation when this can be done without substantial adverse effects on this group of dealers. The Board will support efforts to resolve the remaining impediments to full participation in automated clearance systems by municipal securities dealers so that the goals of Section 17A of the Securities Exchange Act can be achieved for municipal securities.

⁸² The Board understands that DTC, for example, does not allow securities to remain eligible in the depository if an issue is pre-refunded to different maturity dates or prices by certificate number.

⁸³ The Board is aware that self-regulatory organizations for corporate securities markets recently have taken steps to incorporate substantially all DVP/RVP transactions by indirect participants into automated systems. Amendments to NYSE Rule 387 and NASD Uniform Practice Code Section 64; approved by the Commission on November 13, 1987, Securities Exchange Act Release No. 25120.

⁸⁴ The higher costs, in part, can be attributed to the costs added by clearing agents. In addition, indirect participants tend to have lower transaction volumes than direct participants and do not share in the same economies of scale. The customers for indirect participants also appear to be more likely to be retail customers who prefer physical certificates.

Appendix
Securities and Exchange Commission Order
Approving the Board's Automated Clearance Rules
November 14, 1983

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT of 1934
Release No. 20365/November 14, 1983

ORDER APPROVING PROPOSED RULE CHANGE OF THE MUNICIPAL
SECURITIES RULEMAKING BOARD (File No. SR-MSRB-83-13)

I. INTRODUCTION

The Municipal Securities Rulemaking Board (the "MSRB") filed a proposed rule change on September 7, 1983, 1/ under the Securities Exchange Act of 1934 (the "Act"), 2/ concerning clearance and settlement of municipal securities transactions. Generally, the proposed rule change would require use of clearing agency facilities to accomplish various tasks, including comparison of inter-dealer trades; confirmation and acknowledgement of customer trades; and settlement of related delivery and payment obligations by book-entry. The proposed rule change would apply to municipal securities brokers, dealers and their clearing agents, as well as municipal securities investors and their securities custodians. 3/

The proposed rule change would become effective in two stages. After August 1, 1984, for trades subject to the Rules, comparison of inter-dealer trades and confirmation and affirmation of customer trades through clearing agency facilities would be mandatory. After February 1, 1985, those trades would be required to be settled through the book-entry facilities of registered securities depositories.

The proposed rule change was developed through extensive public discussion of appropriate clearance and settlement procedures for municipal securities transactions. The specific dialogue concerning mandatory clearing agency use began when the MSRB published a draft of the proposed rule change in July 1982. That draft concerned only the settlement of

1/ See Securities Exchange Act Release No. 20189 (September 16, 1983), 48 FR 43470 (September 23, 1983).

2/ 15 U.S.C. §78s(b)(1); 17 CFR 240.19b-4 (1983).

3/ The rule change, however, would apply to those entities only if they participate directly or indirectly in clearing agencies registered under the Act.

dealer-customer obligations, but drew 24 comment letters. 4/ In March 1983, the MSRB solicited further comment on that proposal and on a proposal concerning use of clearing agency facilities for comparison and settlement of inter-dealer trades. The MSRB received 27 comment letters on the March 1983 draft, as well as three comment letters after September 7, 1983. Those comments generally discussed the need to implement the proposed rule change in stages and the need for uniform clearing agency systems specifically tailored to municipal securities. All comments addressed to the MSRB were filed with and reviewed by the Commission. The Commission solicited written comment on the proposed rule change as filed on September 7, 1983, but received none.

As discussed below, the Commission has determined to approve the proposed rule change.

II. BACKGROUND

Currently, the majority of the 15,000 - 20,000 transactions in municipal securities that occur daily are processed in much the same way the securities industry processed trades in corporate debt and equity securities issues during the 1950's and 60's. 5/ Dealer trade reports, customer confirmations and institutional settlement instructions are produced manually on paper and are sent by mail to the appropriate parties. Thereafter, settlement occurs in many different locations daily, through the physical exchange of securities certificates versus money.

Securities industry reliance on paper and manual processing techniques for corporate securities transactions led to paperwork crises in the late 1960's, which in turn caused the failure of many securities firms and significant investor

4/ Commenters, while supporting the MSRB's proposal, emphasized three areas of concern: 1) the limited number of municipal securities issues currently eligible for clearing agency services; 2) the difficulty of identifying customers as depository participants; and 3) the need to bring settlement of inter-dealer trades within the same time-frame as customer-side settlement.

5/ See Securities and Exchange Commission, Study of Unsafe and Unsound Practices of Brokers and Dealers, H.R. Doc. No. 231, 92nd Cong., 1st Sess. 28 (1971).

losses. 6/ Problems for the municipal securities industry at that time, however, were much less apparent -- for two reasons. First, significantly lower secondary market trading volume in municipal securities meant less pressure on the industry's municipal firms' back-offices. Second, historically, municipal securities certificates have been issued primarily in bearer-form, rather than registered-form. Thus, delivery of certificates to settle secondary market trades has been possible without the need to transfer record ownership, and efficient interest collection has not depended on transferring record ownership by record date.

The recent increase in the number of municipal securities issues in registered-form 7/ and in secondary market activity for all securities issues, necessarily increases the risk of back-office delays in processing municipal securities transactions. The municipal securities industry is unaccustomed, generally, to the use of registered instruments and to the recordkeeping and other functions of transfer agents and registrars. Increased secondary market activity, therefore, will likely aggravate the delays and inefficiencies inherent in the industry's physical securities processing systems for registered-form municipal bonds. The MSRB and many industry members recognize that the proposed rule change, by promoting efficient processing and timely settlement of certain municipal securities transactions through automated facilities, 8/ should help preclude crises.

6/ Id.

7/ The Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") requires that security issues with maturity dates of more than one year be in registered-form to retain federal income tax-exempt status. Thus, after July 1, 1983, virtually all long-term municipal securities issues are likely to be in registered-form.

8/ Recently, the National Association of Securities Dealers, Inc. (the "NASD") and various national stock exchanges adopted rules similar to that proposed by the MSRB requiring use of registered securities depositories for the processing and book-entry settlement of certain customer-side trades in corporate securities. Adoption of these rules was recommended by a Joint Committee of the Operations Committee of the Securities Industry Association (the "SIA") and the New York Stock Exchange, Inc. (the "NYSE") to insure efficient processing of securities transactions, particularly during periods of high volume trading. See Securities Exchange Act Release No. 19227 (November 9, 1982) 47 FR 51658 (November 16, 1982).

III. DESCRIPTION OF THE PROPOSED RULE CHANGE

The proposed rule change would amend MSRB Rule G-12 concerning comparison, 9/ clearance and settlement of inter-dealer trades; and MSRB Rule G-15 concerning confirmation, affirmation 10/ and settlement of customer delivery and payment obligations. As explained below, the two rules together would require clearing agency participants to use clearing agency facilities for tasks associated with both street-side and customer-side settlement.

The rules define "participation" broadly to encompass both direct and indirect clearing agency participation. Neither rule mandates direct participation in a registered clearing agency nor do they require participation in any particular depository or clearing corporation. However, a non-participant dealer or institution whose clearing agent or securities custodian participates in a registered clearing agency generally would be subject to these rules.

Phase I: Comparison, Confirmation and Affirmation of Participant Trades

As of August 1, 1984, municipal securities dealers, brokers and customers that participate in registered clearing agencies will be required, in effect, to use the facilities of a registered clearing agency to compare, confirm and affirm their municipal securities transactions. Trades covered by

9/ "Comparison" is the process by which brokers and dealers match trades executed in the marketplace. Daily, each broker and dealer compares information about executed purchases and sales. If the relevant terms of the trade match, the two parties have a contract. If the parties report different information respecting a trade, the parties must resolve those differences before the trade can be settled.

10/ The "confirmation and affirmation" process is similar to the comparison process. In a typical institutional trade, an investment manager instructs a broker to execute a trade. After executing the trade, the broker sends the terms of the trade to the institutional customer or its investment manager. If the confirmation matches the customer's instructions to the broker, the customer will issue an affirmation to the custodian bank authorizing it to receive or deliver securities against payment to or by the executing broker.

the rules include all transactions in municipal securities issues that are assigned CUSIP numbers. 11/

MSRB Rule G-12 would require municipal securities brokers and dealers to use the automated facilities of a clearing agency for the comparison of their inter-dealer trades if they, or their agents, participate in a registered clearing agency that provides comparison services. The parties to such an inter-dealer trade would be required to submit trade data and other information to the clearing agency for comparison in accordance with the clearing agency's rules. Parties to an inter-dealer trade that participate in different clearing agencies would not be exempt from the rule if the clearing agencies are interfaced or linked with one another for comparison purposes. Similarly, parties to an inter-dealer trade that participate in a securities depository that is linked or interfaced with a clearing corporation that provides linked comparison services would be subject to the Rule.

MSRB Rule G-15 would prohibit participating municipal securities brokers or dealers from settling trades against payment ("COD/DVP") 12/ with their customers, whenever the customers or their agents participate in a registered securities depository, unless certain conditions are met. First, the dealer must obtain from the customer prior to or at the time of accepting a COD/DVP trade order certain information necessary to identify the customer, its settlement agent or custodian, and the customer's account with the agent. Second, the dealer, customer, and settlement agent, as appropriate, must use the facilities of a securities depository to confirm and affirm

11/ The CUSIP Service Bureau automatically assigns CUSIP numbers to municipal securities issues with greater than one year to maturity and a total principal amount greater than \$500,000. (A CUSIP number may be assigned to an issue with a total principal amount less than \$500,000 upon request.) Currently, over one million long-term municipal securities issues have been assigned CUSIP numbers. This represents more than 20 times the number of corporate issues assigned CUSIP numbers. See Prospects for Automation of Municipal Clearance and Settlement Procedures, MSRB Reports (April 29, 1983), at 11, n.1.

12/ Federal credit regulations require customers to settle securities transactions with their brokers no later than seven business days following execution. Federal credit regulations extend this time limit to thirty-five days for those customers who establish special cash accounts and who agree to settle purchases against the delivery of securities (cash-on-delivery -- "COD") or to settle sales upon payment (delivery-versus-payment -- "DVP"). See 12 CFR 220.4(c) (1982).

transactions in municipal securities issues assigned CUSIP numbers. 13/ The MSRB would exempt from this Rule, however, internal trades of a dealer-bank department. 14/

Phase II: Book-entry Settlement

Effective February 1, 1985, the proposed rule change would require affected persons to settle by book-entry, through the facilities of a registered clearing agency, certain transactions in municipal securities issues that are depository-eligible. A "depository-eligible security" is an issue of securities that is eligible for safekeeping and book-entry transfer services in a registered securities depository. 15/

Thus, MSRB Rule G-12 would require municipal securities dealers and brokers to settle, by book-entry movement, all inter-dealer transactions in depository-eligible municipal securities issues if those transactions are successfully compared through the facilities of a registered clearing agency. Although settlement must occur by book-entry movement, participants will not be required to settle trades through any

13/ See note 11, supra. Under this rule, the municipal securities broker or dealer also must: (i) identify such transactions as DVP or RVP transactions on the trade ticket; (ii) send the confirmation to the customer not later than the first business day following trade date; and (iii) obtain a representation (written or oral) from the customer that instructions regarding the transaction will be transmitted to the customer's settlement agent.

14/ Thus, this Rule would not require a dealer-bank or its non-participant customer to use the automated facilities of a clearing agency for the confirmation, affirmation and book-entry settlement of any customer-dealer obligation when both parties use a department of the dealer-bank as their agent. See MSRB letter to Robert V. Slater, Second Vice President, The Northern Trust Company (September 21, 1983) in File No. SR-MSRB-83-13.

15/ Currently, all registered securities depositories offer safekeeping and ancillary services for registered-form municipal securities. However, only some offer those services for bearer-form municipal securities. See note 36, infra.

particular clearing agency accounting operation. 16/ Accordingly, participants may provide standing instructions to settle on a trade-for-trade basis. 17/

MSRB Rule G-15 would require certain municipal securities brokers or dealers and their customers to settle, by book-entry, through the facilities of a registered securities depository, 18/

16/ Several types of accounting systems are used by clearing corporations. The most sophisticated accounting system is the Continuous Net Settlement ("CNS") system, which generates a single, daily net "buy" or "sell" position for each securities issue in which a participant has compared trades scheduled to settle on the fifth day after trade date and nets accumulated settlement obligations in that issue. The system severs the link between the original parties to the compared trades and interposes the system as the contra party. Accordingly, the clearing corporation's CNS system, rather than the original parties to the trade, becomes the entity obligated to deliver or receive securities and money. Unlike CNS systems, daily balance order ("DBO") systems traditionally have not interposed clearing corporations between parties. Instead, a DBO system generates a daily net "buy" or "sell" position for each issue of securities in which a participant has a compared trade due to settle, and allocates among, and issues to, participants net daily settlement orders to deliver or receive. As a result of the netting cycle, a participant may be required to deliver securities to, or receive securities from, a participant with which it had no direct trades.

17/ Many municipal securities dealers attempt to preserve confidentiality about their trading activities through the use of "broker's brokers". In a traditional Balance Order System, however, broker's brokers can net to zero, leaving municipal securities dealers to deliver securities to and receive payments from securities dealers they, in effect, ultimately "traded with" through the brokers' broker. For that reason, among others, municipal securities dealers historically have settled "trade-for-trade" with their broker's broker when circumstances required. Currently, NSCC does not plan to provide DBO services for the settlement of municipal securities transactions. See infra, note 32.

18/ The Depository Trust Company ("DTC") operates an automated settlement system for institutional transactions (the "ID system") in corporate securities issues. The ID

(Footnote continued)

COD/DVP transactions in depository-eligible municipal securities issues. The proposed rule change, however, would not require securities to remain on deposit after settlement. 19/

IV. DISCUSSION

A. Why Automate Processing And Immobilize Certificates?

All parties to a municipal securities transaction subject to the Rules should realize significant cost savings by clearing transactions electronically, settling obligations by book-entry, and immobilizing municipal securities certificates in depositories. 20/ The savings inherent in automated trade processing should extend to bearer-form as well as registered-form instruments, although the benefits of immobilizing bearer-form certificates may be narrower. Moreover, safekeeping and processing economies and efficiencies should be enjoyed by all parties subject to the Rules.

Automated trade processing should assure timely settlement of securities transactions and reduce settlement financing costs by expediting the transmission of trade reports, confir-

(Continued footnote)

system coordinates among certain brokers, investment managers and custodian banks participating in the system all the tasks that must be accomplished to effect customer-side settlement of these corporate securities transactions. In cooperation with DTC, the Midwest Securities Trust Company ("MSTC"), Pacific Securities Depository Trust Company ("PSDTC") and Philadelphia Depository Trust Company ("Philadep") offer their participants similar services through the National Institutional Delivery Systems. See discussion infra concerning the expansion of this service to municipal securities brokers, dealers customers, and their agents.

19/ This appears to be consistent with those state laws that are interpreted to require certain institutional investors, such as insurance companies, to maintain their assets within the state. See e.g., FLA. STAT. ANN. §628.281 (1978).

20/ The Commission recognizes that there are, inevitably, costs associated with mandating more extensive use of computerized facilities for data processing and communication systems. Under the Act, any such costs to the industry must be reviewed in light of several statutory goals and may be balanced against industry cost savings. See §§15B and §17A of the Act and discussion infra.

mations and affirmations. 21/ Moreover, by eliminating repetitive preparatory tasks, automated processing should enhance the accuracy of trade information and increase the number of trades settling in a timely and predictable manner. As a result, municipal securities industry members should realize significant cost savings as labor and research expenses decline, as dependence on the mail is reduced, and as delayed or lost trade documents are eliminated.

Similarly, book-entry settlement should reduce aggregate costs for the municipal securities industry by reducing the number of physical deliveries. 22/ Since book-entry movements only require physical deliveries of securities in connection with deposits in and withdrawals from the depository, investors, brokers and dealers subject to the Rules should be able to avoid repetitious physical movements of securities. In addition, clearing agency participants can share economies and efficiencies that result from depositories' bulk shipments and special arrangements between depositories and transfer agents for expedited turnaround of transfer requests. Savings in certificate-related expenses should be particularly significant for registered-form municipal securities issues. Moreover, reduced physical deliveries of registered and bearer-form municipal securities certificates should enhance certificate safety and reduce costs associated with certificate loss. Finally, book-entry settlement through the various interfaces should facilitate trading and settlement without regard to the parties' geographic location. One Account Settlement saves participants unnecessary fees for participation in and use of more than one depository and promotes timely and efficient clearance and settlement. 23/

21/ Mailing paper confirmations, affirmations and comparisons can delay receipt of documents necessary for settlement. In turn, such delays can cause settlement agents to reject tendered securities or withhold payment for securities ("DK's"), causing delayed settlement on the customer-side and unnecessary finance charges. The Joint Committee estimated that NYSE trades DK'd on the customer-side cost the corporate securities industry more than \$100 million in finance charges, in 1980.

22/ To the extent municipal securities brokers and dealers use the CNS System, the netting process will reduce the number of actual deliveries necessary, thereby further reducing costs.

23/ One Account Settlement -- a basic feature of the National Clearance and Settlement System -- permits a participant to settle all its trades through one clearing corporation or depository, regardless of the place of execution, recordation, and comparison of the trades.

Increased use of book-entry settlement pursuant to the proposed rule change should encourage participants to immobilize municipal securities certificates in securities depositories. In the corporate area, depositories have provided cost-efficient vault facilities and ancillary services 24/ for registered-form certificates. Such certificates can be handled efficiently in a fungible bulk, through the safekeeping of "jumbo" certificates 25/ registered in nominee name. 26/

B. Why should the MSRB facilitate automation in clearance and settlement?

The proposed rule change reflects an important step in the MSRB's continuing efforts to facilitate improvements in the industry's securities transaction processing. As discussed in a recent MSRB Report, Prospects for Automation of Municipal

- 24/ Income accounting (i.e., the collection and processing of interest and maturity payments) is an important ancillary service for depository-eligible issues.
- 25/ For reasons of safety and economy, depositories generally consolidate the certificates received in each issue by requesting from the transfer agent several large denomination certificates. The particular denominations maintained on deposit depends, primarily, on participant demand for certificates. (Depositories often elect to put interchangeable issues into registered-form for this reason).
- 26/ The cost of immobilizing bearer-form certificates in securities depositories, of course, may be high relative to registered-form certificates and, at least initially, relative to other custodial alternatives. Higher depository fees result, in part, from the need to clip and present coupons to the paying agent prior to collecting interest payments and to provide more storage space for certificates with coupons attached. However, once the number of depository-eligible municipal securities issues in bearer-form grows, significant certificate immobilization by participants could help create certain economies at the depository that all participants can share. In any event, for municipal securities dealers with relatively small inventories and high transaction volume, depository immobilization would provide benefits and economies that likely exceed ex-clearing processing costs.

Securities Clearance and Settlement Procedures, 27/ the MSRB during the last two years has used its rulemaking authority to advance the prospects for uniform national practices and procedures among disparate markets. 28/ Furthermore, that Report notes that "major progress has been made in developing appropriate systems and preparing the industry for the transition to automated clearance....The rule changes [under consideration here] will result in the inclusion of large numbers of transactions in such systems." 29/

The Commission believes that the proposed rule change is a timely and appropriate exercise of the MSRB's rulemaking responsibility. 30/ Promoting back-office efficiency is an appropriate goal of Self-Regulatory Organization ("SRO") rulemaking authority, particularly in light of traditional industry emphasis on front-office execution activities. The MSRB initiative in this area is in keeping with other recent SRO initiatives that the Commission encouraged and approved, 31/ and should generate important economies in both trade and certificate processing. As the MSRB noted in both its filing and its recent Report, the "registered-form" requirement of TEFRA creates a special need for automated processing of these securities.

27/ See note 11, supra.

28/ See e.g., MSRB Rule G-12 (uniform practice respecting: dealer confirmations; comparison and verification of confirmations; delivery of securities; payment; rejection and reclamation; close-out; good faith deposits; and settlement of syndicate accounts), MSRB Manual (CCH) ¶ 3556 (April 1983); MSRB Rules G-12(c)(v)(F), G-15(a)(vii) (mandatory use of CUSIP numbers on dealer confirmations), MSRB Manual (CCH) ¶¶ 3556, 3571 (April 1983).

29/ MSRB Report, at 45.

30/ In its filing, the MSRB notes that the proposed rule change is consistent with Section 15B(b)(2)(C) of the Act, which directs the MSRB to propose and adopt "rules designed . . . to foster cooperation and coordination with persons engaged in regulating, clearing, settling processing information with respect to, and facilitating transactions in municipal securities, to remove impediments to and perfect the mechanism of a free and open market in municipal securities, and, in general, to protect investors and the public interest."

In addition, the MSRB has provided ample time for industry education and preparation before the effective dates of the proposed rule change. Under the rules, for example, municipal securities brokers and dealers will need to develop or modify their internal operations to accommodate automated processing and book-entry settlement through clearing agencies. More importantly, the registered clearing agencies will need to complete system and interface enhancements promptly, so that the objectives of the proposed rule changes can be met. As discussed below, the Commission expects the MSRB to continue to monitor closely industry and clearing agency efforts under these amendments.

C. Current and prospective clearing agency systems provide a foundation for safe and efficient clearance and settlement under the rule change

Currently, only NSCC provides comparison services for registered and bearer-form municipal securities. The Commission understands that NSCC, in the next several months, will establish a national system for the comparison of municipal securities transactions in issues that have been assigned CUSIP numbers (the "National Trade Comparison System for Municipal

(Continued footnote)

The MSRB further suggests that its proposed rule change is consistent with Section 17A of the Act and, in particular, with the Congressional finding set forth in Section 17A(a)(1) of the Act, which encourages "the linking of all clearance and settlement facilities and the development of uniform standards and procedures for clearance and settlement [because it] will reduce unnecessary costs and increase the protection of investors behalf of investors."

31/ See, e.g., Securities Exchange Act Release No. 19227 (November 9, 1982), 47 FR 51658 (November 16, 1982) (approval of Exchange and NASD rules requiring depository participants to use depository facilities for customer-side settlement of certain institutional trades).

The SRO's have used their legislative authority to an even greater extent in other contexts. For example, the NASD has required certain NASDAQ market-makers to use the clearance and settlement facilities of registered clearing agencies. See NASD Manual (CCH) ¶1653A, Securities Exchange Act Release No. 19689 (April 26, 1982), 47 FR 19500 (May 5, 1982).

Bonds"). ^{32/} Initially, MCC and DTC plan to establish "links" to NSCC to access the comparison services of this national system for their respective participants. The Commission urges all other clearing agencies (directly or through NIDS, as appropriate) to establish effective links to NSCC for the national comparison system. Ideally, these arrangements should be concluded well in advance of the Phase I implementation date (August 1, 1984).

As noted above, all depositories currently offer confirmation and affirmation services through a National Institutional Delivery System ("NIDS"), for which DTC is the facilities manager. NIDS provides these services for corporate debt, equity, registered and bearer-form municipal securities issues. For those issues which are eligible for depository settlement, the depositories also provide, through interfaces, book-entry services nation-wide. Although use of NIDS, as it currently operates, would permit participants to satisfy the MSRB Rules, the Commission understands that limited

^{32/} The National System will operate in a manner similar to the National OTC Equity Comparison System for corporate securities issues, for which NSCC is also the central processor. NSCC does not intend at the present time to offer its participants access to the NSCC balance order system because of the reluctance of municipal securities dealers to use netting systems. NSCC believes that municipal securities brokers and dealers would prefer to settle on a trade-for-trade basis to avoid (i) the netting of transactions, which can entail disclosing the parties actually trading, and (ii) partial deliveries of securities, which, under current MSRB Rules, is not mandated. See Participant Report, National Securities Clearing Corporation, No. 16 (October 30, 1983).

NSCC, however, will offer a "Comparison Only" mode for transactions in securities that are not depository-eligible. For these inter-dealer transactions successfully compared at NSCC, however, the resulting delivery obligation may be settled physically, through NSCC's "Envelope" services. (NSCC has a New York City envelope service that consists of a central location where participants can drop off envelopes containing securities and have those envelopes delivered to another participant; NSCC also provides an inter-city envelope service that ships envelopes, by courier, between New York City and several regional locations.)

modifications are being contemplated to accomodate more effectively the unique characteristics of municipal securities issues. 33/

The registered securities depositories also provide a broad range of depository services for most registered-form municipal securities. Only DTC and MSTC, however, safekeep bearer-form municipal securities: 34/ DTC at its central facility in New York and MSTC at a network of regional custodians. The Commission understands that MSTC and DTC anticipate extending their current depository interfaces to accomodate book-entry movements of both bearer and registered-form municipal securities issues. The Commission believes that effective interfacing is crucial if participants are to realize the benefits inherent in "One Account Settlement." 35/ Therefore, the Commission urges DTC and MSTC to complete their arrangements promptly. The success of the MSRB rule change depends critically on earnest cooperation among clearing agencies and between the clearing agencies and the MSRB. 36/

33/ For example, DTC contemplates establishing a separate, more extensive field on the computer-generated confirmation and affirmation forms to capture important descriptive information (i.e., maturity date, issue purpose).

34/ DTC makes eligible for deposit over 40,000 municipal securities-issues, of which approximately 35,000 are in bearer-form. MSTC makes depository-eligible approximately 123,000 eligible municipal securities issues in bearer-form and approximately 35,000 in registered-form.

PSDTC recently initiated a pilot link to MSTC's bearer bond program to offer PSDTC participants the full range of MSTC services. See File No. SR-PSDTC-83-3, Securities Exchange Act Release No. 19802 (May 23, 1983), 48 FR 24504 (June 1, 1983).

35/ See supra, note 23.

36/ Many commenters noted that the current depository-eligibility standards should be made uniform by the Phase II implementation date (February 1, 1985). Currently, eligibility criteria vary substantially between MSTC and DTC: MSTC will accept for deposit, upon participant request, almost any municipal securities issue while DTC requires, among several other things, that the issue have a transfer agent whose performance is consistent with the Commission's 72 hour turnaround standard. (See 12 CFR 240.17Ad-2.)

(Footnote Continued)

The Commission believes that current clearing agency systems provide a foundation for the proposed rule change and for safe, efficient clearance and settlement of municipal securities transactions. The Commission also believes that these systems, if modified and expanded by the clearing agencies and used by their participants, will remove the paper processing shackles that can constrict the municipal securities markets and will prepare active market participants for sustained high volume trading of the 1980's and beyond.

D. General Business Impact and Competitive Considerations

In light of the flexibility afforded municipal securities brokers, custodian banks, investment managers and most municipal securities dealers, the Commission believes that the proposed rule change does not impose any inappropriate or unnecessary

(Continued footnote)

The Commission understands that the rule will not require sole participants of different depositories to settle, by book-entry, transactions in securities issues that are not eligible for deposit at both depositories. Nonetheless, differing eligibility criteria could limit the value of the rule and the National Clearance and Settlement System by forcing settlement of such trades to occur outside clearing agencies. Differing eligibility criteria, coupled with the economic benefits of clearing agency participation, could pressure sole participants to join multiple depositories or to at least join the depository with the greatest number of eligible securities issues.

The Commission is reluctant to require depositories at this time to adopt uniform eligibility criteria. The Commission recognizes that eligibility requirements are important decisions reached by the depositories after extensive consultation with their participants. These decisions reflect a balancing of available resources, participant demand, operational preferences and system safeguards. The Commission also recognizes that eligibility determinations reflect a dynamic process and that the universe of dually-eligible securities issues should grow dramatically by February 1985 as a result of depository and participant experience. The Commission and the MSRB, of course, will monitor developments and, if necessary, will consider appropriate action.

costs on the parties to such trades. The Rules, as a general matter, do not require persons to join clearing agencies, but merely require existing clearing agency "participants" to use the most efficient industry means for clearance and settlement.

The Commission recognizes, however, that industry participants subject to the Rules may incur substantial start-up costs. For instance, municipal securities brokers and dealers will incur costs in connection with identifying accounts which are subject to Rule G-15 and devising procedures to capture and convey to the depository crucial data such as the identity of the customer and agent bank. Similarly, custodian banks and investment managers will incur new costs in connection with the distribution of confirmations.

The Commission believes that the benefits derived from widespread, uniform and safe automated processing of institutional and inter-dealer trades far outweigh the compliance-related expenses. As indicated, the expenses are, for the most part, one time implementation or start-up costs. The benefits, however, should be realized continuously over time. For instance, brokers, dealers and custodian banks ultimately should experience reduced aggregate transaction processing expenses. 37/ Similarly, institutional customers or their investment managers will enjoy increased predictability and efficiency in clearance and settlement, and they may experience reduced commission expenses as a result of broker and dealer cost savings. 38/

The Commission also believes the MSRB has provided appropriate and sufficient lead time for firms to make any needed systems and personnel changes. Indeed, prior to August 1, 1984, many industry members should be able to draw upon their experience with automated customer-side processing of corporate equity

37/ As noted above, for customer-side processing of transactions in corporate securities issues alone, these savings aggregate annually to hundreds of millions of dollars. Moreover, with regard to municipal securities transactions, brokers and dealers face financing costs for fails on both the customer-side and the street-side.

38/ At the present time, depositories recover the costs of confirmation and affirmation processing from participating broker-dealers and custodian banks. The depositories do not charge institutional customers for ID processing. The Commission, therefore, recognizes that those processing costs may well be passed through to institutional customers. Such a pass-through would offset, in some measure, reduced commission fees.

and debt securities transactions. ^{39/} Moreover, several compliance alternatives are available to persons subject to the Rules. For instance, a municipal securities broker or dealer may choose to establish a correspondent relationship with another participating broker-dealer, in lieu of direct clearing agency participation. ^{40/} A participating broker or dealer, on the other hand, may avoid the expense of installing and operating an internal computer system by submitting "hard copy" trade data to a depository (i.e., paper) -- assuming that is a cost-effective alternative in light of that participant's settlement volume. Similarly, custodian banks may obtain from institutional customers standing instructions to affirm trades on behalf of a non-depository participant investment manager, thereby reducing such banks' ID expenses.

^{39/} See note 31, supra. Exchange and NASD rules requiring depository participants to use depository facilities for customer-side settlement took effect in January 1983. Many municipal securities brokers, dealers, and investment managers that effect transactions in both corporate and municipal securities issues are fully automated on the corporate side. These industry members may be able to rely on that experience during the transition to automated processing for municipal securities transactions, since some overlap in systems and personnel must exist. Also, municipal securities dealer-bank departments may be able to rely on the trust department, or other internal or bank subsidiary clearing operation for either the expertise in developing automated clearing and communication systems to interface with clearing agencies or the actual performance of the clearance function.

^{40/} A non-participating dealer department in a bank that has a participating trust department, however, faces a special problem. In that instance, the trust department's participation is imputed to the dealer department under the Rules. If the trust department does not provide clearing services to the dealer department, the dealer department must use a participating clearing agent to be in compliance with the MSRB Rules.

Commenters suggested to the MSRB that, in this situation the dealer department may be "forced" to use clearing agency services. The Commission understands, however, that the vast majority of dealer-bank departments already employ participating broker or bank clearing agents. Nevertheless, should a dealer-bank department find that it must change its clearing arrangements under the Rule, it will face additional start-up costs. Over-time, however, as with all participating parties, the benefits should greatly exceed the costs.

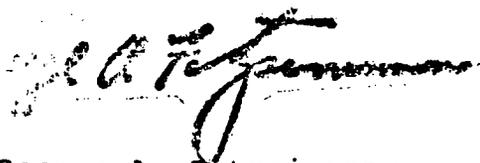
Finally, the Commission has considered the potential competitive burdens of the proposed rule change in light of the relevant benefits and costs, discussed above. In this regard, the Commission acknowledges that depositories compete to some extent with custodian banks and brokers for the sale of custodial services. For the reasons discussed in Securities Exchange Act Release No. 19227, however, the Commission believes the proposed rule change will not impose any inappropriate burden on competition in the sale of custodial services. 41/ The Commission also believes that, as the MSRB stated in its filing, the proposed rule change does not impose any burdens on competition not necessary or appropriate in furtherance of the purposes of the Act.

CONCLUSION

For the reasons stated above, the Commission finds that the proposed rule change is consistent with the Act. The Commission also finds that the proposed rule change will not impose a burden on competition that is not necessary or appropriate under the Act.

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act, that the proposed rule change be, and hereby is, approved.

For the Commission, pursuant to delegated authority, by the Division of Market Regulation.



George A. Fitzsimmons
Secretary

41/ (November 9, 1982), 47 FR at 51662 (November 16, 1982). Those reasons included: the absence of a requirement that securities be maintained in a depository account after settlement; the ability of custodians that wish to perform a full service role for their non-participating institutional customers to operate independent, automated communications systems adequate to assure timely confirmation, affirmation and settlement through the institutional delivery systems; and the flexibility afforded participating custodian banks in choosing direct or indirect participation in a securities depository.



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