Settlement System Changes and the Impact on Individuals

By James B. Cloonan

Later this year, there will be a major effort to begin overhauling the current clearance and settlement system for securities.

There are several elements involved in the proposed changes. The first would require the use of same-day funds in transactions among institutions. This requirement would not apply to individual investors, who would still be able to send in a check. The practical effect of this requirement would be positive for individuals who leave securities with their brokers, because interest and dividends would be credited to their accounts on the payment date. Faster clearing of trades improves liquidity in the system and should reduce price volatility during high volume periods, in addition to reducing costs.

The second area of change is the reduction of the settlement period to three days over the next several years. If practical, an even shorter settlement period would increase liquidity and reduce errors even more. Under the current system, settlement occurs five working days after the trade. This system was put into place in 1968 to accommodate growing volume in a pre-computer setting. While there are few direct benefits to individuals with this change, there are indirect benefits in a smoother, less costly system.

The third change has the most direct impact on the individual, and will surely generate the most debate. This would be the move to "book entry" or "certificateless" security ownership.

While I know that some individuals have an emotional attachment to stock certificates, the advantages of eliminating certificates seem overwhelming. These include:

- The reduction of errors and costs in the back office system, which will lead, in this competitive brokerage environment, to lower commission costs;
- The elimination of the danger of losing securities and the attendant problems;
- A large reduction in the length of time it takes to transfer an account from one broker to another;
- The elimination of the problem of certificate denominations and getting the proper "change" from a certificate with a greater denomination than the amount sold; and
- A reduction in errors and an increase in the speed of the procedure that occurs when an individual wants to change ownership in a "non-exchange" transaction (for instance, a gift to a child, a change in co-owners, transfer to a trust, etc.)

Most individuals now leave their securities in street name at their brokerage firm to avoid safekeeping, delivery and recordkeeping problems. In addition, mutual funds, options, commodities and many municipal bonds, as well as Treasuries, already are certificateless, so only a minority of investment holdings involve the possession of certificates by individuals.

I have had discussions with the organizations pushing for changes and the concerns I expressed have been incorporated into the proposals. The major items I felt were needed were: First, that any same-day funds requirement not pertain to individuals; and second, that a back-up system to provide certificates to those individuals who adamantly wanted them be included. Almost all mutual funds provide certificates if demanded, but options and municipal bonds do not. I think a certificate alternative is desirable, at least for a few years. All in all, I feel the proposed changes will be good for the individual investor.

There will be SEC hearings on these matters. If anyone has ideas or comments, please let me know.

James B. Cloonan is president of AAII. His column is his own opinion and does not necessarily reflect the views of the AAII Journal.