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REGULATION OF CLEARING AGENCIES AND TRANSFER AGENTS

HEARINGS

BEFORE THE

SUBCOMMITTEE ON SECURITIES

OF THE

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS UNITED STATES SENATE

NINETY-THIRD CONGRESS

FIRST SESSION

ON

S. 2058

TO AMEND THE SECURITIES EXCHANGE ACT OF 1934 TO PROVIDE FOR THE REGULATION OF CLEARING AGENCIES AND TRANSFER AGENTS, AND FOR OTHER PURPOSES

JULY 11 AND 12, 1973

Printed for the use of the
Committee on Banking, Housing and Urban Affairs

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U.S. GOVERNMENT PRINTING OFFICE

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REGULATION OF CLEARING AGENCIES AND TRANSFER AGENTS

WEDNESDAY, JULY 11, 1973

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS,
SUBCOMMITTEE ON SECURITIES,
Washington, D.C.

The subcommittee met at 9:40 a.m., pursuant to call, in room 5302, Dirksen Senate Office Building, Senator Harrison A. Williams, Jr., chairman of the subcommittee, presiding.

Senator WILLIAMS. I think we have to rap the gavel.

This is the Subcommittee on Securities. We begin our hearings on a bill concerning the regulation of the clearance and settlement of securities transactions. This bill is similar to S. 3876 which the Senate unanimously passed last year and upon which the House acted, but in a slightly different form.

Unfortunately, the Congress adjourned before there was an opportunity for a conference to resolve the differences between the two bills. This year, we intend to act promptly on S. 2058 so that there will be ample opportunity for a House-Senate conference if that is necessary.

This bill has two objectives. The first is to prevent future paperwork crises in the securities industry.

The second is to create a central governmental decisionmaking authority capable of coordinating the diverse and often antithetical approaches to certificate processing which are now emerging.

Let me say a few words about each of these objectives.

The paperwork crisis during the late 1960's resulted from the securities industry's inability to process the tremendous volume of trading. All too often, deliveries to customers were late and stock certificates were lost, all in this rising tide of paper. Firms lost control of their records, and over 100 broker-dealers were forced into liquidation, largely as a result of faulty recordkeeping and the backlog of uncompleted transactions.

These liquidations caused financial hardships to many investors who left their securities with brokerage houses for safekeeping. A noted economic historian recently characterized this crisis as perhaps the single most dramatic technical failure of the free-enterprise system on record anywhere.

The Congress responded in part to this situation by enacting the Securities Investors Protection Act of 1970. But we in the Congress were not satisfied with merely insuring the public against brokerage house failures. We began to exercise a closer and more continuing

scrutiny of the securities industry. The legislation before us today is a direct result of that scrutiny.

Turning briefly to the bill's second objective, a leading financial reporter has written:

> A labyrinthine and arcane, but intense and often chaotic battle has quietly developed among the Big Board, the regional exchanges, the NASD, the New York banks, the regional banks and the major brokerage houses over just who is going to control the machines that are being set up to take care of the paper [involved in securities transactions].

This bill is intended to bring an end to that battle.

I believe competition in the area of securities processing is healthy, and this legislation does not decree its premature demise. However, the loser in the industry's current round of infighting is not only the investor who must put up with the confusion and delay inherent in the proliferation of clearing systems. The loser is also the individual securities firm which is forced to interface with from one to seven clearing systems and not less than four different securities depositories.

What we have in the securities-processing area is not healthy and strengthening competition, but institutional empire building. The industry is in desperate need of a single governmental agency with the authority and the responsibility to bring order out of the existing jurisdictional chaos. Someone must have the authority to knock heads together and move the whole industry toward a rational, nationwide clearing system. And that someone should have an appreciation of the major costs incurred by securities firms in the settlement of transactions.

This bill which I have introduced with Senators Tower, Bennett, Brooke, and Stevenson, will give the SEC precisely that authority over the policy development and operations of everyone involved in the securities-handling process. It also provides a major role for the bank regulatory agencies in the inspection of the bank components and in the enforcement of the rules with respect to these banks.

The bill before us today reflects the considered judgment of all persons concerned and involved with the processing of securities transactions. I believe that it is important for us to act promptly upon this bill so that investors are assured that their funds and securities are efficiently and economically processed.

[Copy of S. 2058 and letters from regulating agencies follows:]

93D CONGRESS
1ST SESSION

S. 2058

IN THE SENATE OF THE UNITED STATES

JUNE 22 (legislative day, JUNE 18), 1973

Mr. WILLIAMS (for himself, Mr. BENNETT, Mr. BROOKE, Mr. STEVENSON, and Mr. TOWER) introduced the following bill, which was read twice and referred to the Committee on Banking, Housing and Urban Affairs

A BILL

To amend the Securities Exchange Act of 1934 to provide for the regulation of clearing agencies and transfer agents, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. Section 2 of the Securities Exchange Act of 1934 (15 U.S.C. 78b) is amended by striking the word "and" immediately before the phrase "to impose requirements necessary to make such regulation and control reasonably complete and effective," and by adding the following immediately after that phrase: "and to provide for the development of an integrated national system for the prompt

and accurate processing and settlement of securities transactions,".

SEC. 2. Section 15A(k)(2) of the Securities Exchange Act of 1934 (15 U.S.C. 78o–3(k)(2)) is amended by inserting after clause (D) the following:

"(E) the time and method of making settlements, payments, and deliveries and of opening, maintaining, and closing accounts."

SEC. 3. Section 3(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)) is amended by adding at the end thereof the following new paragraphs:

"(22) The term 'clearing agency' means any person who acts as an intermediary in making payments or deliveries or both in connection with transactions in securities or who provides facilities (A) for comparison of data respecting the terms of settlement of securities transactions, (B) to reduce the number of settlements of securities transactions, or (C) for the allocation of securities settlement responsibilities. Such term also means any person who acts as a custodian of securities in connection with a system which permits securities so held to be transferred, loaned, or pledged without physical delivery of securities certificates, or which otherwise permits or facilitates the settlement of securities transactions or the hypothecation or lending of securities without physical delivery of securities certificates. The term 'clearing agency' does

not include (i) Federal Reserve Banks, Federal Home Loan Banks, Federal Land Banks, and (ii) banks, brokers, life insurance companies or their registered separate accounts, registered open end investment companies or unit investment trusts, building and loan, savings and loan, and homestead associations, and cooperative banks by reason of lending, fiduciary, correspondent, or safekeeping functions commonly performed by them on the date of enactment of this paragraph.

"(23) The term 'participant', when used with respect to a clearing agency means any person who uses a clearing agency or securities depository for the purpose of settling or comparing transactions in securities or making or receiving payment for or delivering, lending, or hypothecating of securities. Such term does not include a person whose only use of a clearing agency or securities depository is through another person.

"(24) The term 'transfer agent' means any person who engages on behalf of an issuer of securities, or on behalf of itself as an issuer, of securities in (A) countersigning such securities upon issuance; (B) monitoring the issuance of such securities with a view to preventing unauthorized issuance, a function commonly performed by a person called a registrar; (C) registering the transfer of such securities; or (D) exchanging or converting such securities. The term

'transfer agent' does not include any person who performs such functions solely with respect to variable annuity contracts issued by insurance companies.

"(25) The term 'appropriate regulatory agency', when used with respect to a clearing agency or transfer agent required to be registered under this title, means:

"(A) the Comptroller of the Currency, in the case of a national bank or a bank operating under the Code of Law for the District of Columbia, or a subsidiary of any such bank;

"(B) the Board of Governors of the Federal Reserve System, in the case of a State member bank of the Federal Reserve System, a subsidiary thereof, a bank holding company, or a nonbank subsidiary of a bank holding company;

"(C) the Federal Deposit Insurance Corporation in the case of a bank insured by the Federal Deposit Insurance Corporation (other than a member of the Federal Reserve System) or a subsidiary thereof; and

"(D) the Commission in the case of all other transfer agents and clearing agencies.

As used in this paragraph, the terms 'bank holding company' and 'subsidiary' have the meaning given them in section 2 of the Bank Holding Company Act of 1956, as amended.

"(26) The term 'rules of a clearing agency' means the

clearing agency's constitution, articles of incorporation, by-laws, or rules or instruments corresponding to the foregoing, and its stated policies and practices relating to its organization, participation, rules of procedures, financial condition, methods of safekeeping, settling, hypothecating, lending and accounting for funds and securities, and similar matters.".

SEC. 4. Section 15(c) of the Securities Exchange Act of 1934 (15 U.S.C. 78o(c)) is amended by adding at the end thereto the following new paragraph:

"(6) No broker or dealer shall make use of the mails or of any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any security (other than an exempted security or commercial paper, bankers' acceptances, or commercial bills) in contravention of such rules and regulations as the Commission shall prescribe as necessary or appropriate in the public interest, for the protection of investors or for the development of an integrated national system for the prompt and accurate processing and settlement of securities transactions to regulate the time and method of making settlements, payments, and deliveries and of opening, maintaining, and closing accounts. Nothing in this paragraph shall be construed (A) to affect the authority of the Board of Governors of the Federal Reserve System, pursuant to section 7 of this title, to prescribe rules and regulations for the

purpose of preventing the excessive use of credit for the purchase or carrying of securities, or (B) to authorize the Commission to prescribe such rules or regulations for such purpose."

SEC. 5. The Securities Exchange Act of 1934 is amended by inserting after section 17 (15 U.S.C. 78q) the following new section:

"PROCESSING OF SECURITIES TRANSACTIONS

"SEC. 17A. (a) (1) Except as otherwise provided in this subsection, it shall be unlawful for any person, directly or indirectly, to make use of the mails or any means or instrumentality of interstate commerce to perform the function of a clearing agency with respect to any security (other than an exempted security) unless such person is registered under this section. The Commission, by rules and regulations or by order, upon its own motion, or upon application, may conditionally or unconditionally exempt any person, security, transaction, or clearing agency, or any class or classes of persons, securities, transactions, or clearing agencies from any provision or provisions of this section or of any rule or regulation prescribed under this section if the Commission finds that the application of such provision or provisions to such person, security, transaction, or clearing agency or class or classes of persons, securities, transactions, or clearing agencies is not practical or not necessary or ap-

propriate in the public interest or for the prompt and accurate processing and settlement of securities transactions.

"(2) The Commission shall include in its annual reports to Congress required by section 23(b) of this title information concerning the number of requests for exemptions from this section received, the number granted, and the basis or bases upon which any exemptions were granted.

"(b) Any clearing agency may be registered for the purposes of this section by filing with the Commission a registration statement in such form as the Commission may prescribe containing the rules of the clearing agency and setting forth such other information and accompanied by such other documents as the Commission may, by rule, require.

"(c) An applicant shall not be registered as a clearing agency unless the Commission finds that—

"(1) such clearing agency is organized and operated so as to facilitate the prompt and accurate settlement of securities transactions, to safeguard funds and securities held for the accounts of participants, to comply with the provisions of this title and the rules and regulations thereunder, and to carry out the purposes of this section;

"(2) the rules of the clearing agency provide that all (A) registered brokers or dealers or members of a national securities exchange, (B) other registered clear-

ing agencies, (C) registered investment companies, (D) banks (as defined in section 2(a)(5) of the Investment Company Act of 1940), and (E) such other persons or classes of persons as the Commission may from time to time designate by rule as appropriate to the development of an integrated national system for the prompt and accurate processing and settlement of securities transactions are eligible to become participants in such clearing agency, subject only to such other rules of the clearing agency as are expressly permitted under this paragraph. The rules of the clearing agency may condition participation upon compliance with standards of operational capacity which the Commission has, by rule, found to be necessary to assure the prompt and accurate processing of securities transactions, and upon the deposit with the clearing agency of an amount or the posting of a bond with the clearing agency in an amount which bears a reasonable relationship to the value of positions maintained by and transactions processed for the participant; and such rules may deny participation to persons who have been expelled or suspended by a registered clearing agency during the period of such expulsion or suspension;

"(3) the rules of the clearing agency assure a fair representation of its shareholders (or members) and

participants in the adoption of rules of the clearing agency and any amendment thereto, the selection of its officers and directors, and in all other phases of the administration of its affairs;

"(4) the rules of the clearing agency provide for the equitable allocation of dues, fees, and other charges among its participants;

"(5) the rules of the clearing agency do not impose any schedule of prices, or fix rates or charges, for services rendered by its participants;

"(6) the rules of the clearing agency are designed to promote the prompt and accurate processing and settlement of securities transactions, to provide safeguards for securities and funds which are in its custody, to foster cooperation and coordination with national securities exchanges, national securities associations, other clearing agencies, brokers, dealers, banks, registered investment companies, and with other persons engaged in the processing and settlement of securities transactions, and to protect investors and the public interest, and do not have the effect of unfairly discriminating in the admission of participants or among participants in the use of such clearing agency;

"(7) the rules of the clearing agency provide that its participants shall be appropriately disciplined for any

violation of its rules by expulsion, suspension, fine, or censure; and

"(8) the rules of the clearing agency provide a fair and orderly procedure with respect to the disciplining of participants and the denial of participation to any person seeking participation therein. In any proceeding to determine whether a participant should be disciplined, such rules shall require that specific charges of any rule violation be brought; that such participant shall be notified of and be given an opportunity to defend against such charges; that a record shall be kept; and that a determination to take disciplinary action shall be supported by a statement setting forth—

"(A) any act or practice in which such participant may be found to have engaged, or any required act or practice which such participant may be found to have omitted;

"(B) the specific rule or rules of the clearing agency which any such act or practice, or omission to act, is deemed to violate; and

"(C) the penalty imposed and the reasons therefor. In any proceeding to determine whether a person shall be denied participation, such rules shall provide that the prospective participant shall be notified of, and be given an opportunity to be heard

upon, the specific grounds for denial which are under consideration, that a record shall be kept, and that the determination to deny participation shall be supported by a statement setting forth the specific grounds on which the denial is based. Notwithstanding any other provision of this section, the rules of the clearing agency may provide for the temporary suspension of a participant, the prohibition of such participant's use of the clearing agency, and the closing of its accounts pending determination on the merits of any disciplinary proceeding if, in the opinion of the clearing agency, such suspension, prohibition on use and closing of accounts are necessary for the protection of the clearing agency or its participants, or for the protection of investors or to facilitate the orderly and continuous performance of the clearing agency's services. The rules of the clearing agency shall afford the participant an expedited hearing on the merits in the case of any temporary suspension.

"(d) The Commission shall, upon the filing of an application for registration pursuant to subsection (b), publish notice of the filing and afford interested persons a reasonable opportunity for comment. Within sixty days of such filing, the Commission shall:

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"(1) by order grant such registration if the Commission finds that the requirements of this section are satisfied, or

"(2) institute an appropriate administrative action to determine whether the application should be denied. After notice of the grounds for denial under consideration and opportunity for hearing, the Commission shall by order grant such registration unless it finds that a requirement of this section is not satisfied, in which case the Commission shall by order deny such registration. The Commisison shall conclude administrative action and issue an order granting or denying the application within one hundred and eighty days of the filing of the application unless the Commission finds good cause to extend such period and publishes its reasons therefor.

"(e) A clearing agency registered under this section may, upon such terms and conditions as the Commission may deem necessary in the public interest, for the protection of investors, or to assure the prompt and accurate processing and settlement of securities transactions, withdraw from registration by filing a written notice of withdrawal with the Commission. If the Commission finds that any registrant or person for whom an application of registration is pending is no longer in existence or has ceased to do business in the

capacity specified in the registration statement, the Commission shall by order cancel or deny the registration.

"(f) No clearing agency registered under this section shall, directly or indirectly, participate in the processing or settlement of any transaction in a security (other than an exempted security), or engage in any other activity as clearing agency in contravention of such rules and regulations as the Commission shall prescribe as necessary or appropriate in the public interest, for the protection of investors or to effectuate the purposes of this section with regard to minimum standards for the performance of functions, measures and personnel standards for safe handling and custody of securities and funds, operational compatibility of and cooperation by the clearing agency with other persons involved in the securities handling process, and the prompt and accurate processing and settlement of securities transactions.

"(g) (1) Each registered clearing agency shall file with the Commission, in accordance with such rules as the Commission may prescribe, copies of any proposed changes in, additions to, or amendments to the rules of the clearing agency accompanied by a summary statement of the basis and purpose for such proposed change, addition, or amendment. No such proposed change, addition, or amendment shall become effective except in accordance with the provisions of this subsection.

"(2) The Commission shall, upon the filing of a proposed change in, addition to, or amendment to the rules of a clearing agency, publish notice of such proposal together with the clearing agency's statement of basis and purpose, and shall afford interested persons a reasonable opportunity for comment on the proposed change, addition, or amendment. Within thirty days of such filing the Commission shall—

"(A) by order declare such change, addition, or amendment effective if the Commission finds that the rules of the clearing agency as so changed are not inconsistent with the requirements of this section relating to the registration of clearing agencies or with the purposes of this section and are not otherwise inconsistent with the public interest, or

"(B) institute appropriate administrative action to determine whether the proposed change, addition or amendment in whole or in part, should be disapproved. Within one hundred and twenty days of the filing of the change, addition or amendment the Commission shall conclude administrative action and shall, by order, declare such change, addition or amendment effective unless it finds that the rules of the clearing agency as so changed are inconsistent with the requirements of this section relating to the registration of clearing

agencies or with the purposes of this section, or are otherwise inconsistent with the public interest, in which case the Commission shall by order disapprove such change, addition or amendment.

If the Commission does not declare the change, addition or amendment to be effective or institute administrative action for its disapproval within thirty days of the date it is filed, the change, addition or amendment shall become effective on such thirtieth day with the same force and effect as though it had been declared effective by the Commission.

"(h) Each clearing agency shall at the time of filing a registration statement pursuant to subsection (b), a notice of withdrawal of its registration pursuant to subsection (c), or copies of any proposed changes in, additions to, or amendments to its rules pursuant to subsection (f), file copies of such documents with the appropriate regulatory agency.

"(i) If any registered clearing agency takes any disciplinary action against any participant therein, or denies admission to any person seeking participation therein, such action shall be subject to review by the appropriate regulatory agency, on its own motion, or upon application by any person aggrieved thereby filed within thirty days after such action has been taken or within such longer period as the appropriate regulatory agency may determine. Application to the appropriate regulatory agency for review, or the in-

stitution of review by such agency on its own motion, shall not operate as a stay of such action, unless such agency otherwise orders, after notice and opportunity for hearing on the question of a stay (which hearing may consist solely of affidavits and oral arguments).

"(j) (1) In a proceeding to review disciplinary action taken by a registered clearing agency against a participant, after notice and opportunity for hearing and upon consideration of the record before the clearing agency and such other evidence as it may deem relevant—

"(A) if the appropriate regulatory agency finds that such participant has engaged in such acts or practices, or has omitted such acts, as the clearing agency has found him to have engaged in or to have omitted, and that such acts or practices, or omissions to act, are in violation of such rules of the clearing agency as have been designated in the determination of the clearing agency, it shall by order so declare and affirm the action taken by the clearing agency or, if appropriate, modify the sanctions or penalties in accordance with paragraph (2) of this subsection, or

"(B) if the appropriate regulatory agency finds that the evidence does not warrant the finding required in clause (A), or if such agency determines that such acts or practices as are found to have been engaged in

are not prohibited by the designated rule or rules of the clearing agency or that such act as is found to have been omitted is not required by such designated rule or rules, the appropriate regulatory agency shall by order set aside the action of the clearing agency.

"(2) The appropriate regulatory agency may, having due regard to the public interest, if it finds that any penalty imposed by a registered clearing agency upon a participant is excessive or oppressive, cancel, reduce, or require the remission of such penalty.

"(k) In any proceeding to review the denial of participation in a registered clearing agency, if the appropriate regulatory agency, after notice and opportunity for hearing and upon consideration of the record before the clearing agency, determines that the specific grounds on which such denial or bar is based exist in fact and are valid under this section, it shall by order dismiss the proceeding. In the absence of such a determination, the appropriate regulatory agency shall by order set aside the action of the clearing agency and require it to admit the applicant to participation therein.

"(l) The appropriate regulatory agency, after appropriate notice and opportunity for hearing, is authorized, by order, if such action appears to be necessary or appropriate

in the public interest or for the protection of investors or to carry out the purposes of this section—

"(1) to suspend for a period not exceeding twelve months or revoke the registration of a registered clearing agency or impose limitations upon the activities, functions, or operations of such clearing agency, if the appropriate regulatory agency finds that such clearing agency has violated any provision of this title, or any rule or regulation thereunder, or has failed to enforce compliance with its own rules, or has engaged in any other activity tending to defeat the purposes of this section;

"(2) to suspend for a period not exceeding twelve months or expel from a registered clearing agency any participant therein, if the appropriate regulatory agency finds that such participant has violated any provision of this title or any rule or regulation thereunder or any rule of the clearing agency; and

"(3) to remove from office any officer or director of a registered clearing agency who, the appropriate regulatory agency finds, has willfully failed to enforce the rules of the clearing agency, or has willfully abused his authority.

"(m) If a proceeding under subsection (l) (1) of this section results in the suspension or revocation of the registration of a clearing agency, the appropriate regulatory

agency may, upon notice to such clearing agency, apply to any court of competent jurisdiction specified in section 21(e) or 27 of this title for the appointment of a trustee. In such event, the court may, to the extent it deems necessary or appropriate, take exclusive jurisdiction of the clearing agency involved, and the books, records, and assets thereof, wherever located; and the court shall appoint the appropriate regulatory agency or a person designated by the appropriate regulatory agency as the trustee with the power to take possession and to continue to operate or to terminate the facilities of such clearing agency in an orderly manner, for the protection of participants and public investors, subject to such terms and conditions as the court may prescribe.

"(o) Each registered clearing agency shall make, keep, and preserve for such periods such accounts, correspondence, memorandums, papers, books, and other records, and furish such copies thereof and make such reports and supply such information and documents as the Commission by its rules and regulations may prescribe as necessary or appropriate to keep current or to supplement the registration statement and documents filed pursuant to subsection (b), to facilitate cooperation among clearing agencies and the prompt and accurate settlement of securities transactions, to assure the safekeeping of funds and securities held for the accounts

of participants, or for the protection of investors, or the public interest. The Commission shall promptly furnish to the appropriate regulatory agencies all reports which it receives from registered clearing agencies pursuant to this section. All accounts, correspondence, memorandums, papers, books, and other records of a clearing agency shall be subject at any time to such reasonable periodic, special, or other examinations by examiners or other representatives of the appropriate regulatory agency as such agency may deem necessary or appropriate in the public interest, for the protection of investors or to carry out the purposes of this section. The appropriate regulatory agency shall make a full and detailed report of any examination made of a registered clearing agency and shall promptly furnish to the Commission a copy of any such report.

"(p) The agencies enumerated in section 3(a)(25) of this title shall consult and cooperate with each other and shall advise one another promptly of the pendency or determination of any proceedings, of the promulgation of any rules, and of the entry of any order relating to a clearing agency, participant, class of clearing agencies, or class of participants. At least fifteen days prior to the issuance for public comment or adoption of any proposed rule or regulation regarding clearing agencies, whether pursuant to this title or otherwise, the agency contemplating issuance or

adoption of any such rule or regulation shall first consult with and request the views of each of the other agencies enumerated in section 3(a)(25) toward the end that rules and regulations applicable to banks registered as clearing agencies may be, to the maximum extent practicable, in accord with both sound banking practices and a sound system for the prompt and accurate processing and settlement of securities transactions. Nothing in this section shall impair the authority of any State banking authority or other State or Federal regulatory authority having jurisdiction over a person registered as a clearing agency from making or enforcing rules governing such person which are not inconsistent with this section or any rules or regulations promulgated hereunder.

"(q) The Commission shall, on or before December 31, 1976, take such steps as are within its power to bring about elimination of the stock certificate as a means of settlement among brokers or dealers of transactions consummated on national securities exchanges or by means of the mails or other means or instrumentalities of interstate commerce. Commencing in 1973 and ending in 1976, the Commission shall report annually to the Congress (1) the steps it has taken and progress it has made toward elimination of the stock certificate as a means of settlement, and (2) its recom-

mendations, if any, for further legislation to eliminate the stock certificate.".

SEC. 6. The Securities Exchange Act of 1934 is further amended by inserting after section 17A (added by section 5 of this Act) the following new section:

"TRANSFER AGENTS

"SEC. 17B. (a) (1) Except as otherwise provided in this subsection, it shall be unlawful for any person, directly or indrectly, to make use of the mails or any means or instrumentality of interstate commerce to perform the function of a transfer agent with respect to any security unless such person is registered in accordance with this section. The Commission, by rules and regulations or by order, upon its own motion or upon application, may conditionally or unconditionally exempt any transfer agent or class of transfer agents or security or class of securities from any provision or provisions of this section or any rule or regulation prescribed under this section if the Commission finds that the application of such provision or provisions to such transfer agent or class of transfer agents or such security or class of securities is not practical or not necessary or appropriate in the public interest or for the prompt and accurate processing and settlement of securities transactions.

"(2) The Commision shall include in its annual reports to Congress required by section 23 (b) of this title infor-

mation concerning the number of requests for exemptions from this section received, the number granted, and the basis or bases upon which the exemptions were granted.

"(3) The provisions of this section shall apply only to securities and to persons performing the function of transfer agent with respect to securities which are registered under section 12 of this title or which would be required to be so registered except for the exemption from registration provided in subsection (g) (2) (B) or (g) (2) (G) of that section. The provisions of this section shall not apply to variable annuity contracts issued by insurance companies.

"(b) Any transfer agent may be registered for the purposes of this section by filing with the appropriate regulatory agency a registration statement which shall state the address of its principal office or offices for transfer agent activities, the identity of the issuers and issues of securities for which it is then acting as transfer agent, and such other information in such detail as the appropriate regulatory agency may require as necessary or appropriate with regard to performance capability, standards and procedures for safe handling and custody of securities, and operational compatibility of the transfer agent's activities with those of other persons involved in the securities handling process. Each appropriate regulatory agency, other than the Commission, shall file with the Commission notice of the name of any

transfer agent required to register with such agency under this section, the address of its principal office or offices for transfer agent activity, the identity of the issuers and issues of securities for which it is then acting as a transfer agent and such other information as the Commission may, by rule, require. Each appropriate regulatory agency shall also file with the Commission such additional information as the Commission may, by rule, require to keep current the information in such notice and to carry out its responsibilities under this section. Except as otherwise provided in subsection (d) of this section, a registration of a transfer agent filed under this subsection shall become effective thirty days after the receipt of the registration statement by the appropriate regulatory agency or within such shorter period of time as such agency may determine.

"(c) The appropriate regulatory agency shall, after appropriate notice and opportunity for hearing, by order, deny registration to any transfer agent seeking registration if it finds that such denial is in the public interest and that such transfer agent does not have procedures or the operational capabilities to be able to comply with the provisions and purposes of this section and the rules and regulations prescribed thereunder.

"(d) Pending final determination whether the registration of a transfer agent shall be denied, the appropriate reg-

ulatory agency may, by order, postpone the effective date of such registration for a period not to exceed ninety days, except that such agency may extend such period until final determination if it finds good cause for such extension and publishes its reasons therefor.

"(e) Any transfer agent registered under this section may, upon such terms and conditions as the appropriate regulatory agency may deem necessary in the public interest, for the protection of investors or to assure the prompt and accurate processing and settlement of securities transactions, withdraw from registration by filing a written notice of withdrawal with such agency. If such agency finds that any such transfer agent for whom a registration statement is pending is no longer in existence or has ceased to do business as a transfer agent, it shall by order cancel or deny the registration.

"(f) Each registered transfer agent shall make, keep, and preserve for such periods such accounts, correspondence, memorandums, papers, books, and other records, and furnish such copies thereof and shall make such reports and file such information and documents with the appropriate regulatory agency, as such agency by rule or regulation may prescribe as necessary or appropriate to keep current or to supplement the registration statement and documents filed pursuant to subsection (b) and to carry out the purposes of

this section. Such accounts, correspondence, memorandums, papers, books, and other records shall be subject at any time to such reasonable periodic, special, or other examinations by examiners or other representatives of the appropriate regulatory agency as such agency may deem necessary or appropriate to carry out the purposes of this section. Each appropriate regulatory agency shall make a report of all examinations conducted by it of any transfer agent and shall, upon request, furnish a copy of such report to any other regulatory agency with responsibilities under this section.

"(g) No transfer agent registered under this section shall, directly or indirectly, engage in any activity as transfer agent in contravention of such rules and regulations as the Commission shall prescribe as necessary or appropriate in the public interest, for the protection of investors or to effectuate the purposes of this section with regard to standards for the performance of transfer functions, measures and procedures for safe handling and custody of securities, and operational compatibility of transfer agents with other persons involved in the securities handling process.

"(h) The appropriate regulatory agencies shall consult and cooperate with each other and, as may be appropriate, with State banking authorities having supervision over banks acting as transfer agents so that the accounts, correspondence, memorandums, papers, books, records, and other data

required of banks acting as transfer agents, the rules and regulations applicable to them, and the inspections thereof, may be in accord with sound banking practices and fulfill mutual regulatory needs to the maximum extent practicable. Nothing in this section shall be construed to impair the authority of any State banking authority or of any other State or Federal regulatory authority which has jurisdiction over a person registered as a transfer agent from making or enforcing rules governing such person which are not inconsistent with this section or any rules promulgated hereunder.

"(i) Compliance with the requirements imposed by this section may be enforced under section 8 of the Federal Deposit Insurance Act (12 U.S.C. 1818) by the appropriate regulatory agencies other than the Commission. For the purpose of the exercise by the appropriate regulatory agency of its powers under section 8 of the Federal Deposit Insurance Act, a bank holding company and a nonbank subsidiary of a bank holding company, acting as a transfer agent, shall be considered a bank. Any violation of any requirement imposed under this section upon banks, bank holding companies, or nonbank subsidiaries of bank holding companies registered as transfer agents is a violation of the requirements imposed under the Federal Deposit Insurance Act and shall constitute adequate basis for the issuance of orders under section 8(b) and 8(c) of that Act. In addi-

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tion to its power under section 8 of the Federal Deposit Insurance Act, each of such appropriate regulatory agencies may, for the purpose of enforcing compliance with this section or any rule thereunder, exercise any other authority conferred on it by law.

"(j) The Commission may, after appropriate notice and opportunity for hearing, by order, censure, bar, or place limitations upon any transfer agent for which it is the appropriate regulatory agency, or upon any partner, officer, director, or employee of any such transfer agent, or to suspend for a period not exceeding twelve months or revoke the registration of any such transfer agent, if the Commission finds that such censure, barring, placing of limitations, suspension, or revocation is in the public interest or necessary for the protection of investors and that such transfer agent or partner, officer, director, or employee thereof has willfully violated or is unable to comply with any provision of this section or any rule or regulation promulgated thereunder. All of the functions and powers of the Commission under this title are available to the Commission to enforce compliance by any person with the requirements imposed under this section. Except to the extent that enforcement of the requirements imposed under this section is specifically committed to another appropriate regulatory agency, the Commission shall have primary responsibility to enforce such requirements.

"(k) At least fifteen days prior to the issuance for public comment or adoption of any proposed rule or regulation regarding transfer agents, the agency contemplating issuance or adoption of any such rule or regulation shall first consult with and request the views of each of the other agencies enumerated in section 3(a)(25) concerning such rules toward the end that rules and regulations applicable to banks registered as transfer agents may be in accord with sound banking practices and fulfill mutual regulatory needs to the extent practicable.".

SEC. 7. Section 12 of the Securities Exchange Act of 1934 (15 U.S.C. 78l) is amended by inserting after subsection (i) the following new subsection:

"(j) It shall be unlawful for an issuer, any class of whose securities is registered under this section or which would be required to be so registered except for the exemption from registration provided by paragraph (2)(B) or (2)(G) of subsection (g), by the use of any means or instrumentality of interstate commerce, or of the mails, to issue, either originally or upon transfer, any such securities in a form or with a format which contravenes such rules and regulations as the Commission may prescribe as necessary or appropriate for the prompt and accurate processing of transactions in securities.".

SEC. 8. Section 19 of the Securities Exchange Act of

1934 (15 U.S.C. 78s) is amended by inserting after subsection (e) the following new subsection:

"(f) The Commision is authorized and directed to make a study and investigation of the practice of registration of securities other than in the name of the beneficial owner and to determine (1) whether such registration is consistent with the policies and purposes of this title, with particular reference to section 14, and (2) if consistent, whether steps can be taken to facilitate communications between corporations and their shareholders while at the same time retaining the benefits of such registration. The Commission shall report to the Congress its preliminary findings within six months after the date of enactment of this subsection, and its final results and recommendations within one year of such date.".

SEC. 9. Section 28 of the Securities Exchange Act of 1934 (15 U.S.C. 78bb) is amended by inserting after subsection (b) the following new subsection:

"(c) No State or political subdivision thereof shall impose any tax on any change in beneficial or record ownership of securities effected through the facilities of a registered clearing agency or any nominee thereof or custodian therefor or upon the delivery or transfer of securities to or through or receipt from such agency or any nominee thereof or custodian therefor, unless such transfer or delivery or receipt would otherwise be taxable by such State or political

subdivision if the facilities of such registered clearing agency or any nominee thereof or custodian therefor were not physically located in the taxing State or political subdivision. No State or political subdivision thereof shall impose any tax on securities which are deposited in or retained by a registered clearing agency or any nominee thereof or custodian therefor, unless such securities would otherwise be taxable by such State or political subdivision if the facilities of such registered clearing agency or any nominee thereof or custodian therefor were not physically located in the taxing State or political subdivision.".

SEC. 10. This Act shall become effective on the date of its enactment, except that sections 17A (a) and 17B (a) of the Securities Exchange Act of 1934 (as added by this Act) shall become effective one hundred and eighty days after the date of enactment.

FEDERAL DEPOSIT INSURANCE CORPORATION, Washington, D.C.

JUL 12 1973

Honorable Harrison A. Williams, Jr.
Chairman, Subcommittee on Securities
Senate Committee on Banking, Housing
and Urban Affairs
United States Senate
Washington, D. C.

Dear Mr. Chairman:

Thank you for your letter of June 29, 1973 inviting the Corporation to submit a written statement concerning S. 2058, 93d Congress, a bill "To amend the Securities Exchange Act of 1934 to provide for the regulation of clearing agencies and transfer agents, and for other purposes." The bill is substantially similar to S. 3876 which was passed unanimously by the Senate during the 92d Congress.

With respect to the clearing agency function, S. 2058 would grant to the Securities and Exchange Commission the substantive rulemaking authority over all clearing agencies, and such agencies would be required to file registration statements with the SEC. Administrative disciplinary and review proceedings and other enforcement responsibilities would be conferred upon the "appropriate regulatory agency" which, in the case of an insured bank acting as a clearing agency, would be the Comptroller of the Currency, the Federal Reserve or the FDIC.

The SEC and the bank regulatory agencies would be required to exchange copies of reports concerning clearing agencies where appropriate and to notify each other of actions taken with regard thereto. The SEC and the bank regulatory agencies would also be required to consult with and request the views of each other before issuing any proposed rule for public comment or adopting any such rule.

We agree with the general thrust of these provisions regarding the regulation of clearing agencies, but would recommend that the last sentence of the proposed section 17A(o) requiring the appropriate regulatory agency to make a full and detailed report to the SEC of any

examination of a registered clearing agency be amended to limit this reporting requirement to information relating to the clearing agency function insofar as insured banks are concerned, so as not to imply that unrelated information developed in the course of a general examination of the insured bank need also be reported to the SEC.

As to the transfer agency function, S. 2058 would require registration statements to be filed with the appropriate regulatory agency but, as with the clearing agency function, substantive rulemaking authority would be lodged exclusively with the SEC. The three Federal bank regulatory agencies would be consulted by the SEC in the exercise of its rulemaking authority and the bank regulatory agencies would have the enforcement responsibility with respect to insured banks acting as transfer agents, except that the second sentence of the proposed section 17B(j) appears to give the SEC a residual, concurrent enforcement jurisdiction with respect to banks acting in this capacity. That subsection seems to grant the SEC power to enforce compliance "by any person with the requirements imposed under this section." We recommend that the breadth of the term "by any person" does not seem fully to conform to the concept of lodging exclusive enforcement jurisdiction in the Federal bank regulatory agencies with respect to insured banks acting as transfer agents. We therefore recommend that subsection (j) be amended so as definitely to preclude the possible construction that the SEC is being given concurrent enforcement authority with respect to insured banks acting in this capacity.

The Corporation in the past has strongly recommended that the Federal bank regulatory agencies be granted the same enforcement tools as would be granted by the proposed legislation to the SEC. To this end we recommend that the proposed section 17B(j) be amended to give the Federal bank regulatory agencies enforcement authority similar to that granted therein to the SEC. That subsection might be amended to read as follows:

> "(j) The appropriate regulatory agency may, after appropriate notice and opportunity for hearing, by order, censure or bar or suspend or place limitations upon any transfer agent, or any officer, director, or employee of any transfer agent, or revoke the registration of any transfer agent, if such agency finds that such censure, barring, suspension, placing of limitations, or revocation is in the public interest or for the protection of investors and that such transfer agent or any officer, director, or employee thereof has willfully violated or is unable to comply with any provision of this section or any rule or regulation promulgated thereunder pertaining to such transfer agent or any officer, director, or employee thereof."

If amended as recommended above, the Corporation would support enactment of S. 2058.

Sincerely,

Frank Wille
Chairman

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C.

July 13, 1973

The Honorable Harrison A. Williams, Jr.
Chairman
Subcommittee on Securities of the
Senate Committee on Banking,
Housing and Urban Affairs
United States Senate
Washington, D.C.

Dear Mr. Chairman:

I am writing in response to your letter of June 29, 1973, in which you invite the comments of the Board of Governors on S. 2058, which appears to be substantially similar to legislation passed by the Senate last year.

Under the arrangement in S. 2058, the Securities and Exchange Commission is authorized to prescribe rules relating to clearing agencies (defined to include depositories) and transfer agents. Enforcement authority respecting the application of such rules to such institutions which are banking organizations (banks, bank holding companies and subsidiaries thereof) is lodged in the three Federal bank supervisory agencies: the Comptroller of the Currency in the case of national banks, the Federal Deposit Insurance Corporation in the case of State nonmember insured banks, and the Federal Reserve in the case of State member banks, bank holding companies, and nonbank subsidiaries thereof. Clearing agencies and transfer agents which are not banking organizations will be subject to the enforcement jurisdiction of the SEC.

The Board feels that the provisions of the bill requiring consultation and cooperation among the agencies responsible for administering the legislation are of great importance. The function of acting as a clearing agency (depository) is being carried out by Depository Trust Co., which is chartered as a bank, and is a member bank of the Federal Reserve System. In seems most probable that most other depositories will similarly be State member banks of the Federal Reserve System, and, as such, subject to examination and supervision by the State chartering authority and the Federal Reserve. Because of these unique features of the developing clearing agencies

(depositories), the Board believes that more widespread utilization of such institutions will be made if the rules governing clearing agencies (depositories) are the product of a joint effort by the SEC and the bank regulatory agencies. Although we regard the assignment of joint responsibility for rule-writing to more than one Federal agency to be generally disadvantageous as a regulatory procedure, we believe that the public acceptability of bank clearing agencies (depositories)--which is vital to success of the entire program--will be enhanced by providing for the concurrence of the appropriate bank supervisory agency prior to the adoption of any rule by the SEC applying to any clearing agency (depository) which is a bank.

S. 2058 appears to authorize the adoption of reasonable rules setting standards relating to the financial condition and character of a prospective participant in any clearing agency (depository). Since the matter of integrity is so important in the carrying on of the clearing agency (depository) function--a function which is essentially fiduciary in nature--we believe that the proposed legislation should clearly authorize the adoption of reasonable rules relating to denial of participation in any clearing agency (depository) based upon adverse financial or character factors.

I trust these comments will prove helpful to you, and we are enclosing for your consideration several suggestions for technical amendments relative to the proposed legislation. The Board appreciates having had the opportunity to comment on proposed S. 2058.

Sincerely yours,

George W. Mitchell

George W. Mitchell

FEDERAL RESERVE BOARD

Proposed Amendments to S. 2058

(A) On page 27, line 11, paragraph (i) should be amended to read as follows so that (1) the powers encompassed in the Financial Institutions Supervisory Act will apply to both clearing agencies and transfer agents and (2) temporary orders may issue under that Act to prevent prejudicing the interests of any person affected, and not merely depositors:

"(i) Compliance with the requirements imposed by this section and section 17A of this Act may be enforced under section 8 of the Federal Deposit Insurance Act (12 U.S.C. 1818) by the appropriate regulatory agencies other than the Commission. For the purpose of the exercise by the appropriate regulatory agency of its powers under section 8 of the Federal Deposit Insurance Act, any State member bank of the Federal Reserve System, including each subsidiary thereof, and any bank holding company and nonbank subsidiary of a bank holding company, acting as a clearing agency or as a transfer agent, shall be considered an insured bank. Any violation of any requirement imposed under this section or section 17A of this Act upon banks, bank holding companies, or nonbank subsidiaries of bank holding companies registered as transfer agents or clearing agencies is a violation of the requirements imposed under the Federal Deposit Insurance Act and shall constitute adequate basis for the issuance of orders under section 8(b) and 8(c) of that Act; and for the purposes of this sentence the reference in section 8(c)

to "depositors" shall be deemed to include all persons doing business with a transfer agent or a clearing agency. In addition to its power under section 8 of the Federal Deposit Insurance Act, each of such appropriate regulatory agencies may, for the purpose of enforcing compliance with this section or section 17A of this Act or any rule thereunder, exercise any other authority conferred on it by law."

(B) In order to permit participant banks to purchase stock in depositories as is now required of all participants in Depository Trust Company, Section 5136 of the Revised Statutes (12 USC 24) should be amended by adding the following provision:

"Tenth. Notwithstanding any other provision in this section, to acquire or hold shares of stock or obligations issued by a corporation engaged solely in the functions of a 'clearing agency' as defined in section 3(a) of the Securities Exchange Act of 1934."

THE GENERAL COUNSEL OF THE TREASURY
WASHINGTON, D.C. 20220

July 13, 1973

The Honorable John Sparkman, Chairman
Committee on Banking, Housing and
Urban Affairs
United States Senate
Washington, D. C. 20510

Dear Mr. Chairman:

Reference is made to the requests to this Department and to the Comptroller of the Currency from the Chairman of the Subcommittee on Securities for our views on S. 2058, which you recently introduced in the Senate. This bill is substantially similar to S. 3876, which you introduced in the 92nd Congress and which was passed by the Senate.

The Department supports the aim of S. 2058 to prevent securities handling crises in the securities industry by establishing federal standards and regulations extending to clearing agencies and transfer agents. We also endorse the procedure for accomplishing this purpose in S. 2058 insofar as the bank regulatory agencies are utilized to participate in the administration of the provisions of the bill as they apply to banks. We believe that the supervisory agencies, including the Comptroller of the Currency, are particularly capable of administering the provisions of the bill and the Comptroller of the Currency is willing to do so with respect to national banks.

Rule-making authority, however, is placed in the SEC with regard to minimum standards of performance and certain other operational aspects of clearing agents and transfer agents, banks as well as non-banks. While we note that the bank regulatory agencies have long experience in examining and supervising bank transfer agents, we recognize the value of uniformity and rule-making in the securities processing area, and we offer no objection to these provisions of the bill. The valuable input which bank regulatory expertise may contribute in this respect and which is recognized in section 17 B(h) should be underscored in the legislative record of the bill so that there will be no doubt that the SEC shall consult and cooperate with the appropriate agencies in formulating and promulgating these rules and regulations.

We invite the specific attention of the Subcommittee to the following sentence of section 17 B(3)(b): "Each appropriate regulatory agency shall also file with the Commission such additional information as the Commission may, by rule, require to keep current the information in such notice and to carry out its responsibilities under this section." This requirement seems to be superfluous in view of the provisions of section 17 B(h) regarding cooperation among all agencies, and it would appear to give the SEC a measure of authority over the bank regulatory agencies. If this provision were enacted, the Commission could impose requirements upon the bank regulatory agencies which would be unduly burdensome and counterproductive. Certainly, if this proposed requirement is deemed to be necessary by the Subcommittee, the SEC should obtain the concurrence of the bank regulatory agencies before imposing any such rule.

A recommendation was made by the Office of the Comptroller of the Currency last year in testimony before the Subcommittee on Commerce and Finance of the House Interstate and Foreign Commerce Committee that the securities processing bill be amended to provide that national banks could acquire and hold stock in clearing agencies and depositories. Present law does not permit a national bank to purchase or own a minority stock interest in any corporation with certain statutory exceptions. We continue to believe that it is highly desirable that national banks be permitted to own an interest in depositories or clearing agencies which they utilize. Accordingly, we suggest the following statutory language as part of S. 2058:

> Sec. __. Section 5136 of the Revised Statutes (12 U.S.C. 24) is hereby amended by adding a new subparagraph tenth as follows:
>
> "Tenth. Notwithstanding any other provisions in this section, to acquire or hold shares of stock or obligations issued by a corporation engaged solely in the functions of a 'clearing agency' or 'depository' as defined in section 3(a)(22) of the Securities Exchange Act of 1934, as amended."

Finally, we wish to register our strong disagreement with the suggestion of Commissioner John R. Evans of the SEC in his testimony to the Subcommittee on July 11, 1973, that S. 2058 should be

revised to provide the SEC with inspection power over clearing agencies, depositories and transfer agents organized as banks to aid the SEC in determining appropriate performance standards and recordkeeping requirements. It is unreasonable to anticipate that either the banks involved or the appropriate agencies would withhold any information which might aid the SEC in setting performance standards and recordkeeping requirements. As banks are examined on a regular basis and are closely supervised by the regulatory agencies, additional inspection by the SEC would be redundant, burdensome and unfair.

We respectfully urge that our comments on S. 2058 be taken into consideration in the Subcommittee deliberations on the bill. If we can be of further help in this matter, please do not hesitate to call upon us.

In view of your request for the expedition of this report, it has not been possible to obtain the customary clearance by the Office of Management and Budget prior to its submission.

Very truly yours,

Edward C. Schmults

General Counsel

Senator WILLIAMS. This morning we begin 2 days of hearings on the legislation. We appropriately open this morning with a statement from the Securities and Exchange Commission, from Commissioner John R. Evans.

Mr. Evans, we are pleased to have you join us at the table. We look forward to your statement.

STATEMENT OF JOHN R. EVANS, COMMISSIONER, SECURITIES AND EXCHANGE COMMISSION, ACCOMPANIED BY LEE A. PICKARD, DIRECTOR OF DIVISION OF MARKET REGULATION

Mr. EVANS. Mr. Chairman, I am pleased to be here this morning to testify on S. 2058 which has the purpose of providing a regulatory framework for the development and regulation of an integrated national system for the clearance and settlement of securities transactions. With me is Lee Pickard who is the Director of our Division on Market Regulation. Lee is working in this securities-processing area daily and is very expert in this subject. I appreciate having him here with me, and I am sure as we get into the questioning period, he will be able to provide answers which will be beneficial to your consideration.

I am happy to be working with you again in an effort to obtain reasonable securities processing legislation. I was greatly disappointed last year, as I know you were, after all of our work not being able to obtain enactment of legislation.

How well I remember the efforts of the final week, almost frantic—I guess I could use that term—in trying to get an agreement between the parties and then when we felt we had that agreement having it fall through; and then as a last ditch effort trying to obtain barebones legislation which would at least provide the SEC some authority in the rulemaking area and having that also fall through on the last day of the session.

So we are anxious to work with you again. And we hope securities processing legislation will be enacted this year.

At the outset I would like to state that I am authorized to say the other members of the Commission concur in this statement.

Legislation regarding the processing of securities transactions will, over the long term, have a significant impact on the brokerage industry and other members of the financial community as well as the investing public. We believe that the basic thrust of legislation should be to assure that a series of interdependent developments which are currently being implemented such as comprehensive securities depositories, systems for clearance and settlement of transactions and improved transfer facilities are effectively forged into a modernized, nationwide system for the safe and efficient handling of securities transactions on a timely basis and in a manner which best serves the financial community and the investing public.

In this regard, we would like to see the private sector continue to play the major role in such developments with guidance from the Commission only to the extent necessary to assure an integrated, efficient system providing access on a reasonable, nondiscriminatory basis.

Subject to the changes we recommend in this statement, we believe the Senate bill would provide a regulatory framework within which the above objectives could be accomplished.

There are three basic functions which must be performed in a system for the settlement of securities transactions which will meet present and future needs. These are the function of a clearing agency, the function of a depository and the function of a transfer agent. Of these three functions, those of clearing agencies and transfer agents have existed for many years, while those of the depository are relatively new.

A clearing agent settles transactions between member broker-dealers. Offsetting transactions between broker-dealers are netted out and the settlement and delivery is effected only as to the balance under the traditional balance order system. Under the more recent net-by-net system, balances may be carried forward and netted against future settling trades.

Depositories hold large amounts of securities and effect delivery between participants solely by book entry and without the necessity for actual receipt and delivery of certificates by the participants. Transfer agents transfer certificates from the name of the seller into the name of the buyer.

At present, these functions are uncoordinated. Each of the major exchanges and the NASD has a separate clearing agency for transactions between their members.

In addition, each corporate issues either acts as its own transfer agent or retains a separate organization which may or may not be a bank, to perform that function. Depositories are of recent origin, and there has been a tendency for separate depository systems to be developed, but their interface has been slow and difficult.

We believe that coordination of these presently uncoordinated activities which is a principal objective of S. 2058 is essential. Furthermore, as the bill recognizes, at least in part, the separate functions of clearing agencies, depositories and transfer agents are susceptible as being combined in various ways, and some combination would appear desirable. Thus, the same agency might perform both clearing agency and depository functions; indeed, this seems a logical development.

In addition, it would be possible for a transfer agent to also perform the function of a depository. At present, depositories have developed separately from transfer agents both because of the large number of transfer agents which serve individual issuers of securities and also because depositories were assigned different functions at their inception.

The development of a transfer agent depository could, however, provide certain advantages since it would make depository services available to individual investors and smaller institutions whose participation in the securities markets may not be sufficiently active to justify their assuming the obligations of a participant in a pure depository.

We believe, therefore, that the bill should be modified to permit the combination of depository services and transfer agent services in one institution if the Commission determines that this is feasible and desirable. We would be prepared to assist the subcommittee in framing amendments which would keep this option open.

As I have mentioned, however, the important thing is to develop a nationwide, coordinated system for performing the functions of clearing agents, depositories and transfer agents and to provide adequate

interface among these agencies. Creation of such a system would, among other things, afford the potential for very important economies in the securities processing system which would rebound to the benefit of all participants—broker-dealers, banks, and institutional and individual investors.

The Commission is concerned with the rapidly rising costs of doing business in the securities industry and its adverse effects upon profits and services. Securities processing costs have increased substantially in recent years in the broker-dealer community and I am sure that other financial institutions have experienced similar securities processing cost increases.

Processing economies, the public interest in and our concern for protecting investors against loss of securities and cash, the financial and operational responsibility of broker-dealers, the need for greater public confidence in our market system and the expectation that the markets of the future will be required to handle higher volume, all require a modernized nationwide system for consummating securities transactions.

We believe that to achieve this some public regulatory body must be in a position to oversee the whole process. The Commission presently has authority over the execution of securities transactions, overclearing and oversettlement. We believe it logical that this authority be extended to transfer functions. Such an extension would authorize the Commission to oversee these inextricably related segments of a single process: The purchase and delivery of securities.

It is our view that the development of depositories and clearance systems now operating and being planned, and the functions of transfer agents and other entities involved in the securities handling process must be directed in a manner which keeps each system open-ended and compatible with other systems in order that they may perform at maximum levels and service the entire investment community.

Last year, several bills concerning the clearance and settlement of securities transactions were introduced in both Houses of Congress. Hearings were held and from our review of these hearings, it is quite evident that there was widespread support for securities processing legislation. This support is also evidenced by the fact that bills passed in both Houses although, as has been stated, there was not time to reconcile the differences between them before Congress adjourned.

More effective regulation of the process as a whole is clearly desirable and several approaches have been suggested. In all of the legislative proposals, the Securities and Exchange Commission was selected as the primary regulatory body. We believe that the central issue has been whether, and to what extent, the authority to examine clearing agencies and securities depositories organized as banks, and to enforce the applicable standards to be promulgated by the Commission, should be vested in the bank regulatory agencies or in the Commission.

There is a greater degree of agreement that examination and enforcement authority over bank transfer agents should remain with the bank regulatory agencies, but with the Commission setting the standards. Perhaps the simplest approach would be to provide that the entire regulatory program, including the establishment of standards and responsibility for examination and enforcement over depositories

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and clearing agencies organized as banks, would rest solely with either the Commission or appropriate bank regulatory authorities.

Another approach would be to apportion regulation over depositories, clearing agencies and transfer agents organized as banks to the Commission and the bank regulatory agencies on a functional basis. For example, the bank regulatory agencies could be given primary responsibility over those areas in which they may have greater expertise such as security, safekeeping and financial responsibility. The Commission could be given primary responsibility over all other areas in which it has expertise relating to the processing of securities transactions. This approach would most likely result in overlapping responsibility and thus subject the depository, clearing agent or transfer agent organized as a bank to dual regulation, examinaiton and enforcement. As I recall, last year, this approach was discussed at length during Senate hearings, and no concensus was reached as to where to draw the line between various functions.

The approach which S. 2058 proposes is that the Commission be given direct rulemaking authority for all clearing agencies, securities depositories and transfer agents. However, in the case of such entities organized as banks, this legislation would delegate responsibility for examination and enforcement—and in the case of transfer agents, rulemaking concerning recordkeeping and reporting—to the appropriate bank regulatory agencies.

It has been argued that this regulatory scheme, among other things, will encourage bank custodians to participate in securities depositories. In testimony before the subcommittee last year, witnesses indicated that banks would hesitate to deposit securities with a securities depository unless it "Looked like a bank, felt like a bank, and was regulated like a bank."

When the Commission testified before this subcommittee last year, it stated its preference, and we continue to subscribe to the view that our regulatory authority should include a right to periodic examination of depositories and clearing agencies and authority to enforce compliance with the minimum standards established by the Commission pertaining to these entities.

However, the Commission believes that legislation in this area is vital. Consequently, we support §. 2058 as an acceptable proposal and, if it is adopted by the Congress, we will naturally cooperate with the bank regulatory agencies in this joint effort to see that it is successful.

The legislation should be revised, however, to provide the Commission with inspection power over clearing agencies, depositories, and transfer agents organized as banks to aid us in determining appropriate performance standards and recordkeeping requirements. I would emphasize that these inspections would not be for enforcement purposes, but rather to provide us with a continuing understanding of the actual working of these agencies in aid of informed rulemaking.

Our examinations could be coordinated with those of the bank regulatory agencies so as to avoid any duplication or undue burden upon the regulated organizations. It is our view that without this inspection power, it would be difficult, if not impossible, to set reasonable and meaningful standards for such entities, nor would reading copies of reports of inspections completed by bank regulatory agencies for

compliance and enforcement purposes be an adequate substitute for our own inspections for our regulatory purposes.

Section 3 of the bill would add a new paragraph (25) to section 3(a) of the Exchange Act defining the Federal Reserve Board as the appropriate regulatory agency of a nonbank subsidiary of a bank-holding company. It is my recollection that the bill approved by this subcommittee on June 27 of last year did not contain such a provision and in fact did not take into consideration regulation of bank-holding companies and their subsidiaries.

In a July 24, 1972, letter to Senator Bennett, Chairman Burns of the Federal Reserve Board recommended that the Federal Reserve Board be the appropriate regulatory agency in the case of bank-holding companies and nonbank subsidiaries acting as clearing agencies or transfer agents.

I do not recall any discussion as to whether the appropriate regulatory agency of a nonbank subsidiary of a bank-holding company should be a bank regulatory agency or the Securities and Exchange Commission. The Securities and Exchange Commission presently regulates investment advisers which are subsidiaries of bank-holding companies and mutual funds which are subsidiaries of bank-holding companies.

Since the issue of dual regulation is not a major one because the subsidiary is not organized as a bank, the Commission recommends that it be the appropriate regulatory agency for all such nonbank subsidiaries which are either depositories, clearing agencies, or transfer agents.

We also note that the proposed bill would require a clearing agency to be a self-regulatory organization. We believe, however, that the Subcommittee should be aware that certain privately owned entities will be encompassed by the definition of a clearing agency which includes a depository.

Incidentally, we have referred to depositories and clearing agencies separately in our statement, for the purpose of clarification. We realize of course, that your bill defines the two together, but we ought to be sure it is clear that both are in our comments regarding regulatory and enforcement authority. We have separated the two only for that purpose.

Some of these organizations, particularly certain clearing organizations, have not been self-regulatory bodies and, under the bill, probably should not be. We note that the bill provides for the Commission with broad exemptive powers which could be used to exempt such entities from any clearing agency requirements which we deem to be inappropriate or unnecessary to carry out the purposes of this section.

Proposed section 17A (c) would require the Commission to find as a prerequisite to registration that a depository or clearing agency meets the criteria set forth in that subsection.

Subsection (c) (2) of proposed section 17A would provide that the rules of a clearing agency or depository may condition participation upon compliance with standards of operational capacity, a deposit or the posting of a bond in an amount which bears a reasonable relationship to the value of positions maintained by and transactions processed for the participant, and rules denying participation to persons who have been expelled by another registered clearing agency.

The Commission believes that the rules of a clearing agency or depository should allow these entities to impose additional criteria to those set forth in proposed subsection (c)(2) for admission to the clearing agency provided the Commission determines that such additional criteria are necessary or appropriate in the public interest, for the protection of investors, or to assure the prompt and accurate processing and settlement of securities transactions.

The Commission does not seek to limit entry to a clearing agency or depository; rather it seeks to insure, as a matter of policy, that all broker-dealers and other financial institutions will have access to such entities on a reasonable and nondiscriminatory basis while protecting the financial integrity of these entities and their participants.

Proposed section 17A(g) would require clearing agencies and depositories to submit proposed rule changes along with a summary statement of the proposed change and the basis therefore to the Commission. In addition, this section would require all proposed rule changes to be published for public comment.

It is our view that public notice and comment is desirable. We believe, however, that the depository or clearing agency, rather than the Commission, should solicit public comments on proposed rule changes so that it may have the benefit of such comments before it acts.

We also believe that solicitation of public comments should not be required with regard to all rule changes. This matter should be left to the securities depository or clearing agency subject to Commission discretion to solicit additional comments.

In any event, where a depository or clearing agency has obtained comments, the Commission should not be required to duplicate that effort unless, in its discretion, it wishes to do so. Additionally, copies of the comments should be sent to the Commission with the filing of the proposed rule changes.

Finally, this section would make such rule changes effective within 30 days of filing unless the Commission disapproves such changes through the institution of administrative action. We believe that this time restriction may be too limiting in some instances, especially in view of the fact that a public comment period is presently required in the bill, and may be necessary in some instances even if our recommendation that the depository or clearing agency be required to solicit public comments before submitting rule changes to the Commission is adopted.

Further, the restriction is not likely to significantly aid the administrative decisionmaking process.

Proposed section 17A in the bill would authorize the appropriate regulatory agency to review denials of admission by a clearing agency or depository with respect to any person seeking participation therein. As previously noted, the Commission believes that such entities should grant access to all broker-dealers and other responsible financial institutions on a reasonable and nondiscriminatory basis.

In view of this policy, the Commission believes that it should review denials of participation by a clearing agency or depository. In this regard, it should be noted that the Commission presently has authority to review denials of membership in registered national securities associations, and clearing corporations operated by them, and we believe that access questions also should be determined by the Commission.

Proposed section 17A(q) would require the Commission to take such steps as are within its power to bring about the elimination of the stock certificate as a means of settlement among brokers by December 31, 1976. We are in complete agreement with this goal.

We are concerned, however, that the rigidity of a fixed timetable may make it difficult to weigh the benefits and advantages of eliminating the stock certificate at a fixed point in time against the costs which have to be incurred in order to achieve this goal. However, if Congress fixes a definite timetable, the Commission would undertake to meet it.

Proposed section 17B(f) would provide that each registered transfer agent shall make and keep such books and records and make such reports as the appropriate regulatory agency requires. We believe that in order to achieve uniformity in recordkeeping and reporting with regard to all transfer agents, this authority should rest with the Commission.

We are asking only for authority over the operations dealing with transfer functions. We are not interested in authority over any other segment of the operation of these types of institutions.

Section 8 of the bill would add a new subsection 19(f) of the Exchange Act directing the Commission to make a study of the registration of securities in street name. We concur that such a study should be made and suggest that it also refer to sections 12(g) and 15(d) of the Exchange Act since those sections are very closely related to the other and impose periodic reporting requirements based upon the number of record holders of securities.

If the street name study legislation is enacted, we believe it is appropriate that these two areas be mentioned specifically and combined in a single study.

Section 9 of the bill would amend section 28 of the Exchange Act to prohibit the imposition of any State or local tax on changes in beneficial or record ownership of securities unless such changes would otherwise be taxable if the clearing agency were not located within the jurisdiction of the taxing authority. We strongly endorse this provision.

This concludes my prepared statement, and I will try to respond to any questions that you may have.

Senator WILLIAMS. Thank you very much, Commissioner Evans.

Is this substantially the same position expressed by the Commission last year when we had the bill that was very much similar?

Mr. EVANS. Mr. Chairman, I believe it is substantially the same. I think that the Commission realizes that there were impediments to enactment of legislation last year. Because of those problems, which in a sense are political problems, with a small "p", we are willing to accept legislation which is not exactly what we desire in order to get this process going.

We think the legislation is necessary now while these new institutions and relationships are developing so that guidelines can be established, that overlap will not occur and so that we can have a coordinated, integrated system in this country.

Senator WILLIAMS. But you still linger with the feeling that it is a necessity for the Commission to involve itself with banks, an area reserved under the bill for enforcement by the banking agencies. You

still have the Commission in banking areas for oversight and information for rulemaking, is that——

Mr. EVANS. This is correct. Maybe that was not clear in the statement, but our feeling is that if there were, say, dozens of depositories some of which were not organized as banks and we had the option of going in and examining those which were not banks, inspection of bank related depositories would not be so necessary. We would watch the operations of the nonbank depositories and the others would likely be quite similar.

But if there are only going to be three as there are now or six or whatever develops and all of these turn out to be trust companies and we cannot go in and inspect any of them, it would be extremely difficult for us to sit in our ivory tower and set up appropriate rules, regulations and standards.

Now, a report from another agency would be helpful, but there is a lot of difference between getting a report of an examination from another agency and in being on the ground and looking at the operations of an institution.

Senator WILLIAMS. You can see some of the problems that that presents for us.

Mr. EVANS. Yes; as a matter of fact, I am very familiar with the problems and the questions and the fears that exist on the part of institutions which are bank-related, as the result of my involvement with this legislation last year.

I think that their fears may be overstated to some extent, although they are real. There are problems in relation to the fact that certain institutions want to be sure that their securities are in a depository that is as safe as a bank. I do not know why they think the Commission cannot or would not assure such safety, but that being the case, certainly, we are willing to cooperate with another Federal agency in that area.

Mr. Pickard would also like to comment on that.

Mr. PICKARD. Senator, I would like to put this in historical perspective just for a second. The SEC has traditionally had the authority over depositories and clearing agencies. They have never in the past been viewed as bank institutions. And it is our feeling that the fact they have obtained limited purpose trust companies does not change the nature of these institutions.

Therefore, we see a continuing need for the Commission to have a primary responsibility over depositories and clearing agencies regardless of whether they are called trust companies or ancillary organizations or self-regulatory bodies.

At the same time, however, we do not see in any way a need to preclude the banking regulators from doing what they feel is necessary if in fact the institutions in question would come under their jurisdiction.

Senator WILLIAMS. Before we get into a little discussion on just how the Commission would proceed under this legislation if it were enacted, let me get a picture from you of what the current operational condition capacity of the securities industry is. What if we had another one of these tides of paper? How would the industry handle it now if trading volume picked up substantially?

Mr. EVANS. Well, Mr. Chairman, it is difficult for us to say exactly what will happen. We can say that a lot has changed since the paperwork crisis of several years ago in the late 1960's. We can say that new procedures have been set up. We can say that the SEC and the self-regulatory bodies as well as the institutions themselves have upgraded their operations.

We can say that the self-regulatory organizations receive monthly as well as quarterly reports from their members giving them an opportunity to monitor very carefully the activities of their membership.

We can say that today the level of securities transactions obviously is far below the capacity of the industry. I think that we could use the figures for the first quarter of 1972 when there were an average of about 18.5 million shares a day on the New York Stock Exchange and say that there were no problems at that level. I think we can say that safely.

Now, the average daily level is about 14 million which is 4 million a day less. Other exchanges are also operating at a much lesser rate of capacity than they were at that time. If I had to make an estimate, I would think we could have share days in all markets of 10 million a day more than we are having right now with no major problems.

Obviously, there are individual firms that would have difficulties. There are always marginal firms. There are marginal firms in today's market even as low as it is.

But I think market activity could increase a substantial amount with no difficulties whatsoever. And if difficulties began to appear, we would be able to monitor them very carefully.

I might say this, however, that in today's market a lot of the firms which have this excess capacity are cutting back. Figures I have from our Office of Economic Research show that profits during the first quarter of this year were lower than profits in the first quarter of 1970. This does not mean the industry is in as poor condition as it was in 1970 because it had just experienced 1969 which was a poor year. Last year on the other hand was a relatively good year for securities firms, so they are in much better condition than they were in 1970.

As far as fails are concerned and as far as net capital is concerned, the industry is in good shape today. But since market activity is slow, a lot of firms are experiencing losses. They are cutting back on expenses, which is the natural thing to do with slack business. And this is cutting back capacity.

If this condition should continue for any extended length of time, and then be followed by a rapid and sustained increase in trading, I think we might find some problems. Frankly, we would not expect a problem to result from a substantial increase in market activity. We hope that the market will pick up, and that it will pick up substantially.

I do not know if that answers your question satisfactorily.

Senator WILLIAMS. Yes.

What has been added to the clearing settlement depository transfer picture that makes it better than it was? Is there through self-regulation a more integrated national clearing system?

Mr. EVANS. Yes; some strides have been made in this area, but much still remains to be done. Since 1970, Central Certificate Service, which is now a trust company named the Depository Trust Co., has expanded

its operations. Depository Trust Co. today has about 300 participants, shares on deposit totaling about 1.5 billion with a value of about $55 billion. Just yesterday the Commission approved what we hope will be our final comments on their proposed rules of operation.

The Midwest Stock Exchange's clearing and depository operations have made progress and I understand Midwest has a one-way interface with the Depository Trust Co. The Pacific Securities Depository is also making some progress and the Commission staff is in the process of reviewing their proposed rules.

The National Clearing Corp. of the National Association of Securities Dealers has expanded to major cities and is expected to be nationwide within the next year. The NASDAQ quotation system for over-the-counter securities is operative throughout the Nation. I also understand that the major transfer agencies have improved and modernized their operations. So I believe it would be appropriate to say that substantial progress has been made by individual segments involved in securities processing.

The second part of your question referred to integration and cooperation. This is where the major problem lies. It has been slow in com-the-counter securities is operative throughout the Nation. I also understage. There are some trial runs and some one-way agreements but nothing approaching an integrated national clearing system. There are vested interests, as well there should be. There are differences in approach and there are disagreements. Each group desires to carve out a major role for itself. This is why we need one regulatory body with authority to assure coordination among the individual participants.

Senator WILLIAMS. I would like to deal a little more with the philosophy of the Commission's approach here. Given that this legislation is enacted into law, I get the impression that you would see the Commission's role primarily as one of reacting to developments rather than initiating changes in the system, more in the nature perhaps of resolving differences in conflicts rather than affirmatively establishing policy and leading the industry toward a national clearing system.

Now, is there a way that you can express this to alleviate this apprehension that I get from your statement?

Mr. EVANS. Well, I hope so, Mr. Chairman. I guess you are taking this from the top of page 2 in my statement where I talk about the——

Senator WILLIAMS. It is throughout. I get this flavor of reaction rather than action.

Mr. EVANS. Let me try to explain as clearly as I can how I see our role. I really do not think we see our role too differently from what you do. I hope we do not. Because as the arm of Congress in this area, we hope that we would see our role just the way you would see it—the way the Congress would see it.

We in the Commission are dedicated to a free enterprise system. We are committed to a self-regulatory approach. And thus, we think that the private system itself can provide the impetus needed. However, there are major problems in coordination as you stated in your opening remarks.

In my statement, I said we would provide that guidance necessary to assure an integrated, efficient system providing access on a reasonable, nondiscriminatory basis. This is where the problem lies. We see our role as first establishing an overall framework within which the

private system should work. Then, we see the private participants setting up procedures whereby they can meet the necessary requirements of that framework.

After they have done that, they send it to the Commission and have us look at it and approve it to be sure that their proposals do meet the needs which you have stated and with which we agree, that we have a national integrated system.

Now, we do not want to regulate to the extent that we take away this initiative either in the private institutions or in the self-regulatory institutions. This is the only country in which that exists and we want to maintain and even strengthen it if possible.

We realize however that Adam Smith's invisible hand theory of private enterprise does not solve all the problems involved in working out a national clearing system.

If you are talking about a national system, we do need to have a very definite visible guiding hand of the SEC so that private participants know what is expected. And then, after they have tried to fit their operations within that framework, they know that we have the authority, if it is given to us, through this legislation to assure that they meet our requirements. Within that we hope that the private system would do most of the development.

I hope that somewhat clarifies the Commission's position.

Mr. PICKARD. Let me just supplement what Mr. Evans has said. We would hope to establish the guidelines, as we have done in the past in our study of unsafe and unsound practices of broker-dealers. We established significant points of policy in that study.

We would contemplate that the industry would move within those guidelines, failing which we would then have to take a more affirmative role.

I think that is one of the reasons we are here today because we need the additional authority which this proposed bill would grant us in order to have the ability to move in the event the industry fails to move. As Commissioner Evans pointed out in his statement, progress toward interface has been slow and difficult. It has been literally months or perhaps more than months, perhaps a year, in which the Depository Trust Co. and the National Clearing Corp. have been trying to establish a modest interface.

We have seen time and time again difficulties on the part of the various clearing agencies and depositories in their attempts to interface, perhaps attributable to their desire to preserve their own prerogatives. We would like to have the authority in order to expedite this interface and to expedite the development of national systems.

Mr. EVANS. Let me add one other thing I should probably have said, Mr. Chairman. We hope our actions thus far have shown we intend to take a major role in setting these guidelines. The proposals made in the unsafe and unsound practices study, our white paper on the central market system, and our comments on the consolidated transactions type proposal we believe have shown that we intended to have a major input. Comments on the rules that have been submitted to us thus far by DTC and Mid-West, we think show that we intend to have a major guiding influence over depositories.

We hope if you have any problems with the way we are doing this, you will let us know. And I am sure you will as you have on occasions.

But we are trying to lead and still leave institutions plenty of flexibility to do what the private system can do, I think, better than a government agency.

Senator WILLIAMS. Well, we do not have time to go into some of the tough problems here, but I wish there were more time. Perhaps we might present some hard examples to you to se your approach.

I asked Al Harris to give me a tough one. So without previously reading it, let's see how it goes.

Conflicts between NCC and Pacific Coast Exchange over who clears OTC trades on the west coast.

Now, there is a specific problem.

Mr. EVANS. It is a very tough one.

Thank you, Al.

I do not feel that I am in a position to answer that question. I think that the way it has to be answered is working with those two groups. And in my opinion the Commission does not have the direct authority to take care of that right now.

Mr. PICKARD. Let me just supplement what Commissioner Evans is saying. The NCC has made significant strides in expanding its coverage throughout the Nation. It has not yet established itself on the west coast.

Pacific Coast Clearing Corp. operates a clearing mechanism for over-the-counter securities. And, of course, NCC would do the same thing if it were established on the west coast. The members—and by "members," I mean broker-dealers—do not want the duplication. They made that very clear to us on many occasions.

The two sides are well aware of the problem. And in fact, the Pacific Coast authorized a study by a leading accounting firm to attempt to construct an interface. I understand the NASD has rejected this study and has come back with a counterproposal.

[Additional material on this matter follows:]

PACIFIC COAST STOCK EXCHANGE

618 So. SPRING STREET
LOS ANGELES 90014

OFFICE OF THE PRESIDENT

301 PINE STREET
SAN FRANCISCO 94104

San Francisco
April 2, 1973

Senator Harrison Arlington Williams, Jr.
United States Senate
Washington, D. C. 20549

Dear Senator Williams:

You are all familiar with the fact that here on the Pacific Coast our Pacific Clearing Corporation provides for the clearing and settlement of both listed and over-the-counter transactions and deliveries between banks, institutions and brokers in a single system. In other regions OTC transactions are settled by NCC and listed transactions are settled by other exchange clearing facilities in their respective areas.

We are of the opinion and advocate that a single national system be created with each region operating its intra-regional settlements on an autonomous basis but required to interface with a national system on inter-regional transactions. The accompanying proposal sets forth our presentation on how this may be accomplished.

We will be happy to answer any questions you may have.

Sincerely,

Thomas P. Phelan

Thomas P. Phelan

TPP:bg
Enclosure

PACIFIC CLEARING CORPORATION

LOS ANGELES OFFICE
453 S. SPRING STREET
LOS ANGELES 90013

SAN FRANCISCO OFFICE
301 PINE STREET
SAN FRANCISCO 94104

March 12, 1973

In November 1972, the Pacific Clearing Corporation (PCC) presented an outline of the Joint Approach for clearance and settlement of securities in the Western Region of the United States to an ad hoc committee of the Securities Industry Association (SIA). The committee requested that an implementation plan for the Joint Approach be developed. This presentation, submitted in response to the SIA request, consists of the following three sections:

- A summary of the PCC presentation in November 1972.
- An implementation plan of the Joint Approach prepared by Peat, Marwick, Mitchell & Co.
- A response to certain legal questions advanced by the National Clearing Corporation.

The Joint Approach described herein is the most comprehensive plan developed to date which will lead to the early and efficient development of a national clearing system. There are a number of compelling reasons to adopt the Joint Approach including the following:

- It is the least expensive clearing mechanism from the standpoint of the brokerage community, users of the system. The derivative advantages to the investing public are obvious.
- It avoids the inefficiency and conversion expense of duplicative clearing mechanisms in the Western Region.
- It most directly meets the needs of the brokerage community:
  - all trades, whether listed or over-the-counter, are cleared through a single organization
  - all cash settlement is netted to one daily balance with a single entity for all trades.

- all settlements will ultimately be effected by book-entry, through the Pacific Securities Depository system, with no intra- or inter-regional physical receipt or delivery.

. We feel the Peat, Marwick, Mitchell & Co. report (attached) indicates that the Joint Approach is indeed practical and can be implemented in a timely manner, so that the early development of a national clearing system will be assured.

The Pacific Clearing Corporation has pioneered and perfected a net-by-net (or continuous net) clearing service which provides for its members:

. Common listed and OTC positions for transactions in all marketplaces.

. Complete depository facilities.

. Clearing/depository interface for all listed and a broad range of OTC securities.

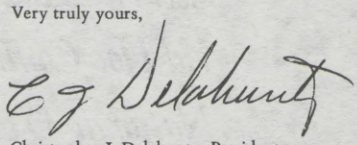
The securities industry in the West Coast Region has thus achieved many of the goals which the industry is working toward on a national scale. To deny Western clearing members these advantages would be a step backward, particularly because the Joint Approach provides a means of progressing toward these goals nationally without retrogressing locally.

For clearing members in the Pacific area, an objective consideration of cost, time, efficiency, and service favors the Joint Approach over the alternative approaches.

* * * *

We appreciate the opportunity of submitting this presentation and look forward to working with other industry groups in the early implementation of the Joint Approach.

Very truly yours,



Christopher J. Delahunty, President

Summary of

JOINT APPROACH

to

NATIONAL SECURITIES CLEARING for the WESTERN REGION

presented to the

Securities Industry Association
Ad Hoc Committee on
National OTC Clearing
by the Pacific Clearing Corporation
on
November 8, 1972

OBJECTIVE

With respect to the Western Region, a clearing system should be judged by how well it:

- Facilitates effective nationwide clearing and settlement of OTC and listed transactions.
- Fulfills the clearing and settlement needs of Western brokers (including wire houses with Western operations) in the
  - most convenient
  - most comprehensive
  - most efficient
  - least expensive
  - most up-to-date

  manner.

WHAT ARE THE CLEARING AND SETTLEMENT NEEDS OF THE BROKERS?

In the CLEARING area (trade comparison and netting), the needs are:

- To clear all transactions simply and cheaply
  - With minimum numbers of clearing agencies.
  - Preferably, with

ONE
- System
- Standardized set of procedures and forms
- Personal contact, familiar with member's individual needs.

In the CERTIFICATE HANDLING area, the needs are:

- To eliminate the physical receipt and delivery of certificates.
  - Preferably working through one depository entity with *all* securities immobilized therein.
  - Reducing securities movement, whether intra-regional or inter-regional (including coast to coast).

In the CASH SETTLEMENT area, the needs are:

- To settle *all* cash balances efficiently.
  - Preferably with one check (given or received).
  - For both listed and OTC trades.
  - For trades with other brokers, banks and financial institutions.

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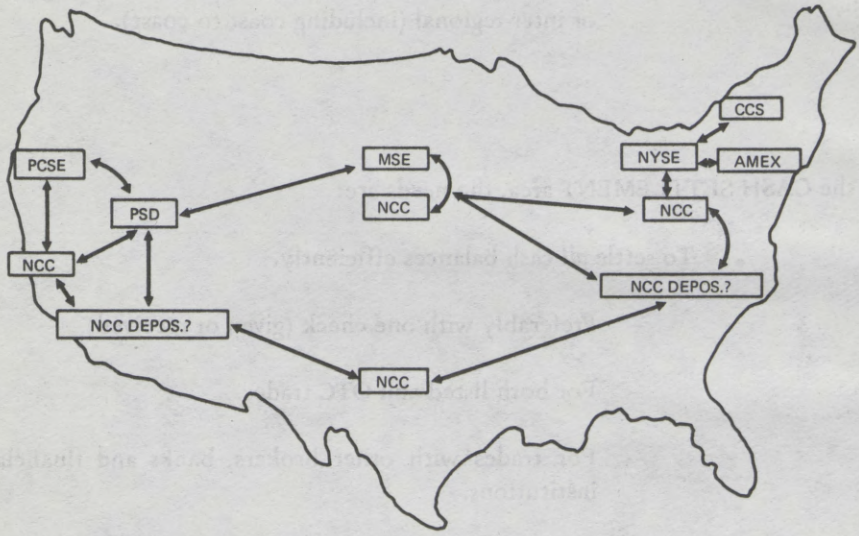
WHAT IS
THE ONE AGENCY APPROACH?



If over-the-counter clearing is handled independently by NCC in the Western Region, fragmented services would not completely satisfy the needs of the brokers.

In the CLEARING area, using the NCC approach, the broker would clear:

- OTC (broker - broker) clearance with NCC.
- Listed { broker - broker / broker - institution } clearance with PCC.
- OTC (broker - institution) clearance direct or with PCC.

Thus, firms must have separate procedures for:

- OTC and listed transactions.
- Institutional and other transactions.

In the CERTIFICATE HANDLING area, using the NCC approach, receipt and delivery of certificates would be handled:

- For listed, by book-entry via PSD (interfaced with CCS and MSE).
- For OTC securities (broker - broker), with NCC.
- For institutional deliveries, separate handling (PSD, direct or NCC).

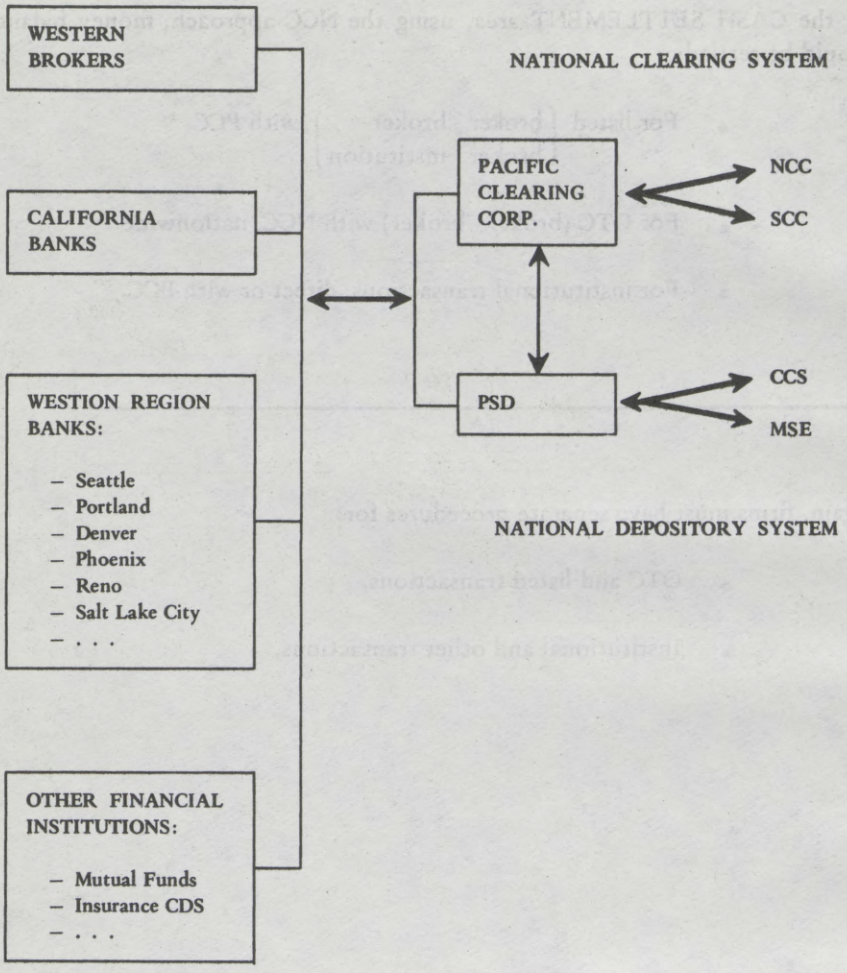
Thus, separate procedures are again required.

In the CASH SETTLEMENT area, using the NCC approach, money balances would be settled:

- For listed { broker - broker / broker - institution } with PCC.
- For OTC (broker - broker) with NCC, nationwide
- For institutional transactions, direct or with PCC.

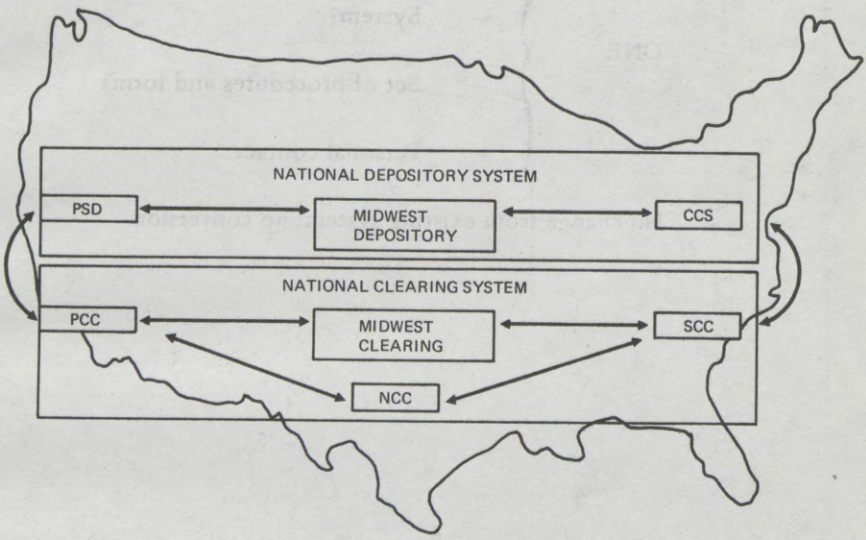
Again, firms must have separate procedures for:

- OTC and listed transactions.
- Institutional and other transactions.



PCC WESTERN REGION CLEARING
AND SETTLEMENT CENTER

**WHAT IS
THE JOINT APPROACH?**



In the CLEARING area, using the PCC approach:

- All trades (listed and OTC; broker and institution) cleared through one organization.

ONE
- Physical location
- System
- Set of procedures and forms
- Personal contact

- No change from existing system; no conversion.

In the CERTIFICATE HANDLING area, using the PCC approach:

All securities (listed and OTC; broker and institution) transferred by book-entry with PSD–

- *No* intra-regional physical movement
  - Including COD's to banks, who are members of PSD
- *No* inter-regional movement
  - Full CCS interface.

In the CASH SETTLEMENT area, using the PCC approach:

- Money balances for ALL trades (listed and OTC; broker and institution) settled with one entity, PCC.

ONE
- Check
- System
- Set of procedures

CONSIDERABLE PROGRESS TO DATE

- National Coordinating Group for Depositories
  - Nationwide Network of Depository Committees
- PCSE Institutional Clearing Program (ICP)
- Major California Banks Now in PCC or Working toward Joining PCC
  - Memorandum of Understanding (Clearing and Depository Participation)
- PSD Implementation Committee – 6 Full-time EDP Systems Specialists;
  - Bank ⟷ PCC Interface (Including On-line ICP)
  - Bank ⟷ PSD Interface
  - PSD Business Plan
  - Full Bank Participation in PSD
    - Infuse capital
    - Deposit agency and fiduciary securities
- Western Region PSD Committee
  - Considerable interest in PCSE clearing ("1st" or "2nd" level clearing)
- All PCC clearing firms to be converted to PSD book-entry transfer.

JOINT APPROACH

The joint approach to clearing on the Pacific Coast is based on the Pacific Clearing Corporation (PCC) using its net-by-net over-the-counter and listed clearing system as the western part of the National Clearing Corporation (NCC) over-the-counter clearing system. The PCC system would be interfaced with the NCC system, so that transactions entered in either one would be effectively entered in both, as required by the system or elected by the broker.

Advantages of the Joint Approach to OTC clearing are that it:

* Accommodates regional differences in business hours, banking relationships, taxes, etc.
* Provides for combined positions and clearing for OTC transactions and transactions on one or more stock exchanges, in the same security.
* Connects to the Pacific Securities Depository, which will ultimately interface with Central Certificate Service and other depositories as formed.
* Permits local flexibility and creativity in developing new and improved services for brokers.
* Can insulate local brokers from national changes.
* Provides good response to local brokers by virtue of local control and responsibility.

"ONE AGENCY" APPROACH

The "one agency" approach is based on a uniform over-the-counter clearing system established in all parts of the country, including the Pacific Coast. The OTC clearing facilities on the West Coast might be contiguous to the listed clearing facilities. However, the broker's OTC transactions and OTC clearing requirements would be entirely independent of any other clearing facilities in which he participates.

Advantages to the "One Agency" Approach to OTC Clearing are that it:

* Does not require coordination with regional centers.
* May connect ultimately to central certificate service.
* Provides all brokers identical services.

JOINT APPROACH	"ONE AGENCY" APPROACH
* Reduces conversion costs for national changes by centralizing conversion efforts in PCC.	
* Provides regional cost control for regional services.	* Permits economies of scale.
* For the national system, reduces the impact of local problems and thus avoids the "least common denominator" effect.	* Provides uniform rules and fees for all brokers.
* Avoids duplication of clearing facilities.	* Provides dedicated facilities for OTC clearing.
* Maximizes intra-regional netting and minimizes shipping costs.	* May provide for intra-regional settlement.
* Provides for direct institutional participation in the clearing process, reducing the workload on brokers and expediting the settlement process.	

A comparison of the advantages listed above shows that considerations of cost, efficiency, and service favor the joint approach over the "one agency" approach.

INDUSTRY AND REGULATORY VIEWS ON INTERFACE

- **SIA**

  The *Seven Criteria for the Establishment of a National Clearing and Depository System* of the SIA state that all firms should be members of one national clearing entity interfaced with one national depository, processing transactions between members in a standard manner and developing only one position per security for a member, with standard fund payments and with regional facilities for the handling of securities. The Pacific Coast Stock Exchange has been informed by SIA that the Joint Approach is entirely consistent with SIA's objectives. In fact, PCC now has the only facility in the nation which provides the capability that SIA desires on a national scale.

- **Central Market System**

  The Martin Report, the SEC, the Congress, and the Exchanges have stated that they support a concept of multiple markets for listed securities. These markets would be linked together electronically to provide access for any order to the best available market. This interface of multiple, similar marketplaces parallels the joint approach for clearing as proposed by PCC.

- **National Coordinating Committee for Depositories**

  "Thus, as outlined, we endorse the concept of a nationwide system of interrelated regional depositories. This approach provides the opportunity to develop the depository concept more quickly, utilizing many existing facilities."

  "A regional approach will be more responsive to local needs and capabilities."

  (Above quotes from John H. Perkins, Chairman of the National Coordinating Group for Comprehensive Securities Depositories, Testimony to the United States Senate Committee on Banking, Housing and Urban Affairs on September 8, 1972.)

  The National Coordinating Committee for Depositories has committed itself to a system of linked regional depositories. These depositories will be connected so that a supply in one may be balanced against a demand in another, and the necessary interface to accomplish this between Pacific Securities Depository and Central Certificate Service is now a major effort to which both organizations have committed themselves. The maintenance of parallel progress and development between clearing systems and depository systems is essential for the efficient conduct of business by the industry in the future.

– SEC

"Rather we should help the firms facing a multiplicity of clearing systems and provide a milieu for the different systems to compete for the business of the brokerage industry. This can be done by providing an interface of the various clearing corporations." (Quoted from memo of June 2, 1972, from Morris N. Simkin, Special Counsel – Division of Trading and Markets to Irving M. Pollack, Director of the Division of Trading and Markets.)

– Congress

"An applicant shall not be registered as a clearing agency unless it appears to the Commission that – . . . the rules of the clearing agency are designed . . . to foster cooperation and coordination . . . with other clearing agencies." (From Senate Bill 3876, National Securities Transfer System, passed by the Senate in August 1972, and sent to the House.)

WHY PCSE SUPPORTS THE JOINT APPROACH

In the fifteen years since the merger of the Los Angeles and San Francisco Stock Exchanges, the Pacific Coast Stock Exchange has pioneered and perfected a net-by-net (or continuous net) clearing service which provides for its members:

- Common listed and OTC positions for transactions in all marketplaces
- Complete depository facilities
- Clearing/depository interface for all listed and a broad range of OTC securities
- Direct participation by institutions
- Close working relationships with banks.

The securities industry on the West Coast has thus achieved many of the goals which the industry is working toward on a national scale. To deny Western clearing members these advantages would be a step backward, particularly because the joint approach provides a means of progressing toward these goals nationally without retrogressing locally.

For clearing members in the Pacific area, objective considerations of cost, time, efficiency, and service favor the joint approach over the single agency approach.

IMPLEMENTATION PLAN

for Interfacing
the Clearing Systems
of

PACIFIC CLEARING CORPORATION

NATIONAL CLEARING CORPORATION

March 1973 PMM&Co Peat, Marwick, Mitchell & Co.

98-978 O - 73 - 6

PEAT, MARWICK, MITCHELL & CO.
CERTIFIED PUBLIC ACCOUNTANTS
555 SOUTH FLOWER STREET
LOS ANGELES, CALIFORNIA 90071

March 14, 1973

Mr. Christopher J. Delahunty, President
Pacific Clearing Corporation
453 South Spring Street
Los Angeles, California 90014

Dear Mr. Delahunty:

We have completed our engagement to prepare an implementation plan for interfacing the clearing system of Pacific Clearing Corporation and National Clearing Corporation.

The enclosed report describes the plan fully and is organized into the following sections:

I	–	Introduction
II	–	Interface Concept
III	–	Policy Assumptions
IV	–	Interface System
V	–	Data Processing Requirements
VI	–	Operating and Implementation Cost Summary
VII	–	Implementation Time Schedule

* * * *

We greatly appreciate the cooperation extended to us by the staffs of Pacific Clearing Corporation and National Clearing Corporation in working on this important assignment.

Very truly yours,

Peat, Marwick, Mitchell & Co.

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I – INTRODUCTION

BACKGROUND

Clearing of securities became a problem to the industry in 1967, when growth in trading volume created operational congestion. This congestion was particularly severe in the over-the-counter area because of the limited clearing facilities available. New York brokers, through the National Over-the-Counter Clearing Corporation (NOTC), and Pacific brokers, through the Pacific Clearing Corporation (which began clearing OTC trades in 1965) had access to intra-regional clearing; virtually all other OTC settlements were handled broker to broker.

In 1968, Arthur D. Little & Co. conducted a study for the NASD, regarding the establishment of an over-the-counter clearing system. Its report concluded that the continuous netting system used by the Pacific Clearing Corporation (PCC) should be the foundation of the over-the-counter system.

After the release of this report, PCC stated to the SEC and the NASD that the establishment of a national over-the-counter clearing network was an appropriate function of the NASD rather than of the Exchange, and that the continuous netting system would be made available to the NASD. At the same time, the NASD was forming the National Clearing Corporation (NCC) to implement the recommendations of the report.

While NCC was being formed, the Midwest Stock Exchange undertook a study of the continuous netting system and was similarly given access to the PCC facilities and system. As a result of this study, Midwest decided to convert its clearing system to the continuous netting concept. During this period, the PCC received assistance from the American Stock Exchange in converting the trade input procedures on the West Coast to be compatible with those used by NOTC. At the completion of this effort in late 1969, a limited inter-regional clearing operation began between NOTC and PCC.

During 1970, at NCC's request, NCC and PCC attempted a joint effort to develop a clearing system for over-the-counter transactions throughout the country. An NCC task force was established on the West Coast and the two organizations worked closely for a number of

months. Differences in operational philosophies arose, and in 1971, NCC decided to stop its efforts on the West Coast in favor of introducing the continuous netting system in the New York area. Shortly afterwards, NCC acquired NOTC.

Also in 1971, a series of meetings began among the clearing organizations of the industry to identify areas in which they could help one another. Resulting from those meetings, various delivery and transfer services have been arranged between a number of clearing organizations.

To aid in resolving the problem of national OTC clearing, the Securities Industry Association formed an Ad Hoc Task Force. During a meeting of this committee on November 8, 1972, in Monterey, California, presentations were made by the National Clearing Corporation and the Pacific Clearing Corporation addressing the question of how best to approach national OTC clearing.

After the presentations, the committee met and recommended the following:

"1. The eventual creation of one national clearing entity for all transactions.

2. That access be provided for all broker/dealers qualified by the entity.

3. That the Pacific Clearing Corporation prepare a detailed implementation plan for interface between NCC and POTC. This plan is to include, but not be limited to, time frames, costs, and access as outlined in No. 2 above. Further, that the plan be completed within ninety days and then submitted to the Boards of NCC and POTC for consideration."

SCOPE AND OBJECTIVE

Peat, Marwick, Mitchell & Co. (PMM&Co.) was engaged by PCC to assist in preparing the detailed implementation plan as described in S.I.A. recommendation No. 3 above. This report is the result of that engagement.

It should be noted that the scope of PMM&Co.'s assignment was not to evaluate clearing approaches other than interface, nor to select the most appropriate method. In effect, PMM&Co. was to determine a feasible implementation plan, including cost estimates, based on the assumptions provided by PCC.

APPROACH

To prepare the implementation plan, PMM&Co. performed the following tasks:

1. Reviewed existing documentation related to the PCC and NCC net settlement systems.

2. Reviewed the history of the systems' development and previous approaches to interface.

3. Reviewed documentation pertaining to the PCC and NCC approaches to interface.

4. Visited NCC and PCC clearing centers and observed clearing operations.

5. Interviewed members of management and staff of PCC and NCC to determine factors related to interface.

6. Analyzed the data gathered through research, interviews and observations, and prepared the implementation plan.

II – INTERFACE CONCEPT

For purposes of this report, interface is defined as a method for linking together clearing organizations; in this case NCC and PCC.

MAJOR PREMISES OF INTERFACE

The discussions of interface are based upon three major premises:

1. Regional clearing corporations would provide their members with clearing house services for intra-regional trades.

2. Regional clearing corporations would communicate with each other to provide their members with clearing house services for inter-regional trades.

3. Regional clearing corporations would provide their members with a single reporting system which would combine the trading and settlement information for both intra- and inter-regional trades as well as a single local facility for stock and money settlement, and delivery.

INTERFACE METHODOLOGY SELECTION

The method utilized in the communication of inter-regional trades is of primary concern since, to a large extent, it defines the relationship between clearing corporations.

The selection of an interface method is affected by the similarities between the systems that are being linked together. In the interface between PCC and NCC systems, there are several functions that are similar in concept although operational procedures may differ. These similarities include:

Function	Present in PCC system	Present in NCC system
Continuous Net Settlement	Yes	Yes
Depository	Yes	Under consideration
T+4 Delivery	Yes	Yes

Function	Present in PCC system	Present in NCC system
Dividend Protection	Yes	Yes
OTC Clearing	Yes	Yes
Listed Clearing	Yes	No
Stock transfer services for members	Yes	Yes
Member protection against failures	Yes	Yes
Comparison of block trades	Yes	Yes

Given the similarities between the two systems, several interface methods appear to exist. For the purpose of this report, however, some selection of a specific method is required. Therefore, a key presumption was made to utilize Pacific Clearing Corporation's dual trade comparison concept. We accepted this concept and did not compare it with other approaches to interface.

The purpose of this section of the report is to describe, in a basic manner, the dual trade comparison interface concept. Section IV of the report describes the process in greater detail.

INTERFACE USING DUAL TRADE COMPARISON

The dual trade comparison approach involves the linkage of regional clearing operations by a national system of inter-regional communications and accounts. Over-the-counter trade information, as it relates to all inter-regional trades, would be exchanged between the two clearing corporations. This trade data would enter both clearing systems and be processed at *both* sites instead of just one location, as is presently done for intra-regional trades. Both clearing corporations would balance and settle their positions with each other through the use of omnibus accounts.

An individual broker would receive his reports from his clearing corporation and would effect all money and stock settlement with it. These reports would include data for both intra- and inter-regional trades. Each broker would be assigned a distinctive number or symbol to identify him and the clearing corporation of which he is a member.

Brokers would be able to effect trades with members of other clearing corporations by having each broker enter the trade to his clearing center. The trade data would be identified as

an inter-regional transaction and would be isolated by each clearing center. Each trade would then be transmitted to the contra clearing center via a data communications interface. Therefore, both sides of an inter-regional trade would exist at the clearing center of the buying broker *and* at the center of the selling broker.

Each clearing operation would operate independently of the other operation once the data transmission is complete. The trade data would enter both clearing systems and would be validated and processed. The broker would receive reports indicating any errors on his reported trade from the clearing center of which he is a member. Corrections to trades would also be entered at the broker's clearing center and transmitted to the contra broker's center. This input data would also be processed by both clearing operations.

SETTLEMENT USING OMNIBUS ACCOUNTS

Prior to settlement date, the broker would be advised of the securities and money due to or from him. He would be required to settle his positions only with his clearing center. This settlement would include intra- and inter-regional trades.

The regional clearing operations would also be advised of the securities and money due to or from them as a result of all inter-regional trades. This information would be netted with respect to each clearing operation by the use of omnibus accounts. The clearing corporations would settle these positions with each other daily, utilizing the omnibus accounts.

DEPOSITORY OR SAFEKEEPING CONSIDERATIONS

Depositories, or safekeeping accounts, can be effectively used to avoid the requirement of physically moving certificates which are allocated to the omnibus account. A depository, or safekeeping account, is no more than a custodian for securities placed on deposit by various members. PCC is currently interfaced with its wholly owned subsidiary, Pacific Securities Depository (PSD), and is implementing a program to increase utilization of the depository.

To reduce transcontinental security movement, it appears to be desirable for each clearing corporation to maintain an account with the other corporation's depository. Using NCC membership in PSD as an example, PCC could allocate securities to the omnibus account and automatically add these allocations to the NCC account at PSD. NCC could use these positions to deliver securities to PCC for satisfaction of some future omnibus account balance. NCC could also use these positions to deliver securities to NCC members who require availability of securities on the West Coast. The converse, relating to a PCC account in the NCC safekeeping facility, would operate in a similar manner.

The major advantage of such a system would be to eliminate the movement of certificates across the country each time one clearing organization makes an allocation to the omnibus account. Each clearing organization would be able to withdraw from its depository account and move securities across the country, but this would only be done as needed. As increasing numbers of certificates become immobilized in such depositories, the need to remove certificates and physically move them should be reduced. This need should be further reduced as depositories and clearing organizations develop increased numbers of interfaces and as banks and other financial institutions having substantial impact on the securities industry join the depositories.

One of the main advantages of a depository facility is elimination of clearing problems in allocating certificates because of denominations which are unacceptable for filling member positions. If the member is required to take receipts from the clearing organization in his depository account, he submits a request to the depository to physically withdraw the certificates. The depository would have a large holding of certificates of various denominations for each security and would be able to meet his request without finding it necessary to send certificates out to transfer.

This means that a clearing organization should be able to allocate all its certificates each day, since every security submitted to the clearing organization is owed by clearing to some other member or members. At present, PCC and NCC are unable to allocate all the certificates submitted to them, as the certificates may be in denominations that are not acceptable to members to whom clearing owes that security.

III – POLICY ASSUMPTIONS

This section of the report describes the policy assumptions inherent in the PCC dual trade comparison approach to interfacing the PCC and NCC systems. Most items in this section relate to matters discussed more fully in Section IV, which describes the operation of the interface system. However, some policy assumptions that are general in nature and do not relate to procedural matters of the interface system are also presented in this section.

ACCESS STANDARDS

It is assumed that each clearing member of either clearing corporation would be able to engage in inter-regional trades.

Present NCC membership requirements include

- NASD membership,
- submission of a clearing fund deposit, and
- maintenance of the deposit based on activity.

Present PCC membership requirements include

- NASD membership,
- submission of a clearing fund deposit,
- maintenance of the deposit based on activity, and
- meeting of PCSE capital requirements.

PCC has indicated that this last item, PCSE capital requirements, would be waived for interface purposes. Therefore, the capital requirements would be the same.

TRADE REPORTING

Brokers would report inter-regional trades to the same clearing corporation to which they report intra-regional trades (and listed trades, for PCC members). If a broker retains

membership in both NCC and PCC, he may then have the option to submit trades to either clearing corporation or both.

The liabilities that could result from the input of erroneous trade data would be assumed by the clearing corporation submitting the erroneous input. This is a legal decision requiring resolution by PCC and NCC.

ELIGIBLE SECURITIES

Securities eligible for inter-regional trading between PCC and NCC would be retained on both systems' security master files. For inter-regional trades, if NCC suspends clearance and settlement of a security, it would also be suspended by PCC. Intra-regional trading capabilities could still exist within PCC, but inter-regional trades would not be possible. In addition, PCC has agreed to clear all securities considered eligible for clearing by NCC.

SECURITY PRICING

The price of securities traded inter-regionally between PCC and NCC must be the same in each clearing system. Price differences would cause the omnibus accounts to be out of balance when valuing open positions and calculating mark-to-market amounts. At present, NCC uses an average price based upon the last three days of trading while PCC utilizes an average of the most recent day's NASDAQ price. This report assumes that, when a difference in a security price exists for a security that is traded inter-regionally, the NCC price will be used.

The policy for pricing of listed securities which are traded over-the-counter will have to be resolved. If the listed security were only traded at one exchange (NY or AMEX), that exchange's price would appear appropriate. For listed securities that are traded at more than one exchange, AMEX and PCSE for example, the price used by the primary exchange would seem more appropriate.

BUY-IN PROCEDURES

Each clearing corporation would assume the same liabilities with respect to buy-in's as now exist with clearing members. A clearing corporation would receive a transmitted notice of

a buy-in if its omnibus account indicates a significant net short position in the security involved. All costs incurred with respect to a buy-in would be charged on a pro rata basis to the contra clearing corporation, based on the security short position.

CLEARING FUNDS

The following four assumptions are made relative to clearing fund requirements and liabilities:

- Individual clearing members would satisfy their clearing corporation fund requirements only.
- Each clearing corporation would guarantee the financial responsibility of its members.
- NCC Operating Rule 5(e), (f), and (g) would be observed. This rule relates to the use of a member's fund should he fail to meet his financial obligations. In this respect each corporation would have access to its regular member's funds in the same manner as at present. However, there would be no access to the clearing funds of the other corporation's members.
- NCC Operating Rule 5(h) would apply. Clearing funds would not be applicable to failures related to block trades.

DIVIDENDS

Cash or stock dividends and stock splits should be processed identically by both PCC and NCC systems. This approach requires the adoption of a standard set of dividend rules by both entities. Accordingly, NCC Operating Rule 10 would be adopted by PCC. A brief summary of Rule 10 follows:

- The amount due to or from a clearing member shall enter the net settlement system.
- Dividend protection is provided between cutoff date and record date.
- Cash dividends will be included in net settlement on payment date.
- Fractional shares will be settled on a cash-in-lieu basis.

- The clearing member is required to submit transfer instructions representing the additional shares due on position transfers as a result of stock dividends, splits or distributions.

- No dividend protection is provided on "As of" and "Withhold" trades and "Advisories" entered on or about cutoff date.

- On or after ex-date the trades permitted to enter the system shall be at the ex-dividend price. Subsequent to record date the clearing corporation shall only settle at the ex-dividend price.

- When a dividend in securities *not* qualified for clearance is declared on a security which *is* qualified for clearance, the clearing corporation will only clear and settle the resulting positions in the nonqualified security. This settlement will be for dividend purposes only.

- Dividend protection will not apply to rights offerings.

Establishment of a policy regarding dividend cutoff dates requires resolution between PCC and NCC. This subject is discussed further in Section IV of the report.

MOVEMENT OF SECURITIES

Inter-regional movement of securities should follow allocation procedures. This would require shipment of securities five days after the trade date (T+5), the settlement date. It appears that the movement of securities between the East and West Coasts would involve one day's financing even when individual clearing members deliver on T+4. It would also appear that the financial burden of financing the securities would be assumed by the clearing corporation delivering the securities.

When a safekeeping system is established on the East Coast, there should be a decrease in the number of stock movements. Rather than delivering securities from coast to coast, the contra clearing corporation's local depository account would be credited for certificates they are due to receive. In this manner, the financing of securities in transit would be reduced. After securities had been credited to a clearing corporation's position in the depository, it would be the responsibility of that corporation to finance any movement of securities from one coast to the other.

It appears that consideration should be given to the potential impact of New York transfer tax related to the financing of transcontinental security movements. These considerations require identification and resolution by NCC and PCC.

Securities lost in transit would be financed by the delivering clearing corporation prior to replacement. This parallels the current procedures between members and clearing corporations. The broker is responsible for securities until clearing acknowledges receipt.

BLOCK TRADES

The definition of block trades, as stated in the NCC Operating Rule 1, would apply for both clearing corporations. A brief summary of the rule states that block trades are transactions involving the same security made at the same price per share. The aggregate value, at contract price, of the securities traded is $250,000 or more. Also, at the option of the parties involved, a block trade may be denoted by the broker if the trade involves the same security at the same price and if the aggregate value at contract price of the securities traded is $75,000 or more. Both parties must report this trade as a block trade on their reporting blotters.

The NCC Operating Rule 12 is also assumed for processing of block trades. A brief summary of Rule 12 is as follows:

- A compared block trade shall be cleared and settled on a trade-for-trade basis and would not be cleared through the net settlement system.
- Dividend protection would not apply to block trades.

MONEY SETTLEMENT BETWEEN PCC AND NCC

It is assumed that money balances, as shown in the omnibus account money positions, would be settled daily between PCC and NCC. The use of a common type of fund for settlement purposes would be advantageous. It has been suggested that clearing house funds would be used for this purpose. This issue requires resolution by PCC and NCC.

INTERFACE POLICY COMMITTEE

Due to the continuing changes within the securities industry, and the requirement for clearing systems to reflect the changes in members' needs and regulatory requirements, it is assumed that an Interface Policy Committee would be formed. The committee would include senior members of management of PCC and NCC as well as representatives from the East and West Coast brokerage communities.

The role of the committee would be to make decisions in rules and policies related to interface.

IV – INTERFACE SYSTEM

This section of the report describes the PCC-NCC interface system. It should be noted that no evaluation of the dual trade comparison concept is intended or implied. The purpose is to describe how such an interface, if implemented, would function.

This section of the report is divided into separate discussions for each major function or aspect of interface. In general, each discussion is organized as follows:

- Definition
- Interface Considerations
- Current PCC Practices
- Current NCC Practices
- Interface Assumptions
- Required Modifications.

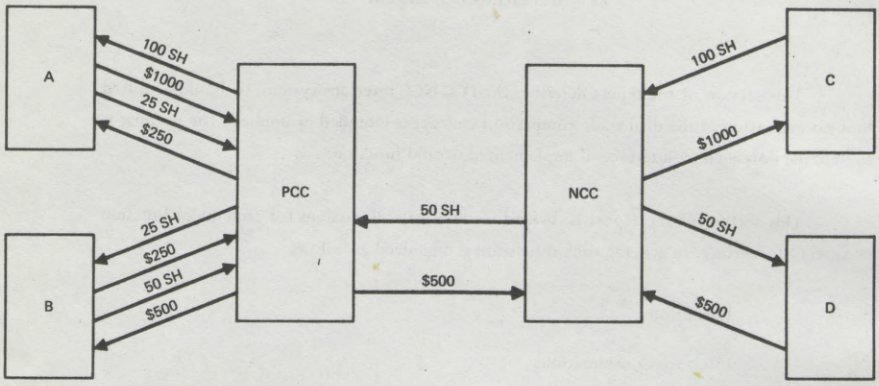
A description of the required implementation tasks, related timings and costs are presented in Sections VI and VII of this report.

DUAL TRADE COMPARISON – AN ILLUSTRATED EXAMPLE

Prior to discussing each separate function or aspect of interface, an illustrated example of the dual trade comparison process is presented. This will enable the reader to more fully understand the relationships among the clearing corporations and their members.

This process can best be illustrated by an example. Assume two clearing corporations, NCC and PCC. Further assume four brokers. Brokers A and B are members of PCC, and brokers C and D are members of NCC. To illustrate the process, several trades will be followed through the systems.

DUAL TRADE COMPARISON
SCHEMATIC ILLUSTRATION



SETTLEMENT SHEETS

A

SHARES L	S	$ TO PCC	FROM PCC
75		750	

B

SHARES L	S	$ TO PCC	FROM PCC
	25		250

NET POSITION AND ACCOUNTING REPORT

C

SHARES L	S	$ TO NCC	FROM NCC
	100		1000

D

SHARES L	S	$ TO NCC	FROM NCC
50		500	

NCC OMNIBUS

SHARES L	S	$ TO NCC	FROM NCC
50		500	

PCC OMNIBUS

SHARES L	S	$ TO PCC	FROM PCC
	50		500

The schematic on the facing page depicts the following transactions.

Transaction number	Buying broker	Selling broker	Number of shares	Price per share	Value of trade
1	A	C	100	$ 10	$ 1,000
2	B	A	25	10	250
3	D	B	50	10	500

Transactions 1 and 3 are inter-regional trades while transaction 2 is a PCC intra-regional trade.

Broker A would submit a "buy" transaction to PCC, who in turn would transmit the "buy" to NCC. At the same time, Broker C would submit a "sell" transaction to NCC, who would transmit the "sell" to PCC. Both clearing corporations now have both sides of the trade within their net settlement systems. Transaction 3 would work in a similar manner. Transaction 2, since it is a PCC intra-regional trade, does not require the transmission of any data to NCC. Trade reporting is described in greater detail in Section IV of this report.

The net effect of the trades can be seen on each broker's reports. Broker A is long 75 shares and owes PCC $750. Broker B is short 25 shares and is due $250 from PCC, Broker C is short 100 shares and is due $1,000 from NCC, and Broker D is long 50 shares and owes NCC $500.

In all cases the individual broker is long or short, owes or is due money from his own clearing corporation. As far as the clearing corporations are concerned, the contra side to its members' activities is the other clearing corporation.

Between the two clearing corporations, individual shares of a stock and all monies are netted. Instead of PCC owing NCC 50 shares and $1,000 and NCC owing PCC 100 shares and $500, only the net difference is required for settlement. The two omnibus accounts reflect each clearing corporation's relationship with the other. As can be seen from Pacific Clearing's NCC omnibus account, PCC is long 50 shares and owes NCC $500. Correspondingly, National Clearing's PCC omnibus account shows that NCC is short 50 shares and is due $500 from PCC. Only one payment and one stock movement per security is necessary.

TRADE REPORTING

Members of the clearing corporations submit "buy" and "sell" trade information to clearing on a daily basis. For control purposes, each member is also required to total the trades by batch before submitting them to clearing.

The type of input media by which the member submits his trade information may be in three forms:

- Trade Tickets
- Trade Reporting Blotters
- Computer Readable Media.

The clearing member is further required to submit the trade information to clearing by a specified time. This can be accomplished by physical delivery to clearing, utilizing messengers, mail services, or a form of data transmission acceptable to clearing.

The items of information that must be specified for each trade are as follows:

- Type of Trade – either a "buy" or a "sell"
- Block Trade Identification
- Trade Date
- Submitting House
- Contra House
- Security Number (CUSIP)
- Number of Shares Traded
- Security Description
- Per Share Price or Extended Amount.

(a) Interface Considerations

Both clearing operations are required to isolate inter-regional trades from all trades submitted to their operation. This will be accomplished by identifying the contra house as a member of the other clearing center. This inter-regional trade information is then exchanged between both clearing centers. This will be accomplished via a data communications network, as described in Section V.

To accomplish trade comparison by both systems, a CUSIP number must be specified as the security number.

(b) PCC Practices

The PCC system currently accepts trade input as previously specified, with one exception. Block trade identification is available but is not currently utilized. A complete description of block trade requirements is found under the caption entitled TRADE COMPARISON in this section. The system utilizes CUSIP numbers.

(c) NCC Practices

The NCC system currently adheres to the reporting requirements previously defined. The system utilizes CUSIP numbers and block trade identifiers are utilized.

(d) Required Modifications

PCC must modify its broker reporting procedures to allow for identification of block trades. The decision rule for this identification is described later in this section.

The timing of trade reporting is a factor that must be considered. Trade input data should arrive at each clearing operation in time to be included in the trade validation and comparison processes.

The primary time constraint relates to trade reporting from the West Coast to NCC. At present, the operating time schedule of the NCC system requires that trade input data be in

machine readable form and ready for input to the system by 1:00 PM on T+1. This corresponds to 10:00 AM on T+1 on the West Coast. Allowing time for data preparation and transmission, it would appear that West Coast brokers would be required to submit their inter-regional trades no later than 8:00 AM on T+1.

A desired goal of interface is the optimization of clearing corporation schedules to provide the maximum time for brokers to prepare input. To this end, it may be necessary for both clearing corporations to modify their internal processing time schedules to accommodate West Coast brokers.

TRADE VALIDATION

Prior to entering the trade comparison system, all trade information submitted by clearing members and the other clearing operation enters a trade validation process. All trades are validated through the following steps:

1. All data fields must contain the proper kind of alphabetic or numeric data.
2. The buying and selling houses must be clearing members of their respective clearing corporations.
3. The security traded must be authorized for inter-regional trades.
4. The contract price must be in the proper format.

If a trade fails one of the validation tests, the reason for its rejection is identified on an error report and returned to the submitting member. Only trades that pass all the above validation tests are allowed to proceed to the trade comparison process.

(a) Interface Considerations

One of the validation tests previously defined requires both the buying and the selling houses to be clearing members. To accommodate inter-regional trades, clearing member, security and dividend master files must be exchanged and kept current between NCC and PCC to insure successful validation. The maintenance of master files is discussed in Section V.

(b) PCC Practices

The PCC system currently validates trade input through the four steps described above.

(c) NCC Practices

The NCC system also utilizes the same trade validation concept.

(d) Required Modifications

Both systems must develop the capability to utilize member master files of the other clearing corporation in their validation processes. This may not require modification to the individual systems but it may necessitate enlarging the master files.

TRADE COMPARISON

The trade comparison process is the procedure by which the trade input received from the seller and the buyer is compared by the clearing system. The result of the trade comparison process is a matched trade which enters the net settlement system. Both sides of a trade must agree as to the proper data elements needed for settlement:

- Trade Date
- "Buy" House
- "Sell" House
- Security Number (CUSIP)
- Price
- Shares Traded.

Two types of trades are handled by the trade comparison process:

- Nonblock trades
- Block trades.

In order for nonblock trades to compare, the "buys" and "sells" must be identical on all input fields except the "shares traded" field. "Buys" and "sells" are summarized to produce a group with one net number of shares traded. These groups are compared and matched on all fields, including total number of shares traded. Nonmatched groups are processed as follows:

- The group with the highest total is searched to find any combination of trades which, when omitted, will produce equal totals.
- If that fails, both "buys" and "sells" are searched again to attempt to find one or two trades in the group with the lowest total which, when omitted in combination with any number of trades in the highest group, will produce equal totals for the remainder. Those that produce the combination when omitted are considered uncompared, and the remainder is compared.
- If the above fails to produce any compared trades, the "buys" and "sells" are again searched to find any individual "buys" that are strictly equal to individual "sells" on the number of shares. These are considered compared, and all remaining trades are uncompared.

Compared trades enter the net settlement system while uncompared trades do not.

Block trades are defined as trades having an extended contract amount above a certain dollar amount specified by the NCC Operating Rule 1 (currently $250,000). They can also be specifically coded as blocks by the NCC member, subject to a certain minimum dollar amount criterion specified by the NCC Operating Rule 1 (presently $75,000). It is at the broker's discretion to identify a trade as a block trade if its value is between $75,000 and $250,000.

The comparison process is the same for both block and nonblock trades, except that block trades must also agree as to the number of shares traded. Compared block trades do not enter the net settlement system.

(a) Interface Considerations

Both systems must have the ability to process block and nonblock trade in the same manner.

(b) PCC Practices

Nonblock trades are currently processed by the PCC system as defined above. Block trades are currently defined by PCC as any trade at the same unit price per share with an extended amount greater than $50,000. These trades are automatically identified as block trades by the PCC system. The member does not have the option to specify a trade as being a block. Block trades *do* enter the net settlement system and are included in the member's net settlement position.

(c) NCC Practices

Block and nonblock trades are processed by the NCC system as previously defined; they *do not* enter the net settlement part of the system.

(d) Interface Assumptions

PCC should adopt the NCC Rule 1 definition of a block trade. PCC should also adopt the processing procedures for block trades as specified in NCC Rule 12, i.e., they do not become part of net settlement.

(e) Required Modifications

PCC would be required to begin processing block trade identification and separation within its system. Furthermore, the PCC net settlement system would be modified to eliminate block trades.

TRADE REPORTING TO MEMBERS

The trade comparison system produces four output reports for clearing members:

- Comparison List – Sales
- Comparison List – Purchases
- Advisory List – Sales
- Advisory List – Purchases.

The comparison lists reflect the input data submitted by the member and the other clearing corporation and show the results of the comparison process. Separate comparison lists are provided for sales and purchases. The information included in the comparison lists is as follows:

- Compared Trades – trades submitted by the buyer and seller that match. These compared trades enter the Net Settlement System.
- Security Description – CUSIP number, description, and per share contract price.
- Uncompared Trades – trades submitted by the other clearing corporation that did not match the trades submitted by the local member. These uncompared trades do not enter the net settlement system, but are retained by the system to allow for error reentry.
- Advisory Trades – uncompared trades submitted by the contra clearing corporation. These trades do not enter net settlement, but are retained for error correction.

Advisories and uncompared trades are related. Valid uncompared trades of the submitting member appear as advisories to the contra member. Conversely, all valid uncompared trades submitted by the contra member would appear as advisories to the local clearing member.

The information contained in the advisory lists is identical to the advisory information shown on the comparison lists. Included in the advisory lists is an advisory number generated by the comparison system. This number is used by the member for reentering corrected trade information. The correction process is further discussed and illustrated later in this section.

(a) Interface Considerations

Both clearing corporations would only be required to produce comparison and advisory lists for their members. Since processing is performed by both clearing corporations, the contra member's lists would be generated by his clearing corporation. In this manner, both intra- and inter-regional trades of a member would be incorporated on one trade reporting blotter.

(b) Required Modifications

Both the NCC and PCC systems currently have the ability to produce comparison and advisory lists reflecting both sides of a trade. Unless the systems were modified, these reports would be generated at both centers for inter-regional trades thus producing redundant information. Accordingly, both systems should be modified to bypass report generation for the contra member of an inter-regional trade.

CORRECTING TRADES

Since trade reporting data from the brokers may contain errors, a mechanism must be available to correct these errors. Both the PCC and NCC systems utilize the same correction concept, although there are some operational differences.

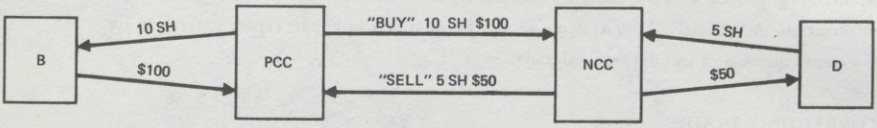
When a trade does not compare in the present systems, both brokers (assuming an intra-regional trade) are notified that a trade they submitted did not compare. Each broker is sent a computer printed report showing his input as an uncompared item and the input of the contra broker as a advisory item. Each advisory item is assigned a unique number. The two brokers communicate with each other and determine who was in error. The broker who made the error submits the advisory, using the unique number, to his clearing corporation. This informs clearing that the other broker was correct and that he, the broker in error, confirms the trade as reported by the contra broker, who entered the data correctly. A compared trade then exists, and the system proceeds with net settlement. If an advisory is not submitted on or before T+3, both sides of the trade will be dropped from the system.

(a) Interface Considerations

It is essential that, when an inter-regional trade is compared by advisory in one system, it results in a compared trade in the other system.

Since each system generates advisory numbers independently of the other system, an acceptable advisory number in one system would be invalid in the other. To ensure that a valid trade be communicated from the system that has a compared by advisory trade to the other system, it appears that an acceptable approach would be to transmit both sides of the trade, the "buy" and the "sell."

DUAL TRADE COMPARISON — CORRECTIONS
SCHEMATIC ILLUSTRATION



COMPARISON LIST-SALES

B

BKR	UNCOMP	ADV#	ADV
D	10	①	5

COMPARISON LIST-PURCHASES

D

BKR	UNCOMP	ADV#	ADV
B	5	②	10

COMPARISON LIST-SALES

D

BKR	UNCOMP	ADV#	ADV
B	5	③	10

COMPARISON LIST-PURCHASES

B

BKR	UNCOMP	ADV#	ADV
D	10	④	5

The facing page illustrates what would occur assuming the following transaction. B buys 10 shares at $10/share from D (D, in error, enters 5 shares sold). Broker B sends data concerning his "buy" (10 shares, $100) to PCC, who transmits this data to NCC. Both clearing corporations now have a "buy" in their systems. Broker D, in error, sends data regarding the "sell" (5 shares, $50) to NCC, who transmits this data to PCC. Both systems now have both a "buy" and a "sell" but they do not compare.

Each system would, if unmodified, generate the required comparison lists and advisories. PCC would generate a report for Broker B showing an uncompared trade of 10 shares and an advisory, arbitrarily called ①, for 5 shares. PCC would also generate a report for Broker D showing an uncompared trade for 5 shares and an advisory ② for 10 shares. At the same time, NCC would be generating the same reports. Broker D would receive an uncompared trade for 5 shares and an advisory ticket ③ for 10 shares. NCC would also generate a report for Broker B for an uncompared trade of 10 shares and an advisory ④ for 5 shares. Both sets of reports, at PCC and NCC, are the same, with the exception of advisory numbers. Since Broker D is a member of NCC and is presumably located on the East Coast, it would not be necessary for PCC to print the Broker D report. Broker D would receive the same report from NCC. Similarly, it would not be necessary for NCC to print Broker B's report.

The two brokers, after reviewing their reports, would know that an error has occurred and would communicate with each other. To correct the error, Broker D should submit the advisory ③ for 10 shares. The 5 share "sell" will automatically drop out of both systems if it remains uncompared.

When Broker D submits advisory ③ for 10 shares to NCC, a compared trade will result. If this advisory data were to be transmitted to PCC however, some confusion would ensue since advisory ③ would not be recognized as a valid advisory number.

To solve this problem, NCC would not transmit the advisory; it would transmit both sides of the compared trade. In effect, this would be a new trade, which would automatically compare, since it is computer-, not broker-, generated. Within the PCC system, the old 10 share "buy" and 5 share "sell" would automatically be dropped, since they were never compared.

(b) Required Modifications

Both clearing systems, PCC and NCC, would have to be modified to recognize an inter-regional compared by advisory trade within their system. Each system would then be required to generate both the "buy" and the "sell" of a compared trade.

NET SETTLEMENT

Each member's compared trades are accumulated until the day before settlement date (T+5), at which time the trades due to settle are netted out for each security. In this process, "buys" and "sells" are offset, and a single net balance position is combined with the previous day's (T+4) position and carried forward for each security.

Each clearing member receives a report indicating his daily net money and security positions with clearing. The member's net position report includes the following items that affect his daily net positions.

- Trades Settling Today
- Receipts from Clearing
- Deliveries to Clearing
- Reclamations and Other Adjustments
- Stock Dividends Payable
- Transfers.

A daily mark-to-market amount, reflecting the fluctuation in market price of a security, is calculated and is paid to, or received from, clearing as part of the day's money settlement. The mark-to-market routine provides a means whereby protection is afforded to members in the event of a fail by a member to deliver against his short position.

Open purchases are marked-to-market on a daily basis, beginning on settlement date. Stock dividends are also included in the calculation beginning on the day after record date.

The member uses the Net Settlement report to determine the money amounts to or from clearing daily.

Compared block trades do not enter the net settlement system. Once block trades pass the trade comparison tests, they are settled ex-clearing, utilizing the clearing corporation as an intermediary for money and security transfer.

Clearing corporation positions with respect to the contra clearing corporation are netted in a manner similar to that of members through the use of omnibus accounts. This will be further described under the caption OMNIBUS ACCOUNTS.

(a) Interface Considerations

Member net settlement would not be affected by the inclusion of inter-regional trade information. Money and security settlement would still be made between the clearing corporations and their members. Clearing must have the ability to isolate inter-regional trade information for inclusion in their omnibus net settlement positions.

(b) PCC Practices

The PCC system includes the capabilities of net settlement, as defined, except for dividend processing. Dividends payable currently appear once a week, and are not included in the mark-to-market routine.

(c) NCC Practices

The NCC system settles net money and security positions as described above. Dividends are automatically included in the mark-to-market and net settlement procedures.

(d) Required Modifications

PCC must include dividends payable as part of the daily net settlement. A complete description of dividend reporting will be found later in this section. In addition, PCC would delete block trades from net settlement.

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Both systems should include the capabilities to produce net settlement information with respect to the contra clearing corporation.

ALLOCATIONS

Allocation is the process by which a clearing corporation assigns stock certificates received from selling members to buying members. Under the net settlement concept many clearing members may be in a short valued position: they sold more stock than they bought; and many members may be in a long valued position: they bought more stock than they sold. The quantity and denominations of stock certificates delivered by the members with short positions would, in all likelihood, not exactly match the long valued positions required to be allocated. The methodology describing how the certificates are allocated to long positions is a process containing extensive decision rules and algorithms.

(a) Interface Considerations

Inter-regional trades for one clearing corporation would net to one long or short position when viewed from the standpoint of the other clearing corporation. For example, if the net of inter-regional trades for all PCC clearing members resulted in their buying more of a specific security than they sold, PCC would have a long valued position within the NCC system. Accordingly, NCC would have to allocate certificates to PCC to meet its long position.

The filling of a clearing corporation's net long position would appear to indicate that a physical movement of securities would result. There are methods that could be utilized to minimize this, and these are discussed later in this section.

(b) PCC Practices

The PCC allocation procedure is basically a manual task. Allocation clerks are supplied with computer printed slips that indicate the security, the broker and the number of shares of the broker's long position. The allocation clerk reviews the certificates in the box and allocates securities to the broker. When all certificates that can be allocated have been allocated, the clerk proceeds to the next security. Unallocated securities remain in the box.

(c) NCC Practices

The NCC allocation procedure is automated. When certificates are delivered to NCC, the number of certificates and the denominations are entered into the system. This data is combined with the data related to certificates that remained in the box the previous day. The computerized system then utilizes an algorithm that attempts to maximize the allocation of certificates to long positions. On the average, approximately 90% of certificates are allocated to long positions each day. The computerized system then prints Security Disbursement Tickets that identify the stock, the broker to receive them, and the denominations to be delivered. Clerks pull the appropriate certificates from the box and attach the Security Disbursement Ticket. These are then sorted by broker and delivered.

(d) Interface Assumptions

It is desirable from both a control and a cost standpoint to minimize the transcontinental movement of securities. To facilitate this, it is assumed that the allocation of contra clearing corporation long positions would be the last position to be allocated. In this manner, certificates would tend to be circulated intra-regionally prior to any inter-regional movement.

In addition to allocating inter-regional long positions last, it may also be desirable to review the trades due to settle in the succeeding days. If the long valued position of the contra corporation was anticipated to be reduced or even become a short position, allocation could be supressed.

(e) Required Modifications

Although an automated allocation procedure appears to improve the percentage of securities allocated, the methodology, computerized or manual, is not critical for interface.

To facilitate attaining the goal of reducing inter-regional movement of securities, both the PCC and NCC practices would be modified to allocate the contra clearing corporation's long position last, after intra-regional long positions had been allocated.

BUY-INS

If a member is due a security from clearing, as shown on his Net Settlement reports, and has not received that security on settlemnt date, he has the option to submit an intention of Buy-In to his clearing corporation to ensure delivery of securities due to him. The clearing corporation shall retransmit the notice of Buy-In to all clearing members who are short or failing to deliver the security on the date of receipt of the intention to Buy-In. The notice of Buy-In will also be retransmitted to the other clearing corporation if the omnibus accounts reflect a significant short position of that security. All costs incurred may be charged on a pro rata basis to all clearing members and the contra clearing corporation, depending upon the value of the short positions.

(a) Interface Considerations

When a clearing corporation receives an intention of Buy-In from a member, the contra clearing corporation would receive a retransmitted notice of Buy-In if its omnibus security net position is significantly short in relation to local short positions. This will result in a retransmission of the Buy-In to the contra clearing corporation's members with short positions of that security. Costs will also be allocated pro rata among the contra clearing corporation's short members.

(b) PCC Practices

PCC uses the described procedures for Buy-Ins in their present operations.

(c) NCC Practices

NCC uses the described procedures for Buy-Ins in their present operations.

(d) Interface Assumptions

It is assumed that through the omnibus accounts, each clearing corporation appears as a member of the other corporation and assumes the same liabilities with regard to Buy-Ins as any clearing member.

(e) Required Modifications

Both clearing operations must have the ability to generate Buy-In notices to their members when a Buy-In notice is received from the other clearing corporation. It may be necessary, however, to develop some decision rule or algorithm to determine the significance of the contra clearing corporation's short position in relation to local short positions.

DELIVERIES TO CLEARING

By 7:30 AM each business day, a Deliveries to Clearing list is available for each member. This list shows the member's short position to clearing for the next day by security. The position is comprised of the member's position from the prior day, his prior day deliveries to clearing, his receipts from clearing resulting from the prior night certificate allocation, and the net trades that are due to settle the following day. The member uses this list as a guide in assembling the certificates he will deliver to clearing that day. Such deliveries will be made to clearing by 4:00 PM of that day (T+4).

(a) Interface Considerations

Since each clearing member would deal only with his respective clearing organization, the certificate delivery to either clearing organization from clearing members would be unaffected by NCC-PCC interface. When NCC develops a safekeeping capability, this would make available an alternative method for member delivery which would be more efficient than the present physical certificate delivery. This would be similar to PCC's present operating system of delivery to clearing from a depository account.

(b) PCC Practices

PCC now receives deliveries from clearing members on settlement date (T+5). However, PCC is in the process of changing procedures to effect a program of delivery to clearing on T+4. Payment to the delivering member will still be on T+5. The advantage of this change is that it will allow PCC to allocate the certificate the night of T+4 and collect from the receiving member on T+5, the same day payment is made to the delivering broker. This will eliminate the necessity of PCC's providing for one day's financing of the certificate value.

The Delivery to Clearing list provides the following information for each security: total number of shares in the short position; CUSIP number; and security description. A column is available for the member to enter manually that day's delivery. PCC does not require the member to report the individual certificate denomination which he is delivering to clearing – only the total number of shares for each security.

(c) NCC Practices

NCC currently receives delivery from members on T+4 to avoid overnight financing requirements. NCC's procedures are similar to those PCC will be using, except that NCC requires the member to report the number of certificates and the certificate denominations as well as the total number of shares for each security delivered to clearing.

(d) Required Modifications

No modifications are needed for interface under present operating procedures. However, to accomplish the goal of minimizing certificate movement during the process of clearing and settling securities transactions, both NCC and PCC plan to offer a securities depository, or safekeeping account, in their systems. The PCC depository has been operational since August 1971, and the NCC safekeeping account is scheduled to be implemented in August 1973. Use of such depository or safekeeping positions by clearing members would not only expedite the delivery of securities to clearing, but would enable NCC and PCC to minimize the flow of certificates between the two clearing organizations. This subject is discussed further under the caption STOCK MOVEMENTS BETWEEN NCC AND PCC.

RECEIPTS FROM CLEARING

During the morning of T+5, clearing members are able to pick up the certificates allocated to them by clearing during the prior night. A Receipts from Clearing list enables the member to verify the physical certificates received with the accounting records which are the basis of the amount he is charged for the securities. The member receives the certificates on settlement date (T+5) and is charged for the securities that same day.

(a) Interface Considerations

Since each clearing member deals only with his respective clearing organization, the receipt of certificates from either clearing organization is unaffected by the NCC-PCC interface. However, as mentioned earlier, depository or safekeeping capability provided by the clearing organizations can greatly increase the efficiency of such member receipts from clearing.

(b) PCC Practices

Members are able to pick up certificates allocated to them and a listing of those certificates by 7:00 AM on T+5. The listing of Receipts from Clearing is combined into the Pay/Collected Report of each member. Depository members can have their receipts from clearing automatically allocated to their depository account, from which the securities may be withdrawn as needed or automatically delivered to clearing for settlement of future short positions with clearing.

(c) NCC Practices

NCC provides a Receipts from Clearing list to each member by 7:30 AM on T+5. Securities are made available for member pickup when the member makes his cash payment to clearing. In addition to the CUSIP number, security description, total shares and dollar value of the shares provided on PCC reports, NCC also includes on their Receipts from Clearing list information indicating whether the allocation was to a long position or to fill a transfer submitted by the member. The report also indicates the denomination of each certificate allocated.

(d) Interface Assumptions

Securities involved in inter-regional settlement will require one day of financing by the clearing organizations even with member delivery to clearing on T+4 and payment to the delivering member on T+5. Securities allocated to the inter-regional omnibus account by each clearing organization on the night of T+4 will not be received until T+5 by the other clearing organization. The receiving clearing organization will allocate these securities to its clearing member the night of T+5 and will deliver the securities to the clearing member and

receive payment from the member on T+6. Since the delivering member received payment for those securities on T+5, a one day financing requirement results.

(e) Required Modifications

No modifications are needed to either the PCC or NCC systems for members to receive certificates from clearing in order to effect an interface between PCC and NCC. However, the movement of certificates between clearing and member firms could be greatly reduced if allocations from clearing were automatically added to a member's depository account and left there until needed for withdrawal. At present, PCC has this capability, and NCC is planning to make a safekeeping account available to its membership in August 1973.

RECLAMATIONS AND REJECTIONS

Any certificate rejected by clearing is accompanied by a Reclamation or Rejection Notice, which provides the necessary information for reclamation and return of securities. A rejection is a return of securities to the delivering member prior to being entered into the system as a delivered security. A reclamation is a return of securities after they have been entered into the system as deliveries. The clearing corporation makes the necessary money and position adjustments at the time the securities are returned.

(a) Interface Considerations

This procedure is performed between the clearing corporation and its members. Interface between NCC and PCC is not affected. The same procedures would appear to apply for reclamations and rejections between clearing corporations.

STOCK MOVEMENTS BETWEEN NCC AND PCC

An interface between PCC and NCC should expedite the clearing and settling of securities transactions between members of NCC and members of PCC and should also attempt to minimize the physical flow of certificates between the two clearing organizations. Nightly, each clearing corporation allocates the certificates received during the day from members, as well as any certificates that have been delivered to clearing on previous days and, to date, have not been allocated.

When allocation is completed, the certificates allocated to the other clearing corporation's omnibus account should be shipped by Brinks or some other air courier delivery service to the receiving clearing organization's office. The certificates will then be treated as deliveries to clearing and allocated to clearing member positions in the next night's allocation.

(a) Interface Considerations

For immediate interface between NCC and PCC, it is necessary to find an efficient method of transporting the certificates allocated to the omnibus account from one clearing organization to the other. It is important that these certificates arrive in time to be included in the receiving clearing corporation's allocation the night following the other clearing corporation's allocation of those certificates to the omnibus account. This would minimize the financing requirement which the clearing organizations must bear in connection with inter-regional settlements.

When depository or safekeeping capability is available through both clearing corporations, certificates allocated to the omnibus account should be added to one clearing corporation's account in the depository or safekeeping facility of the other clearing organization. Certificates could be then moved to the receiving clearing organization only as required, and could be used for future omnibus account settlement.

(b) PCC Practices

PCC now has two programs for inter-regional movement of certificates. There are nearly twenty East Coast firms who are members of PCC and NCC and use facilities at NCC to transmit trade information to PCC pertaining to trades in over-the-counter securities with other PCC members. These transactions are cleared by PCC, and certificate delivery is made between the East Coast member and PCC by Brinks. Daily volume of this system is approximately seven hundred transactions.

PCC also has a mail clearing program which enables distant members to report, clear, and settle trades by mail. Securities are delivered between PCC and clearing members by Brinks or other means.

PCC plans to establish an interface with Midwest Stock Exchange Clearing Corporation that would expedite the settlement of trades between members of both

organizations. The interface would be developed with two-way omnibus accounts to take maximum advantage of netting and thus minimize the movement of certificates. It is anticipated that this would be extended to include depository or safekeeping accounts for each clearing organization in the other's facilities.

(c) NCC Practices

NCC has several activities in cities along the Eastern Seaboard and in the Midwest. Security movements are handled by local members submitting their securities to the NCC facility on a daily basis. These certificates are flown to New York and included in the certificate allocation that night. The member receives other issues allocated to him from NCC during the same allocation process. These are flown the next morning to the regional center where the local member is able to receive them.

(d) Interface Assumptions

One of the most important goals of interface between NCC and PCC is to reduce as much of the physical movement of certificates as possible. Not only will the netting aspect of both clearing systems be used for this, but eventually depositories or safekeeping facilities will reduce certificate movements substantially more than the netting aspect of the interface.

Another assumption of this report is that it is an objective of each clearing corporation to expedite the physical movement of securities between each other as well as to their members. This would maximize the time available to brokers for handling and delivery of certificates.

(e) Required Modifications

The only initial system modification for NCC and PCC is to make certain that certificates allocated to the omnibus account are delivered to the other clearing organization in time to be used in its next night's allocation. NCC could send the certificates on an early morning plane, as it presently does for certificates shipped to all of its regional installations. These would arrive at PCC in time for use in that evening's allocation. The reports concerning these receipts from NCC could either be transmitted and printed at PCC prior to certificate arrival, or printed at NCC and accompany the certificates when delivered to PCC. Either way,

the certificates must be carefully checked against the Receipts from Clearing list to make certain that the omnibus account is being adequately updated by the actual physical certificates received.

Due to the three-hour time difference between the East and West Coasts, timing of certificate movement and omnibus update information is more critical when considering movements from the West to the East Coast. Consequently, PCC should transmit the information listing what certificates have been allocated to the omnibus account to NCC before the certificates arrive at NCC. PCC completes its allocation about midnight and can then transmit the omnibus allocations to NCC. The PCC system should be modified to provide certificate denominations and the number of certificates as well as the total number of shares for each security to be delivered to NCC. The certificates should be sent from PCC on the earliest possible plane to ensure late afternoon or early evening arrival at NCC and will allow maximum time for NCC to check the physical receipts against the omnibus update account which was transmitted earlier that day. It will also enable the certificates to be used in that night's allocation.

MONEY SETTLEMENT

At the conclusion of the daily securities allocation routine, a money amount that is due to or from the clearing corporation is determined for each member. This money settlement amount is calculated by:

- Crediting the member for securities delivered against short positions.
- Charging the member whose long position securities have been allocated.
- Charging the member when transfer instructions are submitted against a member's long positions.
- Charging or crediting for position adjustments.
- Charging or crediting for cash or stock dividends on payable date.
- Charging or crediting for the amount determined by the mark-to-market calculation.

Money amounts based on the above calculation are settled between the clearing corporation and the member on a daily basis.

(a) Interface Considerations

Money settlement amounts due between PCC and NCC would be calculated on a daily basis by a routine identical to the member-to-clearing routine. These amounts would appear in the omnibus accounts as being due to or from the other clearing corporation. Money would be settled daily, and it is suggested that both corporations agree on a common money for exchange, for example, clearing house funds.

CLEARING FUNDS

The clearing corporation requires a clearing fund deposit from each of its members. The basic purpose of the clearing fund is to provide a means of financial recourse should an individual clearing member be unable to meet its obligations.

(a) Interface Considerations

Although some legal questions may arise in this area, for purposes of interface, it is necessary that a clearing member be an authorized member of one of the clearing corporations. However, it should not be necessary for the individual members of one clearing corporation to join the other clearing corporations.

(b) PCC Practices

Currently, PCC requires a minimum $10,000 clearing fund deposit from each of its clearing members. This amount is then adjusted upward based on the value of trades cleared by PCC. The adjusted amount is equal to 5% of the value of the member's short positions.

(c) NCC Practice

At present, NCC requires a minimum $5,000 clearing fund deposit. This amount is adjusted upward to keep it equal to 2% of the value of the member's short positions, plus 2% of the value of the broker's long positions.

(d) Interface Assumptions

Four assumptions are made related to interface:

1. Individual clearing members would be required to satisfy the fund requirements of their clearing corporation. PCC has indicated that it would adopt the NCC minimum clearing fund deposit amount. Therefore, the required clearing fund deposit requirements would be the same for all brokers.

2. Each clearing corporation would guarantee the financial responsibility of its members.

3. NCC Rule 5(e), (f) and (g) would be observed. These relate to the use of a member's clearing fund should he fail to meet his financial obligations. In this respect, it would appear that each clearing corporation would treat the clearing fund of the other clearing corporation as it would its regular members' funds. However, it would not have access to the clearing funds of the other corporation's members.

4. NCC Rule 5(h) would apply. Clearing funds would not be applicable to failures related to block trades.

(e) Interface Modifications

Aside from the clarification of the legal aspects related to the previous discussion, no modifications in practices would be necessary. PCC would, however, be required to include NCC Rule 5(e), (f), (g), and (h) in its rules.

DIVIDENDS

As securities are traded between clearing members and processed by the clearing corporations, instances occur where cash and stock dividends are paid on these securities. Accordingly, both clearing corporations utilize dividend protection routines to protect individual clearing members' positions in specific securities.

In order to understand the dividend protection routines and their impact on interface, it is necessary to understand the following definition:

. Cutoff date – the date, assigned by the clearing corporation, after which securities are protected by a transfer for dividend payment purposes. The

cutoff date would always be the record date or a prior date. The cutoff date is variable for each security depending on the proximity of the clearing corporation and the specific transfer agent.

(a) Interface Considerations

The consistency of data used for dividend protection routines is important. There are alternative services that provide data concerning securities that intend to declare dividends. In addition, since cutoff dates are a function of transfer time, i.e., proximity to the transfer agent a cutoff date that may be reasonable for one clearing corporation may be impossible for another.

The dividend protection routines should be integrated with the rest of the net settlement system to allow the effect of dividends to be reflected on settlement sheets. Mark-to-market considerations are also relevant, as are the individual long and short positions of clearing members.

Unresolved differences in the two systems that are used to generate dividends would, of course, unbalance the omnibus account. In addition, extensive detailed clerical effort would be required to reconcile omnibus dividend positions. The task of interfacing the two systems will be dependent on their degree of compatibility.

(b) PCC Practices

PCC manually accounts for dividends and provides its clearing members with dividend protection on all securities positions up to and including record date. If long or short positions exist for a security on the cutoff date, PCC arranges for appropriate debits and credits directly to the member's net settlement sheets. If certificates have been delivered, they are transferred on behalf of the buying firm to afford protection and the dividends are received by the broker directly from the dividend disbursing agent.

Using published dividend information and the clearing member Position Statements, dividend clerks prepare the data necessary for processing dividends through the net settlement system. PCC settles dividends weekly, on the Friday closest to the payment date.

Shortly after record date, the clearing member receives a Dividend Advice which contains the dividend data related to each security in which he held a position at record date. Two days prior to the assigned settlement date, the clearing member receives a Transaction Blotter on which is indicated, in summary form, the total amount due to or from PCC. On settlement date, the net dividend amount due to or from is posted by the broker.

If securities being transferred are processed too late to meet the record date, PCC charges the last delivering broker and credits the broker due the dividend. The Transfer Department provides the dividend clerks with the transferred securities and transfer order. The position reports are then researched in order to determine the adjustments required.

If fractional shares are involved in a stock dividend, they are settled on a cash-in-lieu basis.

(c) NCC Practices

NCC automatically accounts for dividends and provides its clearing members with dividend protection. Computer-generated computation of cash and stock dividends announced prior to the record date is performed on a cutoff date automatically determined by NCC.

A notice of the dividend computation is sent on cutoff date to each member who has an open position in the specific security. Dividends for stock being processed by NCC for position transfer are credited to the clearing member if the transfer is not accomplished by record date. If the dividend is not announced prior to record date, no cutoff date is assigned and the dividend is computed as of the record date.

On cutoff date, after receipts and deliveries have been recorded, a clearing member's record date position is projected by giving effect to trades due to settle between cutoff and record dates. This projected position is printed on the Dividend Notice Report and indication is made as to whether the member's position is long or short. Dividend calculations are automatically made, based on this projected position, which includes position transfers pending allocation.

Securities allocated to a clearing member's long position and delivered on or before cutoff date have an orange "RUSH TRANSFER" sticker attached. This sticker notifies the

clearing member that the stock is registered for a dividend and must be transferred immediately to be reregistered by record date. Securities delivered to clearing members between cutoff and record date are dividend protected by NCC. A green "DO NOT TRANSFER" sticker is attached. This notifies the clearing member that the security has been dividend protected.

The effect of all dividends, cash or stock, is automatically reflected on the clearing member's Net Position and Accounting Report.

(d) Interface Assumptions

As illustrated by the preceding discussion, there is a basic difference in the manner in which PCC and NCC process dividends. The PCC system is basically manual, while the NCC approach is automated. More importantly, the relative timings are different. PCC settles dividends on a weekly basis, NCC on a daily basis. This factor would, of course, force the omnibus account to be out of balance for much of the time.

In order to minimize system differences, some modifications appear to be necessary. These will be discussed below. In addition, it also appears advisable that a common policy regarding dividends be adopted by both clearing corporations. As a result, for interface purposes, NCC's Rule 10 regarding dividends is assumed to be the standard. Rule 10 is discussed in Section III, POLICY ASSUMPTIONS.

(e) Required Modifications

In order to facilitate interface, the PCC dividend routines should be modified to be similar to NCC's process. The automation of the PCC dividend routine has already been scheduled and, accordingly, should be operational in conjunction with interface. This task would be facilitated should NCC make its automated dividend system available to PCC.

There exists another problem related to dividends that exists independent of interface. As previously stated, the cutoff date is determined by the clearing corporation and is based on the proximity of the transfer agent. For example, XYZ stock announces a dividend, and record date is June 15. If the transfer agent is in New York, NCC would assign a cutoff date of June 14. On or before cutoff date, any shares allocated would have an orange "RUSH

TRANSFER" sticker attached. A New York clearing member would have sufficient time to have the certificates transferred before record date. A broker in Dallas, Chicago, or Los Angeles, however, would not have sufficient time if the securities were first delivered to him prior to his submitting them for transfer.

At least three feasible alternatives appear to exist to solve this problem:

1. Each clearing corporation would determine its own cutoff date in relation to its proximity to the transfer agent. Should this alternative be adopted, it would appear that the dividend subdivision of the omnibus account would require reconciliation on dividend payment date.

2. Establishment of a standard cutoff date would allow sufficient time for all brokers, regardless of location, to effect transfer. For example, the cutoff date would always be three or four days prior to record date. This would allow a West Coast broker enough time to transfer a security whose transfer agent is on the East Coast. However, a problem would exist for an East Coast broker as he may not be able to transfer securities for several days after he had received the certificates.

3. Prior to allocation of a stock nearing its cutoff date to any inter-regional long position, the location of the intended receiver would be evaluated. If there were insufficient time for the member to receive the certificates and effect transfer before record date, the allocation would be suppressed. The clearing corporation would rush transfer in its nominee name or in the name of the intended receiver.

The adoption of a methodology to solve the problem for non-New York brokers requires resolution by NCC and PCC.

TRANSFERS

The net settlement system allows the clearing corporation to process two types of transfers for its members:

- Position Transfers
- Accommodation Transfers.

A position transfer is one which is submitted by a clearing member against a long security position as defined in his net settlement report. The shares to be transferred are paid for by the member at the time a transfer instruction is submitted to the clearing corporation.

In the allocation process, a position transfer assumes a high priority and is filled before member long positions and long positions between clearing corporations. This is done because the securities are paid for at the time the transfer instruction is submitted to the clearing corporation. When the securities become available to the clearing corporation, they are allocated to pending position transfers. The securities are attached to the position transfer and forwarded to the transfer agent by the clearing corporation. Dividend protection is afforded all position transfers in process.

An accommodation transfer with the actual securities attached is submitted to the clearing corporation by a member. This type of transfer is not processed against a member's long position with the clearing corporation. The clearing corporation will use its operating facilities to forward the transfer instruction and securities to the transfer agent, to record and control the stages of transfer, and to deliver the securities back to the member when transfer is complete.

(a) Interface Considerations

Clearing corporations would have the ability to issue position transfer instructions to the contra clearing corporation based on security positions defined in the omnibus accounts. The transfer would be made in the name of the clearing corporation submitting the transfer instruction. This procedure should facilitate physical security transfer based on the location of the transfer agent. Dividend protection would also be afforded to transfers submitted by clearing corporations.

(b) PCC Practices

The PCC system presently has the operating facilities to process position and accommodation transfers for its members.

(c) NCC Practices

NCC currently processes transfer instructions as previously defined.

(d) Required Modifications

Both systems must institute procedures to handle position transfers between the two clearing corporations. Accounting for securities in the transfer process should appear in the omnibus accounts.

OMNIBUS ACCOUNTS

An omnibus account represents the combined security positions and money balances of all inter-regional transactions.

(a) Interface Considerations

Each clearing corporation would have an omnibus account for the other clearing corporation. PCC would have an omnibus account for NCC which would represent the net activity of NCC clearing members. NCC would have an omnibus account for PCC which would represent the net activity of PCC clearing members. The security and money positions included in both accounts must be equal, but opposite in value. For example, the PCC account may show a long security position of 100 shares with NCC and a money balance due from NCC of $1,000. Conversely, the NCC omnibus account should show a short security position of 100 shares and an amount due to PCC of $1,000.

The type of information that would affect the security positions and money balances in the omnibus accounts are as follows:

- Inter-regional compared trades (except block trades)
- Dividends payable/receivable
- Receipts and deliveries
- Service charges
- Adjustments
- Computed mark-to-market money amounts
- Miscellaneous entries.

Inter-regional compared trades would appear in the omnibus accounts on the day they are due to be settled between the member and clearing (T+5). Compared inter-regional block trades would not appear in the omnibus account since they are not part of the continuous net settlement systems.

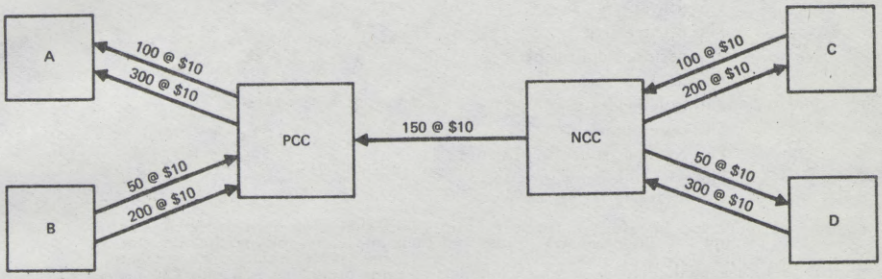
Dividends, both cash and stock, would be included in the omnibus account on the payable date designated by the Dividend Disbursing Agent. Dividends payable would appear on the omnibus statement on payable date even if the securities are out to transfer.

Securities and money delivered or received between clearing corporations affect the daily omnibus account balances. To allow for transcontinental delivery of securities, the omnibus accounts would reflect movement of securities that have been delivered. In this manner, securities in transit should not present a reconciliation problem. Reconciliation procedures would be required if a discrepancy exists between the indicated securities shipped and the actual securities received. Adjustments would be exchanged between clearing corporations to ensure balanced accounts.

Daily money settlements between corporations enter both systems' omnibus accounts on the same day. Mark-to-market amounts are to be calculated by both clearing corporations and should be equal under both systems since pricing data on the master files would be the same. Service charges and miscellaneous entries should appear in the omnibus accounts on a scheduled basis. This should be determined by both clearing corporations to ensure the balance of omnibus accounts. For example, if a service charge were transmitted on a Monday, it would be agreed that both corporations would enter the transaction on Tuesday. Dividends, service charges, adjustments and miscellaneous entries should be identified within subdivisions of the omnibus accounts. This should aid in reconciliation and the determination of discrepancies between the PCC and NCC accounts.

Control of the omnibus accounts can be achieved by comparing the security positions and money balances maintained by PCC and NCC. The data in the omnibus reports generated by each corporation should be exchanged on a daily basis. These reports must be compared daily to the corresponding omnibus account status generated locally. The balances should be equal and opposite.

DUAL TRADE COMPARISON
OMNIBUS ACCOUNT PROCESSING



TRADES TO SETTLE ON T+5:

1. A BUYS 100 SHARES OF XYZ @ $10/SHARE FROM C.
2. D BUYS 50 SHARES OF XYZ @ $10/SHARE FROM B.
3. C BUYS 200 SHARES OF XYZ @ $10/SHARE FROM B.
4. A BUYS 300 SHARES OF XYZ @ $10/SHARE FROM D.

The actual money amount due to or from the other clearing corporation is calculated by the following routine. Today's pay-collect amount equals:

- Receipts
- Plus deliveries
- Plus net transfers
- Plus position adjustments
- Plus mark-to-market
- Plus cash dividends
- Plus cash journals
- Plus previous pay/collect balance
- Plus paid-collected yesterday.

An example of inter-regional trades and their impact on the omnibus accounts is illustrative of the methodology on which omnibus account processing is based. The facing page depicts four inter-regional trades. Brokers A and B are members of PCC and brokers C and D are members of NCC. All four trades are inter-regional and due to settle on the same day (T+5). The inter-regional net results show that NCC owes 150 shares of XYZ stock to PCC and is due $1,500 on T+5.

Exhibit A is a schematic presentation of the omnibus account information for PCC and NCC on settlement date (T+5). Note that this is not the final format since subdivisions for dividends and other charges are not illustrated. The NCC account is processed within the PCC system, and the PCC account processed in the NCC system. The security positions in both accounts are equal and opposite in value.

The accounts reflect no previous stock positions. This is done so that the effect of the illustrated transaction can be readily seen. The NCC account, within the PCC system, shows NCC short 150 shares of XYZ which is due to PCC. The NCC report shows PCC long 150 shares and due to receive stock from NCC.

The money balances are also equal and opposite in value. The contract price traded was $10 per share, as reflected under "settle @ contract" and is $1,500. The current market price of XYZ is $12 per share, as shown in "current position @ market" and is $1,800. The mark-to-market is the difference of $300. This mark-to-market calculated amount is included in the daily pay/collect amount. Since no other transactions settle on T+5, in the example, the mark-to-market amount is the money due to PCC from NCC as reflected in both pay/collect amounts.

Exhibit B indicates the omnibus positions on T+6. The physical delivery of securities from NCC to PCC (on T+5) is reflected in the securities positions and the money balances. The current security position of XYZ is now "flat" for both NCC and PCC.

The money positions show the previous day's market positions at the previous day's market price of $12 per share. This shows PCC owing NCC $1,800. PCC "Receipts" reflects the value of the XYZ securities received on T+6 from NCC. NCC "Deliveries" show the XYZ securities delivered to PCC. The previous day's pay/collect amount is offset by the actual collection to PCC of $300 from NCC.

Using the routine previously defined, the total money due to NCC is $1,800. This sum includes the original contract price of $1,500 plus the $300 received from NCC to accommodate the mark-to-market calculated amount.

(b) Required Modifications

PCC and NCC must develop and include omnibus account processing within their current net settlement systems. INTERregional compared trade data must be isolated from all other trade data and must be included in each omnibus account.

Net settlement currently exists in both systems to process clearing members' security positions and money balances. Omnibus account processing between PCC and NCC is based on the same net settlement procedures.

Reconciliation procedures must be developed to ensure daily balance of both omnibus accounts.

MASTER FILES

Master files, for interface purposes, are those computerized files that contain information about securities, dividends and brokers.

(a) Interface Considerations

The master files of both net settlement systems are an integral part of most processing modules. If each system were to have totally independent master files, and no comparison and

adjustments were made, the omnibus accounts would never be in balance. Accordingly, some methodology is necessary to ensure that both systems' sets of master files are in agreement. There are three major areas of concern:

1. **Broker Master Files** – It is important, for trade validation purposes, that each system recognize valid clearing members of each clearing corporation. While the clearing corporation needs to retain a significant amount of data about a broker, the contra clearing corporation need only know that the broker is a member of the other clearing corporation.

2. **Security Master File** – It is necessary for each clearing corporation to have the same basic data about securities that would be traded inter-regionally. This data includes the CUSIP number and the current price. The price is needed for mark-to-market calculations.

3. **Dividend Master File** – To ensure that both systems agree on dividends, it is necessary that both utilize the same dividend data. This data would be based on the Standard and Poor Dividend Cards as well as other sources.

(b) Interface Assumptions

It is assumed that NCC developed data would be used as the standard for data master files within both systems. This would apply to securities and brokers related to inter-regional trades only. Each clearing corporation would continue to be responsible for broker and security master file data that would be traded intra-regionally.

(c) Required Modifications

It would be necessary to develop, within the NCC system, the capability to extract basic data from the broker, security and dividend master files and transmit this data to PCC. For its part, PCC would have to develop similar routines for its broker file. In addition, PCC would be required to develop processing modules to ensure the inclusion of NCC data in the PCC master files.

V – DATA PROCESSING REQUIREMENTS

This section of the report describes the computer hardware and software required for inter-regional trade processing.

HARDWARE

Each clearing corporation must have computer system facilities for processing and communications line facilities for data transmission. Computer system facilities already exist at PCC and NCC and are being utilized for trade reporting and clearing for their members. At present, PCC members on the East Coast and NCC members on the West Coast may report trades locally. This data is transmitted directly to the other clearing corporation and bypasses the local corporation's net settlement system.

The computer systems planned for installation at PCC and NCC computer centers are:

- PCC – 2 IBM 370/145's
- NCC – IBM 370/158 and IBM 370/135

These computer systems appear to have the capacities to handle the daily inter-regional trade volumes.

(a) Data Transmitted

The communications facilities utilized by both clearing corporations must have the ability to transmit the daily inter-regional trade data within a reasonable time frame. The types of data required for transmission are the following:

- inter-regional trade input.
- Compares by Advisories
- Broker Master Files
- Dividend Master Files (NCC only)

- Security Master Files (NCC only)
- Miscellaneous Input (Adjustments, Omnibus Account Data).

Exhibit C depicts the data elements contained within the data to be transmitted and the projected size of each data record. Exhibit D shows the projected daily transmission volumes of each type of file required for transmission. Exhibit D also shows the alternative line speeds available for data transmission which range from 1200 baud (bit/second) to 4800 baud. Since telephone transmission seldom achieves the maximum rate of speed, we assumed a 67% speed efficiency for each alternative. Total transmission time for all inter-regional trade data could range from forty-six minutes, using a 4800 baud line, to three hours, using a 1200 baud line. These time constraints are based on estimated daily transmission volumes contained in Exhibit D. The estimated transmission volumes for inter-regional trades, compares by advisories and master files are based on information obtained from PCC and NCC.

(b) Data Transmission Alternatives

Two possible alternative techniques of data transmission are presented in this section.

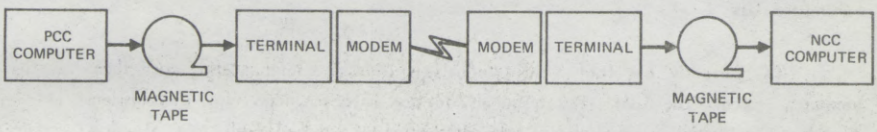
- On-line processing – computer to computer
- Off-line processing – terminal to terminal.

The on-line processing approach utilizes the computer system at both centers to generate and control transmitted data. The additional hardware required at each center, besides the on-site computers, is:

- Communications control units at both installations
- MODEMS at both installations (a MODEM is a device that accepts data from a computer and transforms the data into a form suitable for transmission over telephone lines).

This approach requires the dedication of portions of both computer systems to handle data transmission routines. It requires further analysis by PCC and NCC to identify computer scheduling constraints to determine its feasibility.

OFF – LINE DATA TRANSMISSION



The concept of off-line data transmission is shown on the facing page. Each computer system will generate a magnetic tape containing all the inter-regional data to be transmitted to the contra clearing corporation. This tape will be transmitted using a data tape transmission terminal through the use of telephone communications line. The data is received by an identical terminal and a magnetic tape is created. This tape contains the inter-regional input for processing by the contra clearing corporation.

Off-line transmission capabilities are currently available between PCC and NCC. In addition, off-line communications facilities currently exist between PCC and its San Francisco facilities. This is accomplished by using Mohawk 7500 terminals for transmission to San Francisco. Another Mohawk 7500 terminal is installed in San Francisco for the receipt of transmitted data.

NCC currently has IBM 3780 terminals in Chicago communicating with their computer system. The IBM 3780 terminals do not have magnetic tape transmission capabilities, and input is accomplished through the use of punched cards. NCC also has Mohawk 7500 systems available with the capability to transmit and receive computer generated magnetic tape.

The Mohawk 7500 systems do not have the capability to send and receive data at a 4800 baud rate. Both PCC and NCC would be required to upgrade their present terminal systems and MODEMS to utilize a 4800 baud transmission speed.

SOFTWARE

The on-line technique for data transmission requires communication capabilities within the computer systems operating software. To achieve data transmission from computer to computer, each computer system requires the following software:

- Operating system
- Communications access routines
- Transmitted data handler.

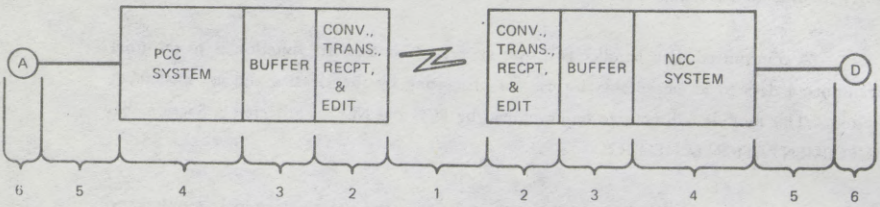
Both PCC and NCC currently use the standard IBM DOS operating system. DOS is a disk-oriented operating system which drives the computer hardware and offers, among other things, communications support.

BTAM (Basic Telecommunications Access Method) is a communication software module which performs basic telephone line and communications control functions. This software module is available from IBM and requires interface with DOS.

A transmitted data handler is a user generated routine. Its function is to reformat transmitted data to an acceptable format for processing by the clearing and net settlement systems. This module will have to be developed by PCC and NCC as reflected in Section VII, IMPLEMENTATION SCHEDULE.

The off-line technique for data transmission, terminal to terminal, requires no software involvement. The physical transmission is accomplished by the hardware integrated in each terminal.

ISOLATION OF EXISTING SYSTEMS



AREA	DESCRIPTION	AFFECTED BY INTERFACE
1	DATA COMMUNICATIONS LINK	YES – ALL NEW
2	DATA COMMUNICATIONS CONVERSION	YES – ALL NEW – SHOULD BE THE SAME FOR BOTH SYSTEMS
3	BUFFER	YES – ALL NEW – DIFFERENT FOR EACH SYSTEM
4	EXISTING SYSTEMS	POSSIBLY
5	BROKER-CLEARING RELATIONSHIP	NO
6	BROKER IN-HOUSE ACTIVITIES	NO

VI – IMPLEMENTATION AND OPERATING COST SUMMARY

This section of the report discusses the tasks, time, and cost related to implementation of the PCC-NCC interface. In addition, an estimate is made of the continuing operating costs associated with the interface.

ISOLATION OF EXISTING SYSTEMS

The interface described in this report assumes, as a goal, that the broker activities, broker-clearing procedures and existing clearing systems remain as unchanged as possible.

The diagram on the facing page illustrates this concept. Wherever possible, the development of interface should have no effect as far as the brokers are concerned. Existing systems would be changed as little as possible.

The areas as shown on the facing page would provide for the following functions:

Area	Function
1. Data Communications Link	Transfers data between computers at PCC and NCC
2. Data Communications Conversion	Sends data related to trades, omnibus balancing and master files . Converts input data to transmission format . Creates block and file control information Receives data . Validates transmitted data with block and file control data . Produces error listings
3. Buffer	Edits transmitted data and reformats for input to existing systems

Area	Function
4. Existing Systems	. Validates input, along with intra-regional data . Trade comparison . Trade reporting . Omnibus account reporting
5. Broker-clearing Procedures	Same as in current use
6. Broker Activities	Same as in current use.

This approach also allows initial development cost to be reduced. The data communications (area 1) and conversion modules (area 2) would be the same for both systems. It is only in the buffer (area 3) that differences would appear. It is in this area and in the existing systems (area 4) where efforts must be customized.

IMPLEMENTATION COSTS

Implementation costs are considered to be those costs associated with the development and modification of the NCC and PCC systems to allow interface. These are basically one-time costs. Costs of a recurring nature associated with the continuing operation of the system will be discussed later in this section.

(a) Implementation Costs Assumptions

For purposes of estimating the costs related to development of the interface system, certain assumptions have been made regarding the types of costs that would be incurred. For analysis purposes, three types of costs have been considered: systems analysts, programmers, and computer time.

1. Systems Analysts -- includes the following functions:
   - Analysis of existing systems and procedures
   - Identification of problem areas
   - Development of detailed solutions

- Preparation of computer program specifications
- Direction of programmers
- Preparation of system documentation
- Development of manual procedures and timetables
- Preparation of user manuals and related documentation.

In order to estimate the tasks which require systems analysis efforts, a $15/hour cost has been assumed. This amount includes a portion of indirect management and secretarial and clerical effort.

2. **Programmers** – includes work related to:
   - Computer program design
   - Computer program coding
   - Debugging programs
   - Testing programs
   - Preparation of system and program documentation.

   We have assumed a $10/hour cost for programmers. This amount also includes a portion of indirect management and secretarial efforts.

3. **Computer Time** – In order to develop or modify a computer system, it is necessary to test the new computer programs. Accordingly, a computer similar to the one to be used in actual operations should be available for test purposes. In estimating the value to be assigned to this resource classification, we discussed the costs of the present and planned computer systems with both PCC and NCC data processing representatives. As a result, a cost of $100/clock hour was assumed. This cost represents the cost of the hardware, operators, supplies, and miscellaneous associated services such as tape librarians and keypunch.

(b) Implementation Task List

The implementation tasks presented here relate to data processing-oriented tasks. Nondata processing tasks are listed in the Implementation Schedule, Section VII.

The following pages briefly describe each data processing-oriented task.

- **Select Implementation Team**

  Various personnel from NCC and PCC would be selected to be part of the implementation team. If possible, team members should be familiar with their own clearing systems.

- **Determine Data Processing and Documentation Standards**

  Representatives from PCC and NCC would determine required documentation criteria and programming practices. In addition, any existing data processing constraints, such as maximum program size, would be agreed upon.

- **Review Current Systems and Background Data**

  The implementation teams would review their own current systems and any available documentation related to interface. Additionally the PCC team would visit the NCC operations in New York and Washington. Conversely, the NCC team would observe the Los Angeles and San Francisco operations of PCC.

- **Automate PCC Dividend System**

  Unless a predeveloped system could be obtained, the PCC dividend system would be automated so as to be similar to the NCC dividend system.

- **Develop Communications Software**

  Programming would be performed to allow for the communication of data via telephone lines. It appears that IBM's BTAM software would be applicable.

- **Define Requirements for and Obtain Telephone Lines**

  Discussion would be held with representatives of the telephone company for the leasing of an appropriate telephone line to be used for data transmission purposes.

- **Develop Software for Computer-to-computer Transmission of Trade Data**

  Programs necessary to format and deformat trade data prior to transmission to the contra clearing corporation would be developed.

- **Develop Computer Modules for Transmitting NCC Master File Data**

  Programs would be developed to transmit, on a daily basis, the security, broker, and dividend master files of NCC to the PCC system.

- **Develop PCC Software for Master File Updates Using NCC Master File Data**

  Update programs within the PCC system would be created or modified to utilize NCC master file data as the primary update source.

- **Modify Broker Master File to Include Contra Clearing Corporation Members and Securities**

  Provision would have to be made for increasing the size of existing data files containing broker and securities data.

- **Modify Systems to Extract Inter-regional Trade Data**

  Each system should be modified to separate inter-regional trade data and prepare it for transmission to the other clearing corporation.

- **Modify Systems to Transmit a Compared Trade Initiated by a "Compared by Advisory" Trade**

  Based on a trade that was compared by a clearing member submitting an advisory, the systems would have to generate both a valid "buy" and "sell" to the other clearing corporation.

- **Modify Broker Reporting Procedures for Identifying Block Trades**

  PCC member manual would be modified to instruct brokers on procedures related to identifying block trades.

- **Modify PCC System to Isolate Block Trades**

  The PCC system would be modified so that block trades do not enter the net settlement process.

- **Modify PCC and NCC Systems to Suppress Contra Members Report Generation**

  Comparison lists and advisory lists/tickets for clearing members of the contra clearing corporation need not be printed.

- **Modify PCC and NCC Systems to Allocate Inter-regional Trades Last**

  In order to reduce the physical movement of securities, the allocation subsystems would be modified to allocate to contra clearing corporations long positions last.

- **Modify PCC and NCC Systems to Suppress Allocation of Securities near Cutoff Date**

  To facilitate dividend protection, the systems would be modified to suppress allocation of inter-regional long positions for those securities near cutoff date.

- **Develop Control Modules for Inter-regional Receipt and Delivery of Stock**

  To establish firm control over securities being transported from coast to coast, a series of physical and reporting controls would be developed.

- **Develop Omnibus Processing Modules and Related Reconciling Procedures**

  Report format and the transmission of miscellaneous charges would be developed and their related timings. In addition, procedures to be followed in case the two omnibus accounts do not agree would be developed.

- **Parallel Test of the System**

  This test would be made using actual data under normal operations conditions.

- **Optimize Time Schedules for Broker Reporting of Inter-regional Trades**

  Due to the three-hour time difference between the East and West Coasts, it appears that the time that West Coast brokers would be able to submit trade data would be adjusted. NCC operating schedules should be reviewed to minimize the adjustment.

- **Prepare System Documentation**

- **Develop Operating Procedures and Timetables**

- **Prepare and/or Modify Broker User Manuals.**

PROJECTED MONTHLY OPERATING COSTS

	On-line transmission	Off-line transmission
Hardware Costs		
1 - Telephone line (Dial-up – leased)	$ 300 - 2,600	300 - 2,600
2 - 1200/4800 baud compatible MODEMS ($100 per MODEM)	200	200
2 - Communications control units ($1,200 per unit)	2,400	–
2 - Data transmission terminals ($500 per terminal)	–	1,000
2 - Voice Telephone and other office expenses	1,000	1,000
Total hardware costs	$ 3,900 - 6,200	2,500 - 4,800
Estimated Personnel Costs		
PCC – 1 liaison representative	$ 1,000	1,000
NCC – 1 liaison representative	1,000	1,000
Security Delivery Costs – not estimated	–	–
Estimated Security Financing Costs – not estimated	–	–
Total monthly operating costs	$ 5,900 - 8,200	4,500 - 6,800

(c) Implementation Cost Summary

Exhibit E itemizes the effort and cost for each data processing related task. In summary form:

PACIFIC CLEARING CORPORATION				NATIONAL CLEARING CORPORATION				Total Cost
System Analyst Man Days	Pro-grammer Man Days	Computer Time Clock Hours	Cost	System Analyst Man Days	Pro-grammer Man Days	Computer Time Clock Hours	Cost	
200	400	300	$86,000	115	180	160	$43,000	$129,000

To this amount should be added any expenses related to travel and subsistence of team members, plus any direct legal costs associated with resolving some of the undefined policy issues.

OPERATING COSTS

The operating costs of a dual processing interface system are based on the inter-regional processing requirements and are in addition to costs for current intra-regional trade processing by each clearing operation. Included in these incremental costs are:

- Communication hardware costs
- Personnel costs
- Security delivery costs
- Security financing costs.

Not included in these costs are those costs related to the financing of inter-regional movement of stock as these costs would be applicable to any method of inter-regional settlement.

The projected operating costs, as displayed on the facing page, are shown for both off-line and on-line data transmission configurations.

The hardware costs include the estimated costs of a telephone line from Los Angeles to New York, the cost of MODEMS at each computer facility, communication control units required for the on-line transmission alternative, and data transmission terminals required for the off-line alternative.

Telephone line costs are dependent on the type of line used for data transmission. A dial-up telephone line is available, and the costs are based on long distance telephone rates. Assuming data transmission to be between 5:00 PM and 11:00 PM, the cost of this service is approximately $15 per hour. The cost to PCC and NCC is based on the amount of time required for transmission purposes. Based on the transmission time estimates defined in Exhibit D, the line cost using the dial-up alternative could range from $300 to $900 a month.

Another alternative line available is leased line. The cost of this service is based on the required length of the telephone line. We assumed a 3,000 mile line from Los Angeles to New York. The rates for this service are as follows:

$3.00 – 1st 25 miles
2.10 – next 75 miles
1.50 – next 150 miles
1.05 – next 250 miles
0.75 – next 2,500 miles.

The monthly cost of this line is approximately $2,600. The costs of the MODEMS, control units, and terminals are estimates and indicate comparable costs of equipment currently on the market.

Personnel costs are those for additional personnel required within both clearing corporations. We believe it will be advantageous for each clearing corporation to assign one person on a full-time basis to act in a liaison function between PCC and NCC. Their principal duties would be to control the omnibus accounts, and ensure proper master file exchanges. We estimate these costs to be approximately $1,000 a month for both operations.

The costs involved with the physical shipment of securities between Los Angeles and New York and the one-day financing costs of these securities cannot be estimated at this time. These costs relate to the value of securities shipped and are based on the allocation routines utilized by both clearing corporations.

VII – IMPLEMENTATION SCHEDULE

This section of the report presents a time phased implementation schedule. The schedule lists tasks related to system development, administrative and policy items.

Although the implementation schedule assigns tasks to weekly time periods, it should be noted that many items, especially policy related items, are not on the critical time line. Accordingly, some flexibility within the time phased arrangement of tasks is possible.

RESOURCE ASSUMPTIONS

The time required to accomplish the systems related interface tasks is a direct function of the resources allocated to the tasks. Assumptions were made as to the requirement of personnel resources. These assumptions were as follows:

Personnel classification	Number of employees from PCC	Number of employees from NCC	Total
Project Leader			1
Senior Systems Analysts	1	1	2
Systems Analysts	1		1
Programmers	3	2	5
			9

It should be noted that all personnel would be required on a full-time basis. It is further assumed that computer test time would be available on an as-needed basis. (Note: We have not assumed the organizational affiliation of the Project Leader.)

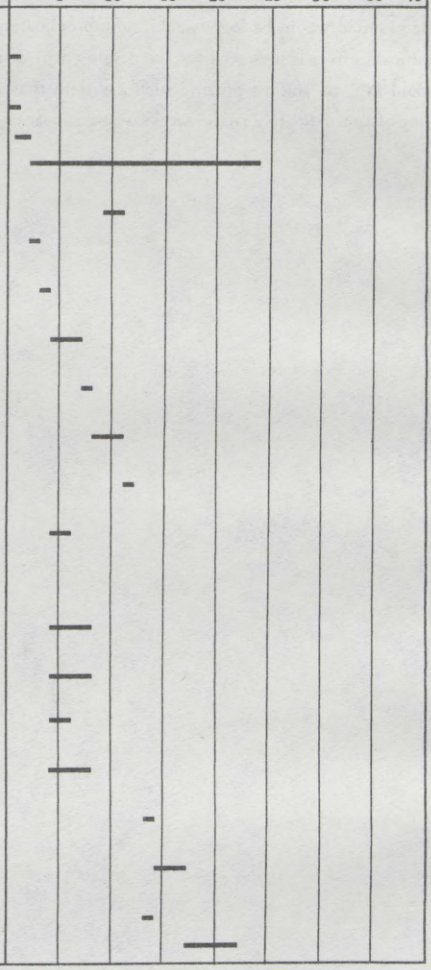
To ensure implementation of the interface, it is essential that, in addition to the manpower resources indicated above, a senior member of management of each clearing corporation be designated as a project monitor. Our experience in systems development efforts of this type has indicated that this management involvement is a vital prerequisite for timely completion of the required tasks. The role of these project monitors would be to ensure allocation of required resources and resolution of problems encountered during implementation.

IMPLEMENTATION SUMMARY

The implementation schedule, as currently defined, illustrates that the total elapsed time required would be forty weeks, or approximately ten months. It should be noted that a significant effort is indicated for the development of an automated dividend system for PCC. Should PCC be able to procure such a system that is already in existence, an elapsed time saving of approximately twelve weeks would appear to exist.

IMPLEMENTATION SCHEDULE

Implementation task	Type of task
Select implementation team	Administrative
Determine data processing and documentation standards	EDP
Review current systems and background data	EDP
Automate PCC dividend system	EDP
Review adoption by PCC of NCC rules related to dividends	Policy
Develop communications software	EDP
Define requirements for, and obtain telephone lines	EDP
Develop software for computer-to-computer transmission of trade data	EDP
Develop computer modules for transmitting NCC master file data	EDP
Develop PCC software for master file updates using NCC master file data	EDP
Modify broker master file to include contra clearing corporation members and securities	EDP
Confirm and review legal aspects of access standards	Policy
Resolve policy considerations related to whether brokers would be permitted to become mail clearing members of the other clearing corporation	Policy
Review and confirm legal aspects related to clearing funds	Policy
Review and adopt definitions of security issues eligible for inter-regional clearing	Policy
Review and confirm procedures and sources utilized for security pricing	Policy
Modify systems to extract inter-regional trade data	EDP
Modify systems to transmit a compared trade initiated by a "compared by advisory" trade	EDP
Modify broker reporting procedures for identifying block trades	EDP
Modify PCC system to isolate block trades	EDP



Implementation task	Type of task	Weeks 5 10 15 20 25 30 35 40
Review and adoption by PCC of NCC rules and procedures related to block trades	Policy	
Modify PCC and NCC systems to suppress contra member report generation	EDP	
Review and resolve legal consideration related to broker reporting of securities (15C3-3)	Policy	
Modify PCC and NCC systems to allocate inter-regional trades last	EDP	
Modify PCC and NCC systems to suppress allocation of securities near cutoff date	EDP	
Develop control modules for inter-regional receipt and delivery of stock	EDP	
Define legal and policy positions related to financing and replacement of securities lost in transit	Policy	
Develop omnibus processing modules and related reconciling procedures	EDP	
Review and resolve legal considerations related to N.Y. tax	Policy	
Final agreement of type of funds used to settle balances between clearing corporations	Policy	
Review, identify and resolve minor differences in the PCC and NCC rules	Policy	
Establish a continuing committee of executives/broker members to resolve future policy and rule questions	Policy	
Parallel test of the system	EDP	
Optimize time schedules for broker reporting of inter-regional trades	EDP	
Prepare system documentation	EDP	
Develop operating procedures and timetables	EDP	
Prepare and/or modify broker user manuals	EDP	
Establish interface	EDP	

Exhibit A

OMNIBUS ACCOUNTS ON T+5

PACIFIC CLEARING CORPORATION						
NCC OMNIBUS ACCOUNT						
STOCK	POSITION TYPE	PREVIOUS POSITION	SETTLE TODAY	SHARE MOVE	XFER	CLOSE POSITION
XYZ	VALUED	0	150S	0	0	150S

NATIONAL CLEARING CORPORATION						
PCC OMNIBUS ACCOUNT						
STOCK	POSITION TYPE	PREVIOUS POSITION	SETTLE TODAY	SHARE MOVE	XFER	CLOSE POSITION
XYZ	VALUED	0	150L	0	0	150L

PREVIOUS MKT POS	0	0
SETTLE @ CONTRACT	$ 1,500 CR	$ 1,500
LONG POS @ MKT ($12/SHARE)	0	1,800
SHORT POS @ MKT ($12/SHARE)	1,800 CR	0
CURRENT POS @ MKT	1,800	1,800 CR
RECEIPTS	0	0
DELIVERIES	0	0
TRANSFER AMT PAID	0	0
POSITION ADJ	0	0
MARK-TO-MARKET	300	300 CR
CASH DIV.	0	0
CASH JOURNALS	0	0
PREVIOUS PAY/COLLECT BAL	0	0
P/C YESTERDAY	0	0
TODAYS P/C	300	300 CR
PAY TO NCC/PCC	300	0
COLLECT FROM NCC/PCC	0	300

Exhibit B

OMNIBUS ACCOUNTS ON T+6

PACIFIC CLEARING CORPORATION

NCC OMNIBUS ACCOUNT

STOCK	POSITION TYPE	PREVIOUS POSITION	SETTLE TODAY	SHARE MOVE	XFER	CLOSE POSITION
XYZ	VALUED	150S	0	150L	0	0

NATIONAL CLEARING CORPORATION

PCC OMNIBUS ACCOUNT

STOCK	POSITION TYPE	PREVIOUS POSITION	SETTLE TODAY	SHARE MOVE	XFER	CLOSE POSITION
XYZ	VALUED	150L	0	150S	0	0

PREVIOUS MKT POS	$1,800	$1,800 CR
SETTLE @ CONTRACT	0	0
LONG POS @ MKT	0	0
SHORT POS @ MKT	0	0
CURRENT POS @ MKT	0	0
RECEIPTS	1,800 CR	0
DELIVERIES	0	1,800
TRANSFER AMT PAID	0	0
POSITION ADJ	0	0
MARK-TO-MARKET	0	0
CASH DIV	0	0
CASH JOURNALS	0	0
PREVIOUS PAY/COLLECT BAL	300	300 CR
P/C YESTERDAY	300 CR	300
TODAYS P/C	1,800 CR	1,800
PAY TO NCC/PCC	1,800	0
COLLECT FROM NCC/PCC	0	1,800

Exhibit C

TRANSMITTED DATA

	Character
Inter-regional trade data compared by advisory:	
Type of trade	1
Block trade identification	1
Trade date	6
Submitting house	5
Contra house	5
Security number (CUSIP)	9
Number of shares traded	10
Price per share or extended amount	12
Transmission control	6
Extra	5
	60
Broker master files:	
NASDQ number	7
PCC/NCC number	5
Extra	7
Transmission control	6
	25
Dividend master file:	
Standard and Poor dividend card format	80
Security master file:	
CUSIP number	9
Current price	8
Filler	7
Transmission control	6
	30
Miscellaneous entry (adjustment, omnibus account data):	
Input card format	80

Exhibit D

ESTIMATED DAILY TRANSMISSION VOLUMES

	Estimated records*	Estimated characters record	Transmission characters
PCC TO NCC			
Inter-regional trades	5,000	60	300,000
Compares by advisories	1,000	60	60,000
Miscellaneous (adjustments, omnibus account data)	100	80	8,000
Broker master file	350	25	8,750
Total characters			376,750
NCC TO PCC			
Inter-regional trades	5,000	60	300,000
Compares by advisories	1,000	60	60,000
Broker master file	250	25	6,250
Dividend master file	1,500	60	90,000
Miscellaneous (adjustments, omnibus account data)	100	80	8,000
Security master file	9,000	30	270,000
Total characters			734,250

Line transmission speed	Characters/sec. transmission (67% efficiency)	PCC transmission time (minutes)	NCC transmission time (minutes)
4800 baud	400	16	30
3600 baud	300	21	41
2400 baud	200	31	61
1600 baud	133	47	92
1200 baud	100	63	122

* Estimated volume of records is based upon suggested volumes obtained from PCC and NCC personnel. These estimates were then expanded in anticipation of increased broker activity related to inter-regional funding.

DATA PROCESSING IMPLEMENTATION PLAN

TIME AND COST RECAP

Implementation	Pacific Clearing Corporation				National Clearing Corporation				Total cost
	System analyst man-days	Pro-grammer man-days	Computer time clock hours	Cost	System analyst man-days	Pro-grammer man-days	Computer time clock hours	Cost	
Select implementation team	1	–	–	$ 120	1	–	–	$ 120	$ 240
Determine data processing and documentation standards	2	–	–	240	2	–	–	240	480
Review current systems and background data	7	–	–	840	7	–	–	840	1,680
Automate PCC dividend system	50	200	100	32,000	–	–	–	–	32,000
Develop communications software	5	5	8	1,800	5	5	8	1,800	3,600
Define requirements for and obtain telephone lines	2	–	–	240	2	–	–	240	480
Develop software for computer-to-computer transmission of trade data	5	15	16	3,400	5	15	8	2,600	6,000
Develop computer modules for transmitting NCC master file data	2	5	8	1,440	1	5	8	1,320	2,760
Develop PCC software for master file updates using NCC master file data	10	15	24	4,800	5	5	8	1,800	6,600
Modify broker master file to include contra clearing corporation members and securities	2	5	6	1,240	2	5	6	1,240	2,480
Modify systems to extract inter-regional trade data	1	3	8	1,160	1	3	8	1,160	2,320
Modify systems to transmit a compared trade initiated by a "compared by advisory" trade	5	15	16	3,400	5	15	16	3,400	6,800
Modify broker reporting procedures for identifying block trades	1	–	–	120	–	–	–	–	120
Modify PCC system to isolate block trades	15	50	40	9,800	–	–	–	–	9,800
Modify PCC and NCC systems to suppress contra member report generation	2	5	8	1,440	2	5	8	1,440	2,880
Modify PCC and NCC systems to allocate inter-regional trades last	5	–	–	600	5	10	8	2,200	2,800

Exhibit E

Implementation	Pacific Clearing Corporation: System analyst man-days	Pacific Clearing Corporation: Programmer man-days	Pacific Clearing Corporation: Computer time clock hours	Pacific Clearing Corporation: Cost	National Clearing Corporation: System analyst man-days	National Clearing Corporation: Programmer man-days	National Clearing Corporation: Computer time clock hours	National Clearing Corporation: Cost	Total cost
Modify PCC and NCC systems to suppress allocation of securities near cutoff date	2	5	4	$ 1,040	5	20	16	$ 3,800	$ 4,840
Develop control modules for inter-regional receipt and delivery of stock	3	10	8	1,960	3	10	8	1,960	3,920
Develop omnibus processing and related reconciliation procedures	20	20	16	5,600	20	20	16	5,600	11,200
Parallel test	5	40	40	7,800	5	40	40	7,800	15,600
Optimize time schedules for broker reporting inter-regional trades	8	–	–	960	–	–	–	–	960
Prepare system documentation	15	8	–	2,440	15	8	–	2,440	4,880
Develop operating procedures and timetables	15	8	–	2,440	15	8	–	2,440	4,880
Prepare/modify broker user manual	15	–	–	1,800	5	–	–	600	2,400
	198	409	302	$ 86,680	111	174	158	$ 43,040	$ 129,720
Amounts rounded to	200	400	300	$ 86,000	115	180	160	$ 43,000	$ 129,000

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March 15, 1973

On January 26, 1973, NCC sent a letter to PCC outlining sixteen areas which "should be further explored by attorneys for both organizations". PCC agrees that the attorneys must resolve the legal questions. However, there has not been adequate time between receipt of the letter and preparation of the report for the investigation of all these areas. PCC has assembled from various sources preliminary responses to the questions raised, which are given below:

1. Q. Will the interface require securities of the clearing corporations to be on deposit with the other party of the interface? If so, will Sec. 8-102(3) of the U. C. C. be a problem; i. e., the need to become a Trust Company?

   A. Although depository relationships are ultimately desirable, they are not suggested for the initial stage of interface. When these relationships are established, the legal questions will clearly have to be investigated.

2. Q. In the event that a member fails to qualify under the rules of the Pacific, who will clear trades intra-area for this member?

   A. Since PCC will have the same access provisions as NCC, this situation should not occur.

3. Q. What will the effect of a decision by the Pacific or NCC to cease to act for a member have on the other party to the interface?

   A. The clearing corporations will settle between themselves with omnibus accounts; each clearing organization will stand behind the positions in its omnibus account, regardless of its relationships with its members.

4. Q. In the event of an insolvency of a member, who clears both inter and intra-area trades, and where will the priorities lie as to deposits or open contractual commitments?

   A. Each clearing organization will guarantee to the other the positions in its omnibus account.

5. Q. How will the qualifications for cleared securities vary between the two organizations? Will there be securities which are only for

intra or inter-area trades?

A. This question is addressed directly in the report. In general, PCC will clear all securities handled by NCC; PCC may handle other securities on an intra-area basis.

6. Q. How will financing arrangements be made with respect to inter and intra-area members?

A. The distinction between inter and intra-area members disappears; a member clear both inter and intra-area, listed and OTC transactions, with a single clearing agency.

7. Q. Where shall the liabilities lie for erroneous trade input data by a regional center in the inter-area procedures?

A. In PCC's opinion, the basic responsibility for confirming the accuracy of reports presented should be with the broker.

8. Q. What type of reclamation procedures are considered for inter and intra-area transactions?

A. This subject is covered in the report.

9. Q. Will broker-dealers be required to make separate reports in light of 15c3-3 for securities either on deposit with or delivered to the inter-area clearing center or intra-area clearing center?

A. Since interface provides a single clearing point, compliance with 15c3-3 is simpler, rather than more complex. We feel that under interface brokers who are members of NCC or PCC would report as they presently do.

10. Q. Of major concern would be the question of the type of funds utilized in the clearing process. Several areas other than New York use federal funds while NCC in New York deals in clearing house funds.

A. This question is answered in the report; clearing house funds are recommended.

11. Q. In the transfer area, where will the burden for filing of informational returns lie? Will PSE continue its practice of reporting all dividends debited or credited to a member, irrespective of whether or not said payments were made by the Disbursing Agent?

A. The meaning of this question is not clear. If the question refers

to IRS reporting forms, it would appear that the requirements and procedures of all clearing organizations should be uniform. Resolving any differences that may exist could be included in the dividend changes contemplated by the report.

12. Q. Who will perform the examining function for members who trade both in inter and intra-regional areas?

A. SIPC is presently assigning responsibility for this function.

13. Q. Will brokers be permitted to become mail clearing members of other clearing corporations?

A. We are not aware of any aspect of interface which would impede other clearing arrangements.

14. Q. What type of agreement is contemplated between the two corporations?

A. The type of agreement is something that should be resolved after the policy questions have been cleared up. PCC has an open mind on this.

15. Q. How will conflicting rules and procedures (i.e., Omnibus Accounts) be resolved between the two corporations?

A. Some adjustments to rules might have to be made. We do not feel this should be a problem once the concepts are agreed on.

16. Q. Who will be responsible for loss in transit; who will be financing prior to replacement?

A. This could be resolved between the clearing agencies, based on insurance and tax and other considerations.

May 29, 1973

Mr. Robert P. Mann
Chairman
Pacific Stock Exchange, Inc.
301 Pine Street
San Francisco, California 94104

Dear Mr. Mann:

In March, we received your report, "Joint Approach to National Securities Clearing ...." We take this opportunity to respond to the report, which in general restates the Pacific Stock Exchange's (Pacific's) position as to "interface" of the Pacific clearing system with that of National Clearing Corporation (NCC), a wholly-owned subsidiary of the National Association of Securities Dealers, Inc. The report has been reviewed and analyzed in great detail by NCC's Board and staff, and by the Board of the NASD. The results of this review and analysis are summarized below.

INTRODUCTORY

In 1969, NASD commenced a study, with the assistance of Arthur D. Little & Co., to solve the mounting and serious operational problems being experienced in the over-the-counter sector of the securities industry. The result was the formation of NCC, whose mission it was to design and implement, at the earliest possible moment, a uniform national system for the clearance and settlement of over-the-counter securities transactions. The continuous net method of settlement was selected as the basis for the system, as opposed to daily netting and issuance of balance orders. Pacific had pioneered such a system for its members and cooperated with the NASD and NCC, as did other exchanges and the SEC, in implementing it by NCC. Operations were commenced in New York in September, 1971, and currently it is estimated that about 55-60% of all OTC transactions are cleared through the system. NCC's system is being offered through its own operations centers in New York, Washington and Atlanta, and in St. Louis, through the facilities of a major bank. In their respective cities, the Midwest, Boston and Philadelphia regional exchanges, from whom NCC has received excellent

cooperation, operate our system. With facilities planned for all major trading areas in the East, Midwest and South, it is expected that by the end of 1973 a substantial fraction of all OTC trades will be included.

As you know, we intend to complete the implementation by establishing our final regional facility on the West Coast this year. To complete our plans in the most timely and efficient manner, so that all regions of the country can be served together through one system, integrated and responsible for nationwide clearing, we have sought your cooperation. Your report of March 15 has been most helpful and, to place it in perspective, we have reviewed Pacific's prior study of this subject, received by NCC in March, 1971.

Pacific's position at that time was that a joint systems, or "interface" approach was desirable. Your report, "Suggested Approach to the National Clearing Problem," in Chapter III sets forth fifteen points to support the view that a "joint systems" approach, a concept based on a national clearing system supported by two or more autonomous regional clearing operations, might have over other possible methods of establishing a nationwide uniform system. These points were stated to be:

"1. Existing facilities are used to the maximum extent possible, rather than being dismantled, replaced, or duplicated.

2. Resources can be concentrated on resolving unsolved problems, rather than replacing existing operations.

3. The cost of implementation is kept at a minimum by avoiding duplicate, experimental, or under-utilized facilities.

4. Concentrating compatability requirements at the point of inter-regional data exchanges avoids the 'least common denominator' problem. Areas may operate most efficiently under their conditions and are not inhibited by conditions in other areas.

5. Changes within a regional area affect only the brokers using that center; for this reason changes can be more easily made and the system can be more responsive to the brokers and the public.

6. Improvements can be made in interregional clearing without affecting the brokers since the area centers act as a buffer between the brokers and the interregional processing.

7. Opportunities and incentives for development and innovation are maximized; each area can improve its operation without affecting any other area.

8. Through the maximum use of existing facilities and organizations, administrative costs are minimized.

9. There is only a limited number of people who are knowledgeable and experienced about securities clearance. A joint system approach brings the maximum concentration of these resources to bear on the project of establishing national clearing.

10. Since existing organizations are encouraged to participate and to independently improve their operations, resistance within the industry is greatly reduced.

11. A broker is not restricted to the clearing operation which is geographically closest to him. Centers will be patronized simply because they offer the best balance of service and cost.

12. Costs of added service or increased financial exposure are borne by the brokers responsible.

13. Opportunities for joint efforts with the Central Certificate Service or other clearing related organizations are maximized.

14. The joint system can be implemented more quickly than any other national system.

15. By interconnecting existing clearing operations, the joint system approaches a single, national clearing system by evolutionary rather than revolutionary methods."

In addition, the report suggested that the joint systems, or interface approach "avoids the problem of stagnation faced by a single, vast national system which, by virtue of its size, faces prohibitive costs of change and becomes locked in inertia." It further suggested that the national organization (NCC) should have the sole responsibility for interregional clearing, and that

regional authorities (Pacific) would operate independent non-standard systems to handle intra-regional clearing. Brokers, it was thought, should be given the opportunity to choose from the available clearing systems, but would not necessarily be restricted to the local clearing operation. The report recommended that the responsibilities for financing the regional clearing operations should rest with the regional centers, the cost of interregional clearing with NCC, and that matters pertaining to admittance and surveillance standards, insurance coverage, financial responsibilities for clearing obligations of members should also rest with the regional centers.

NCC responded point by point, in a report dated April 23, 1971, "Appraisal of the PCSE Joint Systems Approach." History has removed some of the concerns expressed in Pacific's report, such as the lack of feasibility of (1) computer allocation of cleared securities, which the Pacific report suggested would be inflexible; (2) delivery of securities to clearing the day before credit is given, which we understand is now Pacific's practice, too; and (3) the generation by clearing of the brokers' daily pay or collect amounts, rather than by the method then employed by Pacific of allowing the broker to calculate and present to clearing his pay or collect amount. NCC's consideration was that arguments advanced against these points did not appear to outweigh the advantages (and operating necessities) of the automated system designed by NCC. The excellent performance of NCC's system to date attests to the adequacy and logic of its design.

As to the remainder of the concerns set forth in the 1971 Pacific report, the following points of difference were stated by NCC in support of the concept of one nationwide system.

1. Based upon our discussions with many of our members, the perpetuation of a few diverse systems serving limited memberships was not what the membership as a whole appeared to want.

2. The inability of Pacific to define intra-and inter-area trades clearly tended to becloud from the outset of any such arrangement divisions of jurisdictional responsibilities for clearing between NCC and regional operators.

3. Giving brokers the opportunity to choose from available clearing systems, each with differing admittance and surveillance standards as set by its respective exchange (which could in fact act to limit or

preclude admittance), and to allow brokers to change their clearing affiliations should another clearing entity develop systems improvements, would be administratively impractical and time-consuming, cause possible undue burden on many of our members, and even generate unnecessary systems, operations, and administrative duplication.

4. Stressing competition in costs and services, rather than dedicating resources to industry-wide cooperation, aside from appearing not to reflect the desires of the industry, could introduce further imbalances. Competition in costs and services appeared to contradict the theory advanced in the report that constructive ideas possibly developed by one regional center would be handed off to others.

5. That the joint systems approach would provide flexibility to accommodate local conditions did not appear to take into consideration the fact that lack of standardization helped cause many of the industry's operating problems. Further, it assumed that a joint systems clearing vendor would be able to offer advantages not otherwise afforded the user by a national system, which NCC believed was without quantitative support.

6. Statements to the effect that a national system would face prohibitive costs, become locked in inertia, and lead to stagnation were without supportive analysis and appeared therefore to reflect personal judgments.

7. Autonomous regional centers would have no innate advantages over a national system contrary to Pacific's position, as to their capabilities (resources) to develop and refine systems at the operating level.

8. Quick acceptance of NCC's plan by the industry, and of its operating rules by the membership and the SEC, appeared already to have countered Pacific's concern over resistance to NCC's efforts.

9. Existing facilities could be used to the maximum, the report stated; NCC proposed the very same from the outset, even suggesting that regional facilities might expand as a result of providing wider services through a nationwide system.

10. Joint systems, rather than allowing resources to be directed to resolving unsolved problems and minimizing administrative costs, appeared to NCC to preclude the effective marshalling of resources to solve the nationwide clearing problem.

In summary, NCC's response was directed to concern that proposals by Pacific would prove administratively impractical, that many of the reasons advanced by Pacific could apply equally to NCC's standard systems approach, and that the NCC concept of developing a standard system, rather than perpetuating many joint systems, was being responsive to the needs and wishes of the industry.

PRESENT

As previously indicated, NCC has progressed to the point where a substantial portion of all OTC transactions will be cleared in 1973 through its continuous net settlement system, with standard rules designed to provide uniform service to all members: obviously, standardization has been stressed continuously in this endeavor. NCC's clearing membership now stands at 242 firms in New York, and over 50 more throughout its national network. Before the recent downturn in market activity, NCC was processing 17,500 transactions (35,000 sides) daily, and quite often substantially more. NCC's services extend to some 8,000 stocks and almost 3,000 bonds.

Pacific's latest report by and large is a restatement of its earlier position. None of the essential systems concepts dealing with a "joint systems" approach previously set forth have changed, although more specifics are included. Again, the latest report stated that a joint approach is the least expensive clearing mechanism which, to us, fails to acknowledge that NCC already has installed its system throughout vast sections of the country, operated already by three important regional exchanges, and at acknowledged minimal cost. The report's timetable for the development and implementation of an "interface" between the two systems, and the cost of such, which we

believe were underestimated at 40 weeks and $129,000, still remain significantly greater than what would be required to extend NCC's service to the West Coast community. The critical points of the report are as follows, with our comments as to each immediately following.

1. It recommends "dual comparison" of all trades between POTC and NCC members. This method, also advanced in the earlier Pacific report, and commented on by NCC in some depth in its response, calls for the comparison of inter-regional trades at both Pacific and NCC clearing centers. Even if NCC and PSE were to work out successfully the differences between their trade comparison programs, numerous occasions would arise when, because of input or transmission errors, different results would be obtained in the two systems. Controlling this sort of arrangement, including the extensive on-going maintenance of current clearing member security, and dividend master files would be difficult. Modifications would be required to Pacific's current system at a significant cost. Reporting trades to one point for comparison would, in our opinion, be a much more practical method.

2. The report highlights, but does not resolve, the problems created by differences in dividend processing and by the necessity for varying dividend cut-off dates between the two systems. Ten pages of Pacific's report were dedicated to describing dividend procedures and their impact on interface. Differing cut-off dates assigned by clearing for processing dividends in a manner so as to afford protection to each member were acknowledged to be a problem. The report pointed out that unresolved differences in the two systems would unbalance the "omnibus" or accounting control mechanism. It also called for the automation of dividend procedures by Pacific, again at substantial cost, to parallel NCC's. In conclusion, however, the report stated that adoption of a methodology to solve the cut-off problem would require resolution by NCC and Pacific, and in so pointing up the nature of problems to be resolved, set forth three alternatives, all of which would require substantial efforts and incur possible on-going problems. Resolution of this entire matter is achieved, however, through the use of one system.

3. "Omnibus" accounting, which represents the combined securities positions, dividends, and money balances of all inter-regional transactions, was explained. The mechanics of controlling the accounts were stated simply and directly, with emphasis on the daily exchange of data, which should be equal and opposite. Master files of member and security information were covered briefly, the report stating that both systems' master files would have to be in constant agreement, or else omnibus accounts would never be in balance. It is our opinion that the report does not deal sufficiently with controls necessary to insure that mutual omnibus positions and security master files do not get out of balance. The complexity of controlling data between Pacific and NCC systems is not resolved by the simple creation of omnibus accounts. Importantly, even within the standard system used by NCC, controls occupy nearly 25% of clerical and computer processing time.

4. The report recognizes, but does not resolve, many legal and regulatory matters still left open. (As a few examples; coordination of responsibilities for inspection and examination of dealers who are members of both clearing organizations, standards for policing the financial security of members of each system, resolution of conflicting claims in the event brokers are unable to meet their settlement requirements in one system and positions are affected in both systems, determination of priorities in case of insolvencies, responsibility for losses in transfer or in transit, etc. ...) In our opinion, resolution of matters such as these would require substantial time, effort, and unnecessary expense.

All-in-all, the report recommends a systems plan which we do not believe would provide as economic or efficient a service to the NASD membership as the NCC standard system. This, coupled with NCC's accomplishments to date and plans to continue to expand its system throughout the country, caused our Board of Governors to act unanimously to support the continuance of NCC's nationwide program and again to reject the joint systems concept of an interface with Pacific.

FUTURE

NCC is prepared to extend its system and services to San Francisco and Los Angeles, through facilities to be operated for NCC by PSE. Through this arrangement, which has been proposed to Pacific by NCC over the past and which is identical to NCC's arrangements with the Midwest, Boston and Philadelphia Exchanges, all over-the-counter trades involving West Coast brokers would be tied into NCC's national operation. Given timely acceptance by Pacific, an October target date would be realistic. In each instance of working with the other regional exchanges, an eight-week lead-time was required. An October date takes into consideration NCC's plans to develop and implement a "Free Account Net System" this summer, which will provide the groundwork for NCC's use on behalf of its members of the Central Certificate Service depository in New York and of depositories elsewhere, including Pacific's.

Your report indicated a strong feeling on your part of the importance to maintain one clearing system on the West Coast for both listed and over-the-counter business. If this feeling is shared by the brokerage community, to the extent that they would wish to have NCC's system clear their listed business as well, we would be pleased to cooperate with you to this end.

We are anxious to proceed with a program to implement the National Clearing Corporation's system on the West Coast. We look forward to working with you and the staff of the Pacific Stock Exchange at the earliest possible date.

Sincerely,

J. Logan Burke, Jr.
Chairman, Board of Governors

cc: NCC Board of Directors
President, Pacific Stock Exchange
NASD Board of Governors

PACIFIC COAST STOCK EXCHANGE

618 So. Spring Street
Los Angeles 90014

CHAIRMAN OF THE BOARD

301 Pine Street
San Francisco 94104

San Francisco
June 14, 1973

Mr. J. Logan Burke, Jr.
Chairman, Board of Governors
National Association of Securities Dealers, Inc.
1735 K Street, N.W.
Washington, D.C. 20006

Dear Logan:

I have received your letter of May 29th on the clearing subject. It appears to contain a thorough history of the proposals that the Pacific Stock Exchange has made over a number of years for tying together the various clearing entities in the industry, but not much on the most central question on the importance of a single system in the industry for all business, whether listed or over-the-counter.

Logan, I am not familiar with all that has gone on in the past or all the numerous details of the clearing problem, but I am sure that the thing the industry should do is to reduce its operational costs. So I feel that we should forget the past and join forces with the various segments of the industry to create a system that will work nationally. I am confident that our industry people and our Exchange and Clearing personnel share the same view.

It has long been recognized that Pacific has pioneered in clearing and settlement techniques. Our present operation has been developed into a closely integrated system of many services for brokerage firms, banks, and financial institutions on the West Coast. In addition to the "net-by-net" clearing approach (which we helped you with), the system includes settlement for banks, institutions, correspondents, collection and delivery services between other cities, specialist cashiering, and the Pacific Securities Depository, in which currently is housed $1 1/4 billion of securities encompassing some 9,000 different security issues.

These services encompass all types of securities and cover both listed and over-the-counter transactions. There are securities of over 6,000 over-the-counter issues in the Pacific Depository.

Samuel Stewart, Senior Vice Chairman of the Bank of America, represents the banking industry and Tom Phelan represents the securities industry on the National Coordinating Group for Comprehensive Securities Depositories in setting up regional depositories.

We have spent a considerable amount of money in developing the Pacific Securities Depository in line with the National Coordinating Group's plans which we understand has the tacit support of the SEC, Senator Williams, and Congressman Moss. It is my understanding that this Group was formed at the suggestion of BASIC following Congressional hearings before the Williams and Moss Subcommittees in 1971. As you know, Gordon Macklin is a member of BASIC and also of the National Coordinating Group and I assume he and the NASD also support this concept.

The West Coast banks just two weeks ago committed $3.7 million to the further development of the Pacific Depository in which they plan to entrust their fiduciary and custodial securities. We are under obligation to the banks in providing the interface into the Pacific Depository through our clearing operations.

I mention these points not as obstacles to our getting together, but as industry and regional conditions with which we must deal. I note your proposal on Page 9 of your letter to have PSE operate the NCC system on the West Coast. While I have not been aware that there have been any in depth discussions between NCC and PSE in the last year or so, other than the proposal to integrate the systems prepared by Peat, Marwick, and Mitchell which was rejected as advised by your letter, it has been anticipated that the systems should be in some way integrated eventually. While your letter does not set forth any specifics as to how you suggest that these questions be resolved, there are probably several methods in which this could be accomplished.

To this end, I suggest that we have Gordon Macklin and Tom Phelan get together as soon as possible with their appropriate staff members to work out the necessary details to effect an implementation.

PACIFIC COAST STOCK EXCHANGE

Mr. J. Logan Burke, Jr.
Chairman - NASD

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June 14, 1973

I am sure our Board will be open-minded in approving the implementation of any reasonable arrangement to accomplish the desired result for the industry. I further believe that the thinking of Bob Gardener's SIA Industry Committee on clearing should be obtained by our people so as not to run counter to its efforts, and we should also clear our plans with the SEC.

Because of the decision to be made with our depository project and the plans with our banks, an early decision on our course of action is most important.

Shall we proceed this way? Please let me hear from you.

Sincerely,

Bob

Robert P. Mann

RPM:bg

cc: NCC Board of Directors
NASD Board of Governors
President, NASD
PSE Board of Governors

Senator WILLIAMS. Now, that is it. That is the whole troubling problem of the lack of affirmative leadership as I see it.

Mr. PICKARD. Yes.

Senator WILLIAMS. Study, review, and reject and revise. You know, leadership is what we need.

Mr. EVANS. This is why we need specific authority in this bill. We need this legislation now so we can coordinate that.

Senator WILLIAMS. What we see is you not reacting to their studies and disagreements, but not only guidelines, but leadership direction. That is the way I look at the problem if we are going to get this done in our time.

Mr. PICKARD. Mr. Chairman, I think one of the problems we have is that often it is the case—although we would argue specifically against such a proposition if we got into a court—that we do not have the direct authority in many of these areas necessary to create these interfaces. I think your legislative proposal gives us that authority.

Senator WILLIAMS. I was trying to project that situation where we had this as law, and then try and determine your approach.

Now, let's see, what do we have finally here through this round? You suggest that depository and transfer agent services should be allowed to develop in one institution.

Mr. EVANS. Yes.

Senator WILLIAMS. That is the conclusion here. What types of modification in the bill are needed to keep this option open? You have said that this legislation does not clearly make this option possible. Is that right?

Mr. EVANS. Yes; you do not discuss the area. However, we do not have exact legislative language drafted at this time. We are familiar with the problem. We understand that tomorrow the largest of the transfer agents will be in to testify before you. I believe it is Bradford. And we understand that they will discuss some of the problems they may have with the bill.

We understand that this type of a transfer agent does not object to the SEC oversight and SEC regulation. And what we would like to do after your hearings on the basis of the information we can gain also from year hearings is work with your staff to draft language which would take care of this situation.

We do have language at this time which would take care of this for you.

Senator WILLIAMS. Fine, gentlemen, thank you. Thank you, gentlemen, very much.

[The SEC's additional comments on S. 2058 follow:]

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C., July 20, 1973.

Hon. HARRISON A. WILLIAMS, Jr.,
Chairman, Subcommittee on Securities, Committee on Banking, Housing and Urban Affairs, U.S. Senate, Washington, D.C.

DEAR SENATOR WILLIAMS: In accordance with your request, I am pleased to submit to you the following comments on specific provisions of S. 2058 dealing with the processing of securities transactions, which are in addition to the Commission's statement of July 11, 1973.

I wish to once again emphasize that the Commission considers legislation in this area vital to the development of an integrated securities processing system. We believe that the present rulemaking provisions in S. 2058, together with our recommendations, would permit the Commission to accomplish the objectives of

this legislation. The Commission believes that substantial dilution of this authority might jeopardize these objectives.

We hope that these comments will be helpful in your consideration of S. 2058. If you have any questions regarding the comments, please let us know.

For the Commission.

Sincerely,

HUGH F. OWENS, *Senior Commissioner.*

COMMENTS OF THE SECURITIES AND EXCHANGE COMMISSION ON S. 2058

Our comments on specific provisions of S. 2058 are as follows:

SECTION 3

Section 3 of the bill would amend Section 3(a) of the Exchange Act by adding definitions of the terms "clearing agency," "participant," "transfer agent," "appropriate regualtory agency" and "rules of a clearing agency." We note that there are certain exclusions from the terms "clearing agency," and "transfer agent." In this connection, we wish to note that investment company shares (*e.g.*, mutual fund shares) are frequently distributed through methods involving the use of intermediary organizations commonly referred as as "service agents." The functions performed by such agents, acting in various capacities simultaneously for investors, retailing dealers, principal underwriters and issuing investment companies, may vary somewhat throughout the industry, but generally these functions include the following:

1. Receive orders accompanied by payment, directly from shareholders for the purchase of fund shares.
2. Compute the portions of the investor's payment due to the fund, the underwriter, and the retailing dealer, record the transaction accordingly, and credit the monies to the appropriate accounts.
3. Credit the share account of the investor with the number of shares purchased.
4. Mail a confirmation statement of the transaction to the investor, the retailing dealer and the registered representative of the relating dealer. Copies are usually also furnished to the principal underwriter, the fund custodian and the fund for their records.
5. Process orders for the liquidation of fund shares.
6. Calculate and process the reinvestment of cash dividends for shoreholders.

Depending on the nature of the services rendered, most of these service agents appear to come within the definition of the terms "clearing agency," and "transfer agent" as defined in Section 3. In this connection, we note that the last sentence of proposed paragraph (22) and the last sentence of proposed paragraph (24) of Section 3(a) would contain certain exclusions from the term "clearing agency," and "transfer agents." We assume that these exclusions do not refer to service agents who perform these functions in connection with mutual fund shares or variable annuity contracts. We suggest that the exclusionary sentence in proposed paragraph (24) be amended to make this clear.

SECTION 4

Section 4 would amend Section 15(c) of the Exchange Act by adding a new pargraph (6) to make clear that the Commission has authority to adopt rules applicable to brokers and dealers regulating the time and method of making settlement, payments and deliveries, and opening, maintaining and closing accounts. We believe the only meaningful reading of this Section and the parenthetical phrase "other than an exempted security or commercial paper, bankers' acceptances or commercial bills" is that a broker or dealer whose business is entirely in exempted securities would not be subject to rules adopted pursuant to proposed Section 15(c)(6), but that a broker or dealer who engages in transactions in both exempted and nonexempted securities would be subject to the full effect of all the rules under this Section. We recommend that this be made clear in the legislation.

SECTION 5

Proposed Section 17A(c) would require the Commission to find, as a prerequisite to registration, that a clearing agency meets the criteria set forth in

that Section. We note that proposed Section 17A(c)(2) would, among other things, give a clearing agency discretionary authority to deny participation to persons who have been expelled or suspended by a registered clearing agency during the period of such expulsion or suspension. The Commission believes that its approval should be obtained before a person currently under suspension or expulsion from a clearing agency may become a member of another clearing agency.

Proposed Section 17A(d) would require the Commission to publish notice of the filing of the registration statement of a clearing agency and afford interested persons an opportunity for comment. Within 60 days of filing of a registration statement by a clearing agency, the Commission would be required by *order* to grant such registration or institute appropriate administrative action to determine whether the application should be denied.[1] The Commission does not object to a requirement that it institute administrative action to determine whether applications for registration should be denied, if the intent of the proposed amendment is, as we believe, to require due process when denial of registration is being considered and the defect in the registration statement cannot be remedied.

Proposed Section 17A(*l*)(1) would grant the appropriate regulatory agency direct disciplinary power over clearing agencies, and proposed Section 17A(*l*)(2) would grant the appropriate regulatory agency direct disciplinary power over participants. Proposed Section (*l*)(3) would give the appropriate regulatory agency authority to remove from office any officer or director of a clearing agency or securities depository who has willfully abused his authority.

Where the Commission is the appropriate regulatory agency, we suggest the following. In Subsection (*l*)(2) of proposed Section 17A the Commission should be granted direct authority to censure or otherwise impose limitations on a participant. The rather severe sanctions of explusion or suspension may work an undue hardship on the participant, and the additional sanctions suggested above will give the Commission greater administrative flexibility to fashion appropriate remedies. In addition, we believe that Section (*l*)(2) of proposed Section 17A should not authorize the Commission to discipline a participant for violation of a clearing agency rule which relates solely to internal management or procedures between a clearing agency and its members when such violations do not affect the public interest, the interests of investors or the efficient processing of securities transactions. We also believe that under this Section the Commission should not be required to proceed against any clearing agency participant on the basis of violations of clearing agency rules without first notifying the clearing agency of the alleged violations and the Commission's intention to institute a proceeding based on it, and giving such clearing agency a reasonable time within which to take appropriate action. However, the Commission makes no judgment as to whether similar additional sanctions or procedures would be reasonable for the appropriate bank regulatory authorities regarding entities subject to their regulatory jurisdiction.

In Commissioner Evans' statement with respect to the bill, he pointed out that the Commission could not discharge its function under the bill, particularly with respect to rulemaking, in an informed manner unless it had authority to review the operations of clearing agencies. Such review would be solely in aid of the Commission's functions and not for enforcement or compliance purposes. The Committee's staff suggested that the Commission submit a draft of statutory language to accomplish this purpose. We accordingly suggest that paragraph (p) of proposed Section 17A be amended by inserting the following at page 21, line 8 of the bill, in lieu of the provisions of that paragraph commencing with the words "Nothing in this section. . . ."

"Whenever the Commission is considering a rulemaking or other proposal regarding clearing agencies, after submitting a copy of said proposal to each of the other appropriate regulatory agencies, if the Commission determines that in addition to consultation with and the receipt of views from the other appropriate regulatory agencies, it is necessary to review the operations and related activities of a clearing agency or agencies, upon notice to the appropriate regulatory agency for the person involved, the Commission may conduct such reviews as it deems necessary to fulfill its responsibilities under this Section.

"The Commission and the other appropriate regulatory agencies shall coordinate their examinations and reviews in order to minimize unnecessary duplications.

[1] The 60-day period with which the Commission is required to act with regard to clearing agencies is unduly short in view of the fact that the notice of filing must be sent out for public comment. Since the Commission must prepare a release announcing the filing, await comments on the filing, and analyze these comments, we suggest that the Commission be allowed 120 days to act on the case of clearing agencies.

"Nothing in this Section shall impair the examination powers of the Commission with regard to persons for which it is the appropriate regulatory agency or the authority of any state banking authority or other state or Federal regulatory authority having jurisdiction over a person registered as a clearing agency from making or enforcing rules governing such person which are not inconsistent with this Section or any rules or regulations promulgated hereunder."

Similar language should be inserted for transfer agents in proposed Section 17B at the end of paragraph (k), on page 29 of the bill.

SECTION 6

Proposed Subsection 17B(a)(3) would make clear that the provisions of Section 17B shall apply only to securities which are pursuant to Section 12 of the Exchange Act, or which would be required to be so registered except for the exemption provided in Subsection (g)(2)(B) or (g)(2)(G) of Section 12 and persons performing the function of transfer agents with respect to securities. Proposed Section 17B woud not apply to variable annuity contracts issued by insurance companies. The last sentence of proposed Subsection 17B(a)(3) should be revised to make clear that service agents who may perform transfer agent function in connection with variable annuity contracts would be subject to the requirements of Section 17B.

Proposed Subsection 17B(i) regarding compliance with the requirements of proposed Section 17B by the appropriate regulatory agencies other than the Commission, indicates that a non-bank subsidiary of a bank holding company shall be considered a bank. In his statement of July 11, 1973, Commissioner John R. Evans recommended that the Commission be the appropriate regulatory agency for all non-bank subsidiaries of bank holding companies which are either depositories, clearing agents or transfer agents. We again strongly endorse this recommendation.

Mr. Stetson B. Harman, senior vice president and executive trust officer, First National Bank of Oregon, and president, trust division, American Bankers Association.

The bankers are in town, are they not?

STATEMENT OF STETSON B. HARMAN, SENIOR VICE PRESIDENT AND EXECUTIVE TRUST OFFICER, FIRST NATIONAL BANK OF OREGON, AND PRESIDENT, TRUST DIVISION, THE AMERICAN BANKERS ASSOCIATION, ACCOMPANIED BY EUGENE M. TANGNEY, SENIOR VICE PRESIDENT OF THE FIRST NATIONAL BANK OF BOSTON; FRED M. SHELL, VICE PRESIDENT OF THE FIRST NATIONAL BANK OF ATLANTA; AND ROBERT L. BEVAN, ASSISTANT FEDERAL LEGISLATIVE COUNSEL, THE AMERICAN BANKERS ASSOCIATION

Mr. HARMAN. Yes; they are.

Senator WILLIAMS. Senator Packwood certainly wanted to be here, Mr. Harman, but necessarily had to be at the executive session of the Finance Committee. So, therefore, he is not here to welcome you, although he certainly wanted to. He wanted to commend you for your capable and fine work. And I pass on Senator Packwood's observation.

Mr. HARMAN. Thank you.

Mr. Chairman, my name is Stetson B. Harman. I am senior vice president and executive trust officer of the First National Bank of Oregon, Portland, and president of the Trust Division of The American Bankers Association.

This morning. I am accompanied by Mr. Eugene M. Tangney, senior vice president of the First National Bank of Boston who is chairman

of the Corporate Trust Activities Committee of the American Bankers Association's Trust Division on my left, Mr. Fred Shell on my right, vice president of the First National Bank of Atlanta, and Mr. Robert L. Bevan, assistant Federal legislative counsel of the ABA.

We appreciate this opportunity to appear before your subcommittee to discuss S. 2058. And may I respectfully request that while these comments are a summary of our written statement, we would like to have the entire statement included in the record.

Senator WILLIAMS. That will be done.

[The complete statement of Mr. Harman may be found at p. 183].

Mr. HARMAN. Before discussing the bill's provisions, I would like to outline the basic policy position of the ABA on securities processing. The association believes the ultimate objective in modernizing securities processing should be the elimination of the stock certificate to the maximum extent possible. Because there are many major obstacles that must be overcome to achieve this goal, the ABA supports as an immediate objective the development of a regional securities depository system to immobilize as many stock certificates as possible. This depository system should include depositories in any geographic area where there is economic and operational justification.

The internal operating procedures of these depositories do not need to be standardized, but it is essential that standards be developed and implemented to permit efficient and economical interchange of information between depositories and between depositories and banks, brokers, and transfer agents.

Governmental regulation of the system should be accomplished by review of securities processing operations for adequate control, auditing, and conformity to standards. Regulatory authorities should not stipulate nor unreasonably restrict an organization's internal systems, procedures, and staffing, nor should they limit an organization in exercising its management responsibilities.

During the past year since the association appeared before the subcommittee on similar legislation, there has been substantial progress by the three securities depositories.

In our prepared statement, we set out some specific data regarding the New York depository, and since that preparation, we have obtained some specifics on the progress of the Pacific and Midwest depositories. The banking community on the west coast has made financial commitments of $2.3 million to support further development of the Pacific depository and has expressed their intent to provide an additional $1.4 million for its development.

The banks have also committed themselves to participating in the depository.

This depository received trust company approval late last year, but has not yet activated its charter. The depository has approximately 9,000 issues on deposit with a market value of $1.2 billion.

In the Midwest, the banks and exchange have approved a letter of agreement which in addition to other matters commits the banks to $1 million during the first year for development of the depository. The depository has also been chartered as a trust company and has applied for membership in the Federal Reserve System.

This progress reduces significantly any need for new Federal legislation to regulate depositories or transfer agents, at least those which are banks and subject to bank supervisory authorities.

Should Congress, however, decide legislation is necessary recent developments also reveal the shape that the legislation should take. The private sector has proven itself capable of developing solutions; and the problem, if any, is one of implementing standards for efficient and economical interchange of information between the various elements involved in securities processing.

Turning now to S. 2058, we believe this bill with a very few revisions and clarifications would provide a workable responsible regulatory scheme for securities processing. While substantially the same as S. 3876 passed by the Senate last year, there are some important changes, and we believe most of them improve the measure.

Section 6 of the bill relating to transfer agents is of primary concern to banking. It would require transfer agents to comply with rules and regulations prescribed by the SEC:

> As necessary or appropriate in the public interest, for the protection of investors or to effectuate the purpose of this section with regard to standards for the performance of transfer functions, measures and procedures for safe handling and custody of securities and operational compatibility of transfer agents with other persons involved in the securities handling process.

The ABA recognizes the need for one agency to establish standards for compatibility of transfer facilities with other facilities in the securities handling process and that this agency should be the SEC. As to standards of performance, we recognize they could have a direct impact on securities processing and thus should be subject to SEC rulemaking authority.

However, standards of performance also relate directly to internal operations and this makes it imperative that the 15-day provision of subsection (k) remain in the bill as finally enacted. The SEC should give particular consideration to the views of the banking agencies which would be provided under subsection (k) regarding the impact of proposed regulations on transfer agent banks.

In the area of safe handling and custody of securities, we can see no reason for giving the SEC rulemaking authority over banks that serve as transfer agents. One of the principal services of banks over the year has been the safeguarding of valuables of all kinds, primarily cash and securities. This is an area in which the bank supervisory agencies have particular experience and expertise. In 1968, the Congress specifically imposed responsibility in this area on the banking agencies in the Bank Protection Act.

We do not believe the SEC could add anything of value to the current regulation of banks in this area. But it is quite likely that despite the provisions for coordination, banks would find themselves subject to conflicting regulations if the SEC is given authority in this area. Consequently, the association urges the subcommittee to delete the authority for the SEC to prescribe rules and regulations for transfer agent banks with regard to measures and procedures for safe handling and custody of securities.

New language in subsection (j) also raises a question as to its meaning. The last sentence now reads,

> Except to the extent that enforcement of the requirements imposed under this section is specifically committed to another appropriate regulatory agency, the Commission shall have primary responsibility to enforce such requirements.

The word primary, was not found in S. 3876. In the previous bill, this provision clarified the enforcement roles of the various agencies,

placing transfer agent banks under the jurisdiction of the banking agencies and other transfer agents under the SEC. The word primary, however, seems to indicate an enforcement role for the SEC over transfer agent banks, including a primary enforcement role in certain instances.

We oppose the SEC having any enforcement authority over transfer agent banks. The authority should be granted completely to the banking agencies. They would be better able through their periodic examinations and enforcement powers to carry out the new law and the rules and regulations prescribed thereunder.

The Comptroller of the Currency testified last year that considering the nature of bank regulation, registration of transfer agent banks would serve no supervisory purpose. We urge the subcommittee to consider this point. In this day and age, paperwork is already threatening the vitality of our economy, and it would seem unwise to add more if it serves no public purpose.

The regulation of securities depositories is also a matter of major concern to banking because if these depositories are to accomplish their purpose of immobilizing securities, banks must place on deposit with them securities held in a fiduciary or other capacity. Banks are held to the highest standard of care in the protection of trust assets, and they cannot be expected to place such assets in depositories unless they have the utmost confidence in their operations and management.

S. 2058 recognizes this need by splitting responsibility for regulation of depositories between the banking agencies, actually the Fed and the SEC.

As indicated earlier, the progress which has been achieved by the three depositories and their membership or planned membership in the Federal Reserve System reduces substantially the need for legislation. However, if Congress decides to act, we support the depository/clearing agency provisions of S. 2058 with a few revisions.

In addition to considering a potential participant's operational capacity and to requiring a bond or deposit, a securities depository should be allowed to consider the potential participant's character and real financial responsibility. The rules of the depository establishing standards in these areas would, of course, need to be reasonable and consistent with the purposes of the act and with the public interest.

Such rules would be subject to SEC review on registration of the depository or on subsequent adoption. Also, denial of access on either of these grounds would be subject to the procedural safeguards of the bill and to review by the appropriate regulatory agency.

Next, the shareholders of a depository should have complete authority over adoption of rules, election of directors and officers, and all other phases of the administration of the depository's affairs.

A depository is not a public institution in the sense of the NASD or the stock exchanges which more or less stand in the place of Government in regulating their membership. Also, a depository does not directly serve the investing public. Consequently, there does not appear to be any sound reason for departing from the traditional principles of corporate management. Shareholders should control depositories.

Third, the bill, unlike S. 3876, would give the Commission rulemaking authority over depositories with regard to measures and personnel standards for safehandling and custody of securities and funds.

Again, as with transfer agents, any such rules promulgated by the SEC would duplicate the regulation already imposed on banks by Federal bank supervisors.

The ABA urges that the bill be amended to grant this rulemaking authority to the appropriate regulatory agency.

Another problem we find in S. 2058 is the definition of "clearing agency." The exemption of lending, fiduciary, correspondent of safekeeping functions commonly performed by banks, brokers, and other financial institutions which was included in S. 3876 has been changed by the addition of the words, "on the date of enactment of this paragraph." We suggest this new language be deleted as it may unduly restrict the normal growth of services performed by banks and other financial institutions.

A provision should be added to the bill which would authorize national banking associations with the approval of the Comptroller to invest a limited amount in the stock of one or more depositories. National banks would be encouraged to place trust assets in depositories if they could own shares in the depository and participate in its management.

Finally, it should be made clear that the SEC's enforcement authority under section 21 of the 1934 Exchange Act is not applicable to depositories, or that this authority is only residuary and not to be exercised unless a banking agency fails to do its job with regard to the depository/clearing agency provisions of the bill.

The Association fully supports section 9 of S. 2058 which relates to State taxes. Our prepared statement, incidentally, erroneously refers to section 8, and we ask it be corrected in the official record.

So in conclusion, if Congress decides legislation to regulate securities processing is necessary, the ABA supports S. 2058 with the few revisions and clarifications discussed.

I want to thank the subcommittee for this opportunity to appear and discuss the position of the American Bankers Association. And we would like to offer our services to the subcommittee to help in any way in which we can.

Senator WILLIAMS. Well, we appreciate that. And no doubt, there will be consultation, staff consultation, on detail, Mr. Harman.

First, to further understand your concern with the language of subsection (j) and the use of this word "primary" in terms of responsibility to enforce the requirements, at the bottom of the page, the bill provides that the Commission shall have "primary" responsibility to enforce such requirements, as you see, only in those areas where no other agency is designated or committed.

To the extent that enforcement of the requirements imposed under this section is specifically committed to another appropriate regulatory agency, the Commission shall not have primary responsibility to enforce such requirements.

I am a little confused, therefore, with your apprehension.

Mr. BEVAN. Possibly, Mr. Chairman, I could respond to that point.

One of the problems is that the language of the bill does not specifically commit enforcement to the agencies. The way the bill is worded, it defines what is the appropriate regulatory agency. Then, in the subsection just before this, in (i), it says for the appropriate regulatory agencies compliance with the requirements imposed by

the bill may be enforced under section (o) of the FDIC Act, and then it gives specific enforcement authority to the SEC for its role.

And when you use the term "specifically committed," in (j) there is no specific commitment. It is not in the language of the bill.

Also, when you talk about a primary responsibility, there seems to be someone who would have a secondary responsibility. And the only enforcement agencies we have in the bill, the only regulatory agencies involved, are the banking agencies and the SEC. So it is just a matter that it seemed to be unclear, that is what the problem is.

Senator WILLIAMS. For example, you take a State bank, who would be the banking regulatory authority under this bill?

Mr. BEVAN. It would depend on whether it is a member of the Fed or not. If not a member of the Fed, it would be the FDIC.

Senator WILLIAMS. All right, if they are a member of the Fed, who would it be?

Mr. BEVAN. It would be the Federal Reserve System.

Senator WILLIAMS. And if they are not?

Mr. BEVAN. Then the FDIC—

Senator WILLIAMS. I don't see where your apprehension is. You know this better than I do, just who the banking regulatory authority is in all situations. Name a situation that you think is not clear. Who would have the primary enforcing responsibility?

Mr. BEVAN. Subsection (j) says specifically committed, and there's nothing in the bill that specifically commits overall enforcement to the banking agencies.

Senator WILLIAMS. We know who it is committed to but——

Mr. BEVAN. We are all in agreement with what the bill is trying to say and I think there's just some question——

Senator WILLIAMS. You are not worried about the primary word; you are worried about the specifically committed?

Mr. BEVAN. Right; if it was specifically committed there would be no problem.

Senator WILLIAMS. We know who it would end up with but you want it a little more specially stated. You understand that, drafters to my left and drafters to my right? We have got it all clear? Very good.

In your statement, you state that a provision should be added which would authorize the national banking associations with the approval of the comptroller to invest a limited amount in the stock of one or more depositories. The question is: Why are they not permitted to do that now?

Mr. BEVAN. The Glass-Stegall Act prohibits it. These are not a qualified investment for banks at the present time. I think the Comptroller's office has also asked for this authority specifically.

Senator WILLIAMS. There is a specific provision you feel in the law that prevents that?

Mr. BEVAN. Yes. The Glass-Stegall Act.

Senator WILLIAMS. I don't know if we want to borrow that particular problem here. This would get us—you see, we have a strange dichotomy in the Congress on this kind of—this securities legislation. We in the Congress, not here in the Senate because we have it in one place, but in the House——

Mr. BEVAN. Yes, sir, and——

Senator WILLIAMS. You are suggesting that we amend our bill so it would have joint jurisdiction with Congressman Patman?

Mr. BEVAN. We would hope this provision would be such an insignificant part of the bill that it would not have to go through two committees on the House side.

Senator WILLIAMS. Of all the microscopes with power, his is the most powerful, I'll tell you.

Now, Mr. Harman, would banks actively participate in a clearing depository system that is regulated in accordance with S. 2058, the bill before us?

Mr. HARMAN. You say would they?

Senator WILLIAMS. Yes.

Mr. HARMAN. Yes.

Senator WILLIAMS. Actively participate?

Mr. HARMAN. Yes.

Senator WILLIAMS. All right. Now we come back to your first suggestion that your staff people are available for consultation. We accept and that will come to pass. Thank you very much.

Mr. HARMAN. Thank you, sir.

[Complete statement of Mr. Harman follows:]

Statement of Stetson B. Harman
President of the Trust Division of
The American Bankers Association
before the Senate Securities Subcommittee
on S. 2058
July 11, 1973

Mr. Chairman and members of the Subcommittee:

My name is Stetson B. Harman. I am Senior Vice President and Executive Trust Officer of the First National Bank of Oregon, Portland and President of the Trust Division of The American Bankers Association. I am accompanied by Eugene M. Tangney, Senior Vice President of the First National Bank of Boston who is Chairman of the Corporate Trust Activities Committee of The American Bankers Association's Trust Division, and Robert L. Bevan, Assistant Federal Legislative Counsel, ABA.

The American Bankers Association appreciates the opportunity to appear before the Subcommittee to discuss S. 2058.

Before discussing the bill's provisions I would like to outline the basic policy position of the ABA on securities processing. The Association believes the ultimate objective in modernizing securities processing should be the elimination of the stock certificate to the maximum extent possible. Because there are many major obstacles that must be overcome to achieve this goal, the ABA supports as an immediate objective the development of a regional securities depository system to immobilize as many stock certificates as possible. This depository system should include depositories in any geographic area where there is economic and operational justification.

The internal operating procedures of these depositories do not need to be

standardized but it is essential that standards be developed and implemented to permit efficient and economical interchange of information between depositories and between depositories and banks, brokers and transfer agents.

Governmental regulation of the system should be accomplished by review of securities processing operations for adequate control, auditing and conformity to standards. Regulatory authorities should not stipulate nor unreasonably restrict an organization's internal systems, procedures and staffing nor should they limit an organization in exercising its management responsibilities.

During the past year since the Association appeared before the Subcommittee on similar legislation there has been substantial progress by the three securities depositories.

New York's Central Certificate Service was spun off from Stock Clearing Corporation and subsequently was succeeded by The Depository Trust Company, a limited purpose trust company chartered by the State of New York. The Trust Company has become a member of the Federal Reserve System.

CCS's (DTC's) progress has not been limited to corporate structural change. Operationally it has made significant strides forward. During calendar year 1972 over eight million transactions were completed by book entry without the physical delivery of certificates. At the end of February 1973 more than 1½ billion shares, with a market value of approximately $55 billion were on deposit with CCS. These shares represent more than 2,800 securities issues. Currently there are 294 participants in CCS as follows: 270 broker/dealers, five clearing corporations, and 19 banks. The bank participants are really just beginning to place customer

securities in the depository.

The depository's capacity is being expanded to accommodate 9,000 securities issues and at least 600 participants.

Since 1971 the depository has operated a broker loan program which included, at the end of February 1973, 167 broker/dealers and 58 bank pledgees. Forty of these banks are outside New York City, located across the country.

CCS has taken a number of steps to improve efficiency and recently contracted on a trial basis with a number of banks in other cities to open depository facilities so participants could deposit securities in these regional locations and receive immediate credit on CCS's books.

Similarly, the Pacific depository and the Midwest depository efforts are moving forward.

Two statutory amendments are necessary in most states before entities organized under their law can utilize fully the depository system. The ABA, BASIC, and others have been working in the states for such change; and the needed legislation has been enacted in many states, particularly in the larger money-center states. The primary task, we have found, is education.

The transfer agent depository concept is in operation in one bank. The bank's responses to all the legal and operational problems involved have been reviewed and accepted by the Boston Stock Exchange. One company is using this system at the present time. In the first three weeks of operation 29 per cent of the company's stockholder accounts deposited their securities in the depository.

We believe these developments demonstrate that the banking and securities industries recognize clearly the need for action to avoid another paper crunch and are committed to doing what is necessary to make the system work. All this reduces significantly any need for new federal legislation to regulate depositories or tranfer agents, at least those which are banks and subject to bank supervisory authorities.

Should Congress, however, decide legislation is necessary recent developments also reveal the shape that the legislation should take. The private sector has proven itself capable of developing solutions; and the problem, if any, is one of implementing standards for efficient and economical interchange of information between the various elements involved in securities processing.

Turning now to S. 2058 we believe this bill with a very few revisions and clarifications would provide a workable responsible regulatory scheme for securities processing. While substantially the same as S. 3876 passed by the Senate last year there are some important changes and we believe most of them improve the measure.

Section 6 of the bill relating to transfer agents is of primary concern to banking. It would require transfer agents to comply with rules and regulations prescribed by the SEC "as necessary or appropriate in the public interest, for the protection of investors or to effectuate the purpose of this section with regard to standards for the performance of transfer functions, measures and procedures for safe handling and custody of securities and operational compatibility of transfer agents with other persons involved in the securities handling process". At first blush the new language "in the public interest, for the protection of

investors or to effectuate the purposes of this section" seems to be a broadening of the similar provision in S. 3876. However, a close reading of subsection (g) reveals that the new language only describes the purposes for which the SEC is given authority to make rules in the areas of performance, safe handling of securities and operational compatibility. We suggest that this point should be made clear in the Committee report.

Regarding the three areas of rulemaking the ABA recognizes the need for one agency to establish standards for compatibility of transfer facilities with other facilities in the securities handling process and that this agency should be the SEC. As to standards of performance we recognize they could have a direct impact on securities processing and thus should be subject to SEC rulemaking authority. However standards of performance also relate directly to internal operations and this makes it imperative that the 15-day provision of subsection (k) remain in the bill as finally enacted. The SEC should give particular consideration to the views of the banking agencies which would be provided under subsection (k) regarding the impact of proposed regulations on transfer agent banks.

In the area of safe handling and custody of securities we can see no reason for giving the SEC rulemaking authority over banks that serve as transfer agents. One of the principal services of banks over the years has been the safeguarding of valuables of all kinds, primarily cash and securities. This is an area in which the bank supervisory agencies have particular experience and expertise. In fact, in 1968 the Congress specifically imposed responsibility in this area on the banking agencies in the Bank Protection Act.

We do not believe the SEC could add anything of value to the current regula-

tion of banks in this area. But it is quite likely that despite the provisions for coordination, banks would find themselves subject to conflicting regulations if the SEC is given authority in this area. Consequently the Association urges the Subcommittee to delete the authority for the SEC to prescribe rules and regulations for transfer agent banks with regard to measures and procedures for safe handling and custody of securities.

New language in subsection (j) also raises a question as to its meaning. The last sentence now reads "Except to the extent that enforcement of the requirements imposed under this section is specifically committed to another appropriate regulatory agency, the Commission shall have primary responsibility to enforce such requirements". The word "primary" was not found in S. 3876. In the previous bill this provision clarified the enforcement roles of the various agencies, placing transfer agent banks under the jurisdiction of the banking agencies and other transfer agents under the SEC. The word "primary", however, seems to indicate an enforcement role for the SEC over transfer agent banks, including a primary enforcement role in certain instances. We oppose the SEC having any enforcement authority over transfer agent banks. The authority should be granted completely to the banking agencies. They would be better able through their periodic examinations and enforcement powers to carry out the new law and the rules and regulations prescribed thereunder.

The Comptroller of the Currency testified last year that, considering the nature of bank regulation, registration of transfer agent banks would serve no supervisory purpose. We urge the Subcommittee to consider this point. In this day and age paper work is already threatening the vitality of our economy and it

would seem unwise to add more if it serves no public purpose.

While discussing transfer agents one final matter should be raised. There are a few state chartered trust companies that are not members of the Federal Reserve System and are not insured by the FDIC. Under the bill the appropriate regulatory agency for such trust companies would be the SEC. Even if these trust companies were subsidiaries of bank holding companies the SEC would be the appropriate regulatory agency because under the bill the authority of the Federal Reserve System would extend only to bank holding companies and their non-bank subsidiaries. Such trust companies are normally chartered under state banking laws. We urge that the definition of "appropriate regulatory agency" be amended so that these trust companies would fall within the jurisdiction of the Federal Reserve System, particularly if they are subsidiaries of bank holding companies.

To summarize the ABA supports Section 6 of the bill with the following qualifications: 1) the "appropriate regulatory agency" rather than the SEC have the authority to prescribe rules and regulations with regard to safe handling and custody of securities, 2) it be confirmed that the new language of subsection (g) is more restrictive than the similar provision of S. 3876 and 3) the word "primary" in the last sentence of subsection (j) be deleted with a positive statement that bank supervisory agencies have the enforcement authority for transfer agents within their defined jurisdictions.

Banking is the most closely regulated industry in our nation. Annually the federal banking agencies make unannounced examinations of the banks under their jurisdiction. In addition, all state chartered banks are subject to state examinations which may be conducted in conjunction with the federal examination. For

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this reason, the Association believes Section 6 with the above suggested revisions would provide a sound regulatory scheme which would fully protect and promote the public interest.

The regulation of securities depositories is also a matter of major concern to banking because if these depositories are to accomplish their purpose of immobilizing securities banks must place on deposit with them securities held in a fiduciary or other capacity. Banks are held to the highest standard of care in the protection of trust assets, and they cannot be expected to place such assets in depositories unless they have the utmost confidence in their operations and management.

S. 2058 recognizes this need by splitting responsibility for regulation of depositories between the banking agencies, actually the Fed., and the SEC.

As indicated earlier the progress which has been achieved by the three depositories and their membership or planned membership in the Federal Reserve System reduces substantially the need for legislation. However, if Congress decides to act we support the depository/clearing agency provisions of S. 2058 with a few revisions.

In addition to considering a potential participant's operational capacity and to requiring a bond or deposit, a securities depository should be allowed to consider the potential participant's character and real financial responsibility. The rules of the depository establishing standards in these areas would, of course, need to be reasonable and consistent with the purposes of the Act and with the public interest. Such rules would be subject to SEC review on registration of

the depository or on subsequent adoption. Also denial of access on either of these grounds would be subject to the procedural safeguards of the bill and to review by the appropriate regulatory agency.

Next, the shareholders of a depository should have complete authority over adoption of rules, election of directors and officers and all other phases of the administration of the depository's affairs.

A depository is not a public institution in the sense of the NASD or the stock exchanges which more or less stand in the place of government in regulating their membership. Also a depository does not directly serve the investing public. Consequently there does not appear to be any sound reason for departing from the traditional principles of corporate management. Shareholders should control depositories.

Third, the bill, unlike S. 3876, would give the Commission rulemaking authority over depositories with regard to measures and personnel standards for safehandling and custody of securities and funds. Again, as with transfer agents any such rules promulgated by the SEC would be duplicative of the regulation already imposed on banks by Federal bank supervisors. The ABA urges that the bill be amended to grant this rulemaking authority to the appropriate regulatory agency. Otherwise the depositories would probably find themselves attempting to serve two masters with conflicting requirements.

The Association's comments, while discussing transfer agents, on the language "in the public interest, for the protection of investors or to effectuate the purposes of this section" are equally applicable here and the intent of the language

should be clarified.

Another problem we find in S. 2058 is the definition of "clearing agency". The exemption of lending, fiduciary, correspondent or safekeeping functions commonly performed by banks, brokers and other financial institutions which was included in S. 3876 has been changed by the addition of the words "on the date of enactment of this paragraph". We suggest this new language be deleted as it may unduly restrict the normal growth of services performed by banks and other financial institutions.

Also it should be clarified that transfer agent depositories are not included in the definition of "clearing agency". As indicated earlier considerable time, money, and effort have been devoted by at least one bank to the development of this concept, and it now serves one corporation in this capacity. This concept is close to the certificateless concept in that share issuance and transfer are by bookkeeping entry only even in the case of individual shareholders. Such depository function is closely related to the transfer agent function, and such depositories should be regulated the same as transfer agents. This would not cause any coordination problems because the SEC would have full authority to require operational compatibility.

A provision should be added to the bill which would authorize national banking associations, with the approval of the Comptroller, to invest a limited amount in the stock of one or more depositories. National banks would be encouraged to place trust assets in depositories if they could own shares in the depository and participate in its management.

Finally, it should be made clear that the SEC's enforcement authority under

Section 21 of the 1934 Exchange Act is not applicable to depositories, or that this authority is only residuary and not to be exercised unless a banking agency fails to do its job with regard to the depository/clearing agency provisions of the bill.

The Association fully supports Section 8 of S. 2058 which relates to state taxes.

In conclusion, if Congress decides legislation to regulate securities processing is necessary, the ABA supports S. 2058 with the few revisions and clarifications discussed.

Mr. Chairman, I want to thank the Subcommittee for this opportunity to appear and discuss the position of The American Bankers Association. I would like to offer the Association's services to the Subcommittee to help in any way we can.

Senator WILLIAMS. You have been very helpful.

Now we have the National Association of Securities Dealers, the president, Mr. Gordon Macklin, and well-supported.

STATEMENT OF GORDON S. MACKLIN, PRESIDENT, NATIONAL ASSOCIATION OF SECURITIES DEALERS; ACCOMPANIED BY DAVID H. MORGAN, PRESIDENT, NATIONAL CLEARING CORP.; AND LLOYD J. DERRICKSON, GENERAL COUNSEL FOR NATIONAL ASSOCIATION OF SECURITIES DEALERS AND NATIONAL CLEARING CORP.

Mr. MACKLIN. It is a pleasure to be here this morning and as you say, I am well-supported and have David Morgan, the president of the National Clearing Corp., on my right, and Lloyd Derrickson, general counsel of both the National Asociation of Securities Dealers and National Clearing Corp., on my left.

In view of the expertise of your committee relating to securities and because we believe progress of NCC in establishing a nationwide clearing system on OTC transactions is generally known, I will not read our prepared statement, preferring instead to answer such questions as the committee may wish to ask. We would be pleased to submit details or further explanations of our activities for the record or otherwise should the committee so desire or to answer in writing as to any matter you desire.

I would like to take this opportunity to commend the committee and its staff not only for the very excellent study it has recently completed but also for its foresight in undertaking these hearings to deal with the implementation of a comprehensive basis for regulation of securities processing. We stand ready to assist in this endeavor in any way you may desire.

Finally, and parenthetically, may I add with your permission, we would appreciate the opportunity to submit in writing some brief technical comments which may be helpful to the committee relating to the procedures for changes in rules of clearing agencies and as to compliance with the bill's requirements by NCC.

Senator WILLIAMS. Is NCC concerned exclusively with clearing OTC transactions?

Mr. MACKLIN. That is our original mandate and what we set out to do. Of late, we have been approached by the Boston Stock Exchange to explore an arrangement whereby we would clear all transactions for their members and there are extensive discussions going on with them at this time.

In addition, we have had some extensive discussions with the Pacific Stock Exchange and are preparing what we hope will be an arrangement with them to clear over-the-counter transactions on the West Coast and as part of that they have raised the point they would like to see one system to clear both listed and over-the-counter transactions. So it is conceivable on the west coast we will be exploring clearing both types of transactions with the Pacific Exchange.

Fundamentally, our mandate was to clear over-the-counter transactions. We have gotten into exploring other transactions at the invitations of these two exchanges.

Senator WILLIAMS. So are your plans for the future to broaden this?

Mr. MACKLIN. Well, our plan for the future is to fullfill our original mandate to see that there is a clearing facility for all over-the-counter transactions and then to interface that clearing facility with the depository network so that those transactions and those members can have use of all national facilities.

Senator WILLIAMS. What is the jurisdictional relationship between NCC and the clearing depository operations set up by the exchanges such as the Depository Trust Co. in New York, Midwest Securities Trust Co. in Chicago and Pacific Securities Depository in San Francisco?

Mr. MACKLIN. That is a question I would like to defer to Mr. Derrickson because of his legal expertise.

Mr. DERRICKSON. As I see it, Senator, it goes to the prior question and that is clearing by exchanges of listed stocks and by NCC of over-the-counter transactions. The jurisdiction in a legal sense is very clear in the sense that transactions on the floor of the exchange, listed transactions, are cleared by their clearing corporations. They have subsidiary rules or additional rules relating to their depositories which as we have heard today, and as we know, are becoming the trust companies or limited purpose trust companies.

So I think Mr. Macklin's earlier remarks about interfacing with the depositories answers that question. Now, perhaps you have something different in mind as to jurisdiction and if it is in the legal sense, I assume it is whether or not the Commission has jurisdiction over these things in ways that the bill would remedy. If that is the question, then I would have to answer that it does, in my opinion.

Senator WILLIAMS. I think that will be sufficient to cover the subject.

On this question of the interfacing, what precisely is meant by interface in the context of differing clearing and depository operations?

Mr. MORGAN. Mr. Chairman, in the context of securities processing procedures and systems, I guess the easiest way to explain it is to say it is a tying together of the two systems. They must be complimentary to each other. In other words, each system serving the other.

Now, in terms of the clearing element of interface, clearing essentially serves as the front end or input of trade information and trades that have been cleared and settled, and in the case of the depository it would be the depository acting in the custodianship and related bookkeeping or recordkeeping type of capability which is designed to immobilize the certificate movement to the greatest extent practicable.

Now, in addition to that, interface also implies, I believe, that the systems should be supplementary to each other in the sense that the sum of these two systems forms the trade completion process. There is no intent nor should it be inferred that an interface is anything more than having the two systems tie together to provide a more complete service than either one of them could provide on a singular basis.

Senator WILLIAMS. I get the impression that there is movement toward this interfacing and I just wondered how this is progressing and how close are we to this fully supplementary situation and capability.

Mr. MORGAN. The staffs of the Depository Trust Co. and NCC have had a series of meetings and systems discussions over the past several months so that we can define completely what would be required in order to perfect the so-called interface. It will require, for example,

to NCC, an extension of its present system and I am sure it would require some modifications on the part of the Depository Trust Co. in order to pick up what I have referred to as the front end or input information from clearing.

We have worked up a pilot program involving one broker on a very limited and somewhat manual scale which we expect to become operational later this month so that we can better understand how each of our operations work and how we can then improve that to perfect a highly automated type of interface which we plan to do later this year.

Senator WILLIAMS. You believe this bill will speed the development of a true national clearing and depository system?

Mr. MACKLIN. Yes, we do.

Senator WILLIAMS. Ideally, what would be the first move after it is signed into law? Would this put you in a position with those with whom you must ultimately be working in the clearing and depository functions—would you take the initiative or should the SEC take the initiative?

Mr. MACKLIN. We have already taken the initiative in most of the areas where we are involved. I think it would put in front of all of us—all entities concerned—in a very clear manner that there is indeed strong oversight authority and any areas of disagreement have a forum where they will be resolved rather than just prolonged and delayed.

So I think for the most part we would continue to proceed with our programs, but I believe they would move more effectively with a stronger and more coordinated SEC oversight.

Senator WILLIAMS. How much time will be involved in reaching this happy and rational state of clearing?

Mr. MACKLIN. In all fairness to the present atmosphere, a lot of progress has indeed been made. You have seen it through the statements filed and you can see it from the progress that entities like NCC and the Depository Trust Co. and the regional depositories have made. So there is good motion on many fronts.

I think we are much closer to a coordinated national clearing system than a first look might indicate. I would guess within a year or two you would have this problem resolved. I would also say that is an unscientific guess.

[Complete statement of Mr. Macklin follows:]

STATEMENT OF GORDON S. MACKLIN, CHAIRMAN, BOARD OF DIRECTORS, NATIONAL CLEARING CORP.

Chairman Williams and members of the Subcommittee. I am pleased to be here to present our views on S. 2058. Accompanying me are David H. Morgan, President of the National Clearing Corporation (NCC), a wholly owned subsidiary of the National Association of Securities Dealers, Inc., and by Lloyd J. Derrickson, Senior Vice President and General Counsel of the NASD, who is also Vice President—Legal of NCC.

In May 1972, in testimony before this Committee relating to S. 3297 and S. 3412, we supported the establishment of a statutory framework for regulation of the securities processing cycle. In our opinion legislation then proposed, as well as S. 2058, much of which is based upon a very excellent and thorough study recently made by the Subcommittee, is necessary and its enactment would be a meaningful advancement in the establishment of a uniform nationwide pattern for regulation of securities processing, a problem which has plagued the industry's operations since 1968. Despite the fact that significant reforms have been

instituted in almost all operational aspects of the industry, a statutory void remains. S. 2058 will do much to fill the void by mandating the institution of a comprehensive, uniform, and non-discriminatory systems for clearing, transfer and immobilization of certificates in securities depositories.

At the time of our testimony last year NCC had been in operation only since September 1971. You will recall that NCC was organized by the NASD in November 1969 after completion of studies by a specially appointed nationwide Association committee. Association By-Laws were amended to require that qualified members clear over-the-counter transactions through facilities of NCC and rules for its operation were adopted. As you know, these changes were accomplished with the cooperation and approval of the Securities and Exchange Commission. The primary feature of the clearing process of NCC is use of the continuous net settlement (CNS) method for clearing and settling transactions. This system was recommended for NCC use by Arthur D. Little & Co. of Cambridge, Massachusetts in a report to the Association's Committee. In deciding to implement CNS, a fundamental consideration was that a fully nationwide system serving all broker-dealers on a non-discriminatory basis was the ultimate goal.

In order to plan the organization and design of NCC an initial survey of over-the-counter transactions nationwide was taken. Basically, it disclosed that 42% of an estimated 35,000 transactions per day took place within the New York trading area and that the New York area traded with other areas of the country in approximately 15% of all transactions. The survey also indicated that the midwest area accounted for 8%, the south 4%, and the west coast 5%, with trading among these centers accounting for 26% of all transactions. Since no national clearing facility existed it was obvious that the methods for clearing and settling transactions between dealers were numerous in quantity, extremely varied in manner, cumbersome and time consuming. A delivery and a corresponding payment was necessary as to each transaction every day with no netting or other process to eliminate handling of funds and securities.

The only organized clearing entity for over-the-counter transactions at that time was National Over-The-Counter Clearing Corporation, (NOTC) originally sponsored by NASD, which functioned only in New York. However, NOTC used the so-called balance order method for settlement wherein each day's trades between members are netted and balance orders issued to those members having balances to be delivered and paid for daily. No provision was made for transactions which failed to settle, one of the central problems in control of securities processing. It was recognized that for nationwide clearing the more efficient system of continuous netting of all transactions in one centralized clearing corporation was necessary. By use of such a system, at the close of business an each day, a member's securities balances and crash balances are carried forward and are satisfied by receipt and delivery of securities or funds. Fluctuations in market price of securities which have not been delivered are accounted for by a daily mark to the market, requiring a cash deposit in the amount of the difference in price until the securities are delivered. Dividends are accounted for and members are required to make deposits to a clearing fund which, under NCC rules, may be used to satisfy liabilities which cannot be met by clearing members.

In October 1971 NCC and NOTC were merged, and at the present time all over-the-counter stock clearing in the New York area is accomplished through the CNS method. In addition, NCC operates a balance order clearing service for corporate bonds and an envelope delivery service whereby broker/dealers and banks may deposit envelopes containing securities for receipts by other clearing members. The dollar values of securities delivered through this service are accumulated and net receiving members remit the net cash balances due daily. The Service is separate and distinct from the CNS system and its fundamental purpose is to provide a method for receipt and delivery of securities not processed through CNS. An additional service is operated between Pacific Over-The-Counter Clearing Corp. (POTC) and NCC and was originally instituted by Pacific and NOTC to clear trades on pilot basis between certain members the Pacific Coast and in New York City.

Within the past year NCC has made meaningful progress in instituting clearing centers in other cities. Centers have been established and are operated by and with the cooperation of the regional exchanges in Boston, Philadelphia and Chicago. A center is planned for implementation later this year on the Pacific Coast for operation by and with the cooperation of the Pacific Coast Stock Exchange. In addition, independent centers have been established to service

members in Atlanta, Milwaukee, St. Louis and Washington. We estimate that more than 60% of the transactions of members in the New York area are cleared and settled by NCC and that with full implementation nationwide this will be expanded to include more than 90% of all transactions, not only those transactions within the area of each center but also those transactions between members in each of the geographical areas. During nationwide implementation we have conducted training seminars for members' personnel in the use of the system and we have timed the entrance of new members into the system in a manner which would not be disruptive of their operations. We have, of course, received full cooperation and helpful support from the Securities and Exchange Commission and have endeavored to keep them advised of our efforts and goals. It is, we believe only through institution of uniform and compatible procedures nationwide that a viable and efficient mechanism can perform satisfactorily in processing securities transactions.

When the system has been phased in nationwide it is essential that a linkage be established with securities depositories. The NASD has been a member of the Banking and Securities Industry Committee (BASIC) since its inception. We are a party to the original agreement which describes the plan of the signatories to establish the Central Certificate Service as the depository in the New York area. The functions of the depository would be, by bookkeeping entry, to eliminate to the extent possible the transfer of securities and to immobilize their movement. We have supported the objectives of BASIC and also of the National Coordinating Group, of which NASD is also a member. This group was formed last year by representatives of the banking industry outside New York, and by the Midwest and Pacific exchanges to coordinate the establishment of depositories in these areas so that a comprehensive and compatible depository system can be implemented nationwide. Depositories have been established in Chicago and in San Francisco by the Midwest and Pacific Stock Exchanges, respectively. It is our understanding that plans are now being implemented by all depositories, including CCS, to become limited trust companies so as to encourage banking authorities to use them.

It is encumbent upon NCC to provide methods, in cooperation with the various depositories, whereby securities in the NCC system may move into the depository environment since the goal of both the banking and the securities industry is immobilization of certificates. NCC is now completing programs, long planned, which will provide the means whereby members may, if they desire, permit securities to remain in a free account for delivery to satisfy future continuous net obligations of their own, to satisfy future customer requirement for delivery of securities and by early 1974 to provide the means for delivery of securities into the various depositories. We are pleased our progress toward linkage with depositories is on schedule and we look forward to the time when all depositories have progressed to the point where facilities are available to account for OTC issues nationwide.

I am appreciative of the Committee's patience in reviewing NCC's activity to date. We would be delighted to answer any questions from the Subcommittee or to provide any aditional information which might be helpful.

Senator WILLIAMS. Thank you very much.

Mr. John H. Perkins, president, Continental Illinois National Bank & Trust Co. of Chicago, and chairman, National Coordinating Group for Comprehensive Securities Depositories, is our next witness.

STATEMENT OF JOHN H. PERKINS, PRESIDENT, CONTINENTAL ILLINOIS NATIONAL BANK & TRUST CO. OF CHICAGO, AND CHAIRMAN, NATIONAL COORDINATING GROUP FOR COMPREHENSIVE SECURITIES DEPOSITORIES, ACCOMPANIED BY JOSEPH P. CORIACI, HERMAN W. BEVIS, AND HAMILTON F. POTTER, JR.

Mr. PERKINS. Mr. Chairman, I am John Perkins, president of the Continental Illinois National Bank & Trust Co. of Chicago, and I am appearing before you today as chairman of the National Coordinating Group for Comprehensive Securities Depositories. I am accompanied by my associate, Mr. Coriaci, and Mr. Bevis from New York, who is a

member of our National Coordinating Group, and they will be available to help with questions if needed.

Our testimony today on behalf of our group on proposed bill S. 2058 parallels to a great degree that which we presented before this committee last fall on then-proposed bills S. 3876, H.R. 14567, and H.R. 14826, and is limited to section 17A entitled "Processing of Securities Transactions."

As we stated at that time, our group endorses the concept of "* * * a nationwide system of interrelated regional depositories independently operated by the private sector to minimize the movement of physical securities." I would like to stress, along with Mr. Macklin, that a lot more progress has been made than meets the eye. Without going into detail, I would like to touch on some of the key elements in this development.

The Depository Trust Co., in New York, formerly Central Certificate Service, now has approximately $60 billion in securities on deposit. The expansion and acceptance of this regional facility by the brokerage and banking segments of the financial community certainly demonstrates support for the overall underlying concept of "securities immobilization."

Midwest Securities Trust Co., in Chicago. This depository now has approximately $400 million in securities on deposit. The Chicago clearinghouse banks have recently signed a memorandum of understanding with the Midwest Stock Exchange to develop the depository further and expand its capabilities, and I might add, the clearinghouse banks have agreed to put up at least $1 million in the development phase.

The Pacific Securities Depository in San Francisco has approximately $1.2 billion in securities on deposit. Like the Midwest, the west coast banks have recently agreed to provide $2.26 million of financial support to develop their regional depository further.

Common to all three depositories is the fact that they have all become trust companies. In addition, the Depository Trust Co. has become a member of the Federal Reserve System; the Midwest Securities Trust Co. is in the process of applying for membership, and the Pacific Securities Depository is in the process of doing the same.

Our National Group has recently approved the recommendations made by our three working committees on the issues of: (1) Standard funds settlement; (2) a financial industry numbering system, and (3) insurance. These are the nitty-gritty type of things that take a lot of time and a lot of digging to get the facts and then get agreement for action.

A pilot interface study has been underway between the Depository Trust Co. and the Midwest Securities Trust Co. for several months. A like pilot program will begin shortly between the Midwest Securities Trust Co. and the Pacific Securities Depository. Rather than dwell on what we have and are doing any longer, I have submitted for the record, a copy of our National Group's meeting minutes of June 4, 1973, and a copy of a letter to Representative John E. Moss, House of Representatives, which was in reply to a letter he had submitted to our committee. These documents will provide you with additional detail.

In reviewing S. 2058, and assuming that Congress determines to enact legislation, our committee feels that we can and do support this

bill. We do, however, wish to reemphasize our overall position of mandatory consultation on rulemaking between the SEC with the appropriate bank regulatory agency, and we think the appropriate bank regulatory agency should have rulemaking powers with respect to safeguards for securities and funds in clearing agencies which are chartered as banks and are members of the Federal Reserve System. We concur and support the proposal that regulation of depositories be the responsibility of the appropriate bank regulatory agency. The SEC's enforcement authority under section 21 of the 1934 Exchange Act is not to be exercised unless the bank regulatory agency fails to do its job.

In the area of depository participation, we support the bill in its reference to "operational capability" of a potential participant, but we feel that two additional criteria must be considered and they are: (1) character, and (2) financial responsibility. I would like to emphasize that we feel strongly that some minimum criteria on character and financial responsibility of participants is an absolute must if we are going to avoid some real troubles.

As we have stated, stressing the above points, we feel that the approach suggested in S. 2058 is acceptable and workable.

Mr. Chairman, I wish to thank the committee for this opportunity to appear on behalf of our National Group and present our position on these issues which are of such importance to the financial community and our entire economy.

Senator WILLIAMS. I wonder if we could put a little more meaning into your suggestion that additional criteria be considered for character and financial responsibility.

Mr. PERKINS. Well, I think the point that we had in mind there, Senator, is that it would seem that, as I read the bill, if someone is a member of NASD or a securities exchange or the other things outlined, they could become a member of the depository. We think that membership also should require some type of character test in the sense that if someone has had a jail record or something like that he could be forbidden membership because of it.

I realize this is getting to be a touchy area these days. We have the problem all the time where we try to look at somebody's record we are employing for the bank. But I think the depositories would feel that they have to have this right to prescribe some standards and to review an applicant's character and have the ability to turn him down for membership. We feel the same about financial responsibility. We think there are, for example, members of the securities exchanges that don't have adequate financial responsibility maybe in some cases, or at least the depository ought to have a chance to take its look at it.

Senator WILLIAMS. You are suggesting that even if qualifications set out by the SEC were met that there should be an additional opportunity for the depositories who will be under the regulation of tthe banking authority evaluate the credentials of candidates for admission.

Mr. PERKINS. Yes. In a general way we are thinking that the depository itself—I am not talking about setting up rules that would provide for automatic turndown or automatic acceptance—but the depository itself should have the right to make rules which would presumably be approved by the regulatory agencies to examine applicants to be members of the depository.

Senator WILLIAMS. Now, let me just understand a little bit of our problems of interface here.

Mr. PERKINS. Senator, could I comment further on this question you just asked as to the character and financial responsibility? I think we have to remember that in the long run we are hoping that banks in the role of fiduciaries and others will put securities in these depositories. In that connection I think the responsibilities are such that we would want to be able to examine and each depository would want to have the right to examine and have some say about who is a member.

Senator WILLIAMS. Now, who are you concerned about in terms of who should be evaluated in terms of character and financial responsibility? Who specifically are you talking about?

Mr. PERKINS. Participants who will be using the depository.

Senator WILLIAMS. Brokers?

Mr. PERKINS. It would be broker/dealers, among others; yes, sir.

Senator WILLIAMS. Among others. Who else?

Mr. PERKINS. An insurance company that's a member, mutual funds, other banks——

Senator WILLIAMS. Are all of these that you are naming registered as brokers?

Mr. PERKINS. No.

Senator WILLIAMS. They are not? Insurance companies are not?

Mr. PERKINS. No; and banks are not.

Senator WILLIAMS. In other words, the Exchange Act of 1934, does not reach some of the areas you are addressing yourself to. Is that right?

Mr. PERKINS. I think we are probably getting over my head technically, but perhaps——

Senator WILLIAMS. Now, the Exchange Act really has quite a detailed section dealing with testing of character for a broker. There is a whole long list under section 15 that lays it out quite clearly with all of the misdemeanors and felonies, et cetera, et cetera, that are an impediment to doing business as a broker. Certainly that is adequate, I would think, in terms of what we usually consider as a character test. But you are saying that some people who will be using the depository will not be tested under the Exchange Act. Is that what you are saying?

Mr. PERKINS. That would be part of it; yes. Perhaps Mr. Potter, who is an attorney and working with us in this field, could add something to this. He has joined us here at the table.

Mr. POTTER. There is, as the Senator has stated, an itemization of those grounds on which people may be excluded from registration. I think the concern is that that list is not exhaustive. It does not, for instance, permit evaluations as to whether or not a candidate for registration has been convicted of perjury or of extortion or of other matters.

I think the concern also is that the experience that BASIC is beginning to accumulate shows that there are certain types of behavior patterns that emerge as, if you will, financial security risks, and as these various patterns begin to emerge I think the cencern is that they should be subject for evaluation whether or not they emerge as convictions of a particular crime or act that is enumerated.

I think what Mr. Perkins is saying is that subject to review by the appropriate regulatory agency of the criteria and subject obviously

of the right of any disappointed applicant to invoke an administrative review of his turndown, that the depositories should have the opportunity to evaluate the criteria other than operational performance. That is my understanding of the position.

Senator WILLIAMS. Do you have anything to add to that, Mr. Perkins?

Mr. PERKINS. No.

Senator WILLIAMS. Now, you mentioned perjury as a possible impediment to participation. Is that right?

Mr. POTTER. This is by way of illustration, Senator. I do not mean to pick that particular one.

Senator WILLIAMS. The act does deal with crimes that go to security activity, does it not? It is not broader than that? As a limitation upon participation and membership?

Mr. POTTER. Yes, sir; that is correct. Essentially, the position is that, again subject to regulatory review, there should be a qualitative evaluation that goes beyond this.

Senator WILLIAMS. There is a real problem here if the NCC clears a guy and you don't clear him. Where does he fit in the picture? He is out of business, isn't he?

Mr. POTTER. I don't believe so, because he can clear through others and there is a substantial group of people clearing through others at this point and perhaps Mr. Bevis or someone else would like to comment on that.

Senator WILLIAMS. I was assuming we were having a more integrated system here. Under your proposal I would say that there are people qualified to do securities business in some areas and not in other areas. Is that a fair conclusion—your additional authority to evaluate character?

Mr. POTTER. That would be correct and I think my proposal with respect to that is that consideration might be given as to whethere or not registration should be as automatic as it is or, if you will, the preclusion from registration should be limited as it is.

Senator WILLIAMS. It would seem to me that given this first opportunity in the depository area to have an evaluation of character and financial responsibility, that somewhere within the system there should be a final court of apeal to consider, to hear, to evaluate.

Mr. POTTER. Yes, sir, and our proposal essentially encompasses that by contemplating that a rule with respect to access would be subject to not only the appropriate regulatory agency's approval of it in the first instance, but also the application of that rule with respect to a particular candidate in the event that he is denied, and that would in effect set up the court of last resort to which you have just referred.

Senator WILLIAMS. Now, I missed something there. Where would that court of last resort be?

Mr. POTTER. That would be in the regulatory agency and obviously, after that, it can go to courts under the Administrative Procedure Act and so on, in the event that there's a feeling that the agency has been arbitrary or capricious. That is the safeguard that is inherent in the proposal and it would obviously be unfair to have it locked up in a single rule. At the same time, it seems appropriate that there be a chance to evaluate these other qualities as these patterns of behavior or, if you will, the profile begins to emerge through BASIC's experi-

ence and through other events. Otherwise, we are dealing with a fairly short list and always looking over our shoulder.

Senator WILLIAMS. Do you have language that you would propose to fill out the broad statement of character and financial responsibility?

Mr. PERKINS. Senator, we don't have that with us here. I think it's certainly something we could work on and get together with the staff on the specifics.

Senator WILLIAMS. Did you have a proposal on this last year?

Mr. POTTER. Yes, sir, we did, and essentially the proposal that we had before you was that the rules should not have the effect of unfairly discriminating in the admission of participants or among participants in the use of a clearing agency; and the thought there was that you would be able to select among applicants as long as you were not unfair in your selection.

I'm anticipating a little bit Mr. Bevis' testimony tomorrow, but his statement includes as an attachment some proposed language that would give the opportunity for this kind of evaluation. It also goes on to provide that, among other things, rules would contemplate the conditioning of participation on the operational criteria that we are pleased to see in the bill now.

Senator WILLIAMS. Well, I'll tell you, these days—I share your concern. I'll tell you, we don't need any more equity funding. You know what I mean? This is a very sensitive area from the viewpoint of the consuming public and I share your concern. The next time we have one of those—we have a bad market now—we will have a much worse market later. So this has got to be dealt with in some depth and you, Mr. Bevis, will be talking about this tomorrow?

Mr. BEVIS. Yes, sir.

Senator WILLIAMS. Well, I'll tell you, I want to confer at greater length with you on this. I think you have touched something that is of great concern to this Congress.

Mr. PERKINS. I think it is a big concern from that standpoint and from all of our standpoints, too, in terms of building depositories that are going to have acceptability by the entire financial community. This becomes a part of that, too.

Senator WILLIAMS. That is true; that is part of our consideration. You use the words "fairness of access." Certainly we have to have that. But we also have to do as much as we can to purify those who have access.

Mr. POTTER. That is it and our proposal essentially would provide the latitude, subject as I have mentioned to appropriate review first at the regulatory level and if necessary at the court level.

[Complete statement follows:]

STATEMENT OF THE NATIONAL COORDINATING GROUP FOR COMPREHENSIVE SECURITIES DEPOSITORIES BEFORE THE SUBCOMMITTEE ON SECURITIES OF THE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE - S. 2058

July 11, 1973

John H. Perkins

President
Continental Illinois National Bank
and Trust Company of Chicago

Chairman
National Coordinating Group
for
Comprehensive Securities Depositories

Mr. Chairman, my name is John H. Perkins; I am President of the Continental Illinois National Bank and Trust Company of Chicago. I am, however, appearing before you today as Chairman of the National Coordinating Group for Comprehensive Securities Depositories. My testimony today on behalf of our Group on proposed Bill S. 2058, parallels to a great degree that which we presented before this committee last fall on then-proposed Bills S. 3876, H.R. 14567, and H.R. 14826 and is limited to "Section 17A" entitled "Processing of Securities Transactions."

As we stated at that time, our Group endorses the concept of "---a nation-wide system of interrelated regional depositories independently operated by the private sector to minimize the movement of physical securities." We also stated that we preferred this approach because "A series of regional depositories can come into being more quickly than can a national depository." A great deal has been accomplished relative to the development of regional depositories over the past several months. Without going into detail, I would like to touch on some of the key elements in this development:

Depository Trust Company in New York

(formerly Central Certificate Service)

This depository now has approximately $60 billion in securities on deposit. The expansion and acceptance of this regional facility by the brokerage and banking segments of the financial community certainly demonstrates support for the overall underlying concept of "securities immobilization."

Midwest Securities Trust Company in Chicago

This depository now has approximately $400 million in securities on deposit. The Chicago Clearing House Banks have recently signed a Memorandum of Understanding with the Midwest Stock Exchange to develop the depository further and expand its capabilities.

Pacific Securities Depository in San Francisco

This depository has approximately $1.2 billion in securities on deposit. Like the Midwest, the West Coast Banks have recently agreed to provide $2.26 million of financial support to develop their regional depository further.

Common to all three depositories is the fact that they have all become Trust Companies. In addition, the Depository Trust Company has become a member of the Federal Reserve System; the Midwest Securities Trust Company is in the process of applying for membership, and the Pacific Securities Depository is in the process of doing the same.

Our National Group has recently approved the recommendations made by our three working committees on the issues of:

1. Standard Funds Settlement
2. A Financial Industry Numbering System, and
3. Insurance

A pilot interface study has been underway between the Depository Trust Company and the Midwest Securities Trust Company for several months. A like pilot will begin shortly between the Midwest Securities Trust Company and the Pacific Securities Depository. Rather than dwell on what we have and are doing

any longer, I have submitted for the record, a copy of our National Group's meeting minutes of June 4, 1973, and a copy of a letter to Representative John E. Moss, House of Representatives, which was in reply to a letter he had submitted to our Committee. These documents will provide you with additional detail.

In reviewing S.2058, and assuming that Congress determines to enact legislation, our Committee feels that we can and do support this Bill. We do, however, wish to re-emphasize our overall position of mandatory consultation on rulemaking between the SEC with the appropriate bank regulatory agency, and we think the appropriate bank regulatory agency should have rulemaking powers with respect to safeguards for securities and funds in clearing agencies chartered as banks and are members of the Federal Reserve System. We concur and support the proposal that regulation of depositories be the responsibility of the appropriate bank regulatory agency. The SEC's enforcement authority under Section 21 of the 1934 Exchange Act is not to be exercised unless the bank regulatory agency fails to do its job.

In the area of depository participation, we support the Bill in its reference to "Operational Capability" of a potential participant, but we feel that two additional criteria must be considered and they are:

1. Character, and
2. Financial Responsibility

As we have stated, stressing the above points, we feel that the approach suggested in S.2058 is acceptable and workable.

Mr. Chairman, I wish to thank the committee for this opportunity to appears on behalf of our National Group and present our position on these issues which are of such importance to the financial community and our entire economy.

NATIONAL COORDINATING GROUP
for
COMPREHENSIVE SECURITIES DEPOSITORIES

JOHN H. PERKINS, *Chairman*
President
Continental Illinois National Bk. & Tr. Co. of Chicago Chicago, Illinois

GEORGE R. BECKER
Chairman
Midwest Stock Exchange
Partner Wayne Hummer & Co.
Chicago, Illinois

HERMAN W. BEVIS
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Banking and Securities Industry Com.
New York, New York

WILLIAM T. DENTZER, JR.
Chairman
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New York, New York

GORDON S. MACKLIN
President
National Association of Securities Dealers
Washington, D. C.

JOHN M. MEYER, JR.
Chairman
Banking and Securities Industry Com.
New York, New York

THOMAS P. PHELAN
President
Pacific Coast Stock Exchange
Los Angeles and San Francisco, Cal.

WILLIAM L. SOMERVILLE
Chairman, Executive Committee
Canadian Depository for Securities, Ltd.
Toronto, Ontario, Canada

SAMUEL B. STEWART
Senior Vice Chairman
Bank of America
San Francisco, California

Minutes of Meeting

June 4, 1973

Chicago, Illinois

Present

John H. Perkins
George R. Becker
William T. Dentzer, Jr.
Gordon S. Macklin
John M. Meyer, Jr.
Thomas P. Phelan
William L. Somerville
Samuel B. Stewart

Absent

Herman W. Bevis

Also Present

Joseph P. Coriaci	Continental Bank, Chicago
John P. Griffiths	Wells Fargo Bank, San Francisco
William F. Jaenike	American Stock Exchange, New York
John Stimpson	Johnson & Higgins, Chicago
George Strohl	Bank of America, San Francisco
Michael E. Tobin	Midwest Stock Exchange, Chicago
Kenneth S. Uston	Pacific Coast Stock Exchange, San Francisco

John Perkins convened the meeting by welcoming all present and suggesting that every effort would be made to follow the agenda as presented.

William Somerville then began the proceedings by bringing the Group up to date on the status of the Toronto Depository. He indicated that their primary functions thus far have included coordinating the activities of the banks, brokers, and trust companies. The Toronto Depository is basically of the Transfer Agent type. That is, the depository functions as an agency service bureau for the transfer agent. In addition, the Toronto Depository is acting as the Canadian Agent for CUSIP.

Thomas Phelan reported on the progress of the Pacific Securities Depository. He indicated that the banks on the West Coast have made a financial commitment of $2.25 million to support further development of the Pacific Depository. It is expected that the eventual total depository cost will be in the neighborhood of $7 million. Although the PSD received trust company approval late last year, they have yet to activate their charter. They are in the process of preparing their Rules Package for submission to the Securities and Exchange Commission. The depository has approximately 9,000 issues on deposit at the present time with a market value of $1.2 billion. Sam Stewart confirmed and expanded on Mr. Phelan's comments.

William Dentzer stated that CCS became "The Depository Trust Company" on May 11, 1973. The DTC has been approved for Federal Reserve membership. Their Rules Package has virtually been approved by the SEC. They are continuing to expand membership as well as adding issues and registered bonds into their system.

George Becker along with Messrs. John Perkins and Michael Tobin reviewed the current status of the Midwest. They indicated that a letter of agreement between the banks and the Exchange had been approved which not only calls for a split-off of the depository activity from clearings, but also commits $1 million during the first year on the part of the banks to develop the depository system further. Tentative approval of the Midwest Securities Trust Company has been received and final approval is expected at any time. The Midwest has also applied for Federal Reserve membership. In the area of depository interface, the New York Depository has looked carefully at the Midwest operating systems and the few question areas which exist are being addressed. One-way interface between New York and Chicago has been piloted for the last three months with the hope of two-way interface beginning shortly.

Gordon Macklin commented on the progress of the National Clearing Corporation. NCC currently has 300 members and they are continuing to expand. Their operations include New York, Boston, Philadelphia, Chicago, Atlanta, Washington, D. C., and St. Louis. Their Clearings list includes 7,800 issues. NCC is looking at a new "free account netting system." Relative to this system, are some questions with regard to duplication of activity in a regional depository environment. It is NCC's intent to ultimately interface with the various regional depositories.

The meeting proceeded to the point in the agenda where reports from the working committees were submitted. John Stimpson reported for David Morgan on the question of depository insurance. He reviewed the study steps taken by the subcommittee and then proceeded to recap their findings:

a. Regional depositories should develop and maintain coverage on an individual basis. When total interface of regional depositories has been achieved, and some experience has been developed, consideration for some form of catastrophic blanket coverage would be appropriate.

b. An educational program for Insurance Industry representatives should be developed to acquaint the Insurance Industry with the new environment created by regional depositories.

The National Coordinating Group approved the findings of the study and the working committee will develop implementation strategy.

William Jaenike reported on the Financial Industry Numbering System (FINS). He began his presentation by stating that this is really not a system but a standard way of identifying the securities processors whereas CUSIP identifies the securities. His presentation was one of general review including the "what is it and how and when to use it." The FINS concept, as recommended by the working committee, was endorsed by the National Group. The working committee will develop implementation strategy.

Jack Griffiths and George White reported on Standard Funds Settlement. After some discussion relative to historical and source data issues, the recommendation of a "Funds Valued Tomorrow" environment was presented. It was further recommended, that for the sake of equity on the part of depository participants, implementation should take place as soon as possible. The National Group approved the recommendations of this committee and the working committee will now develop implementation strategy.

John Meyer reported on the status of Uniform Commercial Code changes in the various states and also shared some observations relative to H.R.5050. Sam Stewart is scheduled to be in Washington shortly, and he will attempt to visit with Representative Moss or a member of his staff in an effort to update them on the present status of the various regional depositories. The National Group encouraged Sam in this regard since so much is happening so rapidly in the depository environment that an updating might be helpful.

The National Group maintains its position as stated in the past relative to proposed legislation on the rule making for and regulation of depositories.

The Hartford and Boston areas are still studying the possibility of developing regional depositories. The question of whether or not these areas should be included on the National Group was once again reviewed. It was decided that the opportunity for membership should remain open, yet membership should not be granted until the criteria, as previously established, is met.

John Perkins referred to the status reports presented earlier and reinforced the need for full interface as soon as possible. Although studies, correspondence, pilot one-way interfaces, and conversations are and have been going on relative to this issue, he felt that the regional depositories are sufficiently well along to be more specific in this area. He restated the fact that there is no doubt in his mind that there is general agreement in principle on the entire issue of interface. As a result, he requested that by July 1, a letter be submitted to him by each of the four depositories (DTC, MSTC, PSD, and NCC) stating the guidelines for interface.

Mr. Perkins also circulated a letter dated May 29, 1973, which he had received from Representative John E. Moss. It was felt that the progress of the National Group was considerable and that responding to Representative Moss' letter should not present any problems.

The meeting adjourned without a specific date being established for the next meeting.

JPC:MOB

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for
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Toronto, Ontario, Canada

SAMUEL B. STEWART
Senior Vice Chairman
Bank of America
San Francisco, California

July 5, 1973

Representative John E. Moss
Chairman
Subcommittee on Commerce and Finance
Interstate and Foreign Commerce Committee
Congress of the United States
House of Representatives
Washington, D. C. 20515

Dear Mr. Moss:

Your letter of May 29, 1973, relative to the progress being made by the National Coordinating Group was very timely. It just so happened that the National Group was scheduled to meet on June 4, and we had an opportunity at that time to discuss it.

I would like to respond to your letter by directing my comments to the three questions which you raised:

(1) "Guidelines for the interface of regional depositories"

As you will notice in the minutes of our meeting, Enclosure A, a considerable amount of work has been devoted to depository interface. Some of the guidelines have been completed, and others are being developed, including:

Depositories as eligible depositors

The foundation for depository interface is provided by each depository's being a depositor in the other depositories. Thus, Depository "A", being a depositor in Depository "B", can receive and deliver securities by book-entry from and to other depositors in "B", just like any other of "B's" depositors. Of course, "A" would be receiving and delivering in "B" on instruction of its own participants. In this respect "A" is little different from broker and bank depositors who are parties to book-entry transactions in depository "B" on behalf of their many customers.

A pilot interface test has been in progress for several months between the Midwest and New York Depositories. Details are now being worked out for a similar test between the Midwest and the West Coast.

Each depository's rules approved by the SEC provide that a depository shall be eligible to be a "Participant" (i.e., depositor).

Representative John E. Moss
House of Representatives
Washington, D. C. 20515

July 5, 1973

Depositories as custodians for one another

Under the Uniform Commercial Code a "clearing corporation" must, as a practical matter, keep possession of securities held by it or place them in a custodian bank. Interface depends on the capacity of depositories to act as custodians for each other.

This interrelationship among depositories can be accomplished when depositories are chartered as banks (i.e., trust companies incorporated under banking law). This has now been done, as concerns the Midwest, West Coast, and New York depositories.

Regulatory coordination and supervision

Although each of the three depositories will be subject to examination and supervision by their respective state banking departments, what might be called another aspect of depository interface is coordinated regulation.

This has been accomplished by the taking of two steps. The first is the submission of each depository's articles of incorporation, by-laws, and rules to the SEC for review and approval. This has been done by the Midwest and New York depositories, and is in process for the one on the West Coast.

The other step is to obtain coordinated bank supervision and examination. This is to be accomplished by having each depository become a member of the Federal Reserve System. The New York depository has already received such membership and the Midwest is in the process of applying.

Funds settlement

An important question of depository interface is the manner in which the cash side of securities transactions is settled both among depositories and between a given depository and its depositors.

A working committee of the National Coordinating Group has studied this matter in depth and has made recommendations which have been adopted by the National Coordinating Group.

A copy of the Working Committee report is enclosed. (Enclosure B).

Other Interface Matters

Task forces from the depositories are working on a number of technical and procedural matters. Interdepository custodian agreements are being drafted. The use of facsimile and other fast transmission methods is being worked out. Enclosure C, a report on "Applicability of Electrical Communications Within a Depository" is being used to advantage. Other operating-level questions as to detail are surfacing and, one-by-one, being disposed of.

Representative John E. Moss
House of Representatives
Washington, D. C. 20515

July 5, 1973

Attention is also being given to some longer-range opportunities for efficiency and effectiveness. Development of a standard financial industry numbering system (FINS) has been approved and steps authorized to implement. This standard is not urgently needed now, but will definitely be needed later to facilitate use of modern communications technology.

In general, it is believed that depositories can--as they are the hub--act as leaders, stimulators, and catalysts among the entire financial community in bringing modern technology to a major part of the trade completion process. Even for transactions in securities which cannot be made eligible for depositories--but every effort should be made to expand the eligible list--the related systems effect should be substantial.

(2) "Whether banks are giving financial support to the development of depositories"

The answer to this question is "yes" - "banks are giving financial support to the development of depositories."

(a) Six Chicago banks have committed $1,000,000 in the next 12 months for the further development of the Midwest Securities Trust Company. This commitment is reflected in paragraph 3 (page 8) of a Memorandum of Understanding executed by the six banks and the Midwest Stock Exchange, a copy of which is enclosed. (Enclosure D).

(b) The West Coast banks have committed, for Phase I, $2.26 million for the development of the Pacific Securities Depository. The total projected capital investment for the whole project is $7.4 million.

(c) The 12 New York Clearing House banks have contributed to BASIC from its formal inception on March 11, 1970, the amount of $650,000 or 50 per cent of the $1,300,000 expenses incurred by BASIC to date. The remaining 50 per cent has been paid by the American Stock Exchange, National Association of Securities Dealers, and the New York Stock Exchange, each of whom assume 1/3 of the aforementioned 50 per cent.

The Memorandum of Understanding executed in September, 1971, on a Comprehensive Securities Depository System between American Stock Exchange and the New York Clearing House banks is reproduced on pages 1922-28 of your 1971 hearings. For ease of reference, a copy is enclosed herewith. (Enclosure E).

(d) In addition to these incurred and contemplated out-of-pocket expenditures the Midwest, West Coast, and New York banks have contributed extensively the time and experience of many of their officers and staff to the actual development and usage of the depositories in their respective areas and to the development of a Comprehensive Securities Depository System. Some of these contributions are evidenced,

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among other things, by their work pertaining to depository interface, insurance questions, the CHIPS, CUSIP, and FINS Systems, Standardization of Funds Settlement for Securities Transactions, development of collateral loan programs for brokers and banks at depositories and by banks depositing securities with depositories, as participants, on a trial basis pending clarification of regulatory and other questions.

The American Bankers Association has expended time, effort, and advice in furthering the necessary amendments to the UCC and by conducting and participating in seminars as to depository procedures and benefits.

It is clear that banks are not only "giving financial support to the development of depositories" but are incurring further and indirect costs by contributing people, time, and experience in large measure.

These commitments reflect the view that through participation in the development of depositories the banks, all of whom have fiduciary responsibilities, can assure that depositories will have the appropriate character, operational, financial, legal capabilities, and regulatory atmosphere.

(3) "What, if any, new problems have arisen in the development of the interregional concept. More particularly, what is the probable effect of requiring new and higher rates of return on capital or increased interdepository charges?"

No unforeseen problems of substance have been encountered. Some foreseen procedural problems remain to be resolved--and will be--such as the handling of dividends, proxies, withdrawal of nominee certificates, etc., where the internal procedures for the handling of such matters now differ among depository operations.

As to "requiring new and higher rates of return on capital or increased interdepository charges", it is contemplated that beyond a nominal rate of return on shareholders' investment, depositories' charges to users would be scaled to cover depository costs.

Our committee appreciates your interest in this effort and the opportunity to tell you of our continuing progress. We will continue to keep your Committee informed.

Sincerely,

John H Perkins

Chairman

JHP:MOB

Enclosures (5)

MEMORANDUM OF UNDERSTANDING ON A COMPREHENSIVE SECURITIES DEPOSITORY SYSTEM

MAY 9, 1973

I. Objective of Parties

A. It is the desire and intention of the undersigned (the "Parties") to establish and operate a Securities Depository, herein described as the Midwest Securities Trust Company (MSTC). MSTC will provide support for and depository services to the financial community and will interface with other autonomous depositories across the nation to form a depository system.

B. The purpose of MSTC shall be to accomplish, insofar as reasonably practicable, (1) immobilization of stock certificates and other securities by causing them to be deposited with MSTC; (2) effectuation of the transfer of title to, and liens, on, such securities within MSTC by so-called "book-entry" methods; and (3) effectuation of cash settlements with respect to transfer of title to securities effected by "book-entry" within MSTC. To this end, the Parties agree that participation in MSTC by various types of institutions holding and trading large quantities of securities should be encouraged.

II. Creation of the Midwest Securities Trust Company (MSTC)

A. Midwest Stock Exchange Clearing Corporation (MSECC) is currently operated as a subsidiary of the Midwest Stock Exchange (MSE.) MSECC provides trade recording and processing, settlement, depository, and special services facilities

for its participants. The MSE is currently taking action to reorganize MSECC as Midwest Securities Trust Company (MSTC) under the provisions of the Illinois Business Corporation Act, and the Illinois Trust Company Act, and to make application for membership in the Federal Reserve System. All shares of MSTC will be owned initially by MSE.

B. Unless this memorandum is cancelled and provided the parties continue in good faith to work toward the achievement of the objective contemplated hereby, the MSE intends within ninety days from the signing of this Agreement, to establish Midwest Clearing Corporation (MCC) as a separate wholly-owned subsidiary of MSE, distinct from MSTC, and to transfer to MCC, necessary personnel, computer facilities, rights to space, and other appropriate facilities in order to permit MCC to conduct non-depository functions as determined by the Board of MSTC. In the event of the establishment of MCC, MSTC would retain an adequate cash settlement facility.

C. The parties agree to use their best efforts to gain trust company status for MSTC as quickly as possible by endorsing necessary action required of organizations or individuals such as the Securities and Exchange Commission, Illinois Commission of Banks and Trusts, Illinois Secretary of State, and the Federal Reserve Board.

D. It is understood that as MSTC is initially organized:

1. MSTC's Board of Directors will consist of twenty-one

individuals to be elected by the sole stockholder MSE in accordance with the provisions of the Illinois Business Corporation Act. At the time of the establishment of MCC, as an entity separate from MSTC, MSE as stockholder will elect a new Board of Directors for MSTC, consisting of nine individuals, from a slate of nominees, four of whom will be nominated by the MSE and four of whom will be nominated by the Chicago Clearing House Association banks, and a ninth who will be nominated jointly by the MSE and the Chicago Clearing House Association banks, and who upon election, shall also be elected President and chief executive officer of MSTC.

2. The Board of Directors shall have the power to adopt and amend By-Laws and Rules for MSTC by affirmative vote of six Directors.

3. The Board of Directors of MSTC will act to provide the staffing of the Corporation, including the election of such additional officers and the appointment of such permanent or temporary committees and advisory panels as may be required or desirable for the conduct of its activities. However, the parties agree that duplicated staffs, facilities, etc. are to be minimized so that the costs of MSTC and MCC are to be approximately the same as if all of their activities were performed under MSTC.

E. It is recognized that all legal matters, as well as the fees,

procedures, mode of operation, management and financial responsibility of MSTC must be satisfactory to all of the Parties.

F. It is intended that the Board of Directors of MSTC shall from time to time fix the charges to be imposed by MSTC for services rendered. It is anticipated that services to be rendered by MSTC shall include: book-entry transfer of title to securities within the system, acceptance and processing of deposits of securities, processing of pledges on securities within the system, release and substitution of pledged collateral within the system, and cash settlements of transfers of title to, and custody of, securities within the system.

G. It is understood that the Parties will make such investigations of the proposed MSTC operation and such recommendations with respect thereto as they consider appropriate to assure themselves that the procedures, safeguards and controls are designed reasonably to protect the securities deposited by them within the system and to provide for accurate recording of all transactions which are to be effected within the system.

H. The provisions of the present Blanket Bond coverage of MSECC will be applicable to MSTC, and such coverage is in an amount reasonable for MSTC's prospective operations. Losses shall be paid first under that bond and thereafter under the blanket bonds of the respective participants. Each participant shall obtain a rider to its blanket bond to accomplish this coverage. Each participant of MSTC shall contribute to a Participants

Fund to be established by MSTC, which fund shall be similar in purpose to the Clearing Fund of MSECC. Such fund shall be available to meet any and all liabilities of MSTC to any party and shall consist of contributions of cash or government bonds (or an open account indebtedness adequately secured thereby) contributed by each depositor. The Board of Directors of MSTC shall fix the contribution of each such participant on an equitable basis. As in the case with the Clearing Fund of MSECC, each participant of MSTC shall be liable for an additional assessment up to the amount of its contribution to the fund in the event the fund is insufficient to meet the liabilities of MSTC.

III. Expansion of MSTC

A. The Parties pledge to use their best efforts to secure in all States as promptly as possible appropriate and mutually acceptable amendments to Article 8 of the Uniform Commercial Code, and in particular S. 8-102(3) thereof, to the end that MSTC will qualify as a "Clearing Corporation" under the laws of such states even though the capital stock of MSTC may be held not only by one or more national securities exchanges or national securities association, but also by institutions which are subject to supervision or regulation by State or Federal authority, such as, but not restricted to, banks and insurance companies.

B. The Parties also pledge to use their best efforts to secure in all States as promptly as possible appropriate and mutually acceptable changes, in, or additions to, applicable statutes,

rules and regulations affecting fiduciaries, custodians, and other institutions holding large quantities of securities, to the end that any such holder may properly deposit securities held by it in MSTC and effect securities transactions through MSTC.

C. The Parties agree that the facilities and procedures of MSTC should be planned in anticipation that MSTC will be able to interconnect with one or more similar depository systems that have been or may be organized in other States, or serve as a local depository for a national depository system which may include one or more depositories.

D. MSTC will encourage various types of institutions which are subject to regulation by a State or Federal agency and which own or hold substantial amounts of securities eligible for inclusion in MSTC to participate in MSTC to the greatest practicable extent. A determination by the Board of Directors of MSTC of the acceptability of any particular institution as a participant shall take into account such institution's financial responsibility, character, and its capacity to adapt to the operation of MSTC with minimal disruption and dislocation of the system.

IV. Distribution of Ownership of MSTC

A. Prior to distribution of ownership of MSTC, the parties agree to establish a value of MSTC to be used as a basis for payment to the MSE in return for shares of MSTC distributed by the MSE pursuant to such plan as described in the following paragraph.

Such valuation is to be based not only on the cost of developing and installing the MST System used by MSTC, but also the reproduction cost of the system, and the acquisition costs of similar systems.

B. The Board of Directors of MSTC, within one year from the date of this agreement, will develop and approve a plan for the eventual distribution of the capital stock of MSTC among its various participants. Four directors may veto any such proposed plan. The specific plan cannot presently be anticipated but might be based on,

1. Utilization of the services of MSTC which might consider such factors as dollar value of deposits, effected transactions, fees paid, etc.
2. Financial commitment to development of MSTC.
3. Redistribution of ownership on an annual basis.

C. At such time as amendments in various states to Section 8-102(3) of the Uniform Commercial Code make it possible for a depository to be owned by entities in addition to a national securities exchange, it is contemplated that ownership of shares of MSTC, Inc. in its trust company form will be broadened to reflect the intention that it becomes a user-owned entity.

D. The Board shall be reconstituted as participation is expanded to include other financial institutions.

V. Interim Operation of MSTC

A. Subsequent to the establishment of MSTC, it is understood:

1. That MSTC must use the services presently provided by the MSE for a period of three years commencing with the time of signing of this memorandum, and that such services may be discontinued, by either MSE or MSTC, after the three years upon six months prior written notice.

2. MCC, when established, will contract with MSTC for certain services which are best performed by MSTC. Such services will be provided by MSTC to MCC for a period of three years commencing with the time of signing of this memorandum, and can be altered or discontinued after the three years upon six months prior written notice by either MCC or MSTC. Further, the prices of these services provided by MSTC, cannot be increased, except for inflationary caused escalation, without prior MSE authorization.

3. In order to encourage the Parties to participate as quickly as possible in MSTC, and to remove from MSE the burden of underwriting the full costs of MSTC after separation of non-depository activity, the Parties agree to contribute funds to MSTC operations for a period of one year in an amount mutually agreed to by the Parties, such amount not to exceed one million dollars.

4. In order to properly allocate costs and revenues between MSTC and MCC, a firm of certified public accountants will be hired to make a review of the cost and revenue allocation of the two entities' operations and submit

appropriate recommendations.

5. That contribution of funds made by the Parties, as specified in paragraph 3 above, will be credited to them as part of the payment for ownership acquired at the time of distribution of MSTC shares by MSE.

B. The Parties, other than the MSE, will assist the MSTC in their efforts by providing individuals to assist in marketing MSTC's services during the first year to non-broker/dealer institutions to insure broad participation in the system.

VI. Miscellaneous

A. The Parties agree that this Memorandum shall not be construed as a legally binding contract or agreement and that it does not impose any obligations or commitment on any of the Parties. It is merely as an expression of the present intention of each of the Parties and an indication of such Party's willingness to extend its best efforts in good faith to achieve the objectives outlined herein.

B. The MSE may at any time, in its discretion, whether as a result of the development of a clearing depository agency by others, or a change in law making the development of MSTC inappropriate, or otherwise, terminate the further implementation of this Memorandum and retain MSECC as it presently exists, or in its reorganized form as MSTC in which event this Memorandum for all purposes shall be cancelled. Any other Party may at any time in its discretion terminate its participation in the activities provided for herein without liability under this Memorandum,

or otherwise but such action shall not terminate the participation of any other Party.

SIGNATORIES

AMERICAN NATIONAL BANK & TRUST COMPANY

BY Stephen G Anderson Date _____

CONTINENTAL ILLINOIS NATIONAL BANK & TRUST COMPANY OF CHICAGO

BY _____ Date _____

THE FIRST NATIONAL BANK OF CHICAGO

BY _____ Date _____

HARRIS TRUST & SAVINGS BANK

BY _____ Date _____

LASALLE NATIONAL BANK

BY _____ Date _____

MIDWEST STOCK EXCHANGE, INC.

BY _____ Date _____

THE NORTHERN TRUST COMPANY

BY _____ Date _____

Background

In July 1970, the Security Imprinting and Processing (SIP) Task Force sponsored by The American Bankers Association issued its Final Report and Recommendations. Among other things, SIP called for the adoption of FINS by the banking and securities industries. The SIP FINS recommendation is Exhibit I. In short, FINS, which was developed by the CUSIP Technical Subcommittee between 1968 and 1970, would provide a unique number for every financial institution involved in securities processing.

Also in July 1970, the BASIC Task Force distributed approximately 100 copies of the FINS recommendation within the banking and securities industries soliciting comments. Seventeen replies were received. These generally agreed with the theory of FINS but saw no use for it then and would have trouble justifying the change from whatever numbering system they were using.

As a result, the matter was shelved until early 1971 when the BASIC Task Force studied the matter again, suggested a modification to the structure of the number which would make it compatible with existing numbering schemes, and issued a draft report dated February 16, 1971, see Exhibit II. However, BASIC did not recommend that FINS be adopted.

Current Developments

In December of 1971, the National Coordinating Group for Comprehensive Securities Depositories (NCG), consisting of banking and securities industry leaders in New York, Chicago, and on the Pacific Coast, was formed to insure that depository developments in these areas were coordinated. NCG is actively considering the use of FINS to identify the membership within the national depository system.

In anticipation of the NCG needs, the BASIC Task Force opened new discussions with various people within the industry. Included were representatives of the Bank Administration Institute (BAI) who were working with the Bank Communications Committee on the subject of standards for interbank messages. The BAI provided an analysis (Exhibit III) of numbering systems planned or proposed which might be merged with FINS or substituted for FINS. This analysis was discussed with several industry leaders and the BAI people. The consensus was that FINS should not be consolidated with any of the other numbers because of its unique requirements, the difficulty in accomplishing any merger, and the fact that benefits (to banks using the numbers) from any merger were questionable at best.

Subsequently, a discussion was held with a member of the Bank Communications Committee who is also a member of the American National Standards Institute (ANSI) Committee working on industry numbering systems. It was his recommendation that the banking and

securities industry approach ANSI to assign a block of numbers (e.g., 81 XXXXXX) for use within the industry. The industry would control the assignment of numbers within the block to its organizations. Other similar blocks of numbers would be assigned by ANSI for use in non-securities types of financial transactions such as credit card transactions, so there is a cohesiveness to the total approach that would be taken here.

In conversations with representatives of the National Clearing Corporation (NCC), it was learned that NCC is now assigning four-digit numbers (as well as NASDAQ alpha mnemonics) to their broker-dealer members. Care is being taken to coordinate with the NYSE so that there are no conflicts or duplications between NCC assignments and the NYSE's Stock Clearing Corporation assignments. The NCC numbering arrangement is compatible with FINS in that two digits would be added ahead of the NCC number while the existing four digits would remain as now assigned.

It has been argued, convincingly, that a six digit (with an additional check digit possible) number is too long and error prone for use by clerks. Only three of the four digits in the NCC number are normally used when clerks route envelopes for deliveries and transfers. However, there is an awareness that with the gradual elimination of stock certificates more and more securities settlement will be done on an automated basis. (One example of this is the system being developed

in New York to permit placing transfer instructions on magnetic tape -- a system which calls for the use of the FINS number or some equivalent.) The need for FINS will increase as automation increases and as depositories interface with one another using electronic communications. The FINS arrangement proposed would permit the manual three digit number to co-exist side-by-side with the six digit number employed in automated systems. Thus FINS need not cause upheaval to the remaining manual processes especially those that are intra-region or intra-depository.

It is worth mentioning the alternative to an inter-depository numbering standard. If each depository had its own set of numbers to identify national firms every transaction for such a firm that crossed depositories would require the receiving depository to convert the incoming firm number to its own internal number. This could be expensive and error-prone.

FINS Assignment and Maintenance

The question of funding the development and maintenance of FINS has been discussed with a number of industry organizations including the NASD, NCC, American Bankers Association, Stock Transfer Association and the American Society of Corporate Secretaries. From the NCC standpoint, they are already maintaining and enlarging their clearing member list and it seems reasonable to ask them to continue this but on a FINS basis. From the banking side, the ABA indicated

that Rand McNally, who handles the assignment of the eight-digit bank routing and transit numbers (which appear in the lower lefthand corner of checks), would be the logical organization to handle the assignment of bank FINS numbers. ABA personnel indicated that their organization would support a request to Rand McNally to incorporate this FINS number system with their current bank responsibility.

However, for other industry segments, especially transfer agents, the burden of FINS will probably fall on the depositories. It is suggested here that CCS (as the first and largest depository) take on responsibility for assigning numbers to transfer agents, insurance companies, and funds, and that the other depositories work out an arrangement for obtaining that portion of the FINS directory from CCS.

EXHIBIT I

Section D

Financial Industry Number System (FINS)

Included among the original CUSIP objectives was the development of a standard number system which would uniquely identify all brokers. However, as the Committee did not consider it appropriate that the system be developed by persons outside the brokerage industry, it requested the National Association of Securities Dealers to form a special committee to work on this phase of the CUSIP standards program.

The Special Committee comprised of the persons set forth below held its initial meeting in September 1968.

Junius W. Peake - Shields & Co. - Chairman
John S. Barker - McDonnell & Co., Inc.
Lee C. Monett - NASD
Joseph F. Morley - ASEF
Jack Quick - American Stock Exchange
William Tuite - Burnham & Co.
Frank Zarb - Goodbody & Co.
John Nave - Goodbody & Co.
Philip Bernadeo - Goodbody & Co.
Norman Epstein - E. F. Hutton
Lee Arning - New York Stock Exchange
Carl Byham - American Stock Exchange

The Committee developed specific guidelines for a Financial Industry Number System (FINS) from which the CUSIP Technical Sub-Committee then developed the recommended detailed specifications contained in this section of the report.

It should be noted that while a five (5) digit number could accommodate all the names which will be assigned numbers initially, it will not provide a reserve for future expansion sufficient to insure an acceptable life span for the system.

To date these specifications have not been formally accepted by the NASD.

Section D

Recommended Specifications for a Financial Industry Number System (FINS)

A. Names to be Included in the System

1. U.S. Broker-Dealers - All U.S. Broker-Dealers (firms) which are either NASD members or appear in the Standard & Poors Security Dealers of North America Directory.

2. All U.S. Banks assigned an ABA Transit Number including Foreign Bank agencies located in the U.S. and Federal Reserve Banks.

3. Nominees - Nominees of all Banks, Broker-Dealers, and other organizations. Initially this would be the approximately 5,000 listed by the American Society of Corporate Secretaries in their annual directory.

4. Non-Bank Transfer Agents - would include professional agents, e.g., Registrar and Transfer etc. and corporations doing their own transfer work. Companies which provide their own transfer facilities and also use a professional transfer agent could be excluded. However, to simplify the assignment it is recommended that a number be assigned to each non-banking corporation for which a CUSIP issuer number has been assigned.

5. Foreign Brokers - as designated by the NASD.

6. Foreign Banks - All Canadian Banks and other foreign banks - as designated by the NASD. This is in addition to the Foreign Bank agencies located in the U.S. which will be included in (1.) above.

7. Clearing Corporations - as designated by the NASD.

8. Regulatory Agencies - as designated by the NASD.

9. Statistical Service Organizations - as designated by the NASD.

B. Number Format

The basic number will be comprised of six (6) digits plus a Modulus 10 Double add Double Check Digit.

The basic number will be blocked by type of organization as follows:

000001/099999	-	U.S. Broker-Dealers
100000/199999	-	U.S. Banks, etc.
200000/299999	-	Nominees
300000/399999	-	Non-bank Transfer Agents
400000/499999	-	Foreign Brokers
500000/599999	-	Foreign Banks
600000/699999	-	Clearing Corporations, Regulatory Agencies and Statistical Service Organizations

700000/799999	-	Open -
800000/899999	-	Open -
900000/999999	-	Reserved for User

The number will be assigned to the eligible names sequentially without regard as to their alphabetic position within the block.

Numbers will be available for reassignment seven years after the organization ceases to exist. Changes in organizational title will not require assignment of a new number. In the event of a merger the number of the surviving entity will be the number to be retained.

C. FINS Directory

It is recommended that the numbers be assigned and published in directory form by Standard & Poors, the CUSIP Service Bureau, under a separate contract negotiated with the National Association of Securities Dealers. Continuing control of this phase of the CUSIP program, however, will be the responsibility of the CUSIP Board of Trustees

While the numbers will be assigned sequentially within blocks, the directory will be published in alphabetic sequence within type.

D. Special Considerations in Developing the FINS Number

1. The purpose of the number is to provide a standard universal method of uniquely identifying the major holders and processors of securities and securities information. On this basis the original concept to provide for a suffix code to identify a Broker-Dealer clearance location and a Bank department i.e., Trust, Bond, etc. was discarded. The difficulty in gathering and maintaining this data and the problem of multiple numbers for an organizational entity far outweighed any nominal benefits which might result from including this information.

2. The desirability of retaining the original number assigned to an organization in the event of a change in name or merger precluded the design of a system which will provide alphabetic sequencing of the organizations on the basis of a sort of the number. Such alphabetic sequencing will only be necessary in the published directory.

3. The use of the block approach provides a fringe benefit in being able to identify the type of organization without any adverse effect on the total system.

EXHIBIT II

BANKING AND SECURITIES INDUSTRY COMMITTEE

Financial Industry Numbering System
"FINS"

The Problem

There are many numbering systems being used today to identify individual members of the financial community. Securities clearing houses assign numbers to their clearing members. The Federal Reserve System uses codes to identify banks. Other systems are in use. None is compatible with the other.

It seems entirely probable that, ultimately, much of the processing of securities transactions among members of the financial community in this country will be automated. In the ultimate, this could involve wholesale interconnections of computers. Such a system would require a universally used method of identifying securities. CUSIP has already been developed to meet this need.

The systems of the future will also need a uniform numbering system to identify the nation's financial institutions - a system under which a given number uniquely identifies a certain broker-dealer, bank, transfer agent, etc. - distinguishing him from any other financial institution in the country.

At present, however, there is no pressing need for a comprehensive national directory of FINS numbers. If such a directory were created today, it is most unlikely that its use would justify the cost and effort of developing and maintaining it.

Nonetheless, "pockets" within the nation's financial community are using financial industry numbering systems today. Each year sees the adoption or changing of some such systems. What is needed is some device by which these segments of numbering systems could be brought into synchronization with a uniform national FINS over a period of time.

Possible Solution

A plan could be adopted for a uniform national financial industry numbering system to be used in connection with the processing of securities transactions. This plan would go as far as possible in embracing existing numbering systems. It would also provide a framework within which national or regional segments of the nation's financial community could develop numbering systems which would be compatible with an ultimate national FINS, without waiting for the entire numbering system to be implemented.

Specifically, a six-digit code could be adopted, as follows:

1st digit - Identifies the industry.
2nd digit - Identifies one of five geographical areas in the U.S.
Last 4 digits - Identify institutions within the industry within the area.

Possible codes to be used in the first- and second-digit positions are given later. A seventh check digit would be added when a nation-wide system ultimately comes into use.

Discussion

History of FINS

The CUSIP Technical Subcommittee of the American Bankers Association pioneered the idea of FINS, and developed a specific proposed system consisting of six digits plus a check digit. One of these digits identified the industry, a concept which has been incorporated in the

recommendation above. The other five digits were to be used to identify organizations within an industry.

The BASIC Task Force distributed approximately 100 copies of the ABA Committee's plan within the banking and securities industries in July 1970, soliciting comments. Seventeen replies were received. Many endorsed the proposal as is. Others had suggestions for variations most of which are discussed below.

However, it is significant that, while many agreed to the theory of a FINS, most said that they see no present use for it and would have trouble justifying a change from whatever numbering system they now use.

Industry codes in the plan

The first digit would identify the industry, as follows:

0 - Broker-dealers
1 - Broker-dealer nominees
2 - Banks, including foreign bank agencies located in the U.S.
3 - Bank nominees
4 - Insurance companies
5 - Mutual funds
6 - Transfer agents
7 - Clearing corporations, regulatory agencies, statistical services, and miscellaneous
8 - Open
9 - Reserved for user

These are the principal changes in the above from the ABA Committee's numbering plan:

1. Insurance companies and mutual funds have been added as separate categories. These may ultimately be required to be identified in a comprehensive securities depository, if not for other purposes.

2. Separate numbers are provided for a bank's transfer department and a bank as a trader in, or holder of, securities. The segregation of these activities of banks could be meaningful in the processing of securities transactions.

Geographical codes in the plan

The second digit would identify the geographical area, as follows:

0 - New York City
1 - Eastern - Conn., Del., D.C., Me., Md., Mass., N.H., N.J., N.Y. (ex NYC), Penna., R.I., Vt., Va., W. Va.
2 - Central - Ill., Ind., Ia., Kans., Ky., Mich., Minn., Mo., Neb., N.D., Ohio, S.D., Wisc.
3 - Western - Alaska, Ariz., Calif., Colo., Hawaii, Idaho, Mont., Nev., N. Mex., Ore., Utah, Wash. Wyo.
4 - Southern - Ala., Ark., Fla., Ga., La., Miss., N.C., Okla., S.C., Tenn., Tex.
5 - Open
6 - Open
7 - Open
8 - Open
9 - Open

The foregoing plan provides the leeway to make FINS an international system if ultimately needed. For example, the remaining digits might be used somewhat as follows:

5 - Canada
6 - Western Hemisphere south of U.S.
7 - Europe and United Kingdom
8 - Australia, Japan, Asia, Far East, Africa
9 - Open

98-978 O - 73 - 16

However, the immediate objective is not to use the geographical codes for other than to make, after subdivision by industry, a further subdivision of the "universe" in the U.S. After these two subdivisions, the final four digits, providing a numbering capacity up to 9,999, should provide more than enough capacity for the largest industry group in any defined geographical area.

Note - The ABA plan assigned each of banks and brokers abroad an "industry" code, within which each institution would have its sequential number. If the plan proposed herein became world-wide in use, these institutions would be segregated by the first two of the six digits, identifying industry and area abroad, respectively. In interim four-digit systems, banks and brokers abroad could either be assigned numbers within the U.S. bank and broker industry groups, or grouped together in the open 8XXXXX industry series.

Use of existing numbering systems

As in the ABA proposal, the plan contemplates no pattern in assigning the last four digits. No attempt would be made to maintain alphabetic sequence, for example. A directory in alphabetic order would, therefore, be necessary.

Presently assigned numbers could be maintained to a large extent. Broker-dealer numbers assigned by the New York, Midwest, and Pacific Coast Exchanges, for example, could each be retained. Moreover, no more than the present number of digits need be used - whether two, three or four.

It would only be when communications among units of the same industry using FINS numbers crossed geographical area lines that

five digits would have to be used. Broker-dealer 125 in the Midwest could communicate with broker-dealer 150 in that same area using only those numbers. However, broker-dealer 125 in Chicago communicating to broker-dealer 150 in New York would become 20125 vs. 00150.

Communications crossing both industry and geographical lines would require all six digits. Thus, a message from broker-dealer 125 in Chicago to bank 150 in San Francisco would be from 020125 to 230150.

New or revised numbering systems in the near-term

As has been said, there has not yet arisen a need for one national directory of the numbers of all the financial institutions in the U.S. There is also as yet no need for one central national authority to assign numbers to all such institutions.

At the same time, there may be need for coordinating the assignment of numbers within a geographical area for a given industry. Using the geographical areas defined hereinabove, a bank in Los Angeles, for example, should not have the same four-digit number as one in Phoenix, or Seattle. A broker in Boston should not use the same final four digits as one in Philadelphia.

The coordination to synchronize regional industry numbering systems, to the extent that it does not already exist, could be supplied by industry leaders, including securities exchanges. Or, it could be provided by organizations national in scope, like the American Bankers Association, the Association of Stock Exchange Firms, the

American Society of Corporate Secretaries, the Stock Transfer Association, The Investment Company Institute, and the National Association of Securities Dealers. Conceivably, government agencies like the Federal Reserve Board and the Securities and Exchange Commission would be interested in providing the coordination. In due course, a National Securities Depository system would have need for a nationwide FINS numbering plan. While it probably would not have direct contact with all financial institutions - particularly the smaller ones - it might well become the logical organization to coordinate the national numbering plan.

Numbering in alphabetic sequence

Some who commented on the ABA's FINS suggested that the system provide that numbers be assigned to institutions in their alphabetic order. As with ABA, this is not contemplated in the plan advanced herein, for these reasons:

1. The gapping requirements for a continuing system where entries change would probably require an added digit, and the fewer the digits the better;

2. Name changes would often require changed numbers for the same institution, complicating the clerical job of those accustomed to using such numbers; and

3. The advantage of retaining most existing local numbering plans would be lost, since many if not most of them do not provide alphabetic sequencing.

Of course, any sequential numbering system must be accompanied by a directory in which institutions are listed in alphabetic order along with the number assigned to each.

Numbers for branches or departments

Many financial institutions have an extensive network of branches across the country. Some have suggested that the numbering plan provide a separate number for each branch of an institution.

Similarly, some institutions have two or more departments involved in handling securities transactions. They have suggested that FINS provide a separate number for each such department.

It is believed inadvisable to attempt to incorporate such refinements in a comprehensive numbering plan, for these reasons:

1. The needs appear in only a small portion of the total "universe" of institutions;

2. Again, one or more digits would probably have to be added to the numbering plan; and

3. The changes in directories, particularly to reflect new and discontinued branches, address changes, etc. would be substantially increased, magnifying the problem of keeping them up-to-date.

The proposed plan does provide five geographic subdivisions within the U.S., but that probably will not accomplish the branch identification needs of most national organizations. Further identification of subdivisions within an institution would have to be provided by suffixes outside FINS.

CONCLUSIONS

There is at present no urgent need for a nation-wide directory of numbers each uniquely identifying a financial institution involved

in some aspect of the processing of securities transactions. But such a need will undoubtedly come.

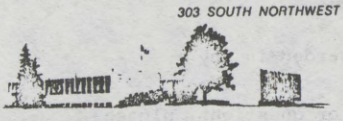
Meanwhile, some device is needed to provide that numbering systems presently being developed or in use can be assured of fitting into the ultimate national plan, or brought into harmony with it over a period of time.

The long- and short-term goals can be served by using the first two digits of an ultimate six-digit code to identify, respectively, the industry and broad geographical area. This results in reducing identified segments of the "universe" to a size small enough that none will exceed the 9,999 capacity provided by the code's last four digits. Any one of the identified segments, therefore, can proceed with assigning the last four digits to institutions within that segment, with the knowledge that such numbers will fit into an ultimate universal plan.

EXHIBIT III

Bank Administration Institute

303 SOUTH NORTHWEST HIGHWAY / P.O. BOX 500 / PARK RIDGE, ILLINOIS 60068 / (312) 775-5344



President
Raymond C. Kolb
Senior Vice President & Cashier
Mellon National Bank & Trust Co.
Pittsburgh, Pennsylvania

1st Vice President
Charles E. Arnar
Senior Vice President
First National Bank of St. Paul
St. Paul, Minnesota

2nd Vice President
Robert L. Kemper
Executive Vice President
Wells Fargo Bank, N.A.
San Francisco, California

Treasurer
Frank D. Radano
Vice President & Asst.
Chemical Bank
New York, New York

Executive Director F. Byers Miller

Administrative Director Harold F. Karandjeff

RESEARCH DIVISION

Virgil H. Disney, Director
Robert H. Long, Assistant Director
Don Momjian / Kenneth R. Gray
George W. Staffen / Linda M. Fenner
Kenneth E. Reich / Lois S. Nixon
Stephen L. Williams / Trenton C. Thompson
Wolfgang P. Hoehenwarter / Eugene T. Cinelli

Mr. William F. Jaenike
Banking and Securities Industry
Committee
84 William Street
New York, N. Y. 10038

May 22, 1972

Dear Mr. Jaenike:

Mr. Disney asked me to review and reply to your letter and enclosure of April 28, 1972, on FINS. I am particularly happy to do this as I am working currently on a comparison of several of the existing and proposed communications systems for banking.

I have prepared a report for you of descriptions of the identification systems currently in use by or proposed for the banking industry. I have also commented on the apparent advantages and disadvantages which I see in them.

This comparison of identification systems is part of a report I am completing on the communications standards currently in use by or proposed for the banking industry. When the report is complete, I shall send you a copy.

My personal opinion is that the development of FINS should be coordinated with the development of BIN (Bank Interchange Number) currently underway by the ABA Bank Card Standardization Task Force. This coordination could be achieved through the Coordinating Committee on Bank Communication Standards chaired by George DiNardo of Mellon Bank. I understand that both BASIC and the ABA Task Force are represented on the Coordinating Committee.

I also feel that BIN should be the subset of the FINS which identifies domestic and foreign banks. If the payments system is moving toward an electronic funds transfer system, a number like BIN should supplant the Federal Reserve routing and transit number as an electronic identifier. I would also hope that FINS could include more varieties of financial institutions such as Savings and Loans, Credit Unions, etc. With possible changes in payment powers,

BANK ADMINISTRATION INSTITUTE

Mr. William F. Jaenike May 22, 1972

these institutions should not be disregarded in any planning for an uncertain future.

If you have any further thoughts or questions, please feel free to contact Mr. Disney or myself. If there is a place for us, we would appreciate being able to work with you.

Sincerely,

Trenton C. Thompson

Trenton C. Thompson
Research Associate

TCT:lw
Encl.

BANK IDENTIFICATION SYSTEMS

FINS - Financial Industry Number System.

Format - 6 digit number plus Mod 10 double-add-double check digit

Numbers are blocked in units of 100,000. Each block is reserved for assigning numbers to a member of one of 7 groups.

These groups include domestic and foreign banks, brokers, nominees, transfer agents, clearing corporations, regulatory agencies, and Statistical Service Organizations.

The first digit identifies an industry group.
The second identifies a geographic region.
The remaining 4 digits identify a particular organization.

BANK WIRE

The bank wire uses a 4 character, alphabetic code to address banks on its system. These are used to identify both the sender and receivers of a message. In addition the receiver is further identified by typing the complete alphabetic name of the receiver on the third line (72 characters, maximum) of the message.

In its 4 character code, the first character is always a "C" or an "N" . The "C" designates that the bank referenced by this address is connected to Bank Wire through the Chicago switching center. The "N" indicates the New York City switching center.

Federal Reserver Wire System, Californis SCOPE, & BAI Lock Box Standards

All three of these systems use the 8 digit Federal Reserve Transit-Routing Number with a check digit. In addition, California SCOPE provides 23 character fields for the alphabetic names of

banks or automated clearing houses.

CHIPS - Clearing House Interbank Payments System

This system uses a 4 digit numeric identifier input from the terminal. The computer system responds by typing at the terminal the alphabetic name, and in some instances the address, of the banks involved as verification of the entry of the proper 4 digit codes.

ABA - Bank Card Standards

As of their latest paper, the subcommittee recommends the use of the BIN (Bank Interchange Number). The BIN is a 6 digit number a BIN represents either a bank or a switching center.

ANSI - Standard Identifier for Organizations (SIO).

Note: This information was taken from the American National Standards Institute draft: "Proposed A N Standard for Identification of Organizations for Information Interchange". As to my best knowledge this document represents a standard which is still proposed and not yet endorsed by ANSI.

The SIO supposes that complete identification of an organization requires two identifiers an alphabetic one and a numeric one. The alphabetic identifier consists of the true and alternate names of the organization (such as Bank Administration Institute - BAI) and a set of characters which are reserved for delimiting those names. For reasons which I shall cover later in this paper, I shall concentrate on the numeric identifier.

The numeric identifier in the SIO is made up of two components. The first is the single digit Identification Code Designator, ICD. This ICD designates which standard or non-standard identifier is used to complete the SIO. The following table shows the ICD's and the code corresponding to each one.

ICD	Code Used	Code Characteristics
ø	User Agreement Code for Individuals	Use whatever code is agreed upon by sender & receiver.
1	Employer Identification Number (EIN) - issued by the Internal Revenue Service.	9 Character numeric.
2.	Social Security Number assigned by Social Security Admin.	9 character numeric.
3.	Data Universal Numbering System (DUNS No.) assigned by Dun & Bradstreet	9 character numeric. The low order digit is a mod 10 double-add-double check digit.
4.	Social Insurance Number (SIN) issued by Canadian Department of National Health and Welfare	
5-7.	Reserved.	
8.	Birth Number-issued by State and Local Registrars of Vital Statistics	
9.	User Agreement Code for Organizations (UACO)	Whatever is agreed upon by sender & receiver.

The numeric part of the SIO is always the size of the particular identifier used plus one digit for the ICD.

The SIO attempts to allow the use of any coding system available by creating "catch-all" categories with ICD's Ø and 9.

If the financial industry were to adopt such an open ended coding system, it should be modified such that the second digit of the SIO is an Identification Code Sub-designator which would further identify the particular financial industry coding system in use.

Comments on the Numbering Systems

FINS

Pros:

1.) It recognizes both regions and industries.
2.) It is compact being only 6 digits.
3.) It includes a larger segment of the financial industries than other existing financial systems, either in use or proposed.

Cons

1.) Could it include the other financial industries such as Savings and Loans, Savings Banks, Credit Unions, Insurance Companies and Loan Companies?
2.) It is not established and would have to start from scratch in gaining acceptance.
3.) If it were coordinated with the BIN system of the credit card designers, that might make it a more attractive system for banks, since credit card could lead the way to its acceptance as the automated identifier.

THE ABA Routing and Transit No.

Pros:

1.) It is well established and understood
2.) It has the Federal Reserve Banking System's full support and enforcement.
3.) It can identify any bank.
4.) It seems to accommodate future growth under the

established financial industry structure.
5.) It is useful for regional analysis

Cons:

1.) It is eight digits, perhaps too many
2.) It accommodates only banks. If other institutions gain bank powers, it might not be able to expand.
3.) The dash is useful for manual recognition but should not be included in its electronic format.

BIN

Pros:

1.) It is compact.
2.) It seems to have growth potential.

Cons:

1.) It includes only banks under its current concept.
2.) Its development should be coordinated with FINS.

4 Character Alpha Codes

Pros:

1.) They're short and can bear some nmemonic qualities for the banks they identify.

Cons:

1.) They are limited in the number of institutions they can identify.
2.) It is clumsy to apply a structure to them.
3.) Unless an interactive system applies reinforcement in they're use, they are error prone.

ANSI Standard Identifier for Organization

Pros:

1.) It can accommodate any numbering system which special groups may devise.
2.) It is before ANSI and may gain its endorsement.

Cons:

1.) Without sub-designators, the system would not be particularly useful in the financial industry. Users must still have agreed on the particular codes used other than the DUNS, Social Security and Employer Identification Numbers.

2.) The proposal still gives no specification of the actual size of identifier. This makes programming more difficult especially when the ICD=9 is used.

3.) I question the necessity of inputting both an alphabetic and a numeric identifier. As in the case of CHIPS, a system could provide the alphabetic verification of the correlation of the addresses' name and number.

EXHIBIT IV

NATIONAL CLEARING CORPORATION

IMPORTANT

TO: *CLEARING MEMBERS, BANK MEMBERS*

ATTN: MANAGER, CASHIERS DEPARTMENT .

SUBJECT: Member Identifiers

NCC Notice No. 195, dated May 25, 1972, outlined a change in NCC's system for identification of Clearing Members for trade comparison purposes. This notice provides greater detail. Also note that due to requests from the Membership, this system change will begin with trades of October 5, 1972, not September 1, as previously announced.

THE FOLLOWING IS APPLICABLE ONLY TO CNS (continuous net settlement) AT THIS TIME.

A. Commencing with trades of October 5, 1972, for clearance in the CNS system, NCC will accept, at the Clearing Member's option, either of these two identifiers:

   a. Four numeric characters, for instance, 0161. For Clearing Members having a previously assigned NCC numeric identifier, they will retain the last four digits of that number.

   b. Four alphabetic characters, for instance, MOTC. The four character alphabetic mnemonic will be identical to the NASDAQ symbol for those Members who are NASDAQ market makers. All members must complete and return the attached questionnaire, (Exhibit G) by August 14, 1972 to Mr. John Carrera, NCC Assistant Vice President - Member Services.

B. Commencing with trades of October 5, 1972, NCC will also implement a geographic identifier to be used to indicate trade comparison location. This will be an alphabetic character and will appear as the fifth character of the symbol. Clearing Members must use this identifier on all trade input data and it will be a part of the comparison process.

   These location symbols will be used initially:

New York City	Y
Philadelphia	P
Boston	B

   The use of this location code by the Clearing Member will also determine the location for the distribution of trade comparison reports (Contract Lists) and advisories.

- continued -

The Clearing Member ID will then consist of five positions - four positions either alpha or numeric to identify the Member plus one position, always alpha, to identify the location.

Example:

MOTCB or 0161B	Merrill Lynch, Boston
MOTCP or 0161P	Merrill Lynch, Philadelphia
MOTCY or 0161Y	Merrill Lynch, New York

C. In addition to the above, each Clearing Member must select one location for settlement purposes.

How the New System will Work

1. Clearing Members will submit either the four character alpha or numeric identifier plus the location symbol on all P & S input (Original, As Of's and Withholds). See Exhibits A, B, and C for the exact location of the Member ID field.

   Input can be submitted by the Clearing Member from any or all of the three facilities, thus the Clearing Members have the option of centralizing, or decentralizing, their P & S operation.

2. The trade comparison process will only compare trades that were submitted by both the Buyer and Seller with identical location codes, all other entries will result in uncompares.

Example 1

Buyer - Merrill Lynch, Boston		Seller - N.Y. Hanseatic, New York	
Major: MOTCB or 0161B	Minor: NYHCY or 0510Y	Major: 0510Y or NYHCY	Minor: 0161B or MOTCB

In this example both the buyer and seller submitted the same office locations, B and Y and Y and B respectively, therefore, the trade would compare. This assumes all other input data matches.

Example 2

Buyer - Merrill Lynch, Boston		Seller - N.Y. Hanseatic, New York	
Major: MOTCB or 0161B	Minor: NYHCP or 0510P	Major: 0510Y or NYHCY	Minor: 0161B or MOTCB

In this example the trade would show as uncompared because, although the member identified the contra side correctly, he did not identify the locations correctly.

- continued -

Merrill Lynch showed N. Y. Hanseatic as reporting the trade via the Philadelphia facility, while N. Y. Hanseatic was actually entering the trade through New York.

Note: Both sides need not input the same type (alpha or numeric) Member identifiers to produce a compared trade. One Member can submit alpha, while the other can submit numeric and still get a compared trade as long as both sides submitted the correct alpha location codes. Also, alpha and numeric identifiers can be mixed on the same ticket.

A Member does not have to code a trade with the location through which he is entering the trade. If a Member is submitting a trade through Boston and wishes to identify the location either as Boston, Philadelphia, or New York, he can code it as such and still input the trade through the Boston location.

3. Once Trade comparison has been completed, the comparison reports (Contract Lists and Advisories) will be forwarded to the Member's office in the city which was identified in the trade input (Tickets, cards or magnetic tape).

   If the Member has centralized P & S, trades may be submitted through one or more trading locations and all output will be received at the central P & S location.

   If the Member has decentralized P & S, trades can be reported from any of the Member's locations and P & S output will be sent to the location(s) identified on the trade input.

   Both the four digit alpha and numeric symbols with location identifiers will be printed on the CNS comparison reports (Contract Lists and Advisories). See exhibits D and E for locations.

4. For the convenience of brokers, the Transaction Summary Report (Exhibit F) will be revised to show the major and minor trade locations of all compared trades.

   As stated previously, all settlement activities (receipt and delivery of securities, money settlement, etc.) will continue to be centralized and each Member must choose one location for these operations. All CNS reports generated after the production of Contract Lists and Advisory Tickets will show this location as well as the four digit numeric identifier.

Any questions concerning this matter should be referred to Mr. Grad Girardi (212) 747-0548 or (212) 747-0549.

John R. Carrera

N#259
July 20, 1972

John R. Carrera
Assistant Vice President
Member Services

Buyer Trade Reporting Ticket

NATIONAL CLEARING CORPORATION

BUYER
Trade Reporting Ticket

BUYING FIRM NAME	BUYING FIRM SYMBOL (6–10)	OFC (13-14)	SELLING FIRM SYMBOL (15–19)	OFC (22-23)
Merrill Lynch	0161Y or MOTCY		0510Y or NYHCY	

NUMBER OF SHARES (24–30)	BLK (31)	SECURITY CODE (32–40)	SECURITY DESCRIPTION	PER SHARE PRICE (41–50)	EXTENDED AMOUNT (41–50)	TRADE DATE
100		009124108	Dome & Son	16 1/2	16,500	6-9-72

02007

Seller Trade Reporting Ticket

NATIONAL CLEARING CORPORATION

SELLER
Trade Reporting Ticket

SELLING FIRM NAME	SELLING FIRM SYMBOL (6–10)	OFC (13-14)	BUYING FIRM SYMBOL (15–19)	OFC (22-23)
N. Y. Hanseatic	0510Y or NYHCY		0161Y or MOTCY	

NUMBER OF SHARES (24–30)	BLK (31)	SECURITY CODE (32–40)	SECURITY DESCRIPTION	PER SHARE PRICE (41–50)	EXTENDED AMOUNT (41–50)	TRADE DATE
100		009124108	Dome & Son	16 1/2	16,500	6-9-72

02008

Exhibit 7

Exhibit B

Format for Original and Supplemental (As Of and Withhold) Trade Input Cards and Tape Detail Record.

CARD COLUMNS	FIELD NAME	DESCRIPTION
01 - 01	Buy/Sell	1 = Buy, 2 = Sell
02 - 02	Exchange Code	4 = NCC Clearing Center
03 - 03	Transaction Code	1 = Regular Trade 3 = As Of Trade 4 = Withhold Trade
04 - 04	Card Type	1 = Detail Record
05 - 05	Batch Number	Should be Numeric
06 - 10	Major (submitting) House	Member ID (0161Y or MOTCY)
11 - 12	Reserved	Blank
13 - 14	Office Location (Optional)	Alphabetic
15 - 19	Minor (contra) House	Member ID (0510Y or NYHCY)
20 - 21	Reserved	Blank
22 - 23	Office Location (Optional)	Alphabetic
24 - 30	Quantity (Shares)	Shares Amount (right justified, zero filled)
31 - 31	Block Code	Blank = Regular; B = Block Trade
32 - 40	Security Number	32-36 = NCC Number (right justified, zero filled), or 32-40 = CUSIP Number (right justified, zero filled)
41 - 50	Extended Contract Amount Or Unit Price	Extended = NNNNNNNNN (right justified, zero filled, no punctuation) 10 = 10bbbbbbbb 16 3/4 = 16-34bbbbb 42.3725 = 42.3725bbb
51 - 51	Price Indicator	1 = Extended Amount Blank = Unit Price
52 - 57	Reserved	Blank

Exhibit C

Format for Batch Card Input and Tape Batch Record.

CARD COLUMNS	FIELD NAME	DESCRIPTION
01 - 01	Buy/Sell Code	1 = Buy, 2 = Sell
02 - 02	Exchange Code	4 = NCC Clearing Center
03 - 03	Transaction Code	1 = Regular 2 = Advisory 3 = As Of Trade 4 = Withhold Trade
04 - 04	Card Type	* = Batch Control Card
05 - 05	Batch Number	Should be Numeric
06 - 10	Major (submitting) House	Member ID (0161Y or MOTCY)
11 - 12	Reserved	Blank
13 - 14	Office Location (Optional)	Alphabetic
15 - 20	Trade Date for Regular Trades; Settlement Date for "As Of" or "Withhold"	MMDDYY
21 - 24	Item Count	Number of Items in Batch (right justified, zero filled)
25 - 34	Total Shares	Total Shares in Batch (right justified, zero filled)
35 - 46	Total Amount	Total Extended Contract Amount in Batch (right justified, zero filled, no punctuation) NNNNNNNNNNN
47 - 80		Blank - Not Used

Note: TOTAL SHARES and AMOUNT are not applicable for Advisory data.

6/72

CLEARING MEMBER NAME	OFC	MEMBER ID	TRADE DATE	SETTLEMENT Date	NATIONAL CLEARING CORPORATION	COMPARISON LIST – PURCHASES	PROCESSING DATE	PAGE NO.
MERRILL LYNCH PIERCE F & S INC	NY	0161Y	6/09/72	6/16/72	*** ORIGINAL ***	CONT. NET SETL.	06-12-72	1B

COMPARED (BOTH SIDES SUBMITTED AND AGREE)			CUSIP ID NCC ID	SECURITY DESCRIPTION				SELLING MEMBER ID		UNCOMPARED (YOU SUBMITTED, SELLER DID NOT)		ADVISORY (SELLER SUBMITTED AGAINST YOU, YOU DID NOT)		
NO. OF SHARES	EXTENDED AMOUNT	ROUNDING		PER SHARE PRICE	CODES	OFC	TRAN*	NUMERIC	ALPHA	NO. OF SHARES	AMOUNT	ADV. NO.	NO. OF SHARES	EXTENDED AMOUNT
100	16,500.00		009124108 01234	DOME & SON INC 16 1/2	T			0510Y	NYHCY					

Exhibit D

COMPARISON LIST

NOTE NEW FORMAT

ODD PENNY BREAKAGE DUE TO ROUNDING DIFFERENCES IN MEMBER'S CALCULATION OF EXTENDED CONTRACT AMOUNT.

BLANK-BUY/R & SELL/R AGREE EXACTLY ON NUMBER OF SHARES
C-INCLUDED IN COMBINED OR CALLED TOTAL
T-TOTAL OF COMBINED COMPARED GROUP

BATCH NUMBER

B - DENOTES BLOCK TRADE

* TRANSACTION CODES
BLANK – ORIGINAL TRADE
ADV. – ADDED BY ADVISORY
AB – AS OF TRADE
WH – WITHHOLD TRADE (Detail shown as Negative Amount)
ERR – INVALID ITEM (*'s Denote Field in Error)

Exhibit E

Advisory Notices

NATIONAL CLEARING CORPORATION — ADVISORY NOTICE

TRADE MO	TRADE DAY	TRADE YR	SETTLE MO	SETTLE DAY	SETTLE YR	PURCHASER	SELLER	CONTROL NUMBER	SECURITY CODE	CUSIP NUMBER
6	9	72	6	16	72	*0161Y	**0510Y	1234567	00429	009124108

QUANTITY	UNIT PRICE	CONTRACT AMT.	SECURITY DESCRIPTION
100	16 1/2	1650000	DOME & SON

*MOTCY **NYHCY

THE ABOVE UNCOMPARED ITEM WAS SUBMITTED TO NCC BY "SELLER" INDICATING YOU AS PURCHASER.
TO ADD THE ABOVE ITEM

1. IMPRINT YOUR NAME & NUMBER STAMP ON COPIES 1 & 2
2. RETURN COPIES 1 & 2 IN ACCORDANCE WITH NCC RULES
3. KEEP COPY 3 AS YOUR RECORD OF ADD

DO NOT ERASE OR CHANGE PRINTED DATA

NCC 25 REV 10-71

1

INSTRUCTIONS TO NCC

ADD THE ABOVE ITEM EXACTLY AS PRINTED TO OUR PURCHASE CONTRACT LIST.

PURCHASER'S NAME & NUMBER STAMP

NATIONAL CLEARING CORPORATION — ADVISORY NOTICE

TRADE MO	TRADE DAY	TRADE YR	SETTLE MO	SETTLE DAY	SETTLE YR	SELLER	PURCHASER	CONTROL NUMBER	SECURITY CODE	CUSIP NUMBER
6	9	72	6	16	72	*0510Y	**0161Y	1234568	00429	009124108

QUANTITY	UNIT PRICE	CONTRACT AMT.	SECURITY DESCRIPTION
100	16 1/2	1650000	DOME & SON

*NYHCY **MOTCY

THE ABOVE UNCOMPARED ITEM WAS SUBMITTED TO NCC BY "PURCHASER" INDICATING YOU AS SELLER.
TO ADD THE ABOVE ITEM

1. IMPRINT YOUR NAME & NUMBER STAMP ON COPIES 1 & 2
2. RETURN COPIES 1 & 2 IN ACCORDANCE WITH NCC RULES
3. KEEP COPY 3 AS YOUR RECORD OF ADD

DO NOT ERASE OR CHANGE PRINTED DATA

NCC 26 REV 10-71

1

INSTRUCTIONS TO NCC

ADD THE ABOVE ITEM EXACTLY AS PRINTED TO OUR SALE CONTRACT LIST.

SELLER'S NAME & NUMBER STAMP

NC160
CLEARING
MEMBER 0161Y - REGION

NATIONAL CLEARING CORPORATION

NY RUN

TRANSACTION SUMMARY REGULAR TRADES TRADES SETTLING 06-16-72

06-13-72

0161Y	0510Y	100		DOME & SON INC		16 1/2	1,650.00			06-09-72
*****		100		BUYS 100 009124108 01234			1,650.00			

Exhibit F

TRANSACTION SUMMARY REPORT

03/06 - 3/72

EXHIBIT G

Date_____

NCC MEMBERSHIP SURVEY

Please answer all questions and return by August 15, 1972.

1. Clearing Member Name _____

2. Current Clearing Number | | | | | |

3. Current NASDAQ Market Maker Symbol | | | | |

If you do not have a NASDAQ Market Maker Symbol, request one (must be four alpha characters) and NCC will confer with NASD/NASDAQ and confirm this assignment to you.

Selection: | | | | |

4. Indicate the location(s) at which you wish to submit trade data (check as many as desired). This determines where your contract lists will be made available.

☐ New York

☐ Philadelphia

☐ Boston

5. Indicate the location with which you wish to Settle your trades (Check only one):

☐ New York

☐ Philadelphia

☐ Boston

Complete and Return to:

Mr. John Carrera
Assistant Vice President-Member Services
Two Broadway
New York, New York 10004

_____
Authorized Signature

Telephone Number_____

NATIONAL CLEARING CORPORATION

DAVID H. MORGAN
PRESIDENT

November 17, 1972

Mr. Joseph P. Coriaci
Second Vice President
Continental Bank
231 S. LaSalle Street
Chicago, IL 60693

Dear Joe:

The Subcommittee on Insurance and Protection is pleased to present to the National Coordinating Group the findings of its study and its recommendations.

APPROACH AND FINDINGS

The Subcommittee analyzed insurance and protection for certificate depositories from a nationwide point of view. It followed the guideline prescribed by the National Coordinating Group of "a nationwide system of interrelated regional depositories independently operated by the private sector."

The work program of the Subcommittee included visits to Central Certificate Service, Inc. in New York and the Pacific Securities Depository in San Francisco. Also, Midwest Stock Exchange Clearing Corporation personnel discussed with the Subcommittee plans to provide adequate depository capacity within its continuous net settlement system, operated in Chicago. Each of these companies already has embarked upon a program of reorganization as a limited purpose trust company. Although it cannot be precisely determined when such reorganization will be affected, estimates of 3 to 6 months appear reasonable. The Subcommittee was given to assume that following trust company formation by each, the three entities will develop "systems interfaces" through the use of reciprocal accounts, and that this will then be the basis for the establishment of the network contemplated by the National Group. Presently, coverage for CCS includes a $50 million broker's blanket bond, $25 million excess transit insurance, and a $5 million lost instrument premium bond. The Midwest and Pacific Coast both have broker's blanket bonds of $20 million.

The study addressed these four points set forth in my letter to you dated September 1, 1972:

1. Investigate the concept of individual depository coverage versus a single "umbrella" concept.

2. Educate the insurance underwriters on a national basis as to the reduction in risk in a depository environment versus the risk in a physical delivery system.

3. Explore the co-insurance concept advanced by BASIC's Herman Bevis in his March 15, 1972 paper.

4. Analyze the risk in the depository environment versus risk in a physical delivery system.

CONCLUSIONS

From an insurer's point of view, risks of type would be the same whether securities are in a depository environment or in a physical delivery system. As a matter of fact, the severity of losses would if anything be significantly greater in a depository environment because of the concentration of securities. However, the frequency of losses - - - therefore the risk of loss - - - obviously should be less, which should bear favorably in obtaining insurance.

The Subcommittee believes that insurance can be obtained at a fair cost. Limits are unknown at this time. It believes that certain marketing techniques such as the "layering" of insurance should keep the cost down to a reasonable level. Because of the catastrophic nature of the risk, a participation by the depositories in any premium reduction program because of favorable past experience (as mentioned by Herman Bevis in connection with co-insurance) is unlikely to be obtained. However, future premiums might be reduced based upon such experience.

The Subcommittee further believes that certain functions such as maintaining large aggregate values of securities positions in custody, handling money settlement, and withdrawing certificates in nominee form (even though withdrawal by transfer would be preferable for insurance purposes) are primary characteristics of existing depository operations. They will govern insurance coverage, not vice versa, and will be viewed by the insurers accordingly.

Jumbo certificates have been considered by some as a means of reducing the possibility of loss. While this may well be true, the size of the certificate must be limited to ensure that the insurance industry can legally respond to the loss of such a certificate.

RECOMMENDATIONS

Because of the different stages of development of the three organizations and their varying services, procedures, controls, and membership requirements, and since at this time their operations do not yet interface, the Subcommittee recognizes that the recommendations which follow are by definition premature.

1. Existing coverage, of course, must remain in force until interfaces through reciprocal accounts have been completed.

2. At that time, the following plan should be implemented, and the existing programs of individual depositories cancelled:

a. A primary underlying program should be purchased by each individual depository in a specified amount (suggest less than $5 million) and on a standardized form to be developed, which must be used by all depositories.

b. An excess "umbrella" program covering all depositories for a catastrophic limit of coverage should be written on the same standardized form for as much coverage as is economically feasible within the market capability of the insurance industry. The premium for such a policy would be allocated to each depository on a basis yet to be determined.

3. This program should be negotiated in advance of the actual time interfaces commence. It should if possible cover agents of depositories as well as the depositories themselves.

4. Other traditional coverages, such as third party liabilities, workmen's compensation, and property damage should be purchased by each depository. EDP insurance also should be individually considered, with special attention to loss prevention. (Reference should be made to National Fire Protection

Bulletin No. 75 for guidance in protecting a data processing facility.) It is assumed that sufficient limits will be maintained for each type of insurance purchased by each depository.

5. Each depository should submit a synopsis of its overall program to the other depositories for annual review. The Subcommittee also would be pleased to review each depository's insurance program.

Errors between depositories should be readjustable and therefore need not require errors and omissions coverage (which is costly and perhaps could not be obtained in sufficient amount in any event).

In connection with the program outlined above, the Subcommittee wishes to point out that adequacy of security and controls will be judged heavily and the size of jumbo certificates duly considered by the insurers when they determine the extent and cost of coverage. It is suggested that each jumbo certificate be limited to the total amount of coverage.

Although insurance underwriters probably have been exposed to the securities depository concept to a point where they acknowledge the benefits of depositories, immobilization of certificates, book-entry methods of accounting, etc., they should in the future be educated through formal educational programs developed by the depositories. Presentations should be made to leading underwriters including their senior executives. (The Subcommittee would be glad to assist in arrangements). Such a program should outline the benefits which would result from a viable depository system and should accomplish two objectives:

1. Indicate the confidence which members of the insurance industry can have in depositing their own securities, and

2. Indirectly change insurance company attitudes toward writing the blanket bond of individual financial institutions.

* * * * *

NATIONAL CLEARING CORPORATION

It was a privilege to serve the National Coordinating Group. If recommendations presented herein are accepted, the Subcommittee would undertake to manuscript the form for primary and excess coverage, as discussed above. It would present the form to underwriters and determine market capacity and pricing.

Respectfully submitted,

David H. Morgan, Chairman, for:

Geoffrey J. Burns
Continental Bank (Chicago)

Byrne Davis
Marsh & McLennan, Inc. (San Francisco)

Harry H. Haacke
Marsh & McLennan, Inc. (New York)

Fred Hampton
Central Certificate Service (New York)

John R. James
Chemical Bank (New York)

Richard Sanguinetti
Wells Fargo Bank (San Francisco)

John Stimpson
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DHM:emb

STANDARDIZATION OF FUNDS SETTLEMENT FOR SECURITIES TRANSACTIONS

FUNDS AND SETTLEMENT SUBCOMMITTEE

OF THE

WORKING COMMITTEE

OF THE

NATIONAL COORDINATING GROUP FOR

COMPREHENSIVE SECURITIES DEPOSITORIES

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INTRODUCTION

Because of the different methods of settling securities transactions throughout the United States, the Working Committee of the National Coordinating Group for Comprehensive Securities Depositories organized a Funds And Settlement Subcommittee to consider standardization of the settlement media for securities transactions involving common stock and registered bonds.

The Funds and Settlement Subcommittee has representatives of the banking and securities industries from the East, Midwest and West. The members of the Subcommittee are:

West: John P. Griffiths, Vice President, Wells Fargo Bank, N.A. and Chairman of the Subcommittee.

Kenneth S. Uston, Senior Vice President, Pacific Stock Exchange.

Midwest: Joseph P. Coriaci, Vice President, Continental Illinois National Bank And Trust Co.

Jerome L. Brien, formerly Vice President of the Midwest Stock Exchange Clearing Corporation, and now Vice President with National Clearing Corporation.

East: John C. Gammage, Vice President, Shields & Company, Incorporated.

George C. White, Jr., Vice President, The Chase Manhattan Bank, N.A.

This report was discussed with representatives of the Securities and Exchange Commission, Federal Reserve System and several Federal Reserve banks, National Association of Securities Dealers, Securities Industry Association and its Securities Operations Division, Banking and Securities Industry Committee (BASIC) and the BASIC Steering Committee, bank clearing houses, stock exchanges'

clearing corporations and knowledgeable brokerage, bank and depository personnel.

SCOPE

The Funds and Settlement Subcommittee initially was to concern itself with matters relating to the money settlement vehicle for depository-eligible securities issues among securities depositories throughout the United States. However, because of the difficulty in separating the settlement of all common and registered bond securities transactions from those affecting only the certificate depositories, the scope of this study became broader than just transactions among depositories. The term "Securities" used in this report refers to equity or common stock.

The implementation of the recommendations of this Subcommittee will, therefore, require a broader sponsorship than that of the National Coordinating Group for Comprehensive Securities Depositories, which is primarily concerned with the interface among depositories. Sponsorship would be expected to include the Securities Industry Association, all registered stock exchanges, The National Association of Securities Dealers, American Bankers Association, Bank Administration Institute, and concurrence in recommendations by governmental agencies, such as the Securities and Exchange Commission and the Federal Reserve System.

Other securities instruments have funds settlements specified in a different manner from securities issues discussed in this report (e.g., Treasury Instruments, money market instruments

and some municipal debt issues are settled in funds valued today or cash equivalent; other municipal instruments are paid for with funds valued tomorrow). These other types of issues were excluded from this analysis.

MANAGEMENT SUMMARY

The Funds and Settlement Subcommittee of the Working Committee of the National Coordinating Group for Comprehensive Securities Depositories made the following conclusions on the settlement of common stock securities transactions:

Securities payments must be standardized throughout the United States. The primary issue is equity for all parties involved in securities transactions. Standardization on settlement in funds valued tomorrow appears to be the best basis to provide equity to all participants.

Payments in funds valued today or cash equivalent conceivably could be accomplished provided time was permitted for money market transactions to take place afterwards. However, because of peak volume of transactions, this method places severe operational demand on the payment system. In addition, settlement in funds valued today could increase the capital requirements of small brokerage firms, since payment or cash could not be transmitted until cash payments were received unless a high enough balance were maintained in the account to cover such situations. These payments or receipts from customers would most probably be in funds valued tomorrow.

Operations of the settlement system that give one party to

a transaction use of funds for an extra day are not equitable (e.g., buyer pays in funds valued today, but as seller, he receives funds valued tomorrow, losing earning power for one day) and will continue until funds settlement is standardized.

Errors in a funds valued tomorrow system can be readily corrected by the transmission on the next day of funds valued today (Federal Funds or cash equivalent) through the Federal Reserve System. Thus, errors or questionable transactions can be "unbundled" or corrected on a funds valued tomorrow basis. The corrections may be impossible on a funds valued today or cash basis if funds physically leave the banking system such as with currency withdrawals.

It appears that international payments will continue to be settled on a funds valued tomorrow basis, although recent discussions had proposed settling on a cash basis. The same problems cited above, such as peak operational requirements and credit problems in addition to requiring a large computer capability, are the reasons these large international payments will probably continue to be settled in funds valued tomorrow for at least 1973.

Changes in the Federal Reserve System's Wire Network schedule and developments of regional certificate depositories could change funds settlement procedures in the future, but are not sufficient factors at this time to warrant conversion to funds valued today or Federal Funds settlement.

The Funds and Settlement Subcommittee recommends that all securities clearing corporations specify their funds settlement procedures to be funds valued tomorrow. Settlements through the New York and American stock exchanges are already made on a funds valued tomorrow basis.

The Subcommittee also recommends that efforts be initiated nationally as soon as possible to standardize payments for all securities settled through clearing corporations or over the counter issues on a funds valued tomorrow basis.

FINDINGS

The Findings portion of this report deals with the following subjects:

Funds Settlement Terms (page 6)
Methods of Settling Securities Transactions (page 8)
Federal Reserve System's Wire Network (page 16)
Bank Wire (page 16)
Status of Federal Reserve System Plans to Modify Funds Settlement System (page 17)
Status of New York Clearing House Association Plans to Settle International Transactions (page 17)

FUNDS SETTLEMENT TERMS

There appears to be considerable misunderstanding about the settlement process for corporate securities issues, some of which may arise from lack of common understanding of terms used. Terms such as good funds, same day money, Federal Funds, Fed Funds, Clearing house funds, next day

funds, etc. are used with many different connotations.

Two funds settlement terms will be used in this report, based on when the funds are available to the depositor:

Funds valued today or cash equivalent

Funds valued tomorrow

Funds Valued Today - The term funds valued today indicates that the recipient of the money has funds placed today in his bank account, which are available for immediate withdrawal in cash or can be considered the equivalent of cash. These transactions are the same as those referred to as payments in: Cash, good funds, available funds, Federal or Fed Funds (designating funds credited to the depositor's bank in the Federal Reserve System).

Funds Valued Tomorrow - The term funds valued tomorrow means that the depositor does not have funds or cash equivalent available for withdrawal until the day after deposit or the next business day. Similarly, the payor realizes a one day delay until the next business day before funds are debited. These types of funds are also referred to as Clearing House Funds, New York Clearing House Funds, one day delay, valued the next day, or "Custom of Wall Street."

An analogy can be drawn with the delay of the settlement of funds and that of securities transactions. A securities transaction that takes place on trade date, or "day zero," does not settle with the delivery of the securities until

"business day five." This allows time to confirm the transaction for accuracy and issue the proper instructions to deliver securities to the purchaser. In earlier trade practices, securities traded on exchanges were delivered on the trade day until 1933 when the time was extended to two days. Subsequent changes were made to three and then four days. In February, 1968, the time allowed for delivery was extended to five days. In much the same way, the delay of funds for value the next business day has developed as a trade practice to allow for time zone differences, the exchange of data, usually in the form of a large volume of checks, etc.

METHODS OF SETTLING SECURITIES TRANSACTIONS

Corporate securities transactions funds settlement procedures have developed differently in various parts of the country. In some cases, various banks in the same city have different procedures for handling the funds aspect of the securities transaction of the debit party and credit party.

Not much attention was centered on the importance of managing money by those in the securities industry until the late 1960's. Most securities transactions were generally concentrated in one geographical area, and different funds settlement procedures did not cause appreciable trouble. In the 1960's, more settlements began to be made locally rather than in New York City. With the development of regional exchanges, plans for regional depositories and the requirement by more institutions to settle locally, differences in funds settlement procedures began to cause

some parties of a securities transaction to have a possible advantage or disadvantage in the use of funds. In the case of large new underwritings or block trades, the sums of money involved in the use of funds for one day can be significant.

Many securities and banking leaders have commented on the need to have a standard funds settlement procedure on a national basis. One of the major positions of the Securities Operations Division of the Securities Industry Association is to standardize funds settlement procedures.

The Subcommittee found that many knowledgeable securities industry people failed to realize that the use of funds valued today requires that cash or available funds be in an account before funds can be transferred. This could cause some brokerage firms to maintain higher balances than might be necessary with a funds valued tomorrow basis in which debits and credits are netted, and it could conceivably require greater capitalization. For example, paying off a loan in funds valued today could be delayed awaiting the receipt of funds valued today. Also with a funds valued today basis, it is conceivable that some transactions could not be completed prior to transfer deadlines and surplus funds would have to be maintained for these situations. Or, customers could be paying by checks with funds valued tomorrow for transactions that a brokerage firm would have to settle in funds valued today.

The information obtained by this Funds and Settlement Sub-

committee on various settlement procedures, which are summarized below, indicates problems for the national brokerage firm dealing in transactions throughout the United States because of the lack of funds settlement standards.

Stock Exchange Clearing Corporations - At least two different settlement procedures exist among the various clearing corporations. For example, on one hand, the stock clearing corporations of the Midwest and PBW (Philadelphia - Baltimore - Washington) stock exchanges require funds settlement in funds valued today or cash. On the other hand, the stock clearing corporations of the New York and American stock exchanges require funds settlement in funds valued tomorrow. The Pacific Stock Exchange typifies another variant settlement procedure that includes some transactions settled in funds valued today and others in funds valued tomorrow.

Banking Practices in Certain Other Cities - The basic methods of settling securities transactions in several money market areas are mentioned here to illustrate the variations that presently exist among different cities. Appendix I describes the basic check processing system with which many persons reading this report are familiar.

New York City - In the New York area, securities transactions are settled in funds valued tomorrow which are usually referred to as "New York Clearing House Funds." In fact, it appears that the connotation to most securities industry

personnel for the term "Clearing House" is the New York type of payment. (Incidentally, the same convention of funds valued tomorrow exists in the settlement of international payments.)

An interesting development in funds settlement has occurred recently with the Central Certificate Service (CCS), Inc. CCS, Inc. rule 9 is as follows:

> "Balances due the corporation from a participant or pledge shall be paid by check payable in New York Clearing House Funds which shall be a cashier's check or certified if in the amount of $5,000 or more, unless such requirement is waived by the corporation in its discretion."

The First National Bank of Boston and the Corporate Trust Activities Committee at the American Bankers Association have requested that the Securities and Exchange Commission, which is reviewing the rules, change the terminology of Rule 9 to this:

> "Balances due CCS, Inc. from a participant or pledge shall be settled in funds valued tomorrow (Clearing House Funds rather than Federal Funds)."

The significant point about this requirement is that it was developed by CCS, Inc. which is a user, and not by banks. CCS needs assurance by receipt of a certified check presented to CCS after the settlement is calculated each afternoon that funds will actually be available the next day for settlement purposes. A check could be presented by a non-New York bank, but there is no guarantee that funds will be available tomorrow even though the bank on which funds are drawn could be a one-day

point for available funds provided the checks were presented to the Federal Reserve Bank before scheduled deadlines. Conceivably, the bank may decide to return the check for some reason. Therefore, it illustrates the need of the user to have assurance that funds will be available as specified.

Another alternative for solving this problem would be to expand the capabilities of the Federal Reserve Wire Network to enable transmission of funds valued tomorrow, or any other time in the future, as well as continuing transmission of funds valued today. With such a change, an organization like CCS could receive a Federal Reserve Wire Transfer, which would guarantee that the sender would have funds transferred from his reserve account in a Federal Reserve Bank the next day just as a certified check today guarantees funds the next day.

Checks issued for the settlement of securities transactions, even if drawn upon the same bank where the depositing broker or organization has a bank account, are generally not debited to withdraw funds from the writer's checking account until the following day. While some banks may show a debit that day on an account statement, the transfer of <u>available funds</u> from the account for determining the available balances or cash in the account actually takes place the following day.

Checks drawn on the eleven New York Clearing House banks, which were received for deposit the previous day by the pre-

senting bank are exchanged at several times during the early morning hours and finally at 10:00 a.m. on each business day. The net position of each bank is determined after the 10:00 a.m. exchange and the individual banks' deposit accounts with the Federal Reserve Bank of New York are debited or credited in funds valued today for this exchange of checks.

There are exceptions to the settlement of funds valued tomorrow where one party is not in the securities industry, as in the case of individuals and corporations. Most banks generally handle all retail checking account transactions by crediting deposits under a deferred availability schedule running from one day (similar to funds valued tomorrow) to several days roughly measuring the time until collection from the payor bank and credit of funds through the Federal Reserve System and allowing sufficient days for "non-sufficient funds," "stop payment," or any other type of checks to be returned. In the case of most large corporations' new securities offerings, the funds are credited as funds valued tomorrow in the same way the transaction would be handled for any broker or financial institution. There are, however, cases where the underwriter pays the corporation in funds valued today, but receives payment in funds valued tomorrow.

Chicago - Securities transactions in Chicago are handled somewhat differently than in New York. The major Chicago banks have an exchange of checks at 10:30 a.m. each business morning similar to the 10:00 a.m. exchange at the New York

Clearing House. Checks drawn on other Chicago banks and deposited in a Chicago bank too late to make the morning exchange are in effect valued tomorrow because they cannot be exchanged until the next day.

However, this standard practice can be avoided by a payee's arranging to deposit at the payor's bank. For example, a brokerage firm could instruct the Midwest Stock Exchange's Stock Clearing Corporation to issue a check drawn on a bank where that firm maintains a Chicago bank account. When that check is deposited, the Chicago bank would make funds valued today or cash available to the firm and it could, therefore, invest funds overnight or pay off loans. Certain Chicago banks will place immediately available funds to the credit of a broker at another Chicago bank on a selective basis.

The same firm if it pays in New York but receives money in Chicago, could gain overnight use of funds provided the funds are invested, such as in Treasury Bills. Conversely, if the firm pays in funds valued today in Chicago for securities but receives payment in New York City, it would lose the use of funds for one day, since the funds received in New York City are valued tomorrow.

California - Los Angeles and San Francisco clearing house practices for exchange of checks are similar in all major respects except that the deadlines for check exchanges are 8:00 a.m. and 7:00 a.m. respectively.

The settlement of securities differs in several ways from that of other major financial centers. Payments deposited in the bank upon which they are drawn are immediately available provided sufficient funds valued today or cash are in the payor's account. If drawn on another local bank, the funds will be valued tomorrow.

Funds settlement practices on out-of-town checks vary. Some banks have their own schedule while others adhere to that of the Federal Reserve Bank.

Funds valued today are withdrawn from brokers' accounts by the issuance of banks' cashiers' checks or the certification of the brokers' checks making funds available to the banks unless special arrangements are made.

In the vast majority of transactions, bank originated debits and credits to brokers' local bank accounts are on a funds valued today basis. Exceptions are arranged by either special requests or standing instructions. The Pacific Stock Exchange Clearing Corporation pays brokers having net clearing balances with a draft drawn on the Clearing Corporation's current bank of account. The Clearing Corporation will accept payments from brokers, in settlement of clearing balances, drawn on the brokers' local banks. Generally, the Clearing Corporation deposits these checks in their account with the bank upon which they are drawn and obtains funds valued today. While this procedure can be handled relatively easily with modest volume, it becomes very difficult with heavy volume such as in New York.

FEDERAL RESERVE SYSTEM'S WIRE NETWORK

Many are familiar with the operation of the Federal Reserve System's (FRS) Wire Network; the basic functions of the FRS Wire Network are discussed in Appendix II.

Funds valued today can be transferred among member banks of the FRS through the facilities of FRS's computer switch located at Culpeper, Virginia. The funds transfer process actually takes place through debits and credits in each individual bank reserve position or deposit maintained at the FRS.

BANK WIRE

As an alternative to the Federal Reserve System's Wire Network, discussed above, the transfer of funds can be handled with the Bank Wire which is managed by major banks in Chicago and New York. The Bank Wire is a switching network connecting over 230 banks throughout the United States. The Bank Wire is described in Appendix III.

It is a fine point, but while funds can actually be transferred throughout the country on the FRS Wire Network, this is not so with the Bank Wire. On the Bank Wire, instructions are transmitted from a bank to its correspondent bank to charge its account with the correspondent and make funds available to some other organization. Frequently, the funds transferred by the Bank Wire are disbursed within the same correspondent bank. Bank Wire funds transactions can be valued today or later.

STATUS OF FEDERAL RESERVE SYSTEM PLANS TO MODIFY FUNDS SETTLEMENT SYSTEM

In September, 1972, the FRS questioned various financial organizations on the feasibility of extending the transmission time of this network later than now available. The FRS announced in early April that the availability of the network will be increased by half-an-hour for transmission from west to east to equalize transmission time in both directions.

STATUS OF NEW YORK CLEARING HOUSE ASSOCIATION PLANS TO SETTLE INTERNATIONAL TRANSACTIONS

International payments in New York City are settled in funds valued tomorrow, a similar convention to that practiced for securities transactions.

In 1970, the New York Clearing House Association (NYCHA) installed an automated clearing house through which international payments could be switched by means of a central computer located at the NYCHA. This system is referred to as the Clearing House Interbank Payments System (CHIPS) and is described in Appendix IV.

It has generally been assumed by some bankers and Federal Reserve officials that CHIPS transactions could be converted from a funds valued tomorrow settlement basis to a funds valued today basis fairly readily. However, NYCHA committees analyzing possible conversion have found major potential problems regarding credit for participants when funds must be paid on a funds valued today basis,

or cash equivalent, since funds valued today or cash cannot be transferred or paid from an account until funds valued today are received if the account does not maintain a high enough balance to cover the transaction.

This appears to cause major queuing problems in completing transactions at the latest time possible. In addition, this also requires that the computer switch maintain the current status of every participating organization's account.

The NYCHA international payment committees have concluded that the advantages of settling international transactions in funds valued today are outweighed by the severe demands this places on the payment mechanism. These committees have recommended that no changes be considered until after early 1974 when a new larger CHIPS computer system is installed.

CONCLUSIONS

The Subcommittee concludes that the question of funds valued today or tomorrow should not be the primary focus of the securities industry. Instead, the focus should be on a standard funds settlement system that will be applicable to current capabilities and adaptable to changes in the future.

The Subcommittee concludes that there are possible abuses in the present settlement process for securities transactions because of the lack of standard industry funds settlement procedures. Generally speaking, there has not been a national effort in the past that had the senior manage-

ment levels of both banking and the securities industry involved in addressing issues, such as the funds settlement process. Under the circumstances, it can only be expected that different procedures would be applied in different parts of the country. Some organizations, in both the banking and securities industries, could benefit from these differences to their own advantage. Consequently, the discrepancies which are inequitable at best will cause problems in settling transactions among securities depositories which are being formed in various parts of the country for participation by both regional and national firms.

Rather than assume that the Federal Reserve Wire Network schedule will be changed, the Subcommittee in its investigation determined that, although changes could occur, conclusions should be based on conditions as they presently exist.

The Subcommittee believes that future efforts to improve the efficiency of the payment mechanism - and particularly to reduce the checks in the process of collection, or float - will include specifying funds settlement dates. This will eliminate the tremendous queuing problems that occur when large volumes of transactions must be settled in cash or funds valued today.

In deciding that a standard funds settlement is necessary, the Subcommittee concludes that the standard adopted must be

able to be implemented as quickly as possible for the benefit of all participants for the settlement of securities transactions. In addition, the Subcommittee concludes that the standard must not be so different from the present way of conducting business that the capital structure of a brokerage firm is affected.

Factors, which are discussed below, could make it feasible to consider converting to a funds valued today basis in the future. The factors in making such a change would be the availability of computer switches in the various money market locations, such as in New York City where CHIPS is installed, and in California where the Federal Reserve installed a switching computer in October, 1972, for use by the California Automated Clearing House Association, Incorporated. In addition, factors such as the availability throughout the entire business day of the Federal Reserve network for the transfer of funds valued today, as is being explored by the Federal Reserve System, should also be taken into consideration.

Another major factor in deciding to change the funds settlement basis would be the ratio of securities transactions taking place in the depository through which a standard settlement process would be followed versus those taking place outside of the depository by the issuance of certificates in institutional and private name registrations. As more settlements take place through depositories, which will be able to determine net settlement positions, it will

be easier to settle the funds related to a securities transaction. It is intended that, in the near term, banks and institutions participating in depositories will deposit their own holdings and securities held for others. It may then be desirable to re-evaluate and change the settlement process even though the same problems mentioned in this report for securities remaining outside of certificate depositories will continue to exist.

RECOMMENDATIONS

The Subcommittee recommends all common stock transactions be settled on a funds valued tomorrow basis. This would require that all securities clearing corporations and the National Association of Securities Dealers specify their funds settlement procedures to be funds valued tomorrow.

The Subcommittee further recommends that upon acceptance of this position paper by the National Coordinating Group for Comprehensive Securities Depositories, copies should be forwarded to the organizations mentioned in the second paragraph of the SCOPE on page 3 inviting their comments by the end of June, 1973. Responses should make it possible to determine if this standard settlement method could be implemented by the end of 1973. Adoption in cities having stock exchanges would encompass the majority of securities transactions. Additional efforts will be made by members of this Subcommittee to secure participation of securities and banking entities in other financial centers within their respective regions in order to achieve standardization of funds settlement for securities transactions on a national basis.

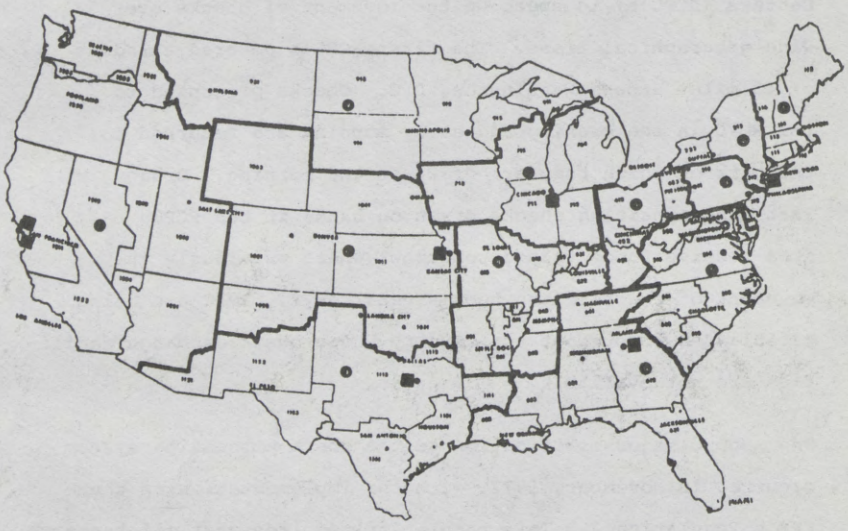
APPENDIX I-CHECK PROCESSING SYSTEMS

Approximately 22 billion checks are handled annually by commercial banks. Approximately 1/3 of all checks are written by depositors in one bank for the credit of depositors in the same bank. Another 1/3 of all checks are written for depositors in the same city or marketing area. These checks are exchanged directly among the banks, most often through the facilities of local clearing houses.

The remaining 1/3 of all checks go outside the local area. Most of these checks are distributed through the facilities of the Federal Reserve System (FRS) or by "direct sending" arrangements which banks establish among themselves when check and dollar volumes warrant.

Federal Reserve System - The map on the next page shows the twelve FRS districts, the locations of FRS banks and branches and the transit numbers for all areas of country, which are the numbers appearing on every check. The FRS receives the deposit of checks from banks on established daily schedules and grants funds valued after today to the banks based on when the checks will be returned to the banks on which they are drawn. The funds for checks drawn on banks in cities where a FRS bank or branch is located usually are credited in funds available tomorrow to the depositing banks. Checks drawn on other points designated "country banks" are usually valued a day or so later depending on the location.

THE FEDERAL RESERVE SYSTEM



BOUNDARIES OF FEDERAL RESERVE DISTRICTS AND THEIR BRANCH TERRITORIES

To speed up the flow of funds through the check processing system, the FRS has recently made two major changes. One change is the establishment of Regional Check Processing Centers (RCPC's) to speed up the movement of checks over wide geographical areas. The first RCPC's covered a radius of 40 miles around Washington, D.C. Checks presented to the RCPC in the evening and early morning are returned to the bank on which they are drawn in the morning. Organizations depositing checks drawn on banks in the RCPC area receive funds valued tomorrow, where previously the movement of checks often took several days. RCPC are being established throughout the country where check exchange facilities are not available.

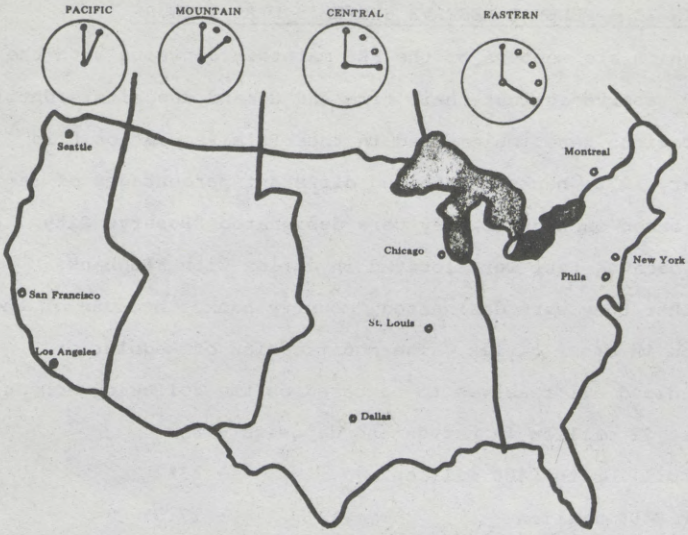
The second major modification to the check processing system occurred in November, 1972, with the implementation of the FRS's Regulation J. This regulation requires that all banks settle checks with the FRS on the day presented in funds valued today. Previously, "country banks" had been allowed one additional day or allowed to settle in funds valued tomorrow. This change puts all banks, regardless of location, on an equal basis of settling checks and reduces the amount of FRS checks in the process of collection - or "float" as it is usually called.

APPENDIX II - FEDERAL RESERVE SYSTEM'S WIRE NETWORK

Banks which are members of the FRS maintain deposits with the FRS for reserve against their time and demand deposits. Until modifications were implemented in the FRS's Regulation D in November, 1972, banks maintained different percentages of reserves based on whether they were designated "Reserve City Banks" because they were located in cities with FRS banks, or whether they were designated "country banks" because of their location in other cities. The modification of Regulation D standardized all reserves to be based on the following schedule:

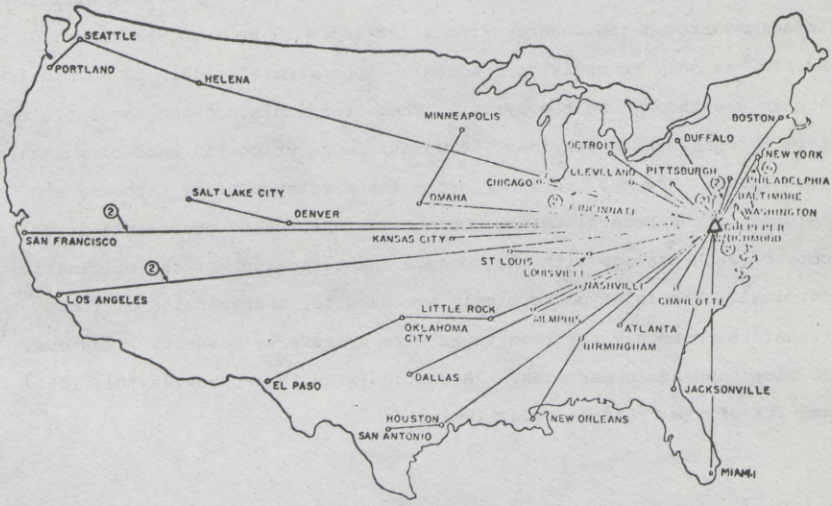
First $2 million in net demand deposits	- 8%
$10 million to $400 million	- 13%
Over $400 million	- 17.5%

Every Wednesday, based upon the average of the daily balances for the preceding two weeks, the FRS member banks settle their reserve position with the FRS, which should be within a range of plus or minus 2% of their reserve position needs. If a particular bank needs funds, it can purchase Federal Funds. Those with excess Federal Funds can settle their available funds. Excess funds left on deposit at the FRS are non-earning assets, while shortages can lead to disciplinary action by the FRS. Non-members of the FRS can maintain their reserve positions with other banks. The FRS moves funds (as well as ownership of Treasury Instuments) on its Wire Network with the schedules for transactions in the various time zones, as shown on the next page.



Pacific Zone Sending Deadlines to:		Mountain Zone Sending Deadlines to:		Central Zone Sending Deadlines to:		Eastern Zone Sending Deadlines to:	
5:30 A.M.		6:30 A.M.		7:30 A.M.		8:30 A.M.	
6:00 A.M.		7:00 A.M.		8:00 A.M.		9:00 A.M.	
6:30 A.M.		7:30 A.M.		8:30 A.M.		9:30 A.M.	
7:00 A.M.		8:00 A.M.		9:00 A.M.		10:00 A.M.	
7:30 A.M.		8:30 A.M.		9:30 A.M.		10:30 A.M.	
8:00 A.M.		9:00 A.M.		10:00 A.M.		11:00 A.M.	
8:30 A.M.		9:30 A.M.		10.30 A.M.		11:30 A.M.	
9:00 A.M.		10:00 A.M.		11:00 A.M.		12:00 Noon	
9:30 A.M.		10:30 A.M.		11:30 A.M.		12:30 P.M.	
10:00 A.M.		11:00 A.M.		12:00 Noon		1:00 P.M.	
10:30 A.M.		11:30 A.M.		12:30 P.M.		1:30 P.M.	
11:00 A.M.		12:00 Noon		1:00 P.M.		2:00 P.M.	
11:30 A.M.	Eastern	12:30 P.M.	Eastern	1:30 P.M.	Eastern	2:30 P.M.	Eastern-Other District
12:00 Noon		1:00 P.M.		2:00 P.M.		3:00 P.M.	Pacific,Mountain,Centr.
12:30 P.M.	Central	1:30 P.M.	Central	2:30 P.M.	Central-Other District	3:30 P.M.	
1:00 P.M.		2:00 P.M.		3:00 P.M.	Pacific,Mountain, Central Within District	4:00 P.M.	Eastern-Same District
1:30 P.M.	Mountain	2:30 P.M.		3:30 P.M.		4:30 P.M.	
2:00 P.M.		3:00 P.M.	Pacific, Mountain	4:00 P.M.		5:00 P.M.	
2:30 P.M.	Local-Outside District	3:30 P.M.		4:30 P.M.		5:30 P.M.	
3:00 P.M.	Local-Within District	4:00 P.M.		5:00 P.M.		6:00 P.M.	
3:30 P.M.		4:30 P.M.		5:30 P.M.		6:30 P.M.	
4:00 P.M.		5:00 P.M.		6:00 P.M.		7:00 P.M.	* EXCEPTIONS
4:30 P.M.		5:30 P.M.		6:30 P.M.		7:30 P.M.	Detroit - 2:30 Est.

The FRS Wire Network is controlled through an electronic switching computer located at Culpeper, Virginia, which connects the FRS Board of Governors and all of the FRS banks and branches. The messages are formatted with the four digit transit numbers and four digit routing numbers shown on the bottom of checks to designate individual banks. Participating banks use M-37 telegraphic type terminals to transmit transactions through their local FRS bank offices and into the network. This network is presently used for the transmission of funds valued today. "The Federal Reserve Communications System" below describes in more detail the capabilities of this system. A map below shows the location of this network which has the ability to transmit data on magnetic tape in addition to the M-37 traffic.



THE FEDERAL RESERVE COMMUNICATIONS SYSTEM

by Albert D. Tinkelenberg,
Federal Reserve Bank of Richmond

The present Federal Reserve System is a direct result of over thirty years communications system development within the Federal Reserve System. The immediate predecessor of our present system was an 81-D-1 torn tape system at the Federal Reserve Bank of Richmond using M-19 teletype terminals at Federal Reserve Offices throughout the country. The new communications system became operational in August, 1970. The heart of the communications system is an M1000 Communications Switch which serves the teletype network, a magnetic tape network and a computer network. The system is a central store and forward communications system with all traffic routed from the originating location to the store and forward switch at Culpeper and then it is routed to the addressee station. Current system throughput is about 45,000 messages throughput/day (input plus output).

The teletype network includes 77 150 baud circuits with traffic to 40 locations around the country (the slide shows 39 because the Miami Branch has only recently been added). Approximately 143 M-37 terminals are in use throughout the system. These terminals are the newest Teletype terminal which provides 150 words/minute using 150 baud communication lines. The M-37 terminal has a standard typewriter keyboard and as used in the Federal Reserve Communications System provides a typed copy of each message with the message identification at the originating terminal. The teletype terminals are used for transmission of funds transfers, commonly referred to as wire transfers; security transfers, (CPD's); and Admin messages. Percentage-wise these provide 70%, 10% and 20% of the traffic respectively.

The second network included within the communications system is a magnetic tape network which uses thirteen 2400 baud circuits to all Federal Reserve District Head Offices and to the Federal Reserve Board of Governors in Washington. At each of these locations, an IBM 2968-7 tape transmission terminal is used. These terminals and circuits are used for the transmission of economic data from all the Federal Reserve Districts to the Board of Governors and to the Research Department at the Federal Reserve Bank of New York. Transmissions may be routed through the M1000 Communications Switch or they may be routed through circuit patching or via circuit switching directly from one location to the other.

The third network, the computer network, is actually a replacement for selected portions of the teletype network. Communications processors are now in use at the Federal Reserve Bank of Chicago and the Federal Reserve Bank of San Francisco. Chicago uses a Control Data M1000 and San Francisco uses an IBM 360/30 especially programmed to handle communications. Currently in the test phase are additional communication processors; and XDS Sigma 5 at the Federal Reserve Bank of New York, and twin IBM 360/30's at the Federal Reserve Bank of Cleveland. The communications processors connect to Culpeper and serve local communications networks at the Federal Reserve city. Using the computer network, funds transfers from the Bank of America in San Francisco are sent to the Federal Reserve Bank of San Francisco communications processor which in turn sends the messages automatically to Culpeper. Culpeper then polls the Chicago communications processor and routes the message to Chicago which would route the message from Chicago Bank over to, say, the Continental Bank in Chicago. In this case, the message would be routed automatically through three communications processors without any manual inter-

vention. It is an objective of the Federal Reserve System to have all Federal Reserve District Offices connected in this manner for high speed (approximately 300 characters/second) communication with Culpeper and for automatic handling of message preparation and message processing at each office.

The M1000 Communications Switching System at Culpeper is a specially designed computer, designed to provide very rapid input and output. The system uses four computers called M1000 exchange units. With each exchange unit (EU) are core memory and fast disc plus secondary storage on disc packs and magnetic tape. As a message enters the system through a line group, it is routed into the exchange unit and immediately recorded on disc storage. After it is recorded on the disc, an acknowledgment is sent back to the originating terminal. The addressed terminal is then polled to determine if it is available for receipt of a message. If the polled terminal is in operating condition, and is not already busy with other traffic, the message is sent to it. While the traffic is waiting to be delivered, it may be stored on a fast access disc within the exchange unit; or on disc packs. As traffic is delivered to the addressee, it is recorded on disc packs and on magnetic tape. The disc pack storage provides a capability for rapid retrieval of a message by a receiving station during the day that the message is delivered. The magnetic tape record of the traffic is a permanent history of all traffic delivered. In most cases, Culpeper keeps the magnetic tapes with delivered traffic for thirty days.

The M1000 system is especially designed to prevent loss of a message in case of failure and to continue communications service in spite of failure of key components. There are four exchange units in the M1000 system. In the case of an EU failure the communications system will continue to serve all terminals connected to the network. In fact,

all three EU's can fail and communication service is still provided to all terminals in the network. Of course, in this case, the overall thruput will be reduced.

The Operators Console for the M1000 is especially designed to provide the information necessary for operator awareness of the transmissions through the system. While each message is routed automatically through the system, the operator needs to have information on the system operation. Circuit activity is shown by blinking lights for each circuit or a steady red light appears in case of circuit or terminal problems. Also, status lights are provided for each EU to show cases where an EU or a part of it, such as a disc, has failed and the function is assumed by the neighboring computer. The status indications from the control panel are supplemented by teletype terminals positioned at the operators console. Periodically, status reports pertaining to the communications through the system are provided at these terminals. Status reports include such things as number of messages delivered to each station, list of circuits and terminals which are inoperative, number of messages handled by each EU within a certain period and number of messages awaiting delivery on each line throughout the system. Also, the console terminals can be used to provide instructions to the M1000 computer to deliver traffic to an alternate terminal or to stop delivery of traffic terminals that have failed. Special commands to request special status reports may be inserted into the M1000 using these terminals.

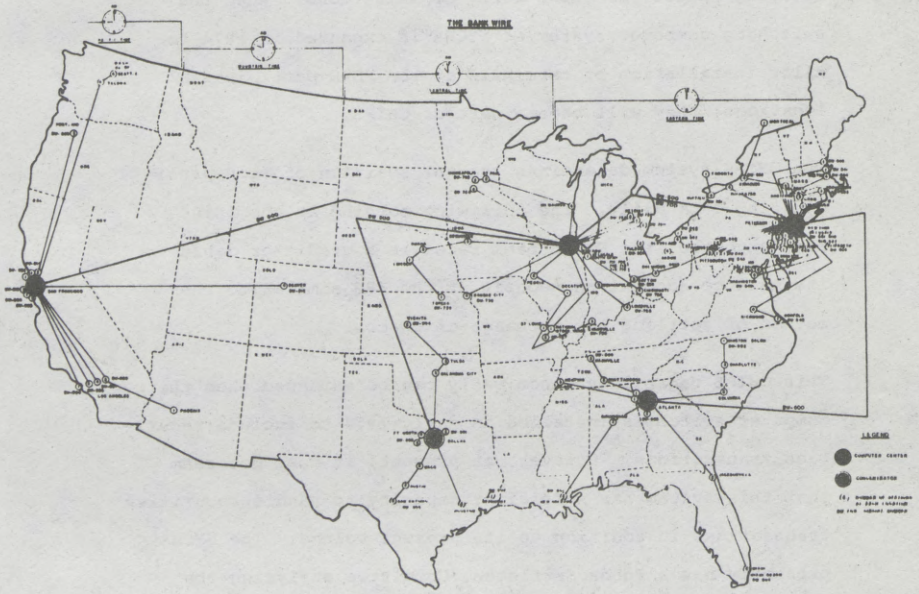
Routing in the Federal Reserve Communications System uses the Bank ABA number in a standard message format. The last two digits of the routing number are a type code that indicates whether the message is a funds transfer, securities transfer, administrative, research, and so on. By this means, receiving terminals or automatic processors may call up a special processing program depending on the type code appearing in the message.

As a message is transmitted from a M-37 terminal to the communications switch at Culpeper, it is printed out on the copy at the M-37 terminal. After the communications switch has stored the message in the disc pack, it sends back to the originating terminal an input message acknowledgment (IMA) at the bottom of the message. The IMA contains an input station identifier, an input date time group, and an input message sequence number. As the message is delivered to the addressed station, these same fields are retained in the message ender and additional fields pertaining to the delivery are added. Additional fields are the message file number which is the location of the message on the M1000 disc pack, the output date time group, the output station identifier and the output message sequence number. With these identifying numbers, the message originator has an identification of the message as part of his acknowledgment from the communications switch. The same numbers are sent to the message addressee. Also the time that the message was received at the communications switch and the time that it was outputed are noted on the message. Over 90% of the traffic through the system is delivered within two minutes from time of receipt in the communications switch. The output numbers in the ender may be used by the addressee to retrieve a copy of the message from the communications switch should this be necessary.

The Federal Reserve Communications System is in a constant state of change; over forty new circuits have been added since it came in use about 20 months ago and there have been a continual series of additions to the communications switch program. With the present drive to connect communications processors at all Federal Reserve Head Offices, the evolutionary characteristics of the communications system will continue to be challenged. The field of data communications is advancing very rapidly and at Culpeper we enjoy our position in the forefront of this technology. It is our intention to keep the Federal Reserve Communications System well advanced in the data communications state-of-the-art.

APPENDIX III - BANK WIRE

In addition to the FRS Wire Network, discussed above, instructions for the transfer of funds can be handled with the Bank Wire. The Bank Wire is a switching network connecting over 230 banks, as shown below. This network switch is based on a four character alphabetic code (NXXX for New York banks, CXXX for Chicago Banks, etc.) but the messages are not formatted in any standard as FRS messages are. Bank Wire is managed by banks in Chicago and New York, but an Ad Hoc Committee is now considering broader ownership of this network.



APPENDIX lV - CLEARING HOUSE INTERBANK PAYMENTS SYSTEM (CHIPS)

In 1970, the New York Clearing House Association (NYCHA) installed an automated clearing house through which international payments could be switched by means of a central computer located at the NYCHA. This system, referred to as the Clearing House Interbank Payments Systems, or CHIPS, has been expanded from the nine participating NYCHA banks to include one new NYCHA member and five Edge Act and foreign agency banks. In addition, forty other banks involved in international transactions participate through a Paper Exchange Payment System, or PEPS, with transactions printed centrally at NYCHA. PEPS may be viewed as an interim or "staging" phase for these forty organizations. When the switching computer system at NYCHA is expanded in 1974 to allow installation of terminals at the PEPS participants' locations, they will become part of CHIPS.

The CHIPS system determines the net position of each participating bank daily. The following morning at the 10:00 a.m. exchange, the NYCHA bank receives a credit or debit to its balance account on deposit at the FRS similar to the method of settling the exchange of checks.

This CHIPS capability conceivably can be expanded when the new computer switch is installed in early 1974 to include securities transactions. However, at present, it does not seem that this system has sufficient capacity to handle securities transactions in addition to its present volume. The NYCHA presently has a Funds Settlement Committee analyzing the feasibility of international payments being settled in funds

valued today rather than funds valued tomorrow in an attempt to aid the FRS in removing uncollected funds from the payment mechanism. This committee has three subcommittees concerned with Operations, Credit and Money Market.

It appears that this group is concluding that settlement should continue to be based on funds valued tomorrow because of operating limitations of the payment mechanism to effect transactions under limited times. In addition, there are severe credit problems caused by the settlement in good funds and the difficulty of unraveling erroneous transactions settled in funds valued today or cash. On a funds valued tomorrow basis, error conditions are corrected in funds valued today, so that the beneficiary of the transaction does not suffer a loss.

While solutions to all the problems mentioned regarding international payments being settled in funds valued today seem to be technically feasible, the benefit of settling transactions on a value today basis does not appear to be worth the severe peak demand it places on the payment mechanism.

NATIONAL COORDINATING GROUP
for
COMPREHENSIVE SECURITIES DEPOSITORIES

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SAMUEL B. STEWART
Senior Vice Chairman
Bank of America
San Francisco, California

July 5, 1973

Representative John E. Moss
Chairman
Subcommittee on Commerce and Finance
Interstate and Foreign Commerce Committee
Congress of the United States
House of Representatives
Washington, D. C. 20515

Dear Mr. Moss:

Your letter of May 29, 1973, relative to the progress being made by the National Coordinating Group was very timely. It just so happened that the National Group was scheduled to meet on June 4, and we had an opportunity at that time to discuss it.

I would like to respond to your letter by directing my comments to the three questions which you raised:

(1) "Guidelines for the interface of regional depositories"

As you will notice in the minutes of our meeting, Enclosure A, a considerable amount of work has been devoted to depository interface. Some of the guidelines have been completed, and others are being developed, including:

Depositories as eligible depositors

The foundation for depository interface is provided by each depository's being a depositor in the other depositories. Thus, Depository "A", being a depositor in Depository "B", can receive and deliver securities by book-entry from and to other depositors in "B", just like any other of "B's" depositors. Of course, "A" would be receiving and delivering in "B" on instruction of its own participants. In this respect "A" is little different from broker and bank depositors who are parties to book-entry transactions in depository "B" on behalf of their many customers.

A pilot interface test has been in progress for several months between the Midwest and New York Depositories. Details are now being worked out for a similar test between the Midwest and the West Coast.

Each depository's rules approved by the SEC provide that a depository shall be eligible to be a "Participant" (i.e., depositor).

Representative John E. Moss
House of Representatives
Washington, D. C. 20515

July 5, 1973

Depositories as custodians for one another

Under the Uniform Commercial Code a "clearing corporation" must, as a practical matter, keep possession of securities held by it or place them in a custodian bank. Interface depends on the capacity of depositories to act as custodians for each other.

This interrelationship among depositories can be accomplished when depositories are chartered as banks (i.e., trust companies incorporated under banking law). This has now been done, as concerns the Midwest, West Coast, and New York depositories.

Regulatory coordination and supervision

Although each of the three depositories will be subject to examination and supervision by their respective state banking departments, what might be called another aspect of depository interface is coordinated regulation.

This has been accomplished by the taking of two steps. The first is the submission of each depository's articles of incorporation, by-laws, and rules to the SEC for review and approval. This has been done by the Midwest and New York depositories, and is in process for the one on the West Coast.

The other step is to obtain coordinated bank supervision and examination. This is to be accomplished by having each depository become a member of the Federal Reserve System. The New York depository has already received such membership and the Midwest is in the process of applying.

Funds settlement

An important question of depository interface is the manner in which the cash side of securities transactions is settled both among depositories and between a given depository and its depositors.

A working committee of the National Coordinating Group has studied this matter in depth and has made recommendations which have been adopted by the National Coordinating Group.

A copy of the Working Committee report is enclosed. (Enclosure B).

Other Interface Matters

Task forces from the depositories are working on a number of technical and procedural matters. Interdepository custodian agreements are being drafted. The use of facsimile and other fast transmission methods is being worked out. Enclosure C, a report on "Applicability of Electrical Communications Within a Depository" is being used to advantage. Other operating-level questions as to detail are surfacing and, one-by-one, being disposed of.

Representative John E. Moss
House of Representatives
Washington, D. C. 20515

July 5, 1973

Attention is also being given to some longer-range opportunities for efficiency and effectiveness. Development of a standard financial industry numbering system (FINS) has been approved and steps authorized to implement. This standard is not urgently needed now, but will definitely be needed later to facilitate use of modern communications technology.

In general, it is believed that depositories can--as they are the hub--act as leaders, stimulators, and catalysts among the entire financial community in bringing modern technology to a major part of the trade completion process. Even for transactions in securities which cannot be made eligible for depositories--but every effort should be made to expand the eligible list--the related systems effect should be substantial.

(2) "Whether banks are giving financial support to the development of depositories"

The answer to this question is "yes" - "banks are giving financial support to the development of depositories."

(a) Six Chicago banks have committed $1,000,000 in the next 12 months for the further development of the Midwest Securities Trust Company. This commitment is reflected in paragraph 3 (page 8) of a Memorandum of Understanding executed by the six banks and the Midwest Stock Exchange, a copy of which is enclosed. (Enclosure D).

(b) The West Coast banks have committed, for Phase I, $2.26 million for the development of the Pacific Securities Depository. The total projected capital investment for the whole project is $7.4 million.

(c) The 12 New York Clearing House banks have contributed to BASIC from its formal inception on March 11, 1970, the amount of $650,000 or 50 per cent of the $1,300,000 expenses incurred by BASIC to date. The remaining 50 per cent has been paid by the American Stock Exchange, National Association of Securities Dealers, and the New York Stock Exchange, each of whom assume 1/3 of the aforementioned 50 per cent.

The Memorandum of Understanding executed in September, 1971, on a Comprehensive Securities Depository System between American Stock Exchange and the New York Clearing House banks is reproduced on pages 1922-28 of your 1971 hearings. For ease of reference, a copy is enclosed herewith. (Enclosure E).

(d) In addition to these incurred and contemplated out-of-pocket expenditures the Midwest, West Coast, and New York banks have contributed extensively the time and experience of many of their officers and staff to the actual development and usage of the depositories in their respective areas and to the development of a Comprehensive Securities Depository System. Some of these contributions are evidenced,

Representative John E. Moss
House of Representatives
Washington, D. C. 20515

July 5, 1973

among other things, by their work pertaining to depository interface, insurance questions, the CHIPS, CUSIP, and FINS Systems, Standardization of Funds Settlement for Securities Transactions, development of collateral loan programs for brokers and banks at depositories and by banks depositing securities with depositories, as participants, on a trial basis pending clarification of regulatory and other questions.

The American Bankers Association has expended time, effort, and advice in furthering the necessary amendments to the UCC and by conducting and participating in seminars as to depository procedures and benefits.

It is clear that banks are not only "giving financial support to the development of depositories" but are incurring further and indirect costs by contributing people, time, and experience in large measure.

These commitments reflect the view that through participation in the development of depositories the banks, all of whom have fiduciary responsibilities, can assure that depositories will have the appropriate character, operational, financial, legal capabilities, and regulatory atmosphere.

(3) "What, if any, new problems have arisen in the development of the interregional concept. More particularly, what is the probable effect of requiring new and higher rates of return on capital or increased interdepository charges?"

No unforeseen problems of substance have been encountered. Some foreseen procedural problems remain to be resolved--and will be--such as the handling of dividends, proxies, withdrawal of nominee certificates, etc., where the internal procedures for the handling of such matters now differ among depository operations.

As to "requiring new and higher rates of return on capital or increased interdepository charges", it is contemplated that beyond a nominal rate of return on shareholders' investment, depositories' charges to users would be scaled to cover depository costs.

Our committee appreciates your interest in this effort and the opportunity to tell you of our continuing progress. We will continue to keep your Committee informed.

Sincerely,

John H. Perkins

Chairman

JHP:MOB

Enclosures (5)

Senator WILLIAMS. Well, I appreciate your statement, all of it, and we will have an opportunity to discuss this particular matter further. Thank you very much.

Mr. Walter F. Thomas, vice chairman of the board, Manufacturers Hanover Trust Co., New York, and chairman, steering committee, New York Clearing House Association.

STATEMENT OF WALTER F. THOMAS, VICE CHAIRMAN OF THE BOARD, MANUFACTURERS HANOVER TRUST CO., AND CHAIRMAN, STEERING COMMITTEE, NEW YORK CLEARING HOUSE ASSOCIATION, ACCOMPANIED BY JOHN F. LEE, EXECUTIVE VICE PRESIDENT, NEW YORK CLEARING HOUSE ASSOCIATION

Mr. THOMAS. Mr. Chairman, my name is Walter F. Thomas. I am vice chairman of the board of Manufacturers Hanover Trust Co. of New York. I appreciate the opportunity of appearing today to express the views of the New York Clearing House Association on proposed legislation affecting the transfer, clearance, and settlement of securities' transactions. The New York Clearing House Association is an association of 12 commercial banks in New York City. Sitting with me is Mr. John F. Lee, executive vice president of the association.

We have submitted a formal statement to the subcommittee. I won't read it in full because I believe it speaks for itself. Rather, I would like to summarize the position of the association.

By way of background, let me point out that the 12 member banks of the New York Clearing House Association act as transfer agent or cotransfer agent for approximately 95 percent of the issues which are listed for trading on the New York Stock Exchange and the American Stock Exchange. They also act as registrar or coregistrar for approximately 81 percent of these same issues. Moreover, the member banks perform similar services for many issues that are traded over the counter, and they act as paying, issuing, and transfer agents for most of the bonds issued by the Nation's large corporations. In addition, the 12 banks alone hold for the account of their customers in excess of 2.8 billion shares of stock having a market value of at least $108 billion, which are eligible for deposit with an appropriate depository.

I would like to talk for a few minutes about transfer agents and registrars. I submit that the job of the stock transfer agent is basically a very simple debit and credit operation. The transfer agent receives from the owner or his agent the old certificate with the proper endorsement and a signature guaranty, together with instructions as to the name, address, and social security or taxpayer number of the new owner. The transfer agent checks the genuineness of the certificate, the fact that the endorsement is exactly as the owner's name appears on the face of the certificate, and the authenticity of the signature guaranty. It then refers to its records to make sure that the particular certificate or certificates are actually held by that owner and that there are no stops or other legal impediments to the transfer. The new certificate or certificates are then issued in the name of the new owner with address and social security number or taxpayer number included. The issuing company's books as maintained by the transfer agent are

then updated to record the debit of the old certificates and the credit of the new certificates. The registrar then reviews the old and new certificates to make sure that there's been no overissuance which is the registrar's principal function and responsibility.

This transfer of securities is one of the simplest operations that we perform in the bank provided the documents are presented to us in proper form. There are always problems of peaks and valleys in the volume of work and we are expected to staff for normal wings. There are also situations in which computers do not function because of blackouts, brownouts, hardware or software failures. But I cannot conceive of any legislation that would eliminate these problems.

It is unquestionably true that the difficulties of bank transfer agents during the paper crunch stemmed primarily from the condition in which the work was received. When the instructions call for the transfer of 300 shares and the envelope contains 200 shares or 400 shares, or the endorsement is not proper or where the signature guaranty is missing or contains a signature which has not yet been furnished to the transfer agent or the name of the transferee is missing or there is no address—in any of these cases, there is nothing the transfer agent can do except return the items to the transferor or his agent. I can't believe any legislation affecting transfer agents would correct these situations.

So-called legal transfers—for example, estates, trusts, joint ownership, foreign ownership—are a completely different ball game. While much has been done toward uniformity of requirements for such transfers, we are still subject to the inconsistencies of the laws of the individual States of incorporation as well as to the requirements laid down by the individual corporations for which the transfer agent acts. Legislation applicable to transfer agents will not simplify these problems.

The possibility of any agency establishing personnel standards, either in terms of quality or quantity is just beyond me. We did have personnel problems during the crunch, primarily because so many of our employees were being bought away from us for the so-called backrooms. Fortunately, we were able to call upon senior personnel from other areas of the bank in order to keep the work flowing and the schedules reasonably tight. I can't imagine any legislation or dicta of a regulatory agency which would cure such problems.

I would also submit that there are many ways with computers, mechanical equipment or even manual systems to produce the simple transfer operation. The determination as to the particular means and methods adopted depends upon the individual situation, with due regard for volumes, peaks and valleys and the number of issues involved. Neither legislation nor regulation should decide these matters. They should be determined in the world of competition, economics and the ultimate benefit to the user who is of course the stockholder.

Having said all these things on the negative side of legislation and regulation, I would like to state most strongly our support of regulation as to performances because this is the name of the game. Regardless of the electrical or mechanical equipment used, regardless of the types and numbers of people involved, regardless of the methods, systems, and flows of work, the turnaround schedules, the audit trails, and the consistency and accuracy of records much be maintained. But we

are already regulated as to performance; by the exchanges who keep records on transfer agents as to turnaround times, by the Depository Trust Co., on the same basis, by the corporations for whom we act as agent and finally by the Federal Reserve Bank, the Comptroller of the Currency and the New York State Banking Department. The banking regulatory agencies are concerned not only with turnaround times but also with the security and protection afforded to the operations, the audit trails, methods, systems, flows of work, and above all the reliability and accuracy of the records.

All of these I submit are integral parts of the term performance. These standards of performance already exist and are being effectively enforced by these agencies. I personally believe that each of them has all the necessary power and authority to require compliance and no further, and especially no separate, regulation by the SEC is either necessary or desirable.

If there is any question about such authority or power, there is certainly no objection on our part to legislation which would specifically grant such authority and power to these banking regulatory agencies. But to include in that legislation provisions which could be a deterrent to progress in performance or which would add the confusion of an additional regulatory agency for the establishment of standards or the monitoring of performance would seem to be unnecessary, unwise, and perhaps even self-defeating.

The association believes that the present system for the transfer of securities is working well and that the improvements since 1969 which Commissioner Evans mentioned as a result of voluntary action by the industry, particularly the banks, is not well understood or appreciated. The association does not believe that legislation aimed indirectly at regulating bank participation in securities depositories or aimed directly at them as transfer agents and registrars should overlook the current pattern of bank regulation and examination. We regard the delegation to the appropriate bank regulatory agencies of full responsibility for the internal operation of those securities depositories that are established under State or Federal banking law and of all bank transfer agents or registrars as *essential* for a workable regulatory pattern.

The position of the association on the provisions of S. 2058 relating to securities depositories coincides with the position which will be expressed to the committee by the Banking and Securities Industry Committee—BASIC—and BASIC's memorandum points out that:

(1) Banking authorities are the most appropriate agencies for the regulation of securities depositories, and assignment of the task to such agencies would call forth the degree of bank participation that is necessary to maximize the public benefits of such depositories.

(2) Banking authorities have analogous experience that could profitably be used in the regulation of depositories, and sufficient resources to do the job.

(3) Banking authorities are not given a sufficient role in the development of depositories, particularly in rulemaking as to safeguards for securities and funds.

The provisions of S. 2058 relating to access and management participation are deficient in that: (1) The bill would guarantee access to entities whose character or financial qualifications might actually deter the degree of participation by others needed to make the depository succeed; and (2) the bill would conflict with well-established principles of corporate management by conferring representation

upon nonshareholders in the adoption of rules, the selection of officers and directors, and in all other phases of administration.

Accordingly, we endorse the recommendations of BASIC with respect to the depository provisions of S. 2058.

Stock transfer and registration are only parts of the broader fiduciary, custody and agency functions performed by banks. A Government agency which is not thoroughly familiar with the other activities performed by banks in the entire securities area might well adopt regulations which might be workable for a nonbank transfer agent but would be inconsistent with the standards prescribed by the appropriate banking agency. Congress has traditionally deferred to the expertise of bank regulatory bodies because it recognizes that regulation of banks requires a balancing of various interests including the solvency and integrity of the banking system. The association urges Congress not to adopt legislation which ignores the existence of a competent group of regulators who are in the best position to prescribe and evaluate standards of performance of bank transfer agents and registrars and securities depositories in the broader context of standards of sound banking practices.

Senator WILLIAMS Thank you very much, Mr. Thomas.

Now, this bill that we are discussing here today in this hearing has had quite an extensive history. You were here last year, weren't you?

Mr. THOMAS. Yes, I was.

Senator WILLIAMS. Is your statement quite similar to last year's statement?

Mr. THOMAS. Very much so, Senator.

Senator WILLIAMS. Was your organization part of the extensive informal staff discussions of how the competency of all of the elements could be brought into the regulatory picture here under this legislation?

Mr. THOMAS. I don't know.

Mr. LEE. There was some last-minute telephone conversations, I think as the Congress was winding up its work last October, we were involved in—some of use were involved in it; yes, sir.

Mr. THOMAS. But not extensively.

Senator WILLIAMS. We thought we had found the best practical way to use the competence of all involved here and in my statement I made in opening the hearing today the bill before us today reflects the considered judgment of all persons concerned and involved with the processing of securities transactions.

One of the stumbling blocks we had with the House was the extent to which we involved bank regulatory agencies in the entire picture. In the House they wanted the leadoff to be the SEC in this. We recognized that if we are to have a centralized system there had to be rules promulgated by one authority. However, when those rules were actually enforced we would use those various regulatory agencies that are most competent within their field. The bank regulatory agencies certainly follow the rules into banking areas where they are involved, clearing, settling, transfer, depository—we thought we had found the best approach here.

Mr. THOMAS. I think we understand the question and appreciate the approach you have taken as far as enforcement. Obviously last year if there had to be a bill we would have preferred your bill to

the bill of Mr. Moss because you did give cognizance and recognition to the bank regulatory agencies. I think the main question in our mind is not on the enforcement but on the establishment of rules and regulations as to how much the bank regulatory authorities will have to say about the establishment of those rules and regulations.

Senator WILLIAMS. Well, we have certainly provided for mandatory consultation. Could the language be any clearer in that connection?

Mr. THOMAS. No; that's as clear as it could be.

Senator WILLIAMS. In another area, Mr. Bucher of the Federal Reserve, recently endorsed the cooperative regulation of transfer agents by the bank supervisory agencies and the SEC. He stated:

In view of the extensive cooperative procedures involving the Federal Reserve Board, the SEC, in connection with the writing of margin requirement rules by the Board and their enforcement by SEC, it's hard to foresee any difficulty in this recommendation.

I think that recognizes that the input should be there, making it mandatory that it be there, and recognizing too that you just can't have the authority for rulemaking fragmented. I think we have found the answer here to recognizing that single rulemaking authority, but in arriving at the rules, drawing on the knowledge of the appropriate areas.

Mr. THOMAS. Well, it very probably will work. I think possibly we fear what we don't know and what we don't understand.

Senator WILLIAMS. That's a fair statement. I understand that. Thank you very much.

We convene again tomorrow at 9:30.

[Whereupon, at 11:45 a.m., the hearing was adjourned.]

[Complete statement of Mr. Thomas follows:]

STATEMENT BY WALTER F. THOMAS, NEW YORK CLEARING HOUSE ASSOCIATION

Mr. Chairman and members of the Subcommittee—My name is Walter F. Thomas, I am Vice Chairman of the Board of Manufacturers Hanover Trust Company of New York. I am appearing before you today in response to your invitation to express the views of the New York Clearing House Association on proposed legislation affecting the transfer, clearance and settlement of securities' transactions. The New York Clearing House Association is an association of twelve commercial banks in New York City. Sitting with me is Mr. John F. Lee, Executive Vice President of the Association.

My presentation will address itself to those portions of S. 2058 which deal with securities processing—the transfer, clearance and settlement of securities transactions.

By way of background let me point out that the twelve member banks of the New York City Clearing House Association act as transfer agent or co-transfer agent for approximately 95% of the issues which are listed for trading on the New York Stock Exchange and the American Stock Exchange. They also act as registrar or co-registrar for approximately 81% of these same issues. Moreover, the member banks perform similar services for many issues that are traded over-the-counter, and they act as paying, issuing and transfer agents for most of the bonds issued by the nation's large corporations. In addition, the twelve banks alone hold for the account of their customers in excess of 2.8 billion shares of stock having a market value of at least $108 billion, which are eligible for deposit with an appropriate depository.

SUMMARY

The position of the New York Clearing House Association may be summarized as follows. Banks share the desire of Congress as well as every stockholder, issuer and broker for a system of speedy, efficient and economic settlement and transfer of securities and securities transactions. The Association believes, how-

ever, that the present system for the transfer of securities is working well and that the extent of improvement since 1969 as a result of voluntary action by the industry, and particularly the banks, is not well understood or appreciated. The Association does not believe that legislation aimed indirectly at regulating bank participation in securities depositories or aimed directly at them as transfer agents and registrars should overlook the current pattern of bank regulation and examination. We regard the delegation to the appropriate bank regulatory agencies of full responsibility for the internal operation of those securities depositories that are established under State or Federal banking law and of all bank transfer agents or registrars as essential for a workable regulatory pattern.

DEVELOPMENTS SINCE 1968–70 "CRUNCH"

There have been a variety of innovations and developments in the area of securities processing since the "paper-work crunch" of the late 1960's, so that in the case of stock transfer regulation S. 2058 may be the classic example of legislation at a time when the crisis has passed and the problems have been corrected. With the assistance of the bank regulatory agencies which currently exercise jurisdiction over bank transfer agencies and which will retain jurisdiction irrespective of whether or not S. 2058 is enacted, delays in processing stock transfers have been for the most part eliminated. Moreover, the industry is witnessing a phenomenon which the Congress may wish to assess at greater length before legislating. This phenomenon is the marked decrease in requests for stock transfers which is occurring quite unrelated to the volume of shares traded.

The volume of stock transfers in the member banks of the Association during the first half of 1972 was down 34% from what it was in the first half of 1969. That is to say, the level of activity in the stock transfer area was in the first six months of 1972 only 66% of what it was in 1969. During the last half of 1972 and the first half of 1973, the volume has continued to drop. This is a drop which cannot be explained by the decrease in the volume of stock traded. Rather, it reflects a steadily increasing percentage of ownership by institutional investors, increasing use of jumbo certificates and the expanded use of The Depository Trust Company (formerly Central Certificate Service).

Perhaps as important in alleviating delays in processing securities are the improvements in procedures which have been made by the member banks of the Association. Since 1969 the twelve banks have spent in excess of $50,000,000 for capital improvements in the stock transfer and registrar area. Significant increases in trained personnel have been made. Night forces have been added where none existed before. Although some operations were computerized before 1969, five of the member banks have completed computerization of their transfer and registrar work since that date. All members have instituted periodic and random testing procedures to ascertain more accurately the level of work performance; they have instituted special audits over movement control and safekeeping of certificates and they have given their employees special training. All member banks have become highly sensitive to inquiries from customers. Reports to top level management now focus on such inquiries and special research teams have been organized in most banks to provide prompt answers. Industry-wide steps have been taken at the initiative of our Association, to improve the overall performance of transfer agents. These steps include new forms and procedures for controlling the movement of certificates in bulk between brokers and banks, the use of facsimile signatures in place of manual signatures and the employment of jumbo certificates.

Another development which has occurred since the paperwork crisis, and as a result of it, has been a closer liaison between the stock exchanges, the bank examiners and the bank stock transfer agencies. The New York Stock Exchange has adopted Rule 496 and the American Stock Exchange, Rule 891, which establish a 48 hour maximum for stock transfers. This is also the time period prescribed by the New York Clearing House Association. The Exchanges monitor their rules and report performance times. The bank examiners are also aware of the rules and they check to see that such time limitations are being met when they examine member banks.

At the same time that changes and improvements were occurring in the transfer agency area, the Association was devoting considerable time, effort and money to the successful creation of a comprehensive securities depository in New York City, now known as The Depository Trust Company ("DTC"). The effort, which began before the Congress or the SEC took an active interest in the problem, grew out of a realization on the part of the financial institutions involved that

the volume of paper work had to be curtailed and handled more efficiently. The banking and the securities industries agreed that this goal could only be reached if stock certificates were largely immobilized and ownership transferred through book entry.

Thus, another important reason for the declining volume of securities transfers has been the continuing effort by all parties concerned to immobilize the stock certificate. This has been done largely through the successful operation in New York City of DTC which provides a system of book entry transfers. In 1969 when the predecessor of this depository was just beginning operations, only 1,212 issues of stock were eligible for deposit and transfer. All were issues listed on the New York Stock Exchange. Now 2,899 issues are on deposit, embracing in addition to New York Stock Exchange issues, issues listed on the American Stock Exchange, the National Stock Exchange and some traded over- the-counter. In terms of total shares, there were 464 million shares on deposit in 1969. Today, there are 1.5 billion shares on deposit, worth approximately $60 billion. Total book entry deliveries at the depository have increased from 300 million shares in the first quarter of 1970 to nearly 1.7 billion shares in the first quarter of 1973.

Participation in DTC includes brokers and all types of financial institutions. Each of the twelve member banks has joined. Securities clearance activity through DTC has increased to the extent that it now accounts for over 50% of the member banks' total securities clearings. Also, the banks have contributed or pledged contributions to the DTC protection fund, which is designed to provide insurance against loss.

In adition, mdember banks have begun, on a trial basis, to make substantial deposits in DTC. Nearly 60,000,000 shares have been so deposited. Unless interrupted, this trend will undoubtedly increase, bringing with it a corresponding reduction in transfers. Member banks of the Association now hold an account for their customers more than 2.8 billion shares which have not yet been placed in DTC. These shares alone, if deposited, would increase the total number of shares on deposit with DTC from 1.5 billion to over 4.3 billion. Moreover, if these bank-held securities were placed on deposit, approximately 22,000 manual deliveries between brokers and banks, involving about $730 million, could be eliminated *per week*. Finally, as the depository develops, corporate and municipal bonds may also become eligible, adding many more billions of dollars to the value of the securities immobilized.

TRANSFER AGENCY PROVISIONS OF S. 2058

The major concern of the members of the Association with the transfer agency provisions of S. 2058 lies in the fact that the Bill will add yet another layer of regulation—by the Securities and Exchange Commission—to a banking industry which is already fully regulated.

Let me summarize briefly the main provisions of S. 2058 applicable to bank transfer agents. The bill would require each bank transfer agent and registrar to register with the appropriate Federal bank regulatory agency which, depending upon the type of bank involved, would be the Federal Deposit Insurance Corporation, the Comptroller of the Currency or the Federal Reserve Board. The registration statement must give information with regard to "performance capability, standards and procedures for safehandling and custody of securities, and operational compatibility of the transfer agent's activities with those of other persons involved in the securities handling process." The bill goes on to require banks to update the information contained in the registration statement and gives broad power to the banking authorities to require preservation of records and to examine such records. To assure maximum uniformity, the bill states that the various banking agencies shall consult and cooperate with each other, with State banking authorities and with the SEC "so that the accounts, correspondence, memorandums, papers, books, records and other data required of banks . . . and the inspections thereof, may be in accord with sound banking practices and fullfill mutual regulatory needs to the maximum extent practicable." The bill provides that a violation by a bank of any of the registration, reporting or substantive standards, is a violation of the Federal Deposit Insurance Act and shall be enforced by the appropriate banking agency under Section 8 of that Act.

These provisions of S. 2058 appropriately, in our opinion, recognize the role which has been played by bank regulatory agencies over the years in assuring that bank transfer agent and registrar functions are performed properly. By delegating to the appropriate banking agency the responsibility to review registration statements which are designed to elicit information as to performance of trans-

fer functions and measures and personnel standards for safe handling and custody of securities, the bill concedes the competence of these agencies to evaluate and determine proper performance standards. Accordingly, it would seem logical to delegate to these agencies the responsibility for adopting substantive rules and regulations as to minimum standards of performance.

Nevertheless, and this is the feature which we oppose, S. 2058 provides that the SEC shall have the power to set the substantive standards for bank transfer agents and registrars both in terms of internal performance and external compatability with other persons involved in different facets of the securities handling process. If the stock transfer and registration activities of banks were not already thoroughly regulated and examined by the bank supervisory agencies, perhaps we could understand the need for the Commission to establish standards as to the performance of transfer functions, measures and procedures for safe handling and custody of securities. But this power presently exists in, and is utilized by, banking agencies.

Bank examiners are thoroughly familiar with the operational and personnel requirements for a safe and efficient bank transfer and registrar department. Bank examiners have been increasingly vigilant in the attention they have paid to corporate trust and stock transfer departments since the "paper-work crunch" of 1968–70. For example:

The Federal Reserve Bank of New York has completely revised its instructions to examiners, placing emphasis upon performance time, back-logs and procedures adopted by management for monitoring the status of its own performance.

The regional office of the Comptroller of the Currency in New York is now placing great emphasis during the course of its examinations upon the turn around time in stock transfer departments.

The Superintendent of Banks of New York State issues detailed instructions to examiners relating to the operation of stock transfer departments of State chartered banks. New York State has also created a special automation unit whose employees are trained in special techniques for checking on transfer agents whose operations have been automated.

In the course of their examinations, examiners check for compliance with stock exchange rules and regulations and make recommendations for improvements in the operations of these departments. In doing so they apply the principle that sound banking practices require that bank transfer agents and registrars act promptly and efficiently.

In these circumstances we believe it would not be desirable to inject a new regulatory agency into the supervision and regulation of bank transfer activities. Indeed, there is danger that such a step would be counterproductive. The uncertainties that would be occasioned by the SEC's entry into the regulation of banking activities, and the possibilities for conflict between the requirements prescribed by the SEC and those prescribed by the bank regulatory agencies, which obviously must continue to exercise their present responsibilities for the examination and supervision of banks, could produce significant delays, conflicts or other difficulties in achieving further improvements in the handling of securities transfers.

If the SEC were, for example, to specify personnel standards which are appropriate for a non-bank transfer agent, it might be applying considerations which are not relevant to a bank transfer agent which is providing a variety of related services such as communication to and from shareholders, dividend disbursements, etc. The bank transfer agent would be required to serve two masters because nothing in the bill would eliminate the existing bank regulatory agency control over this department of a bank. The resulting additional expense and administrative burden is not in the public interest; in fact it might impede efforts to improve transfer services even further.

Moreover, the on-going responsibilities of maintaining books and records for two or more regulatory agencies, of updating registration information, and generally of conforming to a multiplicity of rules and reporting requirements would represent a needless and unfortunate drain upon transfer-agency resources. It would be ironic if, in the name of decreased paperwork and increased efficiency, transfer agents were required to increase paperwork and to divert resources from their transfer operations solely to accommodate a duplicative regulatory regime.

In other areas of securities regulation, Congress has recognized the desirability of avoiding duplication, with respect to supervision of the activities of banks and has allocated responsibility to the agency with expertise in the banking field. No case has been made for subjecting banks to duplicative regulation with

respect to their securities transfer activity. In fact, there is every reason to retain the jurisdiction of the federal banking agencies over securities transfers by banks, just as the 1964 Amendments to the Securities Exchange Act of 1934 established such jurisdiction with respect to the outstanding securities of banks.

In short, we believe that no new regulatory authority over transfer agents is necessary or desirable. The banking agencies already possess fully adequate authority to continue their supervision in this field, and the grant of such authority to the SEC would be duplicative and could be counterproductive.

DEPOSITORY PROVISIONS

Our position on the provisions of S. 2058 relating to securities depositories coincides with the position expressed to the Committee by the Banking and Securities Industry Committee (BASIC). BASIC's memorandum points out that:

Banking authorities are the most appropriate agencies for the regulation of securities depositories and assignment of the task to such agencies would call forth the degree of bank participation that is necessary to maximize the public benefits of such depositories.

Banking authorities have analogous experience that could profitably be used in the regulation of depositories, and sufficient resources to do the job.

Banking authorities are not given a sufficient role in the development of depositories, particularly in rule making as to safeguards for securities and funds.

The provisions of S. 2058 relating to access and management participation are deficient in that:

1. the bill would guarantee access to entities whose character or financial qualifications might actually deter the degree of participation by others needed to make depository succeed; and

2. the bill would conflict with well-established principles of corporate management by conferring representation upon non-shareholders in the adoption of rules, the selection of officers and directors, and in all other phases of administration.

Accordingly, we endorse the recommendations of BASIC with respect to the depository provisions of S. 2058.

CONCLUSION

Stock transfer and registration are only parts of the broader fiduciary, custody and agency functions performed by banks. A government agency which is not thoroughly familiar with the other activities performed by banks in the entire securities area might well adopt regulations which might be workable for a non-bank transfer agent but would be inconsistent with the standards prescribed by the appropriate banking agency. Congress has traditionally deferred to the expertise of bank regulatory bodies because it recognizes that regulation of banks requires a balancing of various interests including the solvency and integrity of the banking system. The Association urges Congress not to adopt legislation which ignores the existence of a competent group of regulators who are in the best position to prescribe and evaluate standards of performance of bank transfer agents and registrars and securities depositories in the broader context of standards of sound banking practices.

REGULATION OF CLEARING AGENCIES AND TRANSFER AGENTS

THURSDAY, JULY 12, 1973

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS,
SUBCOMMITTEE ON SECURITIES,
Washington, D.C.

The subcommittee met at 9:35 a.m., in room 5302, Dirksen Senate Office Building, Senator Harrison A. Williams, Jr. (chairman of the subcommittee) presiding.

Present: Senators Williams and Biden.

Senator WILLIAMS. The committee hearing will come to order.

We continue this morning on S. 2058, a bill concerning the regulation of clearing agencies and transfer agents and other matters.

First we will hear this morning from the New York Stock Exchange. Mr. James J. Needham will substitute for Samuel A. Gay. Very good. We are very pleased to have you.

STATEMENT OF JAMES J. NEEDHAM, CHAIRMAN, NEW YORK STOCK EXCHANGE, ACCOMPANIED BY SAMUEL A. GAY, SENIOR VICE PRESIDENT, NEW YORK STOCK EXCHANGE, AND DIRECTOR OF THE STOCK CLEARING CORP. AND DEPOSITORY TRUST CO.; DONALD L. CALVIN, VICE PRESIDENT, NEW YORK STOCK EXCHANGE; ROBERT C. HALL, CHAIRMAN, SECURITIES INDUSTRY AUTOMATION CORP.; AND WILLIAM T. DENTZER, CHAIRMAN, DEPOSITORY TRUST CO.

Mr. NEEDHAM. Thank you. Mr. Chairman, Senator Williams, I apologize to you and to the committee for this sudden appearance on my part, but yesterday the board of directors of the exchange made what we consider a very important decision, and as you know, I am charged with responsibility under the charter and bylaws of the exchange to speak on all major policy matters. And frankly, I welcome the opportunity to be here because it is always a privilege to appear before this committee. I have asked Mr. Gay to stand aside and, if necessary, amplify the testimony that has been prepared for him to deliver.

For the record my name is James J. Needham, the chairman and chief executive officer of the New York Stock Exchange. Accompanying me today is, seated on my right, Mr. Samuel A. Gay, senior vice president of the New York Stock Exchange and a director of the Stock Clearing Corp., and the Depository Trust Co.; also accompany-

ing me, to my left, is Dr. Donald L. Calvin, a vice president of the exchange; and further to my right is Mr. Robert Hall, chairman of the Securities Industry Automation Corp., which is generally known in the industry by the acronym SIAC; and to my far left is Mr. William T. Dentzer, chairman of the Depository Trust Co.

We appreciate the subcommittee's courtesy in giving us the opportunity to present the views of the board of directors of the New York Stock Exchange on S. 2058—a bill to amend the Securities and Exchange Act of 1934, to provide for, among other things, the regulation of clearing agencies and transfer agents.

The New York Stock Exchange supports the objectives of this bill. We do have a number of suggestions for improving the effectiveness of the proposed legislation in achieving those objectives, which we offer for the subcommittee's consideration.

As the subcommittee is aware, the New York Stock Exchange has been working for more than a decade toward the goal of an integrated national system for the prompt and accurate processing of securities transactions effected on national securities exchanges and in the over-the counter markets. Our initial pioneer efforts embraced the exchange's own membership. More recently, we have been cooperating closely with other organizations in both the securities and banking industries and with others involved in the clearance, settlement, and transfer process.

The subcommittee is well acquainted with these efforts and with the considerable progress that has been made to date. I think it is clear that we share with the Congress and the regulatory authorities the desire and determination to place in operation a securities processing system that will preclude any recurrence of the operations tangle experienced by the industry and the investing public during the period 1968–70. We believe it is now technically possible to create such a system. Indeed, much of the groundwork for establishing a national securities depository system has already been prepared.

Obviously, the legislation now before the subcommittee bears very closely on the work that has been done thus far, and on future developments.

But before commenting on the individual sections of S. 2058, we would like to make it clear that we have some strong reservations about the appropriateness of dealing in a single bill with the regulation of both depositories and clearing corporations. We believe, in fact, that regulatory guidelines for these two very different types of entities might more effectively be set forth in separate legislation.

The existing clearing corporations, which have the primary function of balancing and settling trades, are integral parts of the individual exchanges and the over-the-counter market. Depositories have a quite dissimilar function which centers on maintaining custody of securities in a computerized system which aims at immobilizing the stock certificate. The fact that efficient clearing corporations and depositories will both contribute to minimizing potential back-office problems for brokers should not obscure the fact that the two types of entities operate differently, have different though overlapping clienteles, and face different problems with respect to attracting maximum participation.

Most of our comments today refer to those provisions of S. 2058 which deal primarily with clearing corporations. But we would like to make it clear that the New York Stock Exchange generally supports

the views expressed by the Banking and Securities Industry Committee on those provisions of the bill having to do only with depositories.

Within the context I have just outlined, we would like to proceed briefly to comment on the individual sections of S. 2058.

Section 1 of the bill would amend the 1934 act, by adding to its purpose clause the need for developing an integrated national system for the prompt and accurate processing and settlement of securities transactions.

The exchange agrees, certainly that an integrated national depository system is urgently needed. As the subcommittee knows, the exchange assumed leadership in developing the Central Certificate Service which, since May 11, has been known as the Depository Trust Co. Most recently, our efforts have centered on encouraging wider participation in this prototype computerized securities depository—including preparations for coordinating and interfacing with regional depositories in a series of linkups which would, in fact, constitute a coast-to-coast depository system. We recognize, of course, that the concept and operations of such a system affect interests beyond those of the securities industry. Accordingly, the Depository Trust Co., has expanded its board of directors to include—in addition to representatives of the various major elements of the brokerage industry—representatives of the insurance, banking, and investment company industries. All of the gentlemen that we have appointed to that board are outstanding in their field of endeavor, including one former Chairman of the Securities and Exchange Commission. We believe this expanded board will play an important role in determining the shape and policies of the emerging national depository system.

The exchange also fully supports the development of a national clearing system. We also believe that it is necessary to arrive at a common definition of the clearing function which—apart from the depository—presently involves two principal operations: Trade comparison and accounting processing.

Trade comparison involves reporting, validating, and comparing trading activities to obtain an approved contract listing of all trades. Each market today performs its own trade comparison similarly. However, efforts to consolidate in this area are not being pressed, since the function itself will be eliminated as each market advances toward the goal of the locked in trade.

The second clearing operation—accounting processing—involves netting and consolidating all the compared trade information to produce netted settlement instructions to all parties involved in each trade. Two systems are presently in use. One is the delivery balance order system used by the New York and American Stock Exchange clearing corporations. The second is the continuous net, or net-by-net system, used by the other major clearing corporations.

When alternative approaches to implementing a national clearing system are examined, it appears clear that a continuous net accounting system, closely linked to a national depository system, not only would pose the fewest implementation problems, but would also offer the maximum advantages to both the securities industry and the investing public.

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We are presently working with the Securities Industry Automation Corp., on a plan for developing such a system. It is SIAC's opinion that the existing delivery balance order system could be converted to a continuous net system in less than 1 year. This conversion should provide the practical means to consolidate all clearing accounting systems into a single national system—with a minimum of time and expense.

Sections 2 and 4 of S. 2058 address the same issue and give the Securities and Exchange Commission authority to determine the time and method used in the settlement process, as well as the conduct of accounts. Section 4 would extend that authority in connection with empowering the Commission to make rules leading to the development of a national system of clearance and settlement.

The Exchange is concerned that these provisions could be interpreted to permit the SEC to order a complete new design approach to a national clearance and settlement system. While the Commission might not choose to exercise such sweeping authority, the mere existence of the legislative mandate could inhibit ongoing industry efforts to develop a national system from the various systems already in operation.

We believe that the evolutionary methods is the only practicable one, in terms of the available financial and manpower resources. We would agree, to be sure, that all of the existing systems do have flaws which would make them unsuitable for instant adoption on a nationwide basis. But we believe that the best features of each can be combined in a way that will be acceptable to all participants in a national system. And, in fact, we are convinced that the plan now being developed by SIAC will accomplish just that.

Section 3 defines the terms, clearing agency and rules of a clearing agency. The definition of clearing agency includes both depositories and clearing corporations. And as I stressed at the beginning of this statement, the exchange strongly believes that it is inappropriate for depositories on the one hand, and clearing corporations and their support facilities on the other, to be subject to the same regulation.

We also find the definition of rules of a clearing agency extremely and unsuitably broad. At present, the rules of a clearing agency are generally understood to include its constitution, articles of incorporation, bylaws and rules and instruments corresponding thereto, and its stated policies—all of which are required to be filed with the SEC under rule 17A–8 of the 1934 act. Section 3 adds to this definition, practices relating to—a clearing agency's—organization, participation, rules of procedure, financial condition, methods of safekeeping, settling, hypothecating, lending and accounting for funds and securities, and similar matters.

This definition would even appear to encompass all printed forms used by a clearing corporation, operating and instruction manuals for employees, instructions for using data processing equipment, and similar minute details of everyday operation.

Section 5 adds a new section 17A to the 1934 act, requiring all clearing agencies to register with the SEC, and establishing registration procedures. Both this section and section 3 should include exemptions for existing clearing corporations affiliated with stock exchanges or other self-regulatory organizations.

We agree that depositories and any other clearing associations which may come into existence in the future and be unaffiliated with regulated exchanges should be required to register with the SEC—although even here the proposed requirements may be too stringent.

Section 5 also proposes rules on access, the election of directors, setting of standards for personnel and a variety of other matters. In addition, it would give the SEC authority to discipline clearing agencies, their officers or directors for failure to enforce rules and, if necessary, to take over the operation of a delinquent agency. Which, I might add, Mr. Chairman, I doubt that the Federal Government has the capability of doing.

These rules destroy current concepts of self-regulation and cooperative regulation, replacing them with a series of sweeping mandates for direct regulation by the SEC. Even the SEC does not want that much authority, Mr. Chairman, if I read Commissioner Evans' statement correctly when he appeared before the committee. The likelihood is that such an approach would seriously inhibit the forward movement of the securities industry which—without direct regulation—has created so complex a centralized facility as the Depository Trust Co., and has, among other significant achievements, successfully merged the clearing operations of the New York and American Stock Exchanges.

In general, section 5 outlines an approach to regulation so lacking in flexibility that it is difficult to see how clearing corporations could comply with the proposed provisions and still operate in the manner which both Congress and the industry itself regard as essential. Moreover, the approach is apparently suggested without any evidence that clearing corporations have shown themselves to be incapable of dealing adequately with paperwork problems, of carrying out disciplinary procedures fairly and even-handedly, or of otherwise acting in a responsible manner. Nor does there seem to be any recognition of the substantial regulatory oversight which the SEC already is empowered to exercise in regulating exchange-affiliated clearing corporations as facilities of the exchanges.

Instead of introducing a disruptive new regulatory element and imposing new rules and systems at this time, the legislative thrust should be to encourage the industry to continue its successful efforts to develop the kind of nationwide clearance and settlement system that will best serve the American investing public.

Section 6 requires transfer agents to register with the SEC and establishes the necessary procedures. This is a constructive proposal which recognizes the importance of transfer agents' activities and the impact of their effectiveness on the securities industry and the public.

We would suggest, however, that it might be appropriate for the SEC to set minimum standards of performance, and to explore the possibility of some degree of shared regulatory oversight in this area.

Section 7 would give the SEC control over the form and format of securities at the point of issue, to assure that they are compatible with any provisions established by the Commission with regard to clearance.

The section raises the broader question of immobilization and possible eventual elimination of the stock certificate as contemplated by section 17A(q). But while the exchange certainly agrees that the cen-

tral goal is maximum efficiency for securities industry operations, it cannot now be established that complete elimination of the stock certificate is the best means for achieving that goal.

And, Mr. Chairman, with your permission, I would like to skip over the next couple of paragraphs, leave them in the record if you will, and read my concluding remarks.

In conclusion, I want to emphasize again that the New York Stock Exchange agrees that there should be developed as promptly as possible——

Senator WILLIAMS. Before we go on, Mr. Needham, you are skipping the analysis of section 8?

Mr. NEEDHAM. Yes, sir; only in the interest of conserving time.

Senator WILLIAMS. These comments support the legislation, these two paragraphs?

Mr. NEEDHAM. I don't mean to draw a line between the ones we support and the ones we don't support, but I see I may have. I would not want anyone to infer that the exchange, as I said at the outset, does not generally support this legislation and its objective.

Senator WILLIAMS. Well, I wouldn't want the reporters to overlook the fact that your statement is not a total nuclear blast at this bill. You hit with 16-inch guns, but you left a little bit of a fantail.

Mr. NEEDHAM. I believe in due process, and I am fair-minded. Let me go back to where I left off.

Mr. Chairman, with the committee's permission, I want to draw attention to the fact that the exchange expresses itself in favor of certain aspects of the bill, and only in the interest of time I would like to, with your permission, not read those parts of the bill and our comments thereon.

Senator WILLIAMS. It is unusual procedure. Normally you try to skip the unfavorable comments.

Mr. NEEDHAM. Mr. Chairman, I am only thinking of the committee's time.

Senator WILLIAMS. I think you have made the point. Where are you picking up now?

Mr. NEEDHAM. Mr. Chairman, let me apologize at the outset, and ask your indulgence, because I want to make it absolutely clear precisely what the board of directors of the New York Stock Exchange decided. I didn't think the wording in the testimony which was given made it as clear as the board would want it to be made.

Senator WILLIAMS. Is what you are going to read now different from the copy that I have before me?

Mr. NEEDMAN. It may very well be, Mr. Chairman. I have only written it this morning.

In conclusion, I want to emphasize again that the New York Stock Exchange agrees that there should be developed as promptly as possible a national facility for clearing and settling securities transactions among broker-dealers and other financial institutions which would centralize this service function and would be compatible with all existing clearing and settlement facilities and with security depositories. But the exchange also believes that this new facility must be operated and administered by the industry, subject, of course, to the ultimate oversight authority of the SEC and appropriate bank regulatory agencies, if appropriate. This concept would follow the struc-

ture and philosophy of the existing provisions of the Securities Exchange Act of 1934.

The board of directors of the exchange at its meeting yesterday agreed that the exchange stands ready and willing to oversee development of this new national facility in cooperation with other interested industry groups immediately, utilizing all its available resources. The board further agreed that the users of this facility should own and control it through the payment of appropriate compensation. The facility should be operated as a service organization of the industry on a not-for-profit basis.

And here I depart from what you have.

Finally, the board agreed it would be willing to spin off the exchange's clearing facility Stock Clearing Corp., and to encourage all other regulatory bodies to adopt identical policies. This important step was taken by the board to lead the way for all other regulatory bodies to join together to eliminate wasteful competition in the clearing and settlement function so as to realize the substantial cost reductions and efficiencies which will flow from such an effort.

Certainly all must agree that the public interest requires that all organizations which operate a depository or a clearing corporation must dedicate themselves to conducting their affairs in the most economic and efficient manner, utilizing to the fullest all available technology.

The board also believes that the public interest is best served by appropriate Government oversight, but not direct control. Hopefully, it will never be necessary for the Government to exercise that oversight responsibility.

Thank you, Mr. Chairman. I am sorry for the confusion, and I and my colleagues are prepared to answer whatever questions you may have.

[The complete prepared statement of Mr. Needham may be found at p. 343.]

Senator WILLIAMS. Thank you, Mr. Needham. I wonder if we could get a little of the historical evolution that has brought us to the point we are at today with respect to the attiude of the New York Stock Exchange on this legislation and the clearing and depository questions. Your last appearance on the bill was in May of 1972. It is just a little beyond the anniversary of that appearance by Mr. Richard B. Howland, president, Stock Clearing Corp., executive vice president of the New York Stock Exchange.

This legislation before us basically is the same as the bill that was before us a year ago, and the exchange at that time supported the legislation. It had some reservation about how we dealt with enforcement in the area of banks. That was the only area of reservation, as I recall.

Now we are a year later. As I view it, this industry has more profound problems today than it had a year ago. Although the part of the industry complex's problems with which we are dealing here perhaps isn't as acute as it was a year ago, and more efficient processing methods are developing, I gather, area by area, the progress is not proceeding in a coordinated way. We have not made the progress we should have toward an efficient operational system from the standpoint of the consumers of the industry. Nor have we made the progress from the

standpoint of the profitability of the industry. In light of this I can't understand why this year you are regressing—stepping back—from support for an orderly central direction for the development of better clearing process.

Mr. NEEDHAM. Senator, I'm sorry that the testimony which I delivered today conflicts with prior testimony of the New York Stock Exchange, but a lot of things have changed since that testimony was delivered by Mr. Howland. First of all, he is no longer with the exchange, as you may know. Secondly, since he appeared the entire exchange has been reorganized. We now have—again as you know—a full time chairman, myself, 10 nonindustry directors, as well as 10 industry directors, and there is a tremendous public orientation on this board.

This board viewed your legislation in two ways: One, from the viewpoint of whether or not the industry had the capability of doing this job itself or must it submit itself to complete Federal domination. The board concurred that that was not the American way, that we had the capability, and that it could produce the type of vehicle that your bill is aimed at achieving or bringing into being.

Second, the board felt that the only way to accomplish this goal which you are seeking is to give the users of the facility direct control of it on the theory that they in a competitive environment would introduce an element of discipline, which only they could introduce, and not some intermediary such as the New York Stock Exchange.

It is for that reason that we are willing to spin off in some fashion not yet decided our clearing operation to the owners of the clearing system. And that really is basically, as I understand, the reason we are here today.

Senator WILLIAMS. You are putting the burden of the change on your new public members?

Mr. NEEDHAM. No, not really. I think I might also add, though I don't like to do it, that I am not certain this matter was ever discussed previously with the full board of the New York Stock Exchange.

Senator WILLIAMS. Well, I wanted to get at the evolution of the exchange's changing positions. Some action was taken yesterday, is that right?

Mr. NEEDHAM. That is correct.

Senator WILLIAMS. Was that by the full board?

Mr. NEEDHAM. There were—yes. I think one person was absent.

Senator WILLIAMS. And the new position was agreed on then?

Mr. NEEDHAM. Late yesterday afternoon.

Senator WILLIAMS. And the new members, the public members, were present?

Mr. NEEDHAM. The new public members were present, and the industry members, some of them who are new, were there, too.

Senator WILLIAMS. As an operational matter do you have a vote on something of this nature?

Mr. NEEDHAM. Yes, we do, and it was unanimous.

Senator WILLIAMS. A unanimous vote?

Mr. NEEDHAM. Absolutely unanimous.

Senator WILLIAMS. Were these public members fully aware of the exchange position last year?

Mr. NEEDHAM. It was all pointed out to them, Mr. Chairman.

Senator WILLIAMS. They were not there at the time of the debacle in 1969 and 1970. And you know better than anybody in this room why we are here on this bill. It is basically the debacle and near total disaster of 1969 and 1970—the paperwork crisis—that brought your industry to its knees. And on its knees it came to Washington, and in Washington it came to this committee, and out of this committee came SIPIC, and out of SIPIC came a pledge to the American people that we were going to do as thorough a study as we could of what went wrong. We found in that study that one of the significant things that went wrong was the operational tangle caused by procedures that date back 20 years. In this modern age of technological capability, the industry was working in its own separate little compartments with the movement of amounts of paper, and the paper was just smothering the whole operation.

Mr. NEEDHAM. Senator Williams, there just is no question of the accuracy of what you just said. But as the SEC knows and as we in the industry know, the important steps that have been taken since—SIAC is one, formation of SIAC, formation of a Depository Trust Co., the automation of programs of all of the member firms of the New York Stock Exchange, the efforts of the NADS with NCC—all of these are progressive steps to see to it that repetition of what occurred would never happen again.

We sit here today, Senator, with the perspective that we didn't have a year ago either, and the farther away from the date of the event the more objectivity the historian brings to bear. Now certain decisions made at the time are not really ever changed, but others are.

It was my opinion during the time of the 1968–70 difficulties that it was the fault of the industry, and the industry has taken the necessary steps to correct the problem. It was never my thinking as Commissioner of the Securities and Exchange Commission that the Federal Government could ever solve the problem. The Federal Government has no demonstrated ability to operate anything.

Now putting all that aside, the SEC itself in its testimony by Commissioner Evans yesterday indicates to me that they, too, are willing to allow the industry to go ahead with the oversight of the Securities and Exchange Commission.

I think, too, that the current problem on the street can in part be attributed to the devotion on the part of the securities industry to serve the public, whereas in the past, in the period of this low volume time such as we have now, it would have been a simple matter to achieve substantial cost recoveries by putting off people. That isn't necessary. You can unplug the computer, but the bill is there every month. So the ratio of fixed and variable costs within the securities industries has changed substantially. One of the major reasons for that is because of the automation efforts on the part of the industry.

And I might add, Senator, that in another industry with which you are closely familiar, the banking industry, they, too, are having a similar difficulty with respect to unused capacity. The transfer agents of the country are not utilizing their facilities to the maximum efficiency. And as I understand it, the number of stock certificates printed in 1972 were 35 percent fewer than in the year before. All of which indicates to me, Senator, that the banking and securities industry have taken the appropriate steps, and therefore perhaps the same medicine that was needed a year or two ago is not needed now.

Senator WILLIAMS. You say "the board of directors of the exchange at its meeting yesterday agreed that the exchange stands ready and willing to oversee development of this new national facility in cooperation with other interested industry groups." You have placed yourself at the pinnacle of this integration of systems, is that right?

Mr. NEEDHAM. It could be read that way, yes. What we mean is cooperative effort.

Senator WILLIAMS. Well, you are willing to oversee. You know, I don't read the Institutional Investor as I do Genesis to Exodus, but you have seen this pictorial description of the mess you all are in in your industry, haven't you? The article itself is also very revealing.

[The text of this article follows:]

[From the Institutional Investor, May 1973]

The Great Paper Fight:

WHO WILL CONTROL THE MACHINERY?

(By Charles Welles)

After Wall Street nearly drowned in its own paperwork during the 1967–70 operational crisis, the industry set about an ambitious series of programs to clean up the mess. The New York Stock Exchange has rapidly expanded its Central Ceritficate Service depository to immobilize stock certificates and enable book entry settlements among members and now has $60 billion worth of securities in its vaults. Meanwhile, regional exchanges and the NASD have been actively developing their own systems. Thus has been fostered a public impression that the paper problem is well on its way to solution.

But as General Editor Chris Welles explains in this month's cover story, that impression is an erroneous one. Indeed, a labyrinthine and arcane, but intense and often chaotic battle has quietly developed among the Big Board, the regional exchanges, the NASD, the New York banks, the regional banks and the major brokerage houses over just who is going to control the machines that are being set up to take care of the paper. Here, Welles examines this struggle and reports that a large number of critics view the present paper reduction systems as an ad hoc hodge-podge of warring fiefdoms, each intent on defending its territory against possible invaders. This, they argue, is a highly unsatisfactory solution and one that will never permit the securities industry to enjoy the vast cost savings possible through total automation. Unless the various factions are able to abandon their self-interested squabbling and embrace an effective and comprehensive solution. Welles warns, either Congress and the SEC will design a new system for them or the industry could well fall prey to another—much worse—paper crisis.

Among the many forms of aberrant behavior on Wall Street, one which might be called the Clerk Syndrome has always ranked high. According to its prime percept, such concerns as back offices and the complex mechanism for processing securities trades are properly the province of clerks. Partners and executives, who generally regard the whole subject with a mixture of incomprehensibility and boredom, have always felt their attention should much more fruitfully be directed toward the really important issues like commission rates and institutional membership. The 1967–70 paperwork crisis, during which many partners gazed in horror at their chaotic back offices for the first time, precipitated the realization that "something has to be done" to clean up the mess. But the impression persists widely today that the solution is basically apolitical, a question merely of selecting the best machines for the job.

In fact, as any reasonably perceptive operations man knows, the question of paper and the machines to process it is highly political. Determining which machines will be used and who will own them directly affects the fortunes of all securities firms, exchanges, banks, institutions and even corporations and small investors.

AGAINST MOTHERHOOD?

Just as the New York Stock Exchange was shown in our March cover story "The Big Board takes the offensive" to have achieved impressive success in

winning a consensus for its particular conception of the new central marketplace, so also has it been successful so far in establishing its view of the proper solution to the paperwork processing problem. And just as the exchange's marketplace view is seen by many as excessively self-interested, so also are a growing number of critics skeptical of its paperwork plans. These critics have yet to obtain much visibility and many decline to be identified by name. "My business depends on staying in the exchange's good graces," says one who will only talk off the record. "Besides, this is a pretty tough thing for most people to understand. If you're critical of what the exchange is doing, it comes out sounding as if you're against reduced paperwork, which is like being against motherhood."

The thrust of their complaints, though, is clear. The Big Board's clean-up campaign, they argue, is designed principally to preserve its status as the nation's primary marketplace. With the exchange's "monopoly power over the trading of stocks beginning to crumble," former SEC staff member Hurd Baruch said in a recent speech, the Big Board is now attempting to establish "a new monopoly over the processing of stock trades." The losers, Baruch argued, will be not only the investing public but, ironically, much of the NYSE's own membership as well.

The highly complex processing controversy—which features a heated melee in which all factions of the securities business are fighting desperately to preserve or increase their power bases—has the following important facets:

The NYSE has obtained broad acceptance—in the industry. Congress, the SEC and the financial press—of the concept of the central securities depository, in which stock certificates are "immobilized" and settlements between participants are effected by computerized bookkeeping entries as the chief means to alleviate Wall Street's paperwork problem. Under the current plant, Central Certificate Service, now a subsidiary of the NYSE and later an "independent" organization in which the exchange and the large New York banks would hold by far the majority interest, would become the chief component of a national network of depositories, many actual affiliates of CCS.

Serious questions are being raised about CCS's efficacy. Though it is generally agreed that CCS is a fairly useful short-term expedient, which was its intent when it was first opened, critics point out that it is now being discussed by its proponents as *the* long-term solution to the paper problem, a role for which it is grossly inadequate. They fear that CCS and its affiliates could become, as one critic puts it, "an operational nightmare," an inefficient, distended and redundant bureaucracy which will never bring about the true costs savings of total automation and whose massive monopolistic economic power and likely resistance to change could create havoc for the industry and the securities markets in general.

Even before CCS reaches that point, however, it could become severely debilitated by fierce power struggles among various factions of the banking and securities industries. The Big Board, the regional exchanges, the NASD, the New York banks and the regional banks all recognize that CCS and the securities processing mechanism in general have potent competitive implications. They are maneuvering aggressively to shape the machinery in their own interests. These interests, however, are frequently in diametric opposition and no effective system is possible without major compromises on all sides.

Considerable consensus exists among disinterested experts that a bold and comprehensive program must quickly be designed to automate totally the clearance and settlement process by not merely immobilizing the certificate but eliminating it altogether, a step which is impossible under a CCS system. And most experts feel the best means to achieve certificate elimination is a combination of the depository function with the stock ownership transfer function, specifically in a network of competing *transfer agent depositories*, i.e., present transfer agents with the added power to immobilize certificates and transfer ownership through bookkeeping entries. Despite the advantages of the TAD approach—it is already in wide use in other areas of business and finance—it is being strongly resisted by the most powerful elements of the securities and banking industry because of its potentially revolutionary impact on vested interests. In particular, it would "decentralize the concentration of the capital bookkeeping structure of the United States," as an official of the First National Bank of Boston, a TAD proponent, put it, and virtually destroy the historical geographic advantage of brokers, banks and exchanges in New York. But experts argue that unless it, or some similar idea, is implemented, the industry will never be able to capitalize on the potential vast economies inherent in automating securities processing, arrest the serious cost inflation which has long been eviscerating the industry's profit structure, and regain the badly eroded confidence

of investors and legislators and regulators in Washington in its ability to manage its own affairs.

SLOW MOTION

The New York Stock Exchange's Central Certificate Service, a classic example of the dispatch with which Wall Street embraces new ideas and copes with change, was literally over a half century in the making. As early as 1913, Big Board representatives visited the Giro-Cassen Verein, a depository operated by the Vienna Stock Exchange, which enabled members to deliver and receive cash and securities by bookkeeping entry. "In this way," the exchange noted in a report, "the responsibility of the member is relieved, as he has not sent any cash or securities through the streets from one house to another." Several studies and pilot projects were conducted over the next several decades, but the depository concept, already operational in several foreign exchanges, was resisted by Big Board members who, among other things, feared erosion of their independence and relations with customers. Not until 1962, after the Street had experienced its first major paper crisis, did the board of governors authorize implementation of a "Central Stock Bookkeeping Service."

A further spur to action was development by the regional exchanges of new service corporations and other centralized facilities that, some at the NYSE feared, could injure the Big Board's ties with its members. Indeed, until the idea was dropped in 1967, the exchange studied development of a Central Computer Accounting System—patterned after the Midwest exchange's service corporation—to handle members' back office work.

Development work on CCS lagged, however. When the most recent paper crunch began in 1967, the exchange, under SEC pressure, was forced to rush CCS into operation. Not only did CCS initially not help alleviate the crisis, it actually exacerbated it. "They tried to start it up too fast—before it was ready," concedes Richard B. Howland, former head of the NYSE's Stock Clearing Corp. "When you do that you're just asking for trouble. It very nearly blew up." CCS came close to losing total control of its records and some deposited positions were frozen for months. In 1971, the McClellan committee investigating organized crime told the exchange that there existed, as Howland stated in an interview, "a concerted effort on the part of the underworld to infiltrate CCS . . . A number of employees were set to take us to the cleaners." Only recently, well after the crisis which it was designed to prevent had abated, has CCS managed to debug itself.

From the beginning, CCS was never intended to be a panacea for the entire securities industry. In the first place, it was clearly to be a New York Stock Exchange facility for the exclusive use of NYSE members. Since the NYSE generated the bulk of the trading, this possessed a certain logic. But not a few Big Board officials saw an exclusive CCS as a means of bolstering the exchange at a time when it was coming under growing competitive pressure from the regionals and the third market. In particular, it created a large cost and time incentive for users of CCS to trade with each other instead of with non-users. A trade between users, who were all clearing members of the NYSE, could be accomplished by a bookkeeping entry. A trade involving non-users required certificate movement.

Secondly, while the paperwork crisis had produced a general consensus that the stock certificate had to be eliminated, a task for which CCS was, by itself, admitted to be inherently unsuited. CCS was seen by industry visionaries as a useful intermediate step. CCS, the idea went, would attempt to capture or immobilize as much of the certificate flow as possible. Then, through some mechanism as yet undetermined, those grand goals, the "certificateless society" and total automation, would be instituted.

SPUR OR STIFLE?

Over the past two years, CCS's role has been expanding steadily beyond these initial intentions. As they recovered from the criticism heaped upon them for permitting the paper crisis to develop, some exchange officials came to realize that the large New York banks, which handled much of the stock transfer work for listed companies, were probably as much to blame as the exchange and the Street and would have to be part of any broad solution. Following a long series of discussions, there was launched in 1970 the Banking and Security Industry Committee (BASIC), consisting of top level executives from the NYSE, Amex, NASD and the ten banks who were members of the New York Clearing House Association. Cynical SEC staff members felt that BASIC was really an acronym

for Bureaucratic Attempt to Stifle Innovation and Change, for a major reason of the banks' desire to become involved with CCS was to prevent it from disrupting their transfer business.

Officials on the regional exchanges were no less skeptical. Despite BASIC's avowed intention that it was concerned strictly with New York's problems, the regional officials, long used to the Big Board's predatory instincts, sensed trouble. In 1967, it was noted, CCS officials had quietly held unfruitful talks with the Midwest exchange over establishment of a regional CCS satellite through which certificates held by local firms and institutions could be routed back to CCS's vaults in New York. It was feared that, like Caesar's army, CCS would soon spread across the country, pillage and rape the natives and funnel the spoils back home for the greater glory of Rome. As one official put it, "When you have the New York banks and the New York Stock Exchange getting together to do something, even when it's supposed to be in the 'public interest,' it sends up warning flags all over the place." To protect themselves, the regionals began building up their own clearing and bookkeeping organizations and studying local depositories.

A period of intense and often rancorous jockeying for power commenced. "It's been a little like street gangs in the South Bronx staking out territory," says one operations man. CCS instituted a rule requiring any stock clearing corporation desiring to deal with CCS to put all of its trades through the NYSE's clearing system and pay the usual clearing fees—a move the regionals viewed as a blatant attempt to emasculate their own clearing operations. In a sharply critical statement in 1971 to the Senate Securities Subcommittee, representatives of the Midwest exchange and the "Chicago financial community" termed CCS "essentially an extension of the present condition in which the rest of the country faces growing dominance by, and flow of activity to, New York." "The name-calling got so bad," says one regional clearing man, "that no one was speaking to anyone else. It was like guerrilla warfare. You never knew when somebody was about to lob one on top of you from behind a bush."

DEFENSIVE TACTICS

Though confident of their ability to deal with the regionals, Big Board officials were very concerned about a new entrant into the processing area. Under fierce cajoling from SEC staffers, who pointed out that much of the fails problem during the paper crisis involved OTC securities, the NASD in 1969 established the National Clearing Corp. for OTC issues and there was discussion it might even establish its own depository. At first, the NASD tried to move NCC into California. But it was met with bitter resistance by the Pacific Coast exchange, which was not about to relinquish to an outsider the larger volume of OTC business handled by its own very efficient clearing system. Rebuffed, the NCC decided to try New York City. Opposition from the NYSE was even more hostile. A "duplicate" system in New York, the Big Board said, would frustrate efforts to obtain the "efficiencies of scale" inherent in a single clearing system. Paul Kolton of the Amex advised the NASD to abandon the plan. "It's a tough management decision," he said. "But do you know what a pro does? He cuts his losses. We've scrapped programs in the past. They should scrap this one."

NCC, however, was far from a duplicate of the NYSE's Stock Clearing Corp. For many years, the Big Board has employed the "daily balance order" system which nets out the positions of members vis-a-vis each other and requires imbalances to be rectified daily by deliveries between members. Reflecting the historical nature of the exchange membership, the DBO method is ideally suited to a small geographic area where members know and are used to dealing with each other. NCC, on the other hand, employs the "net-by-net" or "continuous net settlement" (CNS) in which members' netted out positions are not against one another but the clearing house itself. Settlements are made directly with the clearing house, which maintains a continuous inventory. Not only is the net-by-net method effective for a wide geographic area and a diverse membership, but, in the view of virtually all disinterested experts, it is much superior to the DBO system, particularly in controlling fails. The Senate Securities Subcommittee in its initial report said the net-by-net method was a much better model than the DBO method for a future national clearing system to handle all trading.

A national clearing system, indeed, has been gathering a growing number of adherents not only in Congress but among the large NYSE member firms which feel that in being forced to be members of the NYSE's SCC, NCC and the various local clearing systems, they are, in effect, subsidizing the growth of inefficient

redundancy. In an October 1971 statement to the House Securities Subcommittee, Junius W. Peake, senior vice president of Shields & Co. and a respected operations experts, actually called for creation of a "Securities Industry Service Corporation," a federally chartered entity that would not only take over all the industry's clearance and settlement but would absorb CCS, SIPC, and regulate the operation and financial operations of all broker-dealers. In testimony, Peake stated, "In my judgment, the continuous net settlement system is by far the best system for clearing securities."

Peake's testimony was extremely upsetting to the exchange. In fact, according to an exchange source, NYSE officials exerted intense pressure on the senior executives of Shields to prevent Peake from testifying. The exchange's sensitivity is understandable. Many operations experts contend that clearance and settlement are inherently distinct from the trading process. This would presumably permit all of the various clearing corporations to be spun off relatively easily from their exchanges and reorganized into a single national system. Such a national system would almost certainly be net-by-net and, because of its nationwide scope, probably based on an expanded NCC. Significantly, NASDAQ is working on automatic reporting and clearance of trades through its system by NCC. Should participation be mandatory, the NYSE would have to give up its SCC which currently is said to represent perhaps as much as three-quarters of the NYSE's budget and personnel and half its profits. The Big Board would be left simply as operator of a trading floor, a facility whose future survival is somewhat less than assured.

Though forced by the SEC to drop formal opposition to NCC's New York plans, the Big Board thus has been devoting a considerable amount of effort to expunging or at least enfeebling NCC. "Let's be blunt about it," says one former NYSE official. "If we put NCC out of business we won't exactly be unhappy about it. After all, it's the exchange against the NASD as to who's going to run the marketplace, isn't it? That's what the game is all about."

The NYSE, however, did not smugly assume that it would prevail against NCC. NCC's threat, as well as the growth of regional facilities and calls for a national clearing system, all helped make clear to Big Board officials the riskness in myopically structuring their efforts as strictly New York solutions, a realization ambitious CCS staff members had been attempting to instill for some time. BASIC thus announced plans for what it called a Comprehensive Securities Depository System (CSDS), a system of interconnected regional depositories of which CCS would be the "cornerstone." CSDS, a NYSE official said, would be a "super-CCS."

Somewhat warily, without abandoning their distrust of New York, regional and NASD interests gave at least ostensible support to CSDS. A major spur was the strain that all the public squabbling and competitive system construction had had on the patience of Congress and even the SEC, which generally has played an almost negligible role in the operations area. As NCC president David H. Morgan warned at a Securities Industry Association operations seminar last summer, "If we let the SEC develop our standards for us, we're going to get screwed."

ERA OF GOOD FEELING

While maneuvering continues behind the scenes as vigorously as ever, we are now in what at least appears to be a new ecumenical Era of Good Feeling. Yet another organization has emerged called the National Coordinating Group for Comprehensive Securities Depositories (sometimes referred to as "son of BASIC") to promote the veneer of camaraderie. The proliferation of New York and regional clearing corporations and depositories is not wasteful, it is being asserted, because everybody is going to "interface" with everybody else, thus making possible the same efficiencies as a national system.

Views vary widely among operations experts on the degree to which efficient interfacing can be achieved, but the consensus is more negative than positive. The Senate Securities Subcommittee's initial report, for instance, said it would be "difficult, if not impossible" for NCC and the local clearing systems to interface with CCS. It should be recognized that interfacing is not like tying two pieces of string together: what might be loudly announced as the successful linking of two systems could produce an unwieldy monster, which, due to inherent technical incompatibilities, is actually less efficient than no system at all.

Political maneuvering, though, is much more important to the interface drive than solution of technical details. One of the major current power contests is between NCC and the regional clearing facilities. At stake is which clearing

systems will actually process the bulk of the OTC trading. Claiming a "mandate" from the SEC to develop a national OTC clearing system, NCC is continuing its attempt to handle all OTC trades, including those by members of the Pacific Coast exchange and the Midwest exchange—which recently developed an OTC clearing capability modeled after the PCE system. Claiming this would force their members to maintain separate listed and OTC facilities, the regional clearing organizations want to retain their OTC facilities and act as, in effect, local branches of NCC which would interface with NCC's national system. NCC terms this plan "cream-skimming" since it would be left only with business from small NASD members and in the less-active OTC issues. Resolution of this dispute is some time away.

The most crucial current dispute, though, is between the Big Board and all of the net-by-net users. To protect itself from NCC's publicly stated ambition to clear trades in listed issues executed via NASDAQ, which now are cleared directly among participants on a trade-for-trade basis, the exchange has been attempting to increase the efficiency and convenience of working through a combination of SIAC (the Securities Industry Automation Corp., which runs the combined NYSE and Amex clearing facility) and CCS. Joint members may now receive a single settlement statement and will soon be able to settle with a single check. And it has been discussing membership in CCS with several third market firms which might be willing to clear listed trades through SIAC if and when they become participants in the amalgamated central exchange market system.

Adding an offensive component to this defensive tactic, the exchange has accepted for deposit in CCS several hundred OTC securities (9,000 are expected by year-end) and announced plans for admitting for membership in CCS the larger OTC houses. This, it is hoped, will forestall NCC's plan to develop its own depository. And, at some future point, it might even permit SIAC to take OTC business away from NCC. NYSE members now account for more than two-thirds the OTC volume.

NCC, however, professes to be unconcerned over this strategy. It is actively attempting to recruit institutions as direct clearing members and hopes it will be able to handle most of the listed trading between institutions and third market firms. While it expects to keep most of its certificates in CCS, it will maintain its own inventory of "free account positions" for members and effect bookkeeping entry deliveries. On costs, NCC president David Morgan maintains it will be "very competitive with SIAC. We think we have the game in town the brokers are going to want to go to."

STEALING BUSINESS

An even more formidable threat to the NYSE could be the clearing systems on the Midwest and Pacific Coast exchanges, which, of course, already handle listed issues. If, when the composite tape and quotation machines are put into operation, the regionals are permitted a nondiscriminatory access to orders, they could attract a major share of the volume simply by offering cheaper and more efficient clearing. Though market makers on the NYSE and the PCE both bid the same price for a certain stock, the PCE's superior clearing could make it the marketplace with the "best execution." The MSE and PCE already operate their own depositories and like NCC are increasing institutional participation in their clearing systems.

The ability of the regional clearing systems and, eventually, NCC to steal listed business from the Big Board will depend directly on the degree to which they are able to interface with CCS. If all depositories and clearing systems are linked so efficiently that trades can be settled by bookkeeping entry equally expeditiously—no matter where they are executed and cleared—it would seem quite possible that SIAC could be severely debilitated and the NYSE could lose a fair amount of business. After considerable pressure from the regionals, CCS has agreed to an interface, but one that works only in one direction: Regional depositories can have accounts in CCS but their certificates must remain in New York. This enables SIAC to maintain a strong competitive advantage. A similar one-way link with NCC is close to agreement.

In the event that CCS is forced to accept a more equitable interface, SIAC is placing great hopes on plans for a new mechanism whereby trades on the NYSE and Amex floors would be locked in and forwarded directly to CCS for settlement, thus more or less eliminating the clearing function performed under the DBO method. This mechanism, SIAC hopes, will prove competitive with any alternative net-by-net system. Regional officials hope that by the time SIAC puts it far-

ranging system in operation, there may be very little business left for it to handle. "Once book entry settlement on a national basis is a reality," says Pacific Clearing Corporation president Christopher J. Delahunty, "it is reasonable to expect that trading patterns will change. Our hope is that the services we provide will be very useful in attracting business to us."

Presicting failure shifts in the competitive positions of the various disputants is impossible. But one conclusion seems certain: their protective and predatory thrusts and counterthrusts could delay for years agreements on the sort of comprehensive and effective system which is needed to solve the paperwork problem.

The competitive maneuvering between the NYSE, NASD and the regionals may soon seem like a kindergarten exercise, however, compared with the major struggle that is beginning to develop between the Big Board and their co-ventures in BASIC, the New York banks. Though they are good customers of one another, relations between the brokers and the bankers have never been precisely convivial. While both recognized the need for BASIC, each blamed the other for the paperwork mess and the group's early days were very tense. That BASIC worked so well in securing immediate cooperative solutions to several serious impediments, such as the lack of form and procedure standardization, is attributed by many to the diplomacy of executive director Herman W. Bevis.

One reason for Bevis's success would appear to be his scrupulous avoidance of any major long-term analyses of CCS's future. It was never made clear, for instance, just when and how—or even if—the banks would eventually participate in CCS. Indeed, some of the banks now trying to interface with CCS are finding the arrangement so awkward they are considering establishing special satellite computer systems to act as linkages. Bankers Trust and First National City Bank have become major critics of the absence so far of major cost savings. Bevis's disdain for the subject is understandable. For as is now becoming painfully apparent as CCS attempts to evolve into a national structure, the interests of the NYSE and the CCS staff on the one hand and the New York banks on the other are inherently incompatible.

COLLATERAL PROBLEMS

The first major example of this phenomenon, and a harbinger of more serious disputes to come, involved the loans banks provide brokers which are collateralized by securities. Like the NYSE, the banks have always been aware of the possibilities of CCS as a competitive weapon, particularly in their difficult struggle against out-of-town banks which have been making major inroads on New York's long-standing domination of the banking business. In CCS's early days, they devise a ploy which, as a *Securities Regulation & Law Report* study put it, allowed them to obtain a "stranglehold on the lucrative collateral loan business." Under an exclusive arrangement with CCS, New York banks were permitted to use securities deposited in CCS by brokers as loan collateral. Any non-New York bank desiring a similar arrangement, the rule said, had to have the loan "serviced by a New York City bank and trust company located in the vicinity of the New York Stock Exchange." Not only were the country banks in the loan business put at a cost and convenience disadvantage, they were forced to disclose confidential information to their New York competitors.

Several regional banks which had been enjoying good relations with NYSE member firms soon found themselves losing considerable business to New York. Among those most upset was First Pennsylvania Bank & Trust Co., which has an active collateral loan program. When First Pennsylvania approached CCS about the possibilities of participating in CCS, Clement J. Groody, vice president in charge of the bank's brokers loan division, says, "we were told that long-range, the out-of-town banks might be allowed to use the service eventually, but it wasn't on the drawing boards at this time." But as non-users of CCS, he adds, "we could see our collateral loan business just crumbling."

While acceding to First Pennsylvania's request was clearly against the interests of the New York banks, CCS and NYSE officials strongly favored it. In the first place, regional banks are a major source of credit for NYSE firms and during the 1969–70 credit crunch, when many New York banks virtually closed down their lending facilities, regional banks were practically the sole source of funds. Second, the New York banks were insisting that pledged CCS certificates had to be kept in the bank's vaults, which was clearly inconsistent with CCS's work in reducing certificate movement. In fact, certificate movement between CCS and banks for collateral loans had been a major contributor to CCS's start-up problems.

Nevertheless, the power of the New York banks was such that First Pennsylvania, with the tacit encouragement of some large NYSE firms, had to threaten a major antitrust suit to force a change in the rules in 1971. The present program, in which over 60 regional banks now participate, permits collateral loans backed by certificates physically located in CCS vaults to be pledged by book entry.

More currently, the NYSE and the New York banks are involved in a potentially lengthy dispute over ownership of CCS. Until the formation of BASIC, it was the exchange's intention to maintain sole ownership and control of CCS through the Stock Clearing Corp. of which CCS was a subsidiary. Fearful of regulation by the SEC and the perhaps disruptive future aspirations of the Big Board, the banks demanded that CCS be spun off from the exchange and reconstituted as a limited purpose trust company regulated principally by banking authorities.

The exchange, of course, was not happy with this plan but it had no choice but to comply. Otherwise, the banks said, they would simply refuse to deposit in CCS their $200 billion in trust and custodial securities—about three times what CCS now has on deposit—which could fatally block CCS's future expansion. CCS is still a wholly owned subsidiary of the NYSE but plans are under way to reorganize it as the Depository Trust Co., an independent organization, some time next year.

Some New York banks have begun making token deposits in CCS—mainly custodial securities—but as long as the regulatory status remains unresolved their participation is likely to remain limited. A bill introduced in March by the House Securities Subcommittee would give the SEC primary authority over all transfer agents and depositories. While giving the SEC "general rule-making power," the Senate Securities Subcommittee—whose parent is the Committee on Banking, Housing, and Urban Affairs—would give bank regulatory agencies "enforcement authority over entities falling within their respective jurisdictions." CCS chairman William Dentzer, formerly New York State Superintendent of Banks, feels the banks will continue to cooperate with CCS only so long "as no broad legislation is passed that scares the bejesus out of them."

OWNERSHIP BATTLE

Years of jockeying for power may remain ahead. According to proposals submitted to the SEC last November, eventual share ownership in CCS, or rather its successor, would be determined annually—half by the amount of securities deposited in the facility and half by fees paid for its services. Ownership may eventually be open to regional banks but, according to the proposals, the criterion would be "the character, financial stability and operational history and capability necessary to fulfill its commitments in an efficient and businesslike manner." Senator Harrison Williams said he found such "broad discretionary categories for exclusion" unnecessary.

Even if non-New York banks are permitted ownership on a non-discriminatory basis, the present scheme would appear to give the New York banks by far a commanding position, or at least a strong veto power.

A key to the banks' power in CCS, as some banking executives are now beginning to realize, is the willingness of institutions to participate in CCS through their custodian banks instead of directly. If the certificates are to reside physically in CCS, institutions may begin to question the need to pay the banks custodian fees.

Obtaining institutional participation in any case will not be easy, for it is the brokers and banks, not the institutions, which reap the major benefits from a depository. Institutions, in fact, have a vested interest *against* a depository. Due to their practice of COD payment, institutions have never been too concerned over tardy deliveries. During the paper crisis, some institutions made handsome profits on delivery delays through short-term investment of the payment funds. Further, depositing securities in CCS currently would make dealings for an institution in the third and fourth markets much more difficult, for non-CCS members are very likely to be on the other side of the trade. The NYSE has been working assiduouly to remove legal barriers to institutional participation in CCS, but has yet to attract any significant institutional interest. The exchange is considering devising some form of economic incentive as a lure. But if the lure is effective, and it begins to appear that most institutions will join CCS directly, the banks, to preserve their custodial business and relative influence in CCS, might attempt to block the move.

Though it seems destined to own a mere minority share in its once exclusive creation, the Big Board has several compensations. It obtained the banks' approval to a proposal barring broker-dealers, which are the actual users of CCS, from direct ownership while allowing the NYSE, Amex and NASD, which do not use CCS, to retain a major interest. This understandably upset many member firms, which lodged vigorous complaints. CCS recently worked out a compromise which would continue to prohibit member firms from owning shares but allows them direct representation on the CCS board. The NYSE plan, which would simply expand the board to accommodate the two or three new members, would sharply reduce the influence of the NASD, which currently holds just one seat. The NYSE now has three, the CCS staff has two, and the New York banks have three.

One source close to CCS contends board membership may be somewhat irrelevant since the board is too high-level and non-operations-minded to permit active scrutinization of CCS affairs. This has already given much power to the CCS staff. "The board is going to have a hell of a time trying to be boss," says one operations man. Staff power, despite the banking background of William Dentzer, works to the disadvantage of the banks, for most of the staff including CCS president Diran M. Kaloostian, seems heavily disposed to the interests of the NYSE.

The NYSE's continuing stake in CCS has other benefits. Despite the direct broker-dealer membership, the exchange's ownership role serves to reinforce its authority over its membership. And, more important, this reinforces its claim, as distinguished from that of its members, to an important say in the shape and control of whatever clearing and depository structure emerges in the future.

REGIONAL DEPOSITORIES

While the question of the relative power of the banks and the NYSE in CCS is not divisive in itself, it could loom much more impotrantly in attempts to resolve perhaps the most sticky present controversy at CCS: development of regional depositories. This issue focuses directly on one of the fundamental weaknesses of CCS as a national depository system. In testimony before the Senate subcommittee, former NYSE executive vice president R. John Cunningham, who played a major role in CCS's development, described how CCS is basically "local in nature." It was designed initially during the early 1960s as a local broker-to-broker delivery system for exchange members at a time when it seemed as if broker-to-broker dealings constituted a sizable enough share of NYSE transactions to make bookkeeping settlement efficient.

Despite the huge growth of institutional trading and the national expansion of NYSE members during the past decade, Cunningham pointed out that CCS has yet to develop an adequate communications network to serve as an efficient electronic delivery and payment system. Virtually all certificates moving in and out of CCS are still physically transported by messengers in the time-honored Wall Street fashion. CCS participants must still maintain offices in lower Manhattan to facilitate pick-up and delivery. "Can you imagine a national airline reservation system operating in such a local, messenger-oriented manner?" Cunningham asked. To make CCS a national depository, he went on, means that "yesterday's system (CCS) would be used as a basis for dealing with today's and tomorrow's problems."

The CCS staff is well aware of this deficiency. It is testing a means to input magnetic tape of institutional trades executed through its BAS block trading sytsem into CCS, an idea which may not be looked upon too favorably by AutEx and Instinet. Cunningham dismisses this as a "temporary stopgap kind of gimmick. A much more comprehensive solution to the communicatons gap, CCS knows, would be a broad network of regional affiliates to give out-of-town brokers and institutions as efficient an access to CCS as anyone in New York. Not only could this system encourage greater participation, but it could serve to erode the position of the regional exchanges and the NASD.

Over the past year, the CCS staff, in cooperation with exchange officials, divided the territorial expansion plan into three phases. Phase I, now in the pilot stage, calls for establishment of local "depository faciliteis" at regional banks through which local firms and institutions can deposit certificates into CCS and receive same-day credit. The three existing conduits are First & Merchants National Bank in Richmond, Connecticut Bank & Trust Co. in Hartford, and the First National Bank in Dallas. During Phase II, now under discus-

sion, the satellites would be converted into mini-depositories. Instead of sending securities to New York, they would hold them regionally in the common CCS nominee name of Cede & Co. This would permit a local user to make actual local withdrawals of certificates in order to settle a trade involving a non-user. Phase III, under which the regional facility would have the power to move money as well as certificates locally, would give any local CS user virtually the same convenience and service as a New York-based user.

Though there were a few rumblings of misgivings from the New York banks during Phase I, the true implications of the later phases did not become readily apparent until late in February when the CCS staff for the first time explained to the CCS board the details of Phases II and III. The reaction of the bank board members—particularly First National City Bank president William I. Spencer—was immediate and fierce. They accused the staff, not without justification, of not keeping them informed and said the national expansion conflicted with the intent of the New York facility they had originally agreed to support. "Nobody ever had the guts to tell the banks about all this in the beginning," says one official, "because if we had they never would have come in." "This kind of thing always happens when you create a bureaucracy," says William Spencer. "The staff starts to move its elbows around and tries to get bigger and bigger." CCS's expansion plans, he says, "are a little, bit like eating an elephant. The toenails may taste good but as you move up the leg the taste may change." He views the regional affiliate idea as "retrogressive" and indicates he will strongly resist attempts by "selfish interests" to use CCS for purposes which are "deleterious to our major task." CCS officials are now backing away from plans for Phases II and III.

WHO FRIGHTENS WHOM?

The banks' anger is understandable for their interests are fundamentally at variance with those of the exchange and the CCS staff. As one observer puts it, "The New York Stock Exchange is afraid of the Midwest exchange and the Pacific Coast exchange but it couldn't care less about the Continental Illinois and the Wells Fargo. But to the New York banks, it's just the other way around." Further expansion of CCS could have a pernicious effect on the banks' competition with regional banks for it could come close to eliminating their historical geographic advantage. Instead of gaining quick, efficient access to the New York markets through New York banks, regional banks, broker-dealers, and institutions could bypass them entirely. "When you put the whole thing together," says an official of one New York bank, "our business in providing intermediary services in terms of moving cash and securities suddenly doesn't look very healthy. It means that a good part of our present custodial, correspondent, and transfer business could be dead. It could have a hell of an impact." "Securities and money and corporate relations tend to move together," adds a Street operations man. "A truly national depository could sweep away the New York bank's economic power base."

BARGAINING POWER

While no immediate resolution to the dispute at CCS seems likely, action could be forced through independent development of regional depositories with Phase II and III capabilities. Besides the Midwest and Pacific Coast depositories, non-exchange-connected depositories are under study in several financial centers, particularly Hartford and Boston. Initiated at the behest of local banks, they would be owned by the area's financial institutions, would hold securities and money locally and would seek direct affiliation with CCS. "The New York banks have been giving hell to those of us out of town for years," says Salvator V. DeLuca, senior vice president of Hartford Trust Co. of New York, a New York affiliate of Hartford National Corp., the prime mover behind plans for the Hartford facility. "We think this is a way of getting back some of the cash flow which has gone to New York." Hartford Trust president Lawrence Connell, Jr., points out that Hartford institutions hold $60 billion in securities—"a hell of a lot of money for a little country own," he says—and he NYSE members with Hartford offices may find a more friendly local reception if they become participants also. This depository, he goes on, "gives us some bargaining power, some voice in the direction of our own destiny."

That portion of Hartford National's destiny in which it is most interested is the stock transfer business, an area in which the clash between the New York Stock Exchange and the New York banks could become as heated as the regional

depository issue. Due to the physical delivery system on which the flow of certificates still depends, the NYSE long required all listed companies to have transfer agents south of Chambers Street in Manhattan. This naturally permitted the New York banks to dominate the bank transfer business. Being a transfer agent has never been regarded as a particularly remunerative business in itself—most banks claim they lose money on it—but the number of full page ads in *The New York Times* and *Wall Street Journal* promoting transfer abilities indicates that most large banks view transfer work as an important ingredient in their "total relationship" wih corporae clients.

"Country" banks, such as Hartford National, long resented New York's favored position. As Lawrence Connell tells it, his bank typically would work hard assisting the growth of small Connecticut corporations. But a soon as they became big enough to list on the Amex or Big Board, they would obtain a New York transfer agent which would quickly attempt to usurp the concern's other banking business. After stern complaints from Hartford National and First Jersey National Bank in Jersey City, the NYSE in 1971 agreed to Rule 496 permitting out-of-town banks to act as listed company transfer agents so long as they maintained a "drop" office in lower Manhattan and could regularly process transfers within 48 hours.

The consequence has been sudden injection of competition into what was once a rather complacent oligopoly. Regional banks have been quite successful in obtaining new clients and reclaiming lost ones who are not only attracted by the regionals' often lower costs but are pleased to be free from the generally shabby service offered by the New York transfer agents over the past few years. For similar reasons, the New York banks have been also losing transfer business to corporations themselves which in growing numbers have been becoming their own transfer agents. The New York banks, such as Morgan Guaranty, have been making large investments in modernization to remain competitive. But development of regional depositories could make competition even easier for out-of-town transfer agents, both bank and corporate, which could simply receive and deliver certificates locally and would no longer need to maintain a New York office.

LOCAL THREAT

An even larger threat to the New York banks' transfer business, though, is not from out of town. It is from none other than CCS itself. For CCS is cautiously but determinedly developing a plan to take the transfer business away from the New York banks, if not formally at least informally. There are two reasons for CCS's ambitions. First, it desires to remedy its most serious operational weakness. Second, and most important, it desires to save itself from eventual certain destruction.

Despite the remarkable degree of favorable publicity recently about its work in furthering certificate immobilization, the fact remains that CCS is simply too narrowly conceived and designed to encompass the full flow and scope of securities trading and to bring about a comprehensive solution to the paper problem. Perhaps the most notable analysis of this was a June 1971 staff study by the First National City Bank which examined an analysis by BASIC that CCS could reduce transfer volume by 50 per cent. Using the same data, FNCB calculated that even if *all* brokers and institutions belonged to a comprehensive national depository system the result would be only a "relatively minor reduction in physical secruities movements"—roughly 23 per cent compared to no depository at all—of those issues eligible for deposit. Written for internal use only, the study was leaked to the SEC and despite protests by the bank was made part of the Senate Securities Subcommittee's hearing record.

The study clearly highlights CCS's basic weakness, which derives from its origins as a facility to expedite trading among a closed network of brokers. In a marketplace where all participants are members of a depository, all trades can be transferred by book entry and certificatelessness can be achieved. But as soon as non-members are introduced, an element the BASIC figures failed adequately to consider, the depository develops serious problems. Statistically, even if 80 per cent of all market participants were members, they would be able to settle through bookkeeping entry only 64 per cent of the total trades. Whenever a non-member trades with another non-member (both of which put certificates in their own name), for instance, a total of eight certificate movements (i.e., separate transfer instructions) is required, three more than when no depository is involved, since the stock must make extra trips to and from the transfer agent and the depository. Thus in trades involving non-members, the depository can be

a costly and paperwork-generating encumbrance. According to a study by one CCS participant, CCS so far has reduced certificate movement by only 5 per cent. (William Dentzer admits that CCS has never made a comprehensive study of its cost effectiveness.)

The lackluster effects of CCS's rosy-sounding immobilization progress, in fact, are getting growing attention from its broker users who had expected to begin reaping major savings from the $60 billion in securities locked in CCS's vaults. CCS has been effective in reducing theft and errors. However, says one member firm's operations chief, "We figure that for every dollar of costs we've saved from using CCS, we've had to pay them at least a dollar in fees." Some of CCS's cost troubles, according to critics, stem from an unfair weighting of the fee structure toward the banks to encourage their participation as well as from avoidable inefficiencies. "We need to get away from the tremendous amount of manual labor we use," says William Dentzer. "Salaries are just eating us up."

But most of CCS's cost problems derive from the fact that all brokers who are not NYSE and Amex clearing members and virtually all non-bank institutions are not yet participants in CCS. The absence of institutional participants is especially onerous. Since almost all institutions buying securities demand physical receipt of the certificate, CCS is in the position of continually losing its deposits to institutions or their bank custodians. Even if all brokers and institutions are permitted and persuaded to use CCS—an eventuality the careful reader will have realized by this time lies a considerable distance in the future—a significant group of certificate holders would still remain outside the system: private investors without their stock in Street name, whose certificates CCS has never planned on trying to immobilize. "We're a wholesale operation," says Dentzer. Although institutions account for a predominant share of the NYSE volume, individuals trading in their own name continue to be on at least one side of nearly 60 per cent of the actual trades. For the OTC market, the figure is closer to 90 per cent. As owners of 70 percent of the outstanding stock, small investors will be feeding into and taking out certificates for some time to come.

Since CCS's dilemma wih non-members concerns extra certificate movement to transfer agents, it does not require an especially facile mind to perceive that an excellent step would be to permit CCS not only to effect book entry settlement but to become itself a transfer agent with full certificate insurance powers. Such an idea, in fact, has for some time been a gleam in the eyes of the CCS staff. CCS's transfer agent aspirations, though, derive from more than an honest desire to reduce the messengering of certificates along the streets. For CCS, as a depository, is in somewhat of the same position of the state under Marxist theory. As it achieves the success for which it was designed, it is supposed to "wither away." If, as a depository, it captures enough certificates to permit elimination of the certificates altogether, then, ergo, there will no longer be any certificates and any need for a depository. All of the immobilized pieces of paper in CCC's vaults can be immolated in some New Jersey dump in an appropriately grand ceremony As a reward for its achievement, CCS will then be forced to self-destruct.

SURVIVAL INSTINCT

Of the instincts which reside in all organizations, however, self-preservation is perhaps the most finely developed. "Bill Dentzer just has to ask himself," says an operations man, "whether he's going to keep getting the same salary after he has to fire 90 per cent of his staff." Consequently, CCS, as well as the Big Board which had a major stake in CCS's survival, has for some time been casting about for other functions to perform when and if its role as a depository terminates. CCS's collateral loan business, of course, would continue in a certificateless society as would its present role as a distributor of dividends and proxies. It is actively at work developing a stock loan capability and a separate depository for municipal bonds. But that function on which CCS is focusing most intently is stock transfer. Even when the certificate is gone and the whole marketplace is reduced to a computer network. CCS knows, somebody will still have to be around to transfer ownership and maintain stockholder records. CCS would dearly like to handle that job.

There is, unfortunately, a slight catch. The New York banks are well aware of CCS's ambitions and are intent on squashing them at all costs. Brief skirmishes in what could eventually become a broadscale war have already been fought. Not long ago, for instance, some CCS officials suggested that perhaps it might help things if the banks could just send over to CCS some of their transfer personnel

so that transfers could be made without certificates having to leave CCS premises. At another point, CCS asked permission to transfer Cede & Co. shares to buyers' names for COD deliveries. Innocent enough requests. But the banks firmly rejected both. And until the SEC demanded its deletion, the banks had forced CCS to include in its rules proposal last fall a prohibition on CCS becoming a transfer agent.

CCS is now working on plans to become a co-transfer agent, i.e., it would assume some of the actual transfer work such as certificate issuance but would permit the banks to maintain the records and the formal title of transfer agent. "I'd rather not elaborate on this," says William Dentzer when asked about the arrangement. "It's a sensitive area and I don't want to screw up our relations with the banks. But look, I'm not trying to build an empire. I'm just trying to get a job accomplished." CCS recognizes that even certificate issuance will decline as certificate movement is reduced, but they know that assumption of that role could be an important precedent—which is just the reason it will almost certainly be resisted by the banks. "Once an organization like that gets a foot in the door," says a bank executive, "there's no telling what might happen."

A HAIRY APE

The opposition of the banks will be no less than the corporate transfer agents, who are already upset by the registration of all CCS shares in the name of Cede & Co., (technically the nominee of a nominee) which further obfuscates their communications with shareholders. Asked about the possibility of CCS becoming a co-transfer agent, Edward Brown of Phillips Petroleum, who is vice chairman of the 100-member Corporate Transfer Agents Association, replies, "No way. We'd lose control. Who would take the responsibility if they goof up? There is no way I'd let them have any of our stock." What about CCS as the sole transfer agent? "Hah, hah," Brown laughs. "That is ridiculous. If they were the transfer agent for every issue, it would be the biggest pile of spaghetti you've ever seen. It would be a hairy ape. It would be like World War II." It was precisely to extricate themselves from the Wall Street mess and deal with stockholders directly instead of through layers of bureaucracy that many corporations took back the transfer powers. It does not appear they will soon give that power up. Their resistance could doom CCS aspirations, for the ranks of corporate transfer agents can be said to carry a fair amount of influence. Among thm are: AT&T, General Motors, Ford, U.S. Steel, General Electric, RCA, IBM, du Pont and ITT.

Even to disinterested experts, the idea of CCS—an organization which has just recently recovered from a near total bookkeeping breakdown and which was created by an industry which twice within the past fifteen years has been wracked by operational chaos—becoming a giant behemoth handling shareholder records, or even certificate issuance, for thousands of the nation's major corporations gives a certain pause. "It is just not good business judgment for everybody on Wall Street to be dependent on a single entity," says Eli Weinberg, a securities industry expert at Coopers & Lybrand (formerly Lybrand, Ross Bros. & Montgomery) and noted CCS critic.

Even if CCS could handle the chore, a serious question concerns whether it could adapt to what will certainly be the rapidly changing structure of the evolving central marketplace and whether, as presumably an officially sanctioned monopoly, it could avoid being beset with the sort of inefficiencies which lack of competition tends to breed. CCS argues that ownership by "users" would act as a cost control. But one operations expert responds that lacking any competitive facility to serve as a basis for comparison, CCS users would simply pass on whatever fees CCS charges to investors. "The real users," he says, "are the 32 million individual shareholders. They're the ones who will be screwed."

Due to the formidable amount of opposition to its ambitions—federal legislation would likely be required to make CCS either sole transfer agent or sole co-transfer agent for its securities—CCS and others on the Street have quietly dropped elimination of the stock certificate as the official goal of the anti-paperwork drive. "We're going to immobilize the certificate, not eliminate it," says Securities Industry Association president Leon Kendall. "The decision has been made, and it's too late to do anything else."

In the view of most operational experts, including the authors of Lybrand's famous 1970 study of the paper crisis, the vast savings possible through complete automation of securities transactions, often estimated at 50 per cent of costs or more than $3 billion annually, can only come about after the certificate is, for all intents and purposes, eliminated, along with the huge paper and personnel

system which supports its movements. Due to the millions of certificates which will remain under mattresses and in safe deposit boxes for decades to come, the certificate will not soon cease to exist. But the experts contend that a strong comprehensive program must be mounted to eliminate it a least as the means of settling securities transactions so that all of the necessary transaction data for transfer can be made machine "processable." "The lessing of concern for elimination of the certificate is something I find very disturbing—and disturbing is a mild word for it," says Robert B. Maller, an operations authority who until recently was senior vice president with U.S. Trust Co.

THE TAD APPROACH

But if it is both impractical and politically unfeasible for the depository to become a transfer agent as the mechanism for certificate elimination, why not transform transfer agents into depositories? In such a system, the requisite trade information would simply be sent to the transfer agent in each security, which would record the switch in the ownership records. The idea of the "transfer agent depository" is far from new. It was a chief recommendation of broad studies of the Street's processing system by Lybrand and North American Rockwell. It has been supported by many at the SEC including, when he was a SEC commissioner, no less than NYSE chairman James J. Needham.

It is already the basis for several existing markets. The Euro-clear system in Europe, developed by Morgan Guaranty and used by 500 financial institutions, clears Eurodollar issue trades through a TAD mechanism. The Federal Reserve system for trading government securities is a TAD with 60 per cent of the marketable national debt in book entry form. Mutual fund custodians are TADs. Many banks act as TADs as administrators of dividend reinvestment plans through which shadeholders automatically purchase through book entry transfer new shares in about a hundred of the nation's major corporations. First National City Bank, which offers the service for 82 companies, urges participants to add up to $1,000 in cash to their dividends. Some brokerage houses such as Merrill Lynch have for years had continuing relationships with bank and corporate transfer agents, which act, in effect, like TADs. The broker maintains the equivalent of a deposit account at the transfer agent which receives certificates and issues new ones in accordance with the broker's instructions. Merrill Lynch vice president Roger Birk indicates this system seems to offer a distinct cost advantage for his firm over transfers through CCS. Merrill Lynch, which does not use CCS for transfer, is testing an arrangement with Chase Manhattan, and later with other banks, whereby Chase will send out new certificates directly to Merrill's customers, thus eliminating broker-to-transfer-agent certificate movement altogether. With the cooperation of the Boston Stock Exchange, the First National Bank of Boston, one of the largest transfer agents outside New York, is now conducting a pilot plan under existing Massachusetts laws, which is converting the shareholder accounts for two small BSE concerns to a totally book-entry basis, a program other regional banks are watching with considerable interest.

In contrast to establishment of CCS as a transfer agent, the TAD system has one overriding advantage: instead of a giant monolithic, utility-type structure headquartered in one building in lower Manhattan, it envisions a decentralized, multifarious, competitive system that's' distributed throughout the country. Instead of a single bureaucracy which very likely would become ossified, inefficient, and resistant to change, a TAD system would likely be dynamic and responsive to the rapidly evolving structure of the trading markets.

A TAD structure, indeed, would be highly useful if for no other reason than as the only way of replacing CCS. While others maneuver and squabble, CCS grows. It claims already to have become the largest single holder of assets in the world—$110 billion by the end of the year. In its campaign to assume more and more power and functions beyond its depository role, it aspires to become nothing less than the central marketplace's entire clearance, settlement, and bookkeeping mechanism, which would handle everything but the actual trade. In a recent speech, CCS president Diran Kaloostian said, "A locked-in trade on the front end linked to a depository on the back end, in my opinion, eliminates the need for clearing of any type. When such trades become possible, I assure you CCS will be ready for them." This, as has been mentioned, is precisely the arrangement SIAC has in mind, and it should be interesting to observe which organization will control the interface mechanism. "At some point," says William Dentzer, "somebody is going to have to decide where SIAC leaves off and CCS begins." A power struggle between CCS and SIAC is not inconceivable, for CCS,

guided by its aggressive staff, is already showing distinct signs of taking on a life of its own far beyond the intent or self-interest of its creators. CCS's proposed stock loan program, for instance, in which Dentzer indicates institutions will be permitted to participate, could drain off perhaps $90 million to revenues from major Street firms, particularly Merrill Lynch, and has already become an item of great controversy. Eventually, CCS could become a kind of Penn Central, which nobody really wants or likes but which is so big and seemingly vital that nobody can quite figure out a way to get rid of it.

Opponents of the TAD correctly point out that current applications of the concept involve relatively small "universes." The government securities system, for instance, has only a single issuer, the U.S. government. "You give me that universe," says one critic, "and I'll build you a beautiful system." Mutual fund TADs rarely actually transfer ownership—they just issue and redeem. A TAD system for the securities markets would ultimately have to encompass thousands of broker-dealers and transfer agents and more than 30 million shareholders. "The idea is just impractical," says William Dentzer, understandably a strong foe. "It would require every broker to maintain lines with every transfer agent. It just couldn't operate."

TAD proponents reply that a modern communications network need be no more complex than the airline reservation system or NASDAQ, from which a TAD network could quite easily evolve. At least initially, clearing corporations could serve as switches, routing inputs from the trading mechanism to the appropirate TAD, thus obviating the need for direct broker-TAD links. Peter Del Col, president of Bradford Computer & Systems Inc., which handles all transfer paperwork for Bankers Trust, Marine Midland, and Franklin National Bank, says that if the necessary regulatory approval were obtained, "We could begin acting as a TAD in maybe two or three months." In a recent article, Eli Weinberg of Lybrand predicted, "With the full cooperation of all involved [in operating a TAD system], certificates on actively traded issues could be eliminated within a year; inactive stocks would probably require a three to five-year period."

TAD "CHECKS"

The reluctance of individuals to relinquish their certificates, to which CCS has never tried to address itself, could in the opinion of TAD fans, be gradually overcome through education campaigns by the TADs, which would have a competitive motivation to reduce certificate issuance as rapidly as possible. It can be pointed out that certificates "on deposit" at the transfer agent are really no different than money on deposit in a checking account. Just as one writes a check to transfer money from his account to someone else's, to sell securities you would write a transfer check drawing on your securities deposits. A system for processing and guaranteeing transfer checks, claim TAD proponents, need be no more complicated than that for money checks.

The First National Bank of Boston is testing two ways to attract certificates into its TAD program. One is to urge shareholders participating in dividend reinvestment programs to send all of their shares in for deposit. The other is to suggest to new purchasers of the pilot program concerns' stock that the bank retain the certificates for safekeeping. Eventually, all purchasers who demand physical possession could reasonably be assessed and added fee for the extra processing effort.

There are many indications that investors would not prove especially resistant to such a strong program. Millions of investors willingly keep certificates in Street name. Only 10 percent of mutual fund shareholders request certificates. Such asset holders as insurance policyholders and commodity traders do not seem to mind lack of physical possession of a right to the asset. A number of banks have found savers willing to give up passbooks in return for periodic statemtnts. Experience with the dividend reinvestment programs indicates that while shareholders seldom volunteer their certificates for bank safekeeping, they rarely ask for their certificates if the certificates are not sent to them. "We found that really very, very few people ever wanted to see a stock certificate," a First National City Bank man said.

It is true, of course, that much development work, coordination, and legislation would have to be effected before a national TAD system could btgin operations. Uniform accounting procedures would have to be instituted throughout the industry. Numerous very difficult issues and probably many unforeseen technical hitches would have to be dealt with. Yet TAD advocates claim the end result cannot help but be far superior to the ad hoc potpourri of squabbling self-interests

and non-compatible processing systems now in existence or under development. The TAD, they assert, is the only system sufficiently comprehensive in scope and design to actually solve the paperwork problem once and for all.

Why, then, is virtually all of the industry's money and time being directed at the inadequate existing structures? The answer is obvious: The TAD is even a more fundamental threat to the status quo, to the substantial investments of existing interests, than NASDAQ. It is no exaggeration to say that it could literally revolutionize the entire securities and banking industries. In particular:

New York City could suffer a fundamental erosion of its status as the nation's financial center. New York banks would lose a considerable amount of their transfer, custodial and correspondent business to regional banks. The New York Stock Exchange could lose further business to the regionals which could evolve as what Eli Weinberg of Lybrand has called "communications hubs" and "data processing servicing agents in their area." A large portion of trades in their areas could probably be settled most cheaply locally, giving the regionals, Weinberg said. "In effect the right of first refusal on all local orders." New York-based brokerage houses could lose their correspondent business clearing for out-of-town firms. With this clearing cost eliminated, the non-New York houses would become more competitive.

The present clearing and settlement mechanics would be drastically altered. Immediate casualties would be all existing depositories. Clearing corporations would either disappear or be sharply reduced in size. Even under a TAD system, a national clearing system, or a network of competing but compatible clearing systems, could serve a useful role interfacing the marketplaces with the TADs and netting out certificate and money movements. But eventually netting out will probably be built into a locked-in trade mechanism and transaction information will be sent directly on a trade-by-trade basis to the TADs, which would automatically credit and debit share and, ultimately, money accounts. Pressure for development of such a locked-in trade could push all marketplace trading mechanisms toward total automation and accelerate disappearance of exchange trading floors.

The position of the broker vis-a-vis his customer would be severely jeopardized. The broker's free use of customer cash and securities would be eliminated. The practice of keeping certificates in Street name would be ended, even for margin accounts, thus undercutting customer loyalty and increasing movement between firms. Cut-rate brokers, such as Odd Lot Securities, Ltd., could begin to flourish. As part of their campaign to urge shareholders to leave certificates on deposit, bank TADs could make a strong bid as the logical entity to handle investors' brokerage business, thus perhaps ending the Little Man's patronage of Wall Street.

OUTSIDE PUSH?

That the banking and securities industry could ever unite behind a system with such far-reaching implications seems doubtful. In testimony before the House Securities Subcommittee, H. Clifford Noyes, manager for the North American Rockwell Report, stated, "If dramatic change to an automated [processing] system is the accomplished, it is doubtful if the change can come from within the present organizations of the securities industry. While the new system could be of tremendous benefit to the public and to many elements of the industry, it would be destructive to other elements of the industry and to their means of livelihood . . . No dramatically different system can be built if its design is subject to the concurrence of all representatives of all elements of the indusrty."

If the industry fails to act, the burden will probably be assumed by Congress or the SEC. If those bodies decline, perhaps under the erroneous assumption that the indusry has the situation well in hand, the result could be disastrous. Some operations experts contend any prolonged delay in eliminating the hodge-podge of local groups vying self-interestedly for terrritorial advantage could mean that during a major increase in volume the industry could become wracked by another paper crisis that would make 1967–70 look like an unbalanced checkbook.

"I hope to God it doesn't take another crunch to make people realize the need for change, for better systems and more efficiency," says former U.S. Trust official Robert Maller. "If the exchange wants to retain its prominence in the industry, it better move in this direction. But if it doesn't, and there is another crunch, you could get total frustration on the part of the public with the way the system is operated. It could be a real panic."

An alternate scenario is no more inviting. There will be no panic, no crunch. For while the industry argues over the machines, large numbers of investors, frustrated by the rising costs and continuing inefficiencies of the securities processing mechanism, will slowly drift away from the stock market to pursue other more attractive avenues of investment. The effect on the market, the nation's capital-raising structure, and business in general could be calamitous.

Mr. NEEDHAM. Sure. I have seen the latest edition of the Institutional Investor, too.

Senator WILLIAMS. Well, that has a lot of outdated material—pictures of this chairman. I am told. I wonder—you know, all parts of the industry have been in or are on their way in to basically support the approach of this legislation, starting yesterday with the Commission, with the statement of Commissioner Evans. I had certain reservations of his interpretation of the Commission's role if this bill becomes law. I was a bit surprised that he did not accept for the Securities and Exchange Commission quite the leadership position that I believe the bill assumes this Commission will fill. His view was more of a guideline and an oversight function for the SEC. We did agree, however, that we need this bill so that the SEC can oversee development and operation of this new national cleaning system. But those are your words for what you want the New York Stock Exchange to do. You see the kind of mess you are contributing to? You want to be exactly what the SEC should be, and what all other parts of the industry feel that the SEC should be.

Mr. NEEDHAM. To the extent that the SEC wants oversight we say in our statement that we agree that they should have the oversight.

Senator WILLIAMS. They will under this legislation, if it is law, have the responsibility to broadly define the new system and then watch to see that you with your appropriate industry ability—another way of saying self-regulation, but it is a little more than that—follow the SEC's guidelines. Who would propose the integrated system under your approach?

Mr. NEEDHAM. I would believe it would be a joint effort on the part of all of the industry participants, and then subject to the SEC oversight, and they have had the statutory authority for years, Senator. If I may say so, much of the legislation on the Hill today is directing the SEC to do things which in many areas it had the oversight authority, never discharged it properly or adequately, principally because of inadequacy of its budget. So I get caught in the middle, too.

Maybe we ought to ask Don Calvin to step in here because I bring to bear two perspectives, one as a former Commissioner who went through this on a daily basis 24 hours a day, and now as a chairman of an exchange. Mr. Calvin was probably present with Mr. Howland at the time—he wasn't. I was hoping he could shed some light on this area for you. I don't see any conflict in what we said in our testimony. I haven't read the testimony of the people who are going to follow us. I have only read Commissioner Evans'.

Mr. CALVIN. I was not present, as I recall, with Mr. Howland when he testified, but it seems to me, Senator, that what the board thought it was doing yesterday—let me put it that way—is that it was supporting your bill and it was walking away from this fight for control which is described in that Institutional Investor article, because in the sentence following the one you read it says in the prepared statement "The board further agreed that the users of this facility should

own it." The New York Stock Exchange is not going to own it. The New York Stock Exchange board was saying yesterday that they are willing to throw into this pot the existing Exchange Clearing Corp. to establish a national system precisely of the type that I understand you are urging under your bill, and that it would not be owned by the New York Stock Exchange, would not be controlled by any one organization, but would be controlled by the member firms and the banks and the others who were the users of this facility. And I am a bit surprised—I guess it is really a lack of preciseness on our part in this prepared statement, but we are supporting this bill. Our major qualification is the same one that John Evans expressed yesterday in his statement, where he says:

> In this regard we would like to see the private sector continue to play the major role in such development with guidance from the Commission only to the extent necessary to assure an integrated efficient system providing access on a reasonable, nondiscriminatory basis.

We agree with that precisely. We support this bill. Our problem with the bill is the same type of problem I think Commissioner Evans was expressing yesterday, that the degree of SEC oversight goes too far in that it may inhibit private incentives and private innovation in this area in favor of possibly Government direct type of control. I don't think the Senator really wants that either. That is my own feeling. You can speak for yourself. And I don't think we have any real disagreement here.

Our difference in position from that expressed last year is that—and this is Calvin's view—I think we are supporting the bill this year and we weren't last year. But I wasn't here last year on this testimony. Our board thought they were taking a very constructive, helpful step to reach the objectives which you and almost every other member of this committee has supported.

Senator WILLIAMS. Well, Mr. Calvin, you are an Ambassador Plenipotentiary. Very good work.

Just on a technical point here, please help me. I am not a technician in your trade. You folks have the balance order system, is that right?

Mr. NEEDHAM. Yes.

Senator WILLIAMS. The American Stock Exchange does, too?

Mr. NEEDHAM. That's right.

Senator WILLIAMS. Together you are a pretty good chunk of the marketplace.

Mr. NEEDHAM. And we are changing——

Senator WILLIAMS. That was my question. Now in the over-the-counter market they work with what, the continuous net or the net-by-net?

Mr. NEEDHAM. The Pacific Coast Stock Exchange developed the continuous or net-by-net.

Senator WILLIAMS. Which is it going to be under the new system?

Mr. NEEDHAM. Net-by-net.

Senator WILLIAM. It is. We are making progress.

Mr. NEEDHAM. Senator, that is another change from our previous position, too, and I think it is a change you would welcome because it has clearly been established that the net-by-net is a superior system.

Senator WILLIAMS. I think there is a net proposition here. Some

of your inflammatory phrases have gotten a good result. I got a little emotional about——

Mr. NEEDHAM. I will speak to Mr. Calvin about that later.

Mr. CALVIN. Mr. Calvin didn't write this; I will say that for the record. I think what happened—and I think we should be as candid as we can, because the first part of this statement was really written prior to the board's action yesterday. The board, as I said, thought its action was very constructive, thought that the Senator would be very pleased by its action because it is a step away from this competitive type of rivalry which has been described by many and deplored by many, including us. There is a problem here which needs to be addressed on a nationwide basis. All we are saying—and I think the Senator would agree with this—is that it is a problem along the lines Commissioner Evans described that the private sector should move to resolve, but there should be appropriate oversight authority in the SEC and the banking agencies as necessary to see to it that these private sector people do their job in a way that does not in any way adversely affect the public interest. But this doesn't mean on the other side that the SEC should have the authority to discipline, for example, employees of these facilities, nor should they have the authority to operate it and go that far. They should have the traditional type of oversight which has existed in the security industries in the past.

Mr. NEEDHAM. And if I might supplement Mr. Calvin's remarks, the board felt that the only way to achieve the type of entity that you are looking for and which the public interest requires is to provide the only kind of incentive that businessmen understand, and that is an economic incentive, and by owning it themselves rather than vicarious participation by virtue of membership on the New York Stock Exchange, and having direct access to the governing body of this new entity, the exchange board of directors thought they were giving the appropriate incentive rather than a regulatory type of incentive. As you know, the only time you issue regulations and rules is when the private sector fails to respond adequately to their responsibilities to the public.

Senator WILLIAMS. Well, it is our feeling growing out of 1969–70 and in light of present industry confusion that we have reached that point. There is one final thing before we turn to Senator Biden. I wonder if we can't understand a little more and see whether your position is as hard as it seemed at first. On page 2 you say:

> We believe, in fact, that regulatory guidelines for these two very different types of entities might more effectively be set forth in separate legislation.

This is separating in legislation clearing from depository operations. We, of course, have both combined in this bill. The purpose being to deal effectively with all aspects of securities processing—with clearing, transfer, settlement, and depository. But on page 5 you say:

> When alternative approaches to implementing a national clearing system are examined, it appears clear that a continuous net accounting system, closely linked to a national depository system, not only would pose the fewest implementation problems, but would also offer the maximum advantages to both the securities industry and the investing public.

Haven't you tied clearing and depositories right there together in your own statement?

Mr. NEEDHAM. Well, sure we have, because what we are talking about in that sentence, Senator, is the communications network that will have to go together. That is the linking. But as you recognize, SIAC, for instance, at the moment is an exchange facility and subject to regulation under the 1934 act, whereas DTC is a bank trust company and therefore should be subject to a different series of regulations, and in fact is. So that is where the difference is. In one area we are talking about the legal construction of an entity, and in another area we are talking about the interdependence of these two entities, but only in terms of the communications network that would go between them. That's all.

Senator WILLIAMS. But they are linked as an operational matter, and therefore we believe they should be linked in this new area of guidelines so that the SEC can bring them all together in the logical linkage.

Mr. NEEDHAM. I understand that.

Senator WILLIAMS. Now there is another way to do this. We could take everything we are about in this committee, we could take membership, rates, clearing settlement, the depository function, the central market, and so forth and put them all in one bill. Our approach has been to deal separate with those things that go logically together. Therefore we had a bill a few weeks ago, now we have this bill, and down the road a month or two or three we will have another bill. In contrast to our procedure is the House approach.

Mr. NEEDHAM. Well, I, myself, disagree with some of the words you say. I congratulate you on your wisdom in the way you are handling the legislation.

Senator WILLIAMS. Senator Biden, I have taken more than our usual 10 minutes.

Senator BIDEN. I wish you would continue to take the rest of the time, Mr. Chairman, I have only been on this committee for a short time. There has been constant legislation regarding the industry since I have been here. I am more confused today than I was when I got here, and I am more confused—I am almost amused by the positions taken, and apparently if you keep going the way you are going this morning, you are clarifying everything that they are saying, they are clarifying what you are saying, and I may get an understanding of what the position will be. Not having the benefit of the historical perspective—maybe that is an advantage, I don't know. I would just as soon not ask any questions now and let you continue.

Senator WILLIAMS. Well, I think I see.

Mr. NEEDHAM. I see it only too clearly.

Senator WILLIAMS. Well, I had reached the point that I was about ready to say thank you, gentlemen.

Senator BIDEN. Gentlemen, thank you very much.

Mr. NEEDHAM. Thank you, Senator.

[Complete statement of New York Stock Exchange and additional information follows:]

STATEMENT OF THE NEW YORK EXCHANGE, INC.

My name is James J. Needham. I am Chairman of the New York Stock Exchange, Inc. With me are Samuel A. Gay, Senior Vice President of the New York Stock Exchange; Donald L. Calvin, a Vice President of the Exchange; William T. Dentzer, Jr., Chairman of The Depository Trust Company; and Robert

Hall, Chairman of the Securities Industry Automation Corporation which is generally known in the industry for the acronym, SIAC.

We appreciate the Subcommittee's courtesy in giving us the opportunity to present the views of the Board of Directors of the New York Stock Exchange on S. 2058—a Bill to amend the Securities and Exchange Act of 1934 to provide for, among other things, the regulation of clearing agencies and transfer agents.

The New York Stock Exchange supports the objectives of this Bill. We do have a number of suggestions for improving the effectiveness of the proposed legislation in achieving those objectives, which we offer for the Subcommittee's consideration.

As the Subcommittee is aware, the New York Stock Exchange has been working for more than a decade toward the goal of an integrated national system for the prompt and accurate processing of securities transactions effected on national securities exchanges and in the over-the-counter markets. Our initial pioneer efforts embraced the Exchange's own membership. More recently, we have been cooperating closely with other organizations in both the securities and banking industries and with others involved in the clearance, settlement and transfer process.

The Subcommittee is well-acquainted with these efforts and with the considerable progress that has been made to date. I think it is clear that we share with the Congress and the regulatory authorities the desire and determination to place in operation a securities processing system that will preclude any recurrence of the operations tangle experienced by the industry and the investing public during the period 1968–1970. We believe it is now technically possible to create such a system. Indeed, much of the groundwork for establishing a national securities depository system has already been prepared.

Obviously, the legislation now before the Subcommittee bears very closely on the work that has been done thus far, and on future developments.

But before commenting on the individual sections of S. 2058, we would like to make it clear that we have some strong reservations about the appropriateness of dealing in a single Bill with the regulation of both depositories and clearing corporations. We believe, in fact, that regulatory guidelines for these two very different types of entities might more effectively be set forth in separate legislation.

The existing clearing corporations, which have the primary function of balancing and settling trades, are integral parts of the individual exchanges and the over-the-counter market. Depositories have a quite dissimilar function which centers on maintaining custody of securities in a computerized system which aims at immobilizing the stock certificate. The fact that efficient clearing corporations and depositories will both contribute to minimizing potential back-office problems for brokers should not obscure the fact that the two types of entities operate differently, have different though over-lapping clienteles, and face different problems with respect to attracting maximum participation.

Most of our comments today refer to those provisions of S. 2058 which deal primarily with clearing corporations. But we would like to make it clear that the New York Stock Exchange generally supports the views expressed by the Banking and Securities Industry Committee on those provisions of the Bill having to do only with depositories.

Within the context I have just outlined. we would like to proceed briefly to comment on the individual sections of S. 2058.

SECTION 1

Section 1 of the Bill would amend the 1934 Act by adding to its purpose clause the need for developing an integrated national system for the prompt and accurate processing and settlement of securities transactions.

The Exchange agrees. certainly, that an integrated national depository system is urgently needed. As the Subcommittee knows, the Exchange assumed leadership in developing the Central Certificate Service which, since May 11, has been known as The Depository Trust Company. Most recently, our efforts have centered on encouraging wider participation in this prototype computerized securities depository—incuding preparations for coordinating and introducing with regional depositories in a series of link-ups which would, in fact, constitute a coast-to-coast depository system. We recognize, of course, that the concept and operations of such a system affect interests beyond those of the securities industry. Accordingy, The Depository Trust Company has expanded its Board of Directors to include—in addition to representatives of the various major elements of the brokerage industry—representatives of the insurance,

banking and investment company industries. We believe this expanded Board will play an important role in determining the shape and policies of the emerging national depository system.

The Exchange also fully supports the development of a national clearing system. We also believe that it is necessary to arrive at a common definition of the clearing function which—apart from the depository—presently involves two principal operations; trade comparison and accounting processing.

Trade comparison invoves reporting, vaidating and comparing trading activities to obtain an approved contract isting of a trades. Each market today performs its own trade comparison similarly. However, effects to consolidate in this area are not being processed, since the function itself will be eliminated as each market advances toward the goal of the "locked-in' trade.

The second clearing operation—accounting processing—involves netting and consolidating all the compared trade information to produce netted settlement instructions to all parties involved in each trade. Two systems are presently in use. One is the Delivery Balance Order System used by the New York and American Stock Exchange Clearing Corporation. The second is the Continuous Net, or Net-By-Net system, used by the other major clearing corporations.

When alternative approaches to implementnig a national clearing system are examined, it appears clear that a continuous—accounting system, clearly linked to a national depository system, not only would pose the fewest implementation problems, but would also offer the maximum advantages to both the securities industry and the investing public.

We are presently working with the Securities Industry Automation Corporation on a plan for developing such a system. It is SIAC's opinion that the existing Delivery Balance Order system could be converted to a continuous-net system in less than one year. This conversion should provide the practical means to consolidate all clearing accounting systems into a single national system—with a minimum of time and expense.

SECTIONS 2 AND 4

Sections 2 and 4 of S 2058 addresses the same issue and give the Securities and Exchange Commission authority to determine the time and method used in the settlement process, as well as the conduct of accounts. Section 4 would extend that authority in connection with empowering the Commission to make rules leading to the development of a national system of clearance and settlement.

The Exchange is concerned that these provisions could be interpreted to permit the SEC to order a complete new design approach to a national clearance and settlement system. While the Commission might not choose to exercise such sweeping authority, the mere existence of the legislative mandate could inhibit ongoing industry efforts to develop a national system from the various systems already in operation.

We believe that the evolutionary method is the only practicable one, in terms of the available financial and manpower resources. We would agree, to be sure, that all of the existing systems do have flaws which would make them unsuitable for instant adoption on a nationwide basis. But we believe that the best features of each can be combined in a way that will be acceptable to all participants in a national system. And, in fact, we are convinced that the plan now being developed by SIAC will accomplish just that.

SECTION 3

Section 3 defines the terms, "clearing agency" and "rules of a clearing agency". The definition of "clearing agency" includes both depositories and clearing corporations. And as I stressed at the beginning of this statement, the Exchange strongly believes that it is inappropriate for depositories on the one hand, and clearing corporations and their support facilities on the other, to be subject to the same regulation.

We also find the definition of "rules of a clearing agency" extremely and unsuitably broad. At present, the rules of a clearing agency are generally understood to include its constitution, articles of incorporation, by-laws and rules and instruments corresponding thereto, and its stated policies—all of which are required to be filed with the SEC under Rule 17a–8 of the 1934 Act. Section 3 adds to this definition "practices relating to [a clearing agency's] organization. participation, rules of procedure, financial condition, methods of safekeeping, settling, hypothecating, lending and accounting for funds and securities, and similar matters".

This definition would even appear to encompass all printed forms used by a clearing corporation, operating and instruction manuals for employees, instructions for using electronic data-processing equipment, and similar minute details of everyday operation.

SECTION 5

Section 5 adds a new Section 17A to the 1934 Act, requiring all clearing agencies to register with the SEC, and establishing registration procedures. Both this Section and Section 3 should include exemptions for existing clearing corporations affiliated with stock sxchanges or other self-regulatory organizations.

We agree that depositories and any other clearing associations which may come into existence in the future and be unaffiliated with regulated exchanges should be required to register with the SEC—although even here the proposed requirements may be too stringent.

Section 5 also proposes rules on access, the election of directors, setting of standards for personnel and a variety of other matters. In addition, it would give the SEC authority to discipline clearing agencies, their officers or directors for failure to enforce rules and, if necessary, to take over the operation of a delinquent agency.

These rules destroy current concepts of self-regulation and cooperative regulation, replacing them with a series of sweeping mandates for direct regulation by the SEC. The likelihood is that such an approach would seriously inhibit the forward movement of the securities industry which—without direct regulation—has created so complex a centralized facility as The Depository Trust Company and has, among other significant achievements, successfully merged the clearing operations of the New York and American Stock Exchanges.

In general, Section 5 outlines an approach to regulation so lacking in flexibility that it is difficult to see how clearing corporations could comply with the proposed provisions and still operate in the manner which both Congress and the industry itself regard as essential. Moreover, the approach is apparently suggested without any evidence that clearing corporations have shown themselves to be incapable of dealing adequately with paperwork problems, of carrying out disciplinary procedures fairly and even-handedly, or of otherwise acting in a responsible manner. Nor does there seem to be any recognition of the substantial regulatory oversight which the SEC alread is empowered to exercise in regulating exchange-affiliated clearing corporations as facilities of the exchanges.

Instead of introducing a disruptive new regulatory element and imposing new rules and systems at this time, the legislative thrust should be to encourage the industry to continue its successful efforts to develop the kind of nationwide clearance and settlement system that will best serve the American investing public.

SECTION 6

Section 6 requires transfer agents to register with the SEC and establishes the necessary procedures. This is a constructive proposal which recognizes the importance of transfer agents' activities and the impact of their effectiveness on the securities industry and the public.

We would suggest, however, that it might be appropriate for the SEC to set minimum standards of performance, and to explore the possibility of some degree of shared regulatory oversight in this area.

SECTION 7

Section 7 would give the SEC control over the form and format of securities at the point of issue, to assure that they are compatible with any provisions established by the Commission with regard to clearance.

The section raises the broader question of immobilization and possible eventual elimination of the stock certificate as contemplated by Sec. 17A(q). But while the Exchange certainly agrees that the central goal is maximum efficiency for securities industry operations, it cannot now be established that complete elimination of the stock certificate is the best means for achieving that goal. Only when we are in a position to accurately measure the effects of the immobilization toward which we are now striving, will the industry be able to judge the advisability of eliminating stock certificates entirely.

Any effort to eliminate the stock certificate will, of course, require the solution, industry-wide, of many complex automation problems and streamlining of existing operations systems. Customs and laws which are steeped in tradition will

have to be changed—as will the psychological reluctance of many individuals to forego physical possession of certificates.

The New York Stock Exchange has led the way, over the years, in establishing and maintaining the highest existing standards governing the form, format, content and intrinsic security features of stock and bond certificates. But we doubt that this is an area in which total standardization—as Section 7 seems to contemplate—is either desirable or possible. We do not believe that it would be fair or reasonable, for example, to require a small company to meet the same standards with regard to engraved certificates that the New York Stock Exchange requires of its listed corporations.

We ask, too, whether the public interest would be served by disrupting existing well-established and effective procedures—again as would apparently be possible under the provisions of Section 7 on such important ongoing programs as the coordinated industry effort to develop a single denominational form of certificate.

Finally, it would seem essential for this Section of the Bill to acknowledge that state laws which regulate the content of certificates could conflict with developments sanctioned under the provisions of the Section.

SECTION 8

Section 8 would authorize a study by the SEC of the practice of registering securities in street name and of ways to facilitate communication with actual shareholders when street name is used.

The Exchange supports the idea of such a study, but we believe that a more flexible timetable for its completion is desirable. Exchange rules now require members to forward proxy material and other information to the beneficial owners of securities held in street name. In addition, The Depository Trust Company notifies participants in the depository system of the availability of proxy material and by otherwise cooperating to facilitate voting by beneficial owners of stock held in the system. Since these efforts are intended to help keep shareholders informed, the Exchange supports any proposal aimed at assuring their continuation.

Depository Trust is now developing a system to provide issuing companies with a list of brokerage firms having their shares on deposit in the system as of the record date, so that proxy and other materials can be sent directly to those firms without going through the depository itself. Depository Trust does not, of course, vote any of the shares it has on deposit, but acts only as an intermediary in routing communications between the companies and the firms.

SECTION 9

Section 9 would deny local taxing authorities the right to impose transfer taxes on securities solely because of the existence of a clearing agency in the locality.

This proposal would help encourage the development of a national depository system by eliminating any concern that, once a depository is established and located in a particular area, it could be subject to the whims of a local taxing authority. It may be noted that similar legislation has been enacted in New York State.

The New York Stock Exchange fully supports the proposal in Section 9 of this Bill.

In conclusion, I want to emphasize again that the New York Stock Exchange agrees that there should be developed as promptly as possible a national facility for clearing and settling securities transactions among broker-dealers and other financial institutions which would centralize this service function and would be compatible with all existing clearing and settlement facilities and with security depositories. But the Exchange also believes that this new facility must be operated and administered by the industry, subject, of course, to the ultimate oversight authority of the SEC and appropriate bank regulatory agencies, if appropriate. This concept would follow the structure and philosophy of the existing provisions of the Securities Exchange Act of 1934.

Consistent with the foregoing, the Board of Directors of the Exchange at its meeting yesterday agreed that the Exchange stands ready and willing to oversee development of this new national facility in cooperation with other interested industry groups immediately, utilizing all its available resources. The Board further agreed that the users of this facility should own and control it through the payment of appropriate compensation. The facility should be operated as a service organization of the industry on a not-for-profit basis.

Finally, the Board agreed to spin off the Exchange's clearing facility operated by the Stock Clearing Corporation to encourage all other regulatory bodies to adopt identical policies.

This important step was taken by the Board to lead the way for all other regulatory bodies to join together to eliminate wasteful competition in the clearing and settlement functions so as to realize the substantial cost reductions and efficiencies which will flow from such an effort. Certainly all must agree that the public interest requires that all organizations which operate a depository or a clearing corporation must dedicate themselves to conducting their affairs in the most economic manner, utilizing to the fullest all available technology.

The Board also believes that the public interest is best served by appropriate government oversight—but not direct control. Hopefully it will never be necessary for the government to exercise that oversight responsibility.

THE NEW YORK STOCK EXCHANGE,
July 13, 1973.

Hon. HARRISON A. WILLIAMS, Jr.,
Committee on Banking, Housing and Urban Affairs, U.S. Senate,
Washington, D.C.

DEAR PETE: I am enclosing a copy of a memo that we send to our members after each meeting of the Board of Directors.

I would like to call your attention to the first subject which is the Exchange's position on the Operations Bill you are sponsoring which clearly states that we support the objectives of the Bill.

I was terribly distressed yesterday that our testimony was interpreted as being negative in nature. Certainly that was not on my mind.

Hopefully misunderstandings of that type will not occur again in the future.

Sincerely,

JIM.

THE NEW YORK STOCK EXCHANGE,
July 13, 1973.

To: Members and allied members.
Subject: Board of directors meeting—July 11.

There have been no summer doldrums this month as far as policy making by the Exchange's Board of Directors is concerned. In testimony and other public statements this week and next week, the Board's recent work on several very important areas of securities industry policy is being made public.

POSITION ON THE WILLIAMS' OPERATIONS BILL

Yesterday, I testified for the Exchange to the Senate Subcommittee on Securities expressing our views on Senator Williams' Securities Operations Bill, S 2058, along lines authorized at Wednesday's Board meeting. The Exchange supported the objectives of the Williams Bill but put forward a number of suggestions for improving its effectiveness in reaching those objectives.

Our principal conclusion reflected a decision of the Board that the Exchange supports development, as promptly as possible, of a national facility for clearing and settling securities transactions among broker-dealers and other financial institutions. The objective would be to centralize this service function in a manner compatible with all existing clearing and settlement functions and with securities depositories.

The Exchange believes this new facility must be operated and administered by the industry, subject, of course, to the ultimate oversight authority of the SEC and appropriate banking regulatory agencies.

I testified that the Exchange stands ready and willing to aid in the development of this new national facility in cooperation with other interested industry groups immediately.

Our Board agrees that the users of this facility should own it and control it with the payment of appropriate compensation. The facility should be operated as a service organization of the industry on a not-for-profit basis.

The Board also has indicated it would be willing to spin off the Exchange's clearing facility operated by the Stock Clearing Corporation if this would encourage the creation of a national system to eliminate wasteful competition in clearing and settlement. In the context of the projected national clearing system,

I told the Subcommittee that we are working now to develop a plan for converting to the Continuous Net, or Net-by-Net, accounting system which could replace the Delivery Balance Order system now used by the New York and American Stock Exchange Clearing Corporations.

It appears that the continuous net system would pose the fewest problems in implementing a national clearing system and would offer maximum advantages to both the securities industry and the investing public.

Senator WILLIAMS. Mr. Herman W. Bevis, member and former executive director of the Banking and Securities Industry Committee, has returned to our witness table. We appreciate your being here again today.

STATEMENT OF HERMAN W. BEVIS, MEMBER AND FORMER EXECUTIVE DIRECTOR OF THE BANKING AND SECURITIES INDUSTRY COMMITTEE, ACCOMPANIED BY HAMILTON F. POTTER, JR., COUNSEL

Mr. BEVIS. Mr. Chairman, gentlemen, I appreciate the opportunity again to appear before you on behalf of BASIC to discuss legislation having to do with securities depositories. I am accompanied by Hamilton F. Potter, Jr., of Sullivan & Cromwell, counsel to BASIC.

My comments on S. 2058 are confined solely to those provisions having to do with depositories. I offer no comments, pro or con, with regard to provisions having to do with clearing systems, transfer agents and registrars, and other matters covered by the bill.

My oral comments, Mr. Chairman, will follow pretty closely the first three pages of the written statement.

The first point I would make is that we feel that additional legislation is not needed for regulation of depositories at this time.

A comprehensive securities depository system has been developed rapidly during the past 3 years under existing regulatory law. Since my last appearance before this subcommittee, substantial, tangible progress has been made toward the immobilization of securities certificates and book-entry transfer of ownership.

There are now three existing depositories, all of which have been or are being chartered as limited-purpose trust companies under State banking laws, one has become a member bank of the Federal Reserve System and the other two plan to apply for membership. The charters, bylaws, and rules of two depositories have been presented to the SEC for review and clearance and the third is in the process of clearance.

Thus, the two significant Federal regulatory authorities considered in S. 2058 are already engaged. No problem traceable to inadequate regulatory authority has been encountered and none is expected.

If we assume Federal legislation regarding depositories is to be enacted, we are concerned because S. 2058 does not sufficiently reflect the finding that "the bank regulatory agencies must play a major role in the development of a national clearing system." Those words are from your statement, Mr. Chairman, on the Senate floor in introducing this bill. The bill provides broad SEC rulemaking powers with respect to depositories, but is virtually silent as to rulemaking by bank regulatory authorities.

Depositories must involve much more than the securities industry and the SEC as that industry's regulator. Banks and other nonbroker/dealer fiduciary financial institutions, whose participation in any nationwide system of depositories is essential, want "safety first" as the

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regulatory cornerstone before they relinquish possession of assets they hold for others. To them, this means that depositories should not only look like banks and act like banks, but be regulated like banks.

I think the Congress should recognize this desire for assurance of safety—I believe the Congress shares it—and, if it is decided there should be legislation, should select the Federal Reserve System as the prime Federal regulator for bank-chartered depositories in view of its experience, capacity, and philosophy in regulation where safety and financial integrity come first, especially in the areas of safeguards, protection of securities and funds, and related matters such as access. We recognize that such a structure goes against the System's concept that a single agency—the SEC—should have sole authority. However, this is a situation in which a concept, if followed straight through, will not necessarily yield the desired result, and we think the advantages to be gained outweigh the natural inclination to provide for a single regulator responsible for all securities processing matters.

In the subsequent discussion and in attachments, we offer suggested changes in S. 2058 designed to give the Board of Governors of the Federal Reserve System rulemaking authority directly related to the Board's supervisory and examination functions for depositories that are members of its System. We firmly believe that the changes we propose will assist in the development of a comprehensive securities depository system that has a far greater chance of reaching the scale of participation that is urgently needed.

ELIGIBILITY OF PARTICIPANTS IN DEPOSITORIES

Senate bill 2058 limits a depository's latitude to deny access to potential participants in a way that I consider exposes a depository and its participants to undue risk.

BASIC has consistently recommended that, subject to regulation, a depository not be absolutely prohibited from subjecting an applicant to tests of character, financial condition, or operational capability.

We are glad to see in section 17A(c)(2) of S. 2058 that an operational capacity test for applicants has been added. We continue to believe that a depository should not be precluded for screening applicants on the basis of character and financial condition.

Management participation: As in last year's S. 3876, section 17A(c)(3) of S. 2058 continues to provide that participants, in addition to stockholders, among other things participate in selection of a depository's officers and directors and in all other phases of the administration of its affairs.

Ample provision can be made that participants can become owners, thus encompassing what is believed to be the principle behind section 17A(c)(3). Our objection is that this section is in direct conflict with the relevant corporation laws under which depositories are being incorporated.

We see no need to invite confusion and conflict to accommodate the desirable principle involved, and which, we believe, can be met in the proposed revision of section 17A(c)(3).

Section 17(A)(1) of S. 2058 gives enforcement authority over depositories that are banks to the appropriate bank regulatory agency. Section 21 of the 1934 act, which is not modified by S. 2058, gives substantially the same authority to the SEC.

Last year, in connection with S. 3876, the committee report made clear that it is not contemplated that SEC examinations would be a matter of routine but, so to speak, made only under unusual or exceptional circumstances. Senator Bennett repeated the point on the Senate floor. We hope that this point is repeated and made even clearer in the legislative history of S. 2058 if a specific provision is not included in the bill.

I should like to add two points, Mr. Chairman, to what is in the written statement. Yesterday there was some discussion and some questioning about transfer agent depositories. Transfer agent depositories are not a new idea, having been around for several years. So when BASIC was formed and started studying these various potential solutions to the securities handling problem we, among other things, studied the transfer agent depository idea, and we prepared a white paper on TAD in July of 1971. If you wish, I shall be glad to submit for the record this paper which examines TAD's versus comprehensive securities deposit systems in great detail.

Senator WILLIAMS. That would be helpful. Thank you.

[The full text of this paper follows:]

(7/19/71)

BANKING AND SECURITIES INDUSTRY COMMITTEE

TAD v. CSDS

(A Task Force Analysis of The "Transfer Agent Depository" Idea in Relation to that of the "Comprehensive Securities Depository System")

Summary

The "Transfer Agent Depository" is a term used by many to describe a proposed improved securities transaction processing system for the future. An examination of these proposals leads to the conclusion that the TAD term is being applied indiscriminately to two radically different concepts:

(1) A certificateless system whereunder transfer agents would maintain the official records of securities ownership and changes therein. A transfer agent's record for a given issue would take the place of certificates as the contra against which would be balanced the recorded position in that issue of financial organizations, individuals, and others. By the same token, financial organizations and others owning or holding many securities would balance their recorded positions against the records of as many agents as transferred the issues.

(2) A system, not contemplating near-term elimination of the certificate, in which the transfer agent would add only the certificate custody function to his present responsibilities. Ownership of the shares represented by these certificates held by the transfer agent would be recorded by a centralized record keeping service for all fungible issues. This service would balance its securities positions against the holdings of the transfer agents, on the one side, and of its depositors, on the other.

BASIC's plans follow the second system much more closely than the first. BASIC believes that its approach toward extensive

immobilization of certificates in what it has chosen to call a Comprehensive Securities Depository System will, when compared with all the alternatives advanced to date:

Give the needed relief from securities handling problems much more quickly (involving, as it does, only an extension of an already huge immobilization facility - CCS);

Accomplish the transition to the system of the future with less cost (again, merely building on CCS);

Require fewer changes in practices and procedures (almost none for broker/dealers, but important ones for banks and others that presently file physical securities by account);

Provide more quickly a system under which the certificate could be completely eliminated, if that should ultimately be deemed desirable.

* * * * *

The problem: Reducing or eliminating certificate movements

There is widespread agreement that the reduction of certificate movements should be the most important goal of the securities industry. North American Rockwell, in its Final Report to the American Stock Exchange, says; ..."taking securities certificates out of circulation, placing them in depositories and automating the accounting process is the answer to the operations problems of the securities industry". (1)

It is asserted that the accomplishment of this goal will result in a substantial reduction of operations costs. Frank Zarb has

(1) N.A.R. Information Systems Company; Securities Industry Overview Study; Final Report to the American Stock Exchange, September 1969 p.39

stated: "An estimated 35 percent of a clearing firm's fixed operations costs could be eliminated if the actual stock certificate were done away with". (2) He also predicts lower commissions resulting from these cost savings, lower interest costs, as fails are virtually eliminated, the avoidance of any future curtailment of trading hours, reduction of securities thefts - and possibly of insurance premiums - and he says flatly that "Most important, if the certificate had been eliminated in 1967, we would not have had the failing-firm crisis of 1969-1970". (3)

The concepts of both immobilizing and eliminating the certificate have been introduced in the foregoing quotations. The purpose of either course would be to increase the transfer of securities ownership by book-entry without physically moving certificates. But regardless of the ultimate fate of the certificate - and there is little disagreement that something must be done about it - there are differing ideas as to the mechanism for making book-entries to record security ownership and changes therein. One of these is the "Transfer Agent Depository" ("TAD").

What is the "Transfer Agent Depository Concept?

North American Rockwell is often referred to as an advocate of the TAD concept. Actually, NAR advanced the idea of a combination of a National Clearing System (NCS) and TAD as follows:

(2) Zarb, Frank. "Let's Abolish the Stock Certificate", Institutional Investor, March 1971, p.28

(3) ibid. p.28

NCS can best be visualized as a computer with on-line files of security positions and active communications links to Regional Clearing Services (RCS's) and Transfer Agent Depositories (TAD's). The clearing services will not handle certificates. They will perform all accounting functions related to the transfer of ownership of securities left on deposit in the system and produce composite security position and activity reports for both clearing members and transfer agent depositories to verify.

Broker to broker settlement is accomplished automatically. On trade day plus one the clearing service notifies each broker of his net dollar position and new net security position for each day until settlement day. On settlement day, for each trade, the shares are debited from the selling broker's account and credited to the buying broker's account. Similarly, dollars are transferred from the buying to the selling broker. Trades are settled with whom they are made. No allotting is necessary. No computation of settlement prices different from trading prices is necessary.

...

Brokerage firms would submit any customer name certificates received to the TAD for deposit. The clearing member's net position would be adjusted immediately by the on-line network between TAD's and the respective national or regional clearing operations.

...

The broker who wishes to withdraw securities for a customer name delivery sends a transfer instruction directly to the TAD which in turn requests the clearing service to debit his account. Upon confirmation the TAD then issues the new certificates.(4)

(4) N.A.R., Op Cit, p.p.39-42.

A task group commissioned by the Midwest Stock Exchange included in a comprehensive report the following of which is pertinent to a discussion of the TAD concept:

> ...We recommend that the following steps be taken:
>
> Establish an independent corporation, the National Securities Corporation, which would be owned by members of the Chicago Financial Community, and which would develop and operate a Chicago-based depository system.
>
> ...
>
> Develop a depository system based on the Transfer Agent Depository (TAD) concept.
>
> We concur with the increasingly widespread conclusion that a TAD system offers greater advantages to the industry -- both short and long term -- than other existing or proposed systems. These advantages include:
>
> The elimination of duplication of effort by the depository center and the Transfer Agent in handling deposited certificates;
>
> The elimination of duplicate control systems required when physically moving certificates between depository, transfer agent, and custodian bank;
>
> The availability of experienced people and of systems and vaults for the handling and safekeeping of deposited securities at Transfer Agent banks;
>
> The feasibility of evolution to a "certificateless society" using existing equipment and systems in the banking industry.
>
> ...
>
> Incorporate the Depository Balance Certificate (DBC) concept in the TAD system.

The depository system would be comprised of the following components:

1. Control center - the National Securities Corporation (NSC);
2. Transfer Agent banks - serving as custodians of deposited securities and agents of NSC;
3. Participants - depositing brokers, banks and institutions;
4. Data input organizations - Midwest Stock Exchange Clearing Corporation, NYSE Stock Clearing Corp., etc.

...

The function of the (NSC) system would be:

1. To hold securities, in nominee name of NSC, for depositing participants -- brokers, banks, institutions, etc.;
2. To provide evidence of delivery to clearing houses;
3. To provide evidence of collateral for pledgee banks, and to deliver pledged securities in the event of default.

...

Deposits into the system would be made by participants -- brokers, banks, institutions -- by delivery of certificates to the appropriate transfer agent (TA) bank. The TA would verify "good delivery" and would advise NSC, which would then credit the account via computer entry. The TA would then re-register the certificates in the name of the NSC nominee.

...

Withdrawals from NSC would commence with a request by the broker, on a standard form, giving re-registration instructions. This request would be certified by NSC, which would debit the "general" position of the account, credit the "Transfer" position, and forward the request to the appropriate TA. The TA would then issue new certificates as required, registered as

> instructed. The new certificates would be delivered to the broker's messenger by the TA which would advise NSC. NSC would then debit the accounts "Transfer" position. Normal withdrawal time would be 24 hours, but a faster turnaround time could be established based on the TA ability to issue new certificates on demand.
>
> ...
>
> Transfer of ownership between NSC participants would involve nothing more than delivery instructions from a broker through a clearing corporation to NSC. This input would be processed into the computer as required and would, in effect, keep a true "Current" position of the account.
>
> To deliver in the system, banks would withdraw the required certificates from their vault, and deposit them in NSC. Simultaneously, NSC will use the bank's delivery instructions to debit the account and credit the receiving broker.
>
> ...
>
> Because of the potential savings to be gained as well as the improved control provided, we recommend that evidence of a security position in the TA depository be in the form of a Depository Balance Certificate (DBC). The use of DBC's, a concept not unfamiliar to some TA, would permit a TA to issue individual certificates and cancel individual certificates independently of each other. This would be done by cancelling the old and issuing a new Depository Balance Certificate at the end of each day by netting the issues, cancellations, and old DBC's. Although this is a significant change from existing procedures, we believe it is feasible and practical and will provide significant savings to Transfer Agents, to say nothing of the savings resulting from the reduced need for large vault areas to hold securities. (5)

A Midwest group of the Stock Transfer Association has suggested the following, bearing on the TAD idea, which is quite

(5) "Meeting the Challenge", July 1970. Privately printed.

similar to the NAR and Midwest Stock Exchange proposals:

> The centralization of all active certificates and bookkeeping in one depository is dangerous for several reasons. The handling of receipts and deliveries of all stock as well as the bookkeeping required to maintain the internal records of one depository requires the concentration in a single area of a large and highly qualified staff to handle rising volume. Admittedly, the refinement of computer techniques will be extremely helpful but these machines cannot totally compensate for the manpower required to process receipts and deliveries. Unusual volume or requests in the market place will create a logjam which could not be dispersed in critical situations.
>
> A chain of regional depositories interfacing with each other is preferable and more practical. If we can assume that the Central Certificate Service of the New York Stock Exchange could be the example for and keystone of such a system then the various regional exchanges could create compatible satellite operations. The bookkeeping required, though still substantially located in New York, would at least be decentralized sufficiently to draw on the manpower and technical know-how available across the country. This system would, in fact, permit the regional exchanges to remain viable by bookkeeping all of their own active trades as well as cooperating with C.C.S. through an interlocking electronic system for N.Y.S.E. and A.S.E. trades.
>
> The speed of deliveries of required certificates to and from the depository could be greatly increased by the use of transfer agent custodians. We do not believe that transfer agents have any desire to do bookkeeping for individual stock issues held in the depository. But if the stock certificate supply were lodged with the transfer agent the depository would be relieved of the necessity of handling certificates coming into and going out of the system.

> Going one step further, we think that the transfer agent could cancel the multitude of immobilized stock certificates and simply keep a so-called balance certificate. The transfer agents would then give priority to depository orders and at the end of each day a new balance certificate would be issued after netting all depository transactions in an issue. The elimination of substantial certificate handling by the depository as well as the elimination of the auditing and storage of depository certificates would seem to be a large step in the reduction of our paperwork problems.
>
> Finally, it is, unfortunately, within the realm of possibility in today's era, that our country might come under attack from within or without. A centralized securities depository would be an ideal target for those bent on the complete disruption of our economy. We think it neither wise nor helpful to consider but one depository. (6)

Note that the foregoing three plans call for a clearing facility, which facility makes the book entries to record financial institutions' holdings of securities and changes therein. The clearing facility would balance the total of its holdings of a securities issue with the transfer agent, who would act as custodian. Total elimination of the certificate is not an integral part of the proposals.

Eli Weinberg, a partner of Lybrand, Ross Bros. & Montgomery, recently gave this sketch of a TAD (proposed in conjunction with complete elimination of the certificate):

> The basic procedures for placing orders to buy and sell securities would not change. As a by-product of the trade, the broker would notify the transfer agent of the transaction and identify the affected stockholders' account. Street name and nominee name would also be accepted. A copy of the confirmation, which would replace the present transfer instruction,

(6) Stock Transfer Association, Midwest Operations Subcommittee, "The Role of the Transfer Agent and Registrar in the 'New Securities Industry'", October 27, 1970.

could be used for this purpose. A uniform, machine-readable confirmation format would be designed for use by all brokers. Initially, each confirmation copy would be individually signature guaranteed by the broker. In time, however, this requirement could be changed to cover confirmations in toto, and each instruction would be automated and controlled along the lines of check-signing procedures for automated payroll systems.

Under the proposed system, the functions of the Stock Exchange Clearing Corp. would be greatly simplified. A special contract sheet that shows, for each security, the total number of shares purchased and sold for each broker, by broker number, would be prepared. Individual customers would not be shown, only totals by broker. Transfer agents would receive copies of these contract sheets for each listed corporation they represent. The transfer agent would use the contract sheet (also in machine-readable form) to control the individual confirm instructions received directly from the brokers. On the whole, transfer procedures will be both simpler and reliable because the contract sheets will be balanced and proven at the clearing house as well as by the brokers in checking their money settlements. The clearing house would not handle any securities.

When the transfer agent receives the broker confirmation, he would prepare a statement of account change and mail it to the stockholder. This would be similar to a mutual fund statement or a savings account notice of interest. It would provide a final audit verification and notification to the customer that his transaction has been properly executed. This notice should reach the customer by settlement date. In the case of securities registered in broker or in street name, the broker would receive the notice of account change for all transactions in a specific security. This notice, too, would be in machine-readable form.

> This total processing scheme eliminates the need for brokers to handle securities in the normal course of trading activities. The transfer agent communicates directly with the stockholder, notifying him of any account changes. This relationship provides for improved control to avoid account errors and manipulations. Opportunities to misappropriate securities through loss or theft are virtually eliminated. Effective controls over all data processing operations will, of course, be necessary, but they will parallel the controls currently required for bank checking and savings accounts. (7)

Zarb recently proposed a similar TAD system:

> As this is envisioned, the basic procedures of placing orders to buy and sell stocks would not be changed. There would, however, be additional emphasis put on the responsibility of registered representatives to identify properly the account name to be charged for a transaction, specific delivery instructions, and the location of securities sold (i.e., in customer name or broker name). All of these are required under present procedures, but weaknesses in existing systems result in uneven enforcement.
>
> As a by-product of the trade - and probably utilizing a copy of the confirmation itself - the broker would notify the transfer agent of the transaction and identify the customer account to be added or deleted as a result of the buy or sell trade. This notification would replace the present transfer instructions. The format would be uniform for all brokers, and would be machine readable; that is, the instruction may take the form of punch cards or - for larger brokers - magnetic tape. Initially, there may be a need for each confirmation copy or transfer form to be individually guaranteed by the broker. This is now required for most stock transfers. Yet in time,

(7) Weinberg, Eli, "A System for Certificateless Stock Transfer", Bank Administration, May 1971, pp 18-21.

and with some legal changes, this requirement could be changed to cover guarantees in total rather than for each individual item. The need to guarantee each instruction would be automated and controlled, similar to check-signing procedures on payroll checks in most automated payroll systems.

...Following the normal procedure for settling trades by money and by shares, a special contract sheet - by security - would be prepared. The contract sheet would show, for each security, the total amount of shares purchased and sold for each broker - by broker number. Individual customers would not be shown, only totals by broker. Transfer agents would receive copies of these contract sheets for each listed corporation they represent. The transfer agent would then use the contract sheet as his control for the individual confirmation or transfer instructions received directly from the brokers. The contract sheets would probably also be in machine-readable format, most likely magnetic tape. For out-of-town transfer agents, the contract sheets should be wired or sent via telecommunication links from computer to computer. Transfer procedures would be much simpler and more reliable because the contract sheets, acting as a control for the agent, would have already been balanced and proven at the clearing houses, and by the brokers in checking their money settlement. The clearing house would no longer handle any securities.

Under this system, when the transfer agent receives the broker confirmation or transfer instructions, he prepares a statement of account change and mails it to the stockholder. This would be similar to a mutual fund statement, savings account notice of interest, or even department store bill. It is a final audit verification and notification to the customer that his transaction has been properly executed. It is very likely that this notice will reach the customer by settlement date. In the case of securities registered in broker or street name, the broker would receive the notice of account change, probably in total, for all transactions in a specific security. The notice would also be in machine-readable form. (8)

(8) Zarb, Op cit p. 18.

The "Comprehensive Securities Depository"

The Banking and Securities Industry Committee ("BASIC") is moving toward the formation of a Comprehensive Securities Depository System ("CSDS"). It has a two-stage plan: first, establishing a New York CSD; second, interrelating or integrating the NYCSD with a series of similar depositories in the principal financial communities to form a national CSDS. The precise interrelationship among the various regional depositories has yet to be worked out, but the objective would be to immobilize the certificate to the greatest extent practicable for interstate as well as intrastate securities transactions.

The plan is that eligible depositors in the CSDS would be financial organizations subject to regulation or supervision of federal or state authorities. Thus, at least the following would be eligible: brokers, dealers, banks, insurance companies, and mutual funds. It is probable that not all the companies in these categories would be - or would wish to be - direct depositors, however. The CSDS's minimum charges, required financial commitment from depositors, and required expertise on the part of depositors' employees might, when compared with a small volume of securities transactions, convince many that they should participate in CSDS via correspondents rather than directly.

Depositors would deposit their holdings of eligible securities with the CSD. Transactions among depositors in eligible securities would be by book-entry - no securities would physically move. Securities

received by depositors from outside the system would be deposited in the CSD; deliveries outside the system would require withdrawals-by-transfer from the CSD.

The CSDS does not require mandatory elimination of the certificate, although the more certificates are eliminated from circulation by being immobilized within it, the more effective it will be. This would suggest that, after a CSDS is in effective operation, a widespread campaign be launched to have individuals and others deposit their securities with their local brokers or banks. The latter would transfer the certificates to the CSDS, either as direct depositors or through correspondents, for immobilization. Individuals would receive securities account statements, showing transactions and balances, as they now do when they leave their securities with brokers or banks.

Each depositor would receive from the CSD each morning a statement reporting, by issue, the previous day's transactions and the new balance of shares on deposit. Periodically, probably monthly, each depositor would receive from the CSD a statement listing his entire holdings on deposit. All depositors, therefore, would receive information so as to be able daily to balance their securities position records against the quantity of securities held for them by CSD.

At the present time, Cede nominee certificates are endorsed and issued by CCS and are in general circulation. Because of this, CCS cannot now balance the aggregate of its holdings of a security

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with the transfer agent's record of shares in the Cede name, Means are being explored of eliminating the necessity of issuing Cede certificates, to the end that all withdrawals from CCS (and the future CSDS) are by transfer. If this change can be made - and it is believed that it can - then it would become feasible for the CSDS to balance its records against the transfer agent's authoritative record of registered holdings.

Effectuation of the change in the preceding paragraph would make more feasible direct delivery of deposited securities from depositors to transfer agents, with appropriate notification from depositors and transfer agents to CSDS, and direct deliveries of withdrawn securities from transfer agents to depositors upon appropriate authorization by CSDS. CSDS's daily balance certificates, representing its holdings, could then actually be left with transfer agents (after essential controls and fixing of responsibilities had been worked out). Were these steps found feasible, CSDS would conform closely to the first three TAD proposals cited above.

Three of the TAD systems being advanced would appear to start with trades and their comparison and netting. A CSDS can be designed to accommodate input from any type of clearing system, and thus will not have to wait for total uniformity in that area.

Principal characteristics
of the Transfer Agent Depositories

It can be seen from the quotations above that there are

variations in the role of the transfer agent among the plans of those who have given thought to the subject. The NAR and two Midwest proposals are close to CSDS, and differ in important respects from the other two systems. Comments about TADs hereinafter usually apply only to the Weinberg and Zarb proposals.

In order to discuss the TAD idea in concrete terms, the following points have been selected as important characteristics of the proposed TAD systems:

> A certificateless system - There would be record-keeping by, and information flows to, the transfer agent in substitution for that now supplied to a fair degree by the existence, possession, or movement of the certificate.
>
> Computer network - The various members of the financial community would be linked to transfer agents either directly via computers, or via passage of magnetic tapes or punched cards between compatible computer systems.
>
> Authority as to security ownership - The transfer agent's records would become telling evidence as to ownership (in contrast to the present, where the registration of the certificate, its endorsements, and its possession, have a heavy bearing on ownership and transfer thereof).

These principal characteristics will be examined in comparison with CSDS. Two points of comparison - of the utmost importance - will be prospective timing for commencement of a new or improved system, and the extent to which such system builds upon, departs from, or replaces existing procedures and relationships.

A certificateless system

A great deal of space could be devoted to the feasibility of near-term compulsory elimination of the certificate, along with

the activation of a comprehensive book-entry system to establish ownership of securities and changes therein. The subject has been extensively discussed within the banking and securities industries.

Mandatory elimination of the certificate would, of course, not be easy. Changing the desires and habits of those who presently wish to hold certificates would make the passage of legislation to effect compulsory elimination as much a political matter as one of economics or finance. The characteristics of the replacing book-entry system would be all-important, for legislators would undoubtedly wish to be shown that there would not be the slightest increase in risks associated with the book-entry system above those now incurred by a holder of a certificate.

Disposing of the question of complete elimination of the certificate is not believed to be necessary to evaluate the TAD idea, however. While the TAD concept may have been developed as a replacing mechanism by those desiring to eliminate the certificate, there is no reason to consider complete elimination a condition precedent to the operation of a TAD. The latter could operate under the same principles with respect to those certificates immobilized within it, and at the same time accommodate itself to the existence of other certificates in circulation.

The attractiveness of the TAD concept, in relation to that of the CSDS, would seem to turn on considerations other than mandatory elimination of the certificate.

This assessment may be considered incorrect by those sponsoring the TAD approach, who may contend that mandatory elimination of the certificate is an inseparable part of the TAD system. If so, the question of timing becomes all-important - timing not so much to obtain legislation, difficult as that may be, but to construct a universal book-entry system to account for securities ownership and changes therein. This subject is discussed later.

If we are moving toward ultimate elimination of the certificate - and we well may be - it is possible, even probable, that CSDS will get there quicker than TAD.

Computer network

It will have been noted that the TAD plan is discussed in the same breath with an on-line, real-time computer network linking transfer agent with exchanges, brokers and, probably, other significant elements of the financial community.

There is no doubt that the technology for such a network is here. Experience also shows that there is no doubt that such networks are not easily and quickly developed when they interlink large numbers of varied, dispersed institutions. The problems of people, machines, and standards are of a nature that they can be overcome - but not without considerable time, effort, and money.

A requirement that communications be speedy does not necessarily or automatically mean the ultimate in speed - a computer-to-computer network. Those advocating the TAD idea would undoubtedly

agree that a TAD system could be commenced without an extensive on-line real-time computer system - ideal as that would be. Therefore, like certificatelessness, it would appear that the relative merits of the TAD concept can be considered without the assumption that it needs a full-blown computer system to make it work.

Again, it may be that TAD sponsors would insist upon the computer network as essential. If it is contended that it is a prerequisite, then any comprehensive system linking many transfer agents with many holders and traders of securities is quite a number of years away. If it is envisioned that the number of transfer agents in the system would be reduced to a sophisticated few, a proposal along these lines has not been advanced.

CSDS should be able to embrace advanced communication technology much faster than TAD. CCS presently interfaces with brokers and banks on the one side, and transfer agents on the other. CCS's information input-output at the present time is in printed form. It would be a small technological step for such input-output to be via magnetic tape or computer remote terminals. Moreover, any change in this respect need not be done all at once; it could be accomplished step-by-step with any broker, bank, or transfer agent that equipped itself for the interface.

In terms of utilizing advanced communications technology - including computer-to-computer talk - CSDS holds far more promise of early achievement than TAD because it will start with a hugh information clearing center, CCS, that already exists - and works.

tion or correction. For individuals, the required timing may be measured in days but, for brokers, it may be hours.

TAD advocates may contend that, in a system with the locked-in trade, automatic broker-broker comparison and settlement, universal stockholder identification codes, etc., all tight timing requirements would be more than met. Such a system, however, is simply too many years away to be considered of potential near-term help.

From the standpoint of holders of multiple issues of securities, like banks or brokers, their interface with transfer agents will be complicated. They would no longer check their records of security positions against securities in their vaults or in CCS, but with transfer agents. It has been reported that there are at least 850 agents in the United States that transfer for two or more issuers, and that probably 4-5,000 issuing companies transfer their own shares or have this done at some local facility. Twenty-five or fifty transfer agents may be able to check out a bank's or broker's position for a high percentage of its securities, but many others - often unsophisticated - might be involved in checking out the remainder. This could present a problem of enormous magnitude. The problem would have to be worked out in advance in clear-cut terms, because the amounts involved would often run into large sums of money.

It will be remembered that in 1968-69 many firms had difficulty in balancing their security position records, even against certificates supposed to be in hand. Certificates may be alleged to have created much of the problem then but, more accurately, it was

Authority as to security ownership

The fundamental distinction between the TAD system and a CSDS lies in who keeps authoritative records of security ownership, and where, and in procedures for authorizing book-entries to change ownership.

Validating security positions via TADs - It is of the utmost importance that any and all holders of securities be able easily and quickly to check security holdings called for by their records with their holdings in fact. At the present time this is done:

1. For those holding certificates, by actual count. This applies to brokers, banks, other institutions, individuals, and others.

2. For those lodging their certificates with others, by checking holdings called for by their records with frequent statements from the holders of the physical securities. This applies to:

   a. Brokers' deposits of securities with CCS.

   b. Institutional and individual investors' deposits of securities with brokers, banks, and others.

A TAD would maintain the security positions of all those who did not demand certificates, and would balance its security holdings against their position records. This would apply to brokers, banks, and others - including individuals. Since any securities system must be able to face up to, and rectify the inevitable unintentional and intentional discrepancies, from the transfer agent's standpoint it must quickly and regularly transmit its records of changes and new security positions to recorded security holders for confirma-

errors regarding them, in procedures which were complex because of the certificates' physical movement, that was at the root of the problem. Little comfort would be derived from eliminating the certificate as a problem only to replace it with the inability of a firm to keep in balance with a multiplicity of contra records of varying degrees of accuracy.

The great problem of thousands of individuals interfacing with any TAD would be that of precise identification. No longer would the old certificate be coming in to the transfer agent with its signature guarantees to corroborate the name to be debited on the stockholder records. At present, most of the major transfer agents have or are in the process of developing a computerized shareholder register. The extent and type of information stored, and the modes of access to this information are, however, by no means uniform. Some agents use an assigned account number for access. This may be on the certificate or provided by the holder, or may be looked up by the agent from a paper record. Others use a punched-card file or the certificate number to access the master record; a few can use the holder's name to go directly to the master file and record changes. In some cases, stop-transfer orders and restricted share notations are a part of the master record, but in many - probably most - cases this information must presently be checked manually against a separate file before a debit entry can be completed. A prime concern of any transfer

agent - who may, for example have dozens of Does, Joneses and Smiths in his file - is to debit and credit the correct accounts. Presently, the certificate number and registration are compared with the file (and perhaps with a separate "stop" file) before the debits are processed, and the full registration and address are compared with the file before credits are processed.

Without the certificate and with transfer agents' records being so important in establishing ownership, a uniform account numbering system seems to be a prerequisite. Without such a number to help in positively identifying every selling holder (the certificate and its number now largely serve this purpose) the transfer agent's operation - and, consequently the broker's - would be plagued with unmatched and mismatched items. Considerable potential liability could be involved here. For credit transactions, the broker would have to transmit the full registration and address of every buyer - so that John Doe, Brooklyn; John Doe, Bronx; John Doe, Hong Kong; John Doe, Byhalia; John and Mary Doe, as joint tenants; and John Doe as custodian for Mary Doe would not be confused. In the absence of the account number as a positive identification, the transfer agent would have to create a new account whenever there was the slightest variation in either name or address from an account already on its records, giving rise to reconciliation problems.

To summarize the principal points about the transfer agent's

ownership records under a TAD system: Every owner of securities who does not hold his certificates must be in a position to balance his record of security holdings against an authoritative record of securities held for him. This authoritative record would be that of the TAD for all the names on its stockholder list, and those balancing their positions with the TAD would be brokers, dealers, banks, other institutions, individuals, and others. An institution holding a wide spectrum of securities would have to balance its position with many TADs. All out-of-balance conditions would have to be quickly and conclusively corrected. This would be a problem not easily solved.

From the standpoint of effectively and efficiently validating ownership positions, the TAD system would require monumental changes from the system in effect at present.

Payment for securities deliveries under the TAD system - Securities transactions within the financial community are almost without exception on a COD basis - deliveries are made only against payment.

It would appear that in the proposed TAD plans the parties would exchange cash as a separate operation from that of the book-entry delivery of securities. If this inference is correct, there is a gap to be bridged between the person who does not wish to give up his securities until payment is received, and the person who does not wish to pay until he receives his securities. Again, this problem must be viewed as involving, not an isolated transaction here and there, but - daily - thousands of sellers in hundreds of thousands of transactions

delivering securities via book-entry to similarly numerous buyers through a multiplicity of TADs. The point here is not that a delivery-against-payment system could not be worked out; it is merely that it is not clear how the TADs would interface with the payment nechanism.

Ownership positions and changes therein under CSDS - The CSDS builds upon existing relationships within the banking and securities industries, and between these industries and the investing public. Drawing a parallel between the future handling of securities transactions and that which now exists for cash, the Executive Director of BASIC recently stated:

> The BIG difference between today's cash and securities clearance systems - insofar as using book-entry is concerned - is that there is an integrated national network for cash but not for securities.
>
> The system for book entries to transfer ownership of cash consists of:
>
> 1. A national focal point - the Federal Reserve System - with its twelve integrated regional Federal Reserve banks;
>
> 2. The first network level fanning out from the Fed, its member banks;
>
> 3. The second network level fanning further out, the remainder of the 14,000 banks that have a correspondent relationship with one or more member banks; and, finally,
>
> 4. The relationships between the 14,000 banks and their depositors.

Every person in the country who owns more cash than he cares to keep in currency in his possession has easy access to a commercial bank to establish a deposit account. Through it, he can transfer his right to currency to anybody else, and the transfer will be carried out through the integrated banking network. True, that check has to move - but that is a millifraction of the problem of moving the equivalent in currency around.

BASIC is working on - and has already completed a great deal of legal and other exploratory work for securities book-entry network. These stages correspond to the first two elements cited above for the cash system. They are:

1. A Comprehensive Securities Depository to house certificates, and maintain records of ownership and changes therein by book-entry - ultimately to be national in scope via integrated regional depositories;

2. The first network level fanning out from the Depository, namely, the inclusion of the major financial institutions as direct depositors: brokers, banks, and other institutional investors.

These two steps alone will enable securities transactions among members of the financial community - whether in securities they own outright or those they hold for others - to be accomplished by book-entry. No certificates would physically move. This by itself would eliminate a huge amount of certificate movement and paperwork.

But it would have more significance than that. It would provide the core mechanism for a second network level fanning out. This second network would consist of the banks and brokers without a volume of securities transactions large enough to justify economically becoming direct depositors in the Comprehensive Securities Depository. They would use their correspondent relationship with banks and brokers that <u>are</u> depositors to deposit their holdings of securities and accomplish transactions by book-entry.

> Then investors throughout the country would have right at hand a broker or bank to maintain their Security Accounts - and these security credits would tie into an integrated national network leading to the Comprehensive Securities Depository.
>
> Then it might well be feasible to eliminate the certificate. In fact, for all those who maintained Security Accounts and had all their changes in security ownership reflected therein, to all intents and purposes the certificate would have been eliminated.
>
> Transititon to the "certificateless society" requires the careful construction of something that does not now exist. This is an orderly mechanism for accomplishing by book entry throughout the country - for investors large and small - the identification of security ownership and the recording of changes therein. These functions are now performed to a significant extent by possession and movement of the certificate.
>
> The transition cannot be accomplished by fiat. Yes, the certificate could be legislated out existence tomorrow. But the result would be the biggest dislocation since Humpty Dumpty fell off the wall. It would make 1968-69 look like a period of order and precision. (9)

While the foregoing concluding comments were directed to complete elimination of the certificate, they are also pertinent to any partial elimination in calling for a substitute book-entry system of ownership records that will be sure to work.

It is an integral part of the plan that CSDS be able to settle the cash as well as the securities sides of transactions, thus making no change in the customary deliver-against-payment practice.

Preserving the corporation - stockholder link

The relative disadvantage of TADs' interfacing with tens of thousands of stockholders would be an advantage in another respect:

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(9) Bevis, Herman W., "Portion of Remarks before the American Society of Corporate Secretaries, Biltmore Hotel, New York City, March 17, 1971."

corporate issuers would have on their records the names of all stockholders who did not allow their securities holdings to be registered in "street" or nominee names. The TAD system would probably tend to encourage individual name registration on the transfer agents' records.

CSDS, on the other hand, would concentrate more and more of an issuer's shares in the name of the CSDS nominee. The more CSDS is successful, the more names disappear from stockholders records. Even at the present time, corporations complain of the difficulty and delay in getting proxies from, and otherwise communicating with, beneficial owners of their stock registered in street and nominee name.

It is clearly in the interest of the financial community that a healthy corporation-stockholder relationship continue to exist. A CSDS should not interfere with that. Accordingly, a successful CSDS will require that some new ground be broken.

It is a part of the Canadian depository plan that, as of a record date for a dividend, other mailing, or any compilation of a stockholder list, the depository provide the transfer agent with a list of its depositors and their holdings in the issue involved. The tranfer agent would substitute these names and holdings for those of the depository nominee, and mail direct to the depositors.

There would seem to be no insuperable difficulties to applying the Canadian plan in the United States. Some changes would have to be made in laws. The procedures for transmitting and validating information

between CSDS, transfer agents, and depositors would not be easy to work out. However, the technology for such communications between sophisticated organizations exists, and is being used more and more.

Although not essentially a CSDS problem, the foregoing concept could also be applied to brokers and banks, i.e., each of these could supply the transfer agent as of record date with a list of customers (who so authorized) and their holdings for direct mailings. One should not minimize the problems involved in working out the procedures for precise balancing, timing, etc., but the plan is potentially workable. Issuers could provide financial incentives: direct payments for such stockholder lists would probably be far less than the reduction in transfer and certificate cost from the immobilization and the eliminated payments in connection with proxy solicitation.

It might be said that plans to substitute stockholder names for that of a CSDS nominee on stockholder lists now approaches the TAD plan, but with CSDS as an unnecessary, intervening party. This is hardly the case. Under the TAD plan, the transfer agent would be recording a multitude of changes in ownership daily. Under the approach described above, he would be recording no changes for immobilized certificates, but would be exploding his stockholder list the six, eight, or so times a year when mailings to stockholders are required or a stockholder list is required for other purposes.

* * * * *

There are many similarities in the thinking and objectives

of those who advocate TADs and those working on the CSDS. The fundamental difference in the two approaches lies in with whom, and how, persons and firms would balance their security positions without certificates to help. Under the TAD system, numerous TADs would do the counterbalancing with the entire universe of holders of record. Under CSDS, this would be accomplished under a series of relationships: smaller investors with their local brokers or banks; smaller brokers or banks with their correspondents in financial centers; brokers and banks having the larger securities volumes with CSDS; and CSDS with transfer agents. The question is which system will work better and more quickly. BASIC has concluded that CSDS will - on both counts.

Mr. BEVIS. I can summarize, I think, the two main points. One is that TAD's cannot be considered an alternative to comprehensive securities depositories. That is my opinion after a lot of study, and the opinion of many, if not most, informed people with whom I have discussed the subject. So that I think there is not a consideration of alternative systems in TAD and the comprehensive securities depositories.

The other point is the TAD's do strike at the elimination of the possession of the certificate of the individual investor and attempts to attract those certificates into its system. I think that's fine. And it is an area which has not been explored to date, of persuading the individual investors to give up those certificates and have book entry records substituted. So, as I have told Mr. Tangney of First National of Boston, who is the first experimenter in this area, I think that is fine. But the TAD's started to date are proprietary institutions and in no way are substitutes, in my judgment, for a comprehensive securities depository system immobilizing securities of the financial community and substituting book entry.

The other point is that yesterday when we were up with Mr. Perkins you were interested in exploring the matter of potential screens for applicants who might be unworthy participants in a depository, and we promised that we would pursue that matter with you if you wished, and Mr. Potter will be glad to suggest language to you.

Senator WILLIAMS. Yes, I wish you would. That was my first question really, to try to rationalize a situation where a broker-dealer could be qualified to deal with the public but you would find that he was unqualified to deal with the depository. It seems whatever his character limitations, the most important effect would be in his dealing with the public rather than with the depository. You are suggesting a dual standard of qualification here. That's the way I got it.

Mr. POTTER. I think we were suggesting either a dual standard of qualification or possibly I was presumptuous enough to suggest that consideration be given to changing the standard for registration. I don't think you really have to get into that question at this point.

Our thought is that there are a variety of clearing agencies as the definition is presently set up that would include depositories, clearing corporations, and other types of organizations, and our thought is that there should be enough flexibility so that if the regulator, the Commission, wants to approve a rule of a particular depository or of a particular type of clearing agency it may do so and allow a greater degree of latitude for exclusion than is allowed the Commission in registration under the 1934 Act. And it is really based on the feeling that I expressed yesterday, that the list of bases for exclusion is not broad enough, does not, for instance, permit exclusion upon conviction of perjury. It does not permit exclusion for conviction of extortion. It does not permit exclusion for events that are subject to investigation by other governmental agencies or that are widely reported in the newspapers. Perhaps it should not. This is really a question of considerable sensitivity that is before your committee.

We urge that the matter should be broadened by permitting rules of a clearing agency that would have enough flexibility but would be limited by the requirement that they not unfairly discriminate in the admission of participants. All we are saying is that if the occasion re-

quires there be an opportunity to consider factors other than convictions, or other than convictions of these particular matters.

What we have done in structuring our proposal is to start with Mr. Bevis' appendix—let me correct that—the appendix to Mr. Bevis' statement. We have placed in brackets the provision, this is in S. 2058 that is before us, and there you will notice that participants are to be eligible subject only to such other rules of the clearing agency as are expressly permitted under this paragraph. And then there is—and we are glad to see it—an operational capacity standard. There is room for a bond, but there is no room for anyone to be excluded other than for suspension by the clearing agency. And what we have done is over on the next page revised that so that we in effect pick up what was in subparagraph 6 of S. 2058, and the part of that that I am referring to is the phrasing down at the end, "do not have the effect of unfairly discriminating in the admission of participants." We have taken that idea, we have eliminated the requirement of specific enumeration under that paragraph, and have proposed really that the rules simply not unfairly discriminate in the admission. This means that selection can be made, but it must not be unfair; and the safeguards, as we see it, are that the Commission would be approving the rules on registration, and there is a control in 17A(g)(1) of your proposed bill that in effect would require SEC approval for any changes in the rule of the clearing corporation, and yesterday we were discussing the philosophy that anyone disappointed by a ruling of the clearing agency could have access to the appropriate regulatory agency, and this is available under section 17A(i). Actually that appears without change on our part of the appendix.

Mr. BEVIS. I think the point, Mr. Chairman, we are trying to make is as we read S. 2058 if a depository got an application, to take some names out of the paper, from the Meyer Lansky brokerage firm or the Robert L. Vesco Bank or——

Senator WILLIAMS. De Carlo depository.

Mr. BEVIS. Or the Vesco Lansky Mutual Fund, it ought to review the background of those people very carefully before admitting them. And as we see it, under 205(A), if I am right that they haven't yet been convicted of any crimes, there would be no basis for the depository to exclude them.

Senator WILLIAMS. Let me just get to the organization of the appendix material. The bracketed parts are the bill that you would omit, and you have revised them with your——

Mr. POTTER. Our italicized material.

Senator WILLIAMS. Where did we begin. The first language in italics is on page 6.

Mr. POTTER. Yes, sir, and there is a guide on page 19 of the statement that is in tabular form that may be of assistance.

Senator WILLIAMS. You know, I have no real argument with the substance of your comments on qualifications. I think you are solid. I just have this problem of the dual regulation you propose. You know our structure, the regulation authority in the SEC, and then the enforcement power in its appropriate place.

Mr. POTTER. That's right. And what we propoee, and what shows on the table is that there be primary regulation particularly with respect to safeguards for securities and funds lodged in the Federal

Reserve Board for those depositories that are chartered as banks and that are members of the Federal Reserve System.

Mr. BEVIS. I think, Mr. Chairman, we have recognized all along the desire of everyone to obtain prompt and accurate processing and settlement of securities transactions. That is an essential objective of everyone. Our concern, in trying to build depositories that have fiduciary securities attracted to them, is that that is not enough, and that there should be another objective which is the financial and physical integrity of the processing institutions.

That is the reason we have tried from the beginning in talking to you and on the House side to try to get the bank regulatory role more prominent than it has been, as we see it, in proposed legislation. The compromise and the balancing is recognized far more in your proposal than anything we have seen on the House side. Nonetheless, we feel you haven't gone quite enough to attract securities of financial institutions into depositories which everyone, including the brokers, agrees is absolutely essential. And we are trying to set up an atmosphere which will attract them, and we think we have sold them on the idea; but they could be frightened away if they feel that their bank authorities do not have a big enough hand in the securities depositories.

That is the essence of our whole plea.

Senator WILLIAMS. You know, in this business of the safety, security of the certificates, this committee doesn't have the jurisdiction to look at criminal activity in this area, as you know. This resides in other committees here. It is probably that part of the whole bundle of securities that gets the most public attention.

I mentioned one name here, and one of the problems there was the fear that that man had been involved in security theft. Where does this problem of theft fall? Not with the depositories, does it? It is the brokerage house, isn't it?

Mr. POTTER. Well, it is conceivable it could fall anywhere.

Senator WILLIAMS. But historically where have these thefts been?

Mr. BEVIS. They have been in brokerage houses and in banks.

Mr. POTTER. But there is more and more elimination of certificates and less and less opportunity for theft of them, and we want to be sure that the depositories at least where the certificates are lodged and where the transactions are effected are regulated with the same thoroughness and safety-first orientation, if you will, as the banks in whose vaults they are lodged now are themselves regulated.

Senator WILLIAMS. Speaking for the depositories, you are expressing their view that, by God, it's their responsibility and they want to have something to say about who is participating is that right?

Mr. BEVIS. They do not wish to be precluded from screening people. No one can tell you in advance what applicant they would challenge and probe deeply, I'm afraid. They would not like their hands tied in doing that probing, and if the occasion required, saying "I'm sorry, but we can't accept you as an applicant." Now they would not have sole authority in that, of course, because the applicant could appeal to the appropriate regulatory anuthority.

Senator WILLIAMS. That is essential. We all agree.

Senator Biden.

Senator BIDEN. I apologize, but I have to leave. I am very interested in what is going on, but I have to leave. Thank you very much.

Senator WILLIAMS. Returning to our conversation yesterday, you feel that the language in this bill in the qualifications area is inadequate that in addition to operational capability, we need——

Mr. BEVIS. Character and financial responsibility had to do with access.

Mr. POTTER. Those are the factors we would like to be able to consider. They are not available to us under the bill.

Senator WILLIAMS. Well, under character doesn't the law come down to rather precise questions that could be raised under character? For instance, crimes, but crimes relating to securities.

Mr. POTTER. Well, that is the way the 1934 act is presented drafted.

Senator WILLIAMS. The law.

Mr. POTTER. Yes, sir.

Senator WILLIAMS. You argue with that?

Mr. POTTER. I agree with your conclusion. Our testimony this morning is to suggest that there be a different standard for access to depositories where it is appropriate, and our thought is that with the safeguard of access to an agency and access to the court—and I would like to expand my remarks yesterday to say that I have reread section 25 of the Securities Act of 1934 and I have some language changes that would make it clear that that would be applicable that I will submit. Our testimony is that this is a way of providing greater flexibility, which we think is appropriate, and really it is up to you and your committee to decide whether you want to give access automatically to everyone who is a broker or who is a bank and who has not been convicted of one of the enumerated crimes or whether there should be an opportunity for flexibility.

Mr. BEVIS. Put another way, Senator, I think we believe that nobody, even Congress in its wisdom, can make an inventory of all the people who should be eliminated, and we wouldn't like further screening to be precluded.

Senator WILLIAMS. Well, we don't want this test to be purely subjective either. That is our problem. Flexibility, I agree. But within a framework that does not permit arbitrary subjective testing. That is what we are after . If you can give us language it would be welcomed indeed for our consideration.

Mr. POTTER. Well, we have tried to do that by deleting the provision on requiring express permission and picking up the phrase "unfairly discrimianting" that was in the draft bill. Now, that does not contain an enumeration of what unfair discrimination is going to be, but in selecting it would appear to me that the regulatory agency will take a look at it and see whether or not there has been a subjective exclusion. If it does not, the courts I would expect would be pretty quick to hold it was arbitrary to exclude somebody on essentially subject grounds.

Senator WILLIAMS. Let me ask you this: Under the present law, the 1934 act, there is now no appeal in the law to the regulatory agency on exclusion, is there?

Mr. POTTER. I think there is.

Senator WILLIAMS. Well, now, for instance, membership.

Mr. BEVIS. On the exchange?

Senator WILLIAMS. On the exchange; yes.

Mr. POTTER. Membership on the exchange, no, sir. I thought you were talking about exclusion from registration as a broker/dealer,

and that is available under section 25. You have access to the court on that. But your bill does provide for access to the Securities and Exchange Commission by anyone who is denied access, and that is available under section subtitle (i).

Senator WILLIAMS. I gather, under present law on membership of the exchange that it is a very difficult course to get a hearing before the SEC or go to a court of law. As far as membership in the NASD it is otherwise, and you do have under present law an opportunity for appeal to the SEC.

Mr. POTTER. Yes: I think your bill meets that point by the provision of subtitle (i), by giving direct access to the agency and the only technical change that I would make is to section 25—to make reference to the appropriate regulatory agency where it turns out to be the Federal Reserve Board, say, so that there is access to the courts in both instances.

Senator WILLIAMS. Mr. Potter, are you going to have more language for us? Did you say you had something more to submit?

Mr. POTTER. Yes, sir.

Senator WILLIAMS. Fine; we would appreciate that.

Mr. BEVIS. If I may, Mr. Chairman, you will see that we have tried our best to throw under the jurisdiction of the SEC all the matters that we have heard of in which they would be interested in connection with membership and establishing a national system for processing securities transactions and have tried to confine the Federal Reserve Board's jurisdiction to those areas tying in closely with their examination and supervisory requirements in connection with safety and operations. It seems to us that this is workable and attempts to accomplish what your committee has been trying to accomplish except that it does emphasize more than we see in S. 2058 the safeguarding of securities and funds and responsibility for that.

Senator WILLIAMS. You know, most of our discussion yesterday and today seems to be—a great deal of it—about rules regarding safeguards for securities and funds. Am I right on that?

Mr. BEVIS. I think that is right.

Senator WILLIAMS. That is your major concern here. Well, it is a reasonable concern in my judgment, and I appreciate it and I know how much time you have put in on this and worked with our staff, too, and we certainly appreciate that full measure of cooperative creativity.

Mr. BEVIS. Thank you. We are glad to do it, Senator.

Senator WILLIAMS. Thank you, and we will be hearing from you, Mr. Potter. Thank you very much.

[Complete statement follows:]

STATEMENT OF HERMAN W. BEVIS, Member and former Executive Director of the Banking and Securities Industry Committee ("BASIC"), before the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs, Thursday, July 12, 1973.

Mr. Chairman, gentlemen, I appreciate the opportunity again to appear before you on behalf of BASIC* to discuss legislation having to do with securities depositories. I am accompanied by Hamilton F. Potter, Jr. of Sullivan & Cromwell, counsel to BASIC.

My comments on S. 2058 are confined solely to those provisions having to do with depositories. I offer no comments, pro or con, with regard to provisions having to do with clearing systems, transfer agents and registrars and other matters covered by the bill.

Summary of Comments

Legislation Is Not Needed at This Time

Additional legislation is not needed for regulation of depositories at this time.

A comprehensive securities depository system has been developed rapidly during the past three years under existing regulatory law. Since my last appearance before this subcommittee, substantial, tangible progress has been made towards the immobilization of securities certificates and book entry transfer of ownership.

There are now three existing depositories all of which have been or are being chartered as limited purpose trust companies under state banking laws, one has become a member bank of the Federal Reserve System and

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* The following are members of BASIC: Chairman: John M. Meyer, Jr., formerly Chairman, Morgan Guaranty Trust Company of New York; Herman W. Bevis, formerly Senior Partner, Price Waterhouse & Co.; Paul Kolton, Chairman, American Stock Exchange, Inc.; Gordon S. Macklin, President, National Association of Securities Dealers, Inc.; William H. Moore, Chairman, Bankers Trust Company; James J. Needham, Chairman, New York Stock Exchange, Inc.; and Walter B. Wriston, Chairman, First National City Bank.

the other two plan to apply for membership. The charters, by-laws and rules of two depositories have been presented to the SEC for review and clearance and the third is in the process of clearance.

Thus, the two significant federal regulatory authorities considered in S. 2058 are already engaged. No problem traceable to inadequate regulatory authority has been encountered and none is expected.

A Bigger Role for Bank Regulatory Authorities

If we assume federal legislation regarding depositories is to be enacted, we are concerned because S. 2058 does not sufficiently reflect the finding that "the bank regulatory agencies must play a major role in the development of a national clearing system."* It provides broad SEC rule making powers with respect to depositories but is virtually silent as to rule making by bank regulatory authorities.

Depositories must involve much more than the securities industry and the SEC as that industry's regulator. Banks and other non-broker/dealer fiduciary financial institutions, whose participation in any nationwide system of depositories is essential, want "safety-first" as the regulatory cornerstone before they relinquish possession of assets they hold for others. To them, this means that depositories should not only look like banks and act like banks but be regulated like banks.

I think the Congress should recognize this desire for assurance of safety—I believe the Congress shares it—and, if it is decided there should be legislation, should select the Federal Reserve System as the prime federal regulator for bank-chartered depositories in view of its experience, capacity and philosophy in regulation where safety and financial integrity come first, especially in the areas of safeguards, protection of securities and funds and related matters such as access. We recognize that such a structure goes against the "systems concept" that a single agency—the SEC—should have sole authority. However, this is a situation in which a concept, if followed

* Senator Williams for himself and Senators Brooke, Stevenson, Tower and Bennett, *Congressional Record*, June 22, 1973, p. S. 11730.

straight through, will not necessarily yield the desired result, and we think the advantages to be gained outweigh the natural inclination to provide for a single regulator responsible for all securities processing matters.

In the subsequent discussion and in attachments, we offer suggested changes in S. 2058 designed to give the Board of Governors of the Federal Reserve System rule making authority directly related to the Board's supervisory and examination functions for depositories that are members of its System. We firmly believe that the changes we propose will assist in the development of a comprehensive securities depository system that has a far greater chance of reaching the scale of participation that is urgently needed.

Eligibility of Participants in Depositories

S. 2058 limits a depository's latitude to deny access to potential participants in a way that I consider exposes a depository and its participants to undue risk.

BASIC has consistently recommended that, subject to regulation, a depository not be absolutely prohibited from subjecting an applicant to tests of character, financial condition, or operations capability.

We are glad to see in Section 17A(c)(2) of S. 2058 that an "operational capacity" test for applicants has been added. We continue to believe that a depository should not be precluded from screening applicants on the basis of character and financial condition.

Management Participation

As in last year's S. 3876, Section 17A(c)(3) of S. 2058 continues to provide that participants, *in addition to stockholders,* among other things participate in selection of a depository's officers and directors and in all other phases of the administration of its affairs.

Ample provision can be made that participants can become owners, thus encompassing what is believed to be the principle behind Section 17A(c)(3). Our objection is that this section is in direct conflict with the relevant corporation laws under which depositories are being incorporated.

We see no need to invite confusion and conflict to accommodate the desirable principle involved, and which, we believe, can be met in the proposed revision of Section 17A(c)(3).

Duplicate Examinations

Section 17A(1) of S. 2058 gives enforcement authority over depositories that are banks to the appropriate bank regulatory agency. Section 21 of the 1934 Act, which is not modified by S. 2058, gives substantially the same authority to the SEC.

Last year, in connection with S. 3876, the Committee Report made clear that it is not contemplated that SEC examinations would be a matter of routine but, so to speak, made only under unusual or exceptional circumstances. Senator Bennett repeated the point on the Senate floor. We hope that this point is repeated and made even clearer in the legislative history of S. 2058 if a specific provision is not included in the bill.

Past and Prospective Development of Depositories Evinces that Additional Regulatory Legislation Is Not Now Needed

Since 1970, BASIC has been dealing on an inter-industry basis with the conditions which caused the paperwork crisis of the late 1960's. For three years it has proposed solutions, based on in-depth research, to various aspects of processing securities transactions and handling certificates. By far the most important of BASIC's recommendations is that securities certificates be immobilized in privately-owned regional securities depositories, linked to form a nationwide system in which transactions are effected by book-entry rather than through physical delivery of certificates.

The impressive growth of The Depository Trust Company ("DTC")* in New York alone demonstrates the extent to which the immobilization and book-entry concepts can be applied under existing regulatory authority.

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* DTC is the limited purpose trust company which is the successor to the business and operations of Central Certificate Service, Inc. which, in turn, was the successor to Central Certificate Service, a division of Stock Clearing Corporation, a subsidiary of the New York Stock Exchange. Historical references herein to DTC encompass CCS, Inc. and CCS.

As the table below shows, during the year ended December 31, 1972 approximately 8,000,000 transactions were consummated by book-entry transfer—8,000,000 transactions for which the need to deliver certificates had been eliminated. At the end of February 1973 there were more than 1,500,000,000 shares representing more than 2,800 issues with a market value of approximately $55,000,000,000 on deposit at DTC.

Number of Transactions	**Year Ended 12/31/71**	**Year Ended 12/31/72**
Book-entry deliveries	6,191,929	8,166,342
Number of Shares on Deposit in DTC	**12/31/71**	**2/28/73**
Shares listed on NYSE	789,057,259	1,127,245,397
Shares listed on AMEX	246,932,964	361,578,237
Shares traded over-the-counter	30,553,812	57,785,934
Shares listed on National Stock Exchange	—	3,640,235
Total	1,066,544,035	1,550,249,803
Market value	$37 billion	$55 billion
Number of Issues on Deposit in DTC		
Issues listed on NYSE	1,336	1,414
Issues listed on AMEX	95	1,035
Issues traded over-the-counter	239	358
Issues listed on National Exchange	0	48
Registered non-callable bond issues listed on NYSE	9	26
Total	1,679	2,881

As of a recent date DTC had 294 participants (270 broker/dealers, 5 clearing corporations and, on an introductory basis, 19 banks). With the recent move to its new quarters DTC's capacities will be increased from 350 to 600 participants by mid-1973 and thereafter as needed.

Capacity also is being expanded initially to accommodate up to 9,000 issues; most of the additional issues to be included will be over-the-counter issues.

A feasibility study as to including state and municipal bearer bonds is in progress.

Since its inception in 1971, the brokers loan program has expanded continuously. On February 28, 1973 the market value of securities pledged by book-entry was more than $4.8 billion.

DTC Brokers' Loan Facilities	12/31/71	2/28/73
Number broker/dealer users	125	167
Number bank pledgees	19	58
N. Y. City banks	10	18
Banks outside N. Y. City	9	40
Market value of pledged collateral	N.A.	$4.8 billion

Operational refinements continue to improve efficiency. For example, a recently developed technique, pre-authorized automatic delivery (PDQ), has resulted in the elimination of 1.75 million individual documents per month. The evaluation of BASIC's proposal that magnetic tape replace the current paper forms used to transfer securities into customers' names is also under way.

Immobilization of securities certificates is a national objective and progress has by no means been confined to DTC and New York.

Since its formation in 1971, the National Coordinating Group for Comprehensive Securities Depositories ("NCG")* has guided and encouraged an interface among DTC, and the Pacific and Chicago depositories to the end that participants in any one depository may be able to deliver to a participant in any other by book-entry.

Regional brokers and banks outside New York, San Francisco and Chicago are linking up with the depositories in those cities or making plans or inquiries as to doing so.

* The members of NCG are: Chairman: John L. Perkins, President, Continental Illinois National Bank and Trust Company; Herman W. Bevis; George R. Becker, Chairman, Midwest Stock Exchange and Partner, Wayne Hummer & Co.; William T. Dentzer, Jr., Chairman, DTC; Gordon S. Macklin; John M. Meyer, Jr.; Thomas P. Phelan, President, Pacific Stock Exchange Inc.; William L. Somerville, Canadian Depository for Securities; and Samuel B. Stewart, Senior Vice Chairman, Bank of America.

NCG would encourage others to join the nationwide network. The financial communities of Boston and Hartford are studying the desirability of establishing their own depositories instead of linking up directly with DTC.

Other areas of progress include scheduled DTC interface with the Pacific and National Clearing Corporations and existing DTC relationships with the clearing corporations of the Midwest, PBW, Boston and Detroit Stock Exchanges. Banks in Atlanta, Baltimore, Boston, Columbus, Dallas, Hartford, Milwaukee, Minneapolis, Philadelphia, Richmond, St. Louis, St. Paul and Washington, D.C. are now operating on a trial basis as depository facilities for DTC, a program which allows participants to deposit securities in DTC at regional locations and to receive prompt credit in DTC records.

Further, appropriate authorities are or will be regulating depositories under existing regulatory relationships.

After approval by the New York Superintendent of Banks and Banking Board of DTC's organization certificate, DTC took over the assets and operations of Central Certificate Service, Inc. on May 11, 1973. The application by DTC for membership in the Federal Reserve System was approved on April 19, 1973 and became effective on June 27, 1973. SEC acceptance of the rules of DTC is virtually complete.

Midwest Securities Trust Company has been chartered as a trust company in Illinois and commenced operations as such on June 11, 1973. Its rules have been cleared with the SEC and it plans to apply for membership in the Federal Reserve System. As of late June 1973, MSTC had on deposit about 13,000,000 shares with a market value of approximately $325,000,000. About 1,350 issues were eligible for deposit. Some 325 broker/dealers are participants and 6 banks are in the collateral loan program.

Pacific Securities Depository has received approval to operate as a trust company from the California banking authorities, but has not yet commenced operations in that capacity. This is awaiting clearance by the SEC

of PSD rules, which is in process. In addition, PSD plans to apply for membership in the Federal Reserve System. As of late June 1973, PSD had on deposit 73,000,000 shares with a market value of approximately $800,000,000. About 8,100 issues were eligible for deposit. Some 63 broker/dealers are participants and 9 banks are in the collateral loan program.

The result, then, is that at the federal level DTC is being regulated by two agencies of coordinate jurisdiction—SEC with its expertise in the area of securities and securities markets and the Federal Reserve Board with its expertise in examining banking institutions with respect to safekeeping and financial integrity and similar regulation is, or soon will be the pattern for the others.

DTC's Board of Directors* includes its Chairman and President, representatives from the New York Stock Exchange, the American Stock Exchange, the National Clearing Corporation, a subsidiary of the National Association of Securities Dealers, Inc., brokerage firms, banks, an investment company and an insurance company.

It is evident from the foregoing that enormous progress has been made to date in the development of depositories and that substantial further progress is imminent—all without new federal legislation. Existing bank regulatory authority has been enlisted to assure the quality of depository inspections and supervision. Coordination of depository development by the SEC has been afforded by that agency's review of depository certificates of incorporation, by-laws, and rules.

* The following are members of the Board of Directors of DTC: William T. Dentzer, Jr., Chairman—formerly Superintendent of Banks, New York State; Diran M. Kaloostian, President; Elliott Averett, President, The Bank of New York; R. Manning Brown, Jr., Chairman, New York Life Insurance Company; Hamer H. Budge, President, Investors Group of Companies—formerly Chairman, Securities and Exchange Commission; George E. Doty, Partner, Goldman, Sachs & Co.; Samuel A. Gay, Senior Vice President, New York Stock Exchange, Inc.; David H. Morgan, President, National Clearing Corporation, a subsidiary of the National Association of Securities Dealers, Inc.; James J. Needham, Chairman, New York Stock Exchange, Inc.; Francis J. Palamara, Executive Vice President, New York Stock Exchange, Inc.; John T. Roche, Jr., Vice President and Director, Kidder, Peabody & Co., Incorporated; William I. Spencer, President, First National City Bank; Walter F. Thomas, Vice Chairman, Manufacturers Hanover Trust Company; and Robert C. Van Tuyl, Vice Chairman and Governor, American Stock Exchange, Inc. and Chairman, Shearson, Hammill & Co. Inc.

Full Development of Depositories Requires Primary Regulation Be Vested in Banking Authorities

Although there has been a great deal of progress, the depositories in California, Chicago, and New York continue to serve chiefly brokers and dealers. While some commercial banks are receiving pledges of securities for broker/dealer loans through DTC and some have begun to deposit securities held as custodians, they have not deposited shares they hold in their trust departments as fiduciaries.

In order to eliminate physical deliveries as a significant factor in the processing of securities transactions, depositories must attract institutional investors, including fiduciaries, banks, trust companies, insurance companies and mutual funds. These institutions and their customers presently account for about 60% of total public trading volume in shares on the New York Stock Exchange. A study in New York City indicated that, for every $2 in value of securities held by brokers, the banks held $3. However, New York is unusual in that multi-state brokerage firms tend to keep all or almost all their securities holdings in New York. An estimate recently prepared in California showed that Western banks held $30 billion worth of securities while Western broker/dealers held $4 billion.

Another reason why securities held by banks as fiduciaries must be attracted to depositories is that transactions involving banks largely consist of deliveries to and from banks on a cash-on-delivery or COD basis—the most troublesome, paper-intensive, and costly of all types of transactions.

Banks are reluctant to give up physical possession of securities they now hold because they are charged with a high degree of responsibility for the safekeeping of assets belonging to others. Recent failures of some firms to safeguard other peoples' securities confirm the wisdom of banks' continuing to require the exercise of prudence and serve to remind them and their customers of risks involved in placing securities in the hands of persons not subject to the experienced regulation and examination of a banking authority.

Institutions and individuals using banks and trust companies as fiduciaries and to process securities transactions do so in reliance, among other

things, on fiduciary responsibility and banking agency supervision. Banks will not—and should not be expected to—lightly give up to depositories the physical possession of securities for which they are responsible and which have market values ranging from hundreds of millions to billions of dollars. Insurance companies and mutual funds can be expected to take a similar view.

Moreover most banks could not, even if they wished, give up possession of a large portion of the securities they hold as fiduciaries because of restrictions in the trust and estate laws of most states. Those laws must be changed before they can do so. Legislators and bar associations traditionally have been reluctant to advocate such change. In New York, California, Connecticut, Georgia, Illinois, Maine, Maryland, New Mexico, Virginia and Washington such laws have been changed so that a securities depository can now receive deposits of fiduciary securities from banks in these states, in each case with the expectation that depositories would be subject to banking-type regulation.

To repeat, *the main effort is to attract securities held by the remainder of the financial community* under a common depository roof with those held by broker/dealers.

The characteristics and the ultimate success of depositories will be shaped by the nature of the regulators. BASIC believes strongly that depositories must have the qualities and attributes of banks. If we are to achieve this objective, banking authorities, including the Federal Reserve System, must play a major regulatory role. At the same time, we believe that the SEC can effectively discharge its responsibilities in connection with a national system for processing securities transactions by working with depositories on the formulation of their charters, by-laws and rules, as it has in the past.

The reluctance of fiduciaries to participate in a depository as fully regulated by the SEC as S. 2058 would require stems from their belief that the *sine qua non* of regulation is that the system be absolutely, completely

safe and that in selecting among regulators the Congress should pick as the agency responsible for that aspect of regulation a regulator that has the expertise and the pre-existing philosophy that the single most important factor is safety of assets held by the institution being regulated.

We would hope that the Congress would share the view that the form of examination and type of regulation to which fiduciary and safekeeping functions of banks are subject should be extended to depositories.

The Federal Reserve System and Other Banking Authorities Have the Capacity and Experience to Provide the Appropriate Regulatory Climate of Safeguards and Public Confidence

Although no regulatory agency can claim actual experience in regulating or examining securities depositories as such, the Federal Reserve System and other banking authorities have for many years examined banks and trust companies that hold securities for others, receiving them, keeping them, presenting them for transfer, delivering them out upon customer's instructions and collecting and crediting dividends and interest. If one disregards the power to effect securities transfers by book-entry, such banks and trust companies are close to being securities depositories in that they carry out the essence of a depository's custodial functions and procedures.

The Capabilities of Bank Authorities to Examine

The banking authorities have ample capability to supervise banks, trust companies and limited-purpose trust companies functioning as depositories. For example, as of year-end 1972, the Federal Reserve System shared responsibility for the examination and regulation of 1,092 state member banks and had approximately 535 full-time examiners. And on the state level the New York State Banking Department as of year-end 1972 was responsible for the examination and state regulation of 500 commercial banks, savings banks, savings and loan associations, credit unions, trust companies and banking agencies, of which 70 were members of the Federal Reserve System. The Department then had 286 full-time examiners.

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In examining banks, the Federal Reserve System and other bank regulatory authorities address themselves to the following, among other areas:

Organization

Structure

Management policies and deviations therefrom, if any

Committees and their functions

Minutes of the board of directors and committees

Financial Soundness

Capital structure; withdrawal of capital

Earnings and expenses

Dividend payments versus restrictions

Adequacy of insurance and review thereof by the board of directors

Contingent liabilities; repurchase agreements; accounts receivable and payable; suspense accounts and overdrafts

Uncompleted purchases and sales

Litigation

Personnel

Compensation of directors, officers and staff

Conflicts of interest

Recruiting methods and proper preemployment investigation of credentials

Benefit plans

Vacation schedules and adherence thereto

Accounting and Auditing

Audits and examinations by outside directors and their auditors

Adequacy of accounting and internal auditing procedures; application of computer techniques

Requests for confirmations from customers; verification programs

Administration and Operations

Adequacy of records, systems and controls; vault operations

Security procedures

Emergency preparedness measures, including reconstruction of records

Assets held by others than the bank itself, including collateral*

Performance as fiduciary, and compliance with pertinent statutes, regulations and agreements

Procedures for voting proxies and handling related material

Proper maintenance of files and records

Controls established to effect collection and credit of interest and dividends

Timely investigation of differences

Others

Violation of statutes

Exposure to surcharge

Complaints from customers

The security afforded to those by whom the bank's engagements are held

Such other matters as may be prescribed by the regulatory authority

The Federal Reserve System and New York State banking authorities are required to make at least one examination each year of each bank and trust company supervised. Each director of the institution examined is notified of the completion of the examination reports which must be

*Operations concerned with pledged securities are noted to determine the effectiveness of controlling such assets for the account of the pledgor and pledgee. Where such securities are not in possession of the bank a review is made of the system of controlling these items, and where necessary direct confirmations are required to check the controls established over said securities. Note: The New York Clearing House banks and others sought and received clearance from the New York State Banking Department, the Comptroller of the Currency and the Federal Reserve System before fully participating in the broker-bank collateral loan program at DTC under which collateral for broker loans is held outside of the pledgee bank.

presented at the next board of directors meeting. The bank must report to the regulatory authority action taken by its board in response to recommendations and criticisms contained in the examination report.

Examinations by these banking authorities are thorough; a recent joint annual examination of one large New York City bank by New York State and Federal Reserve examiners took a total of approximately 2,400 man-days of regulatory staff time, excluding time devoted to the bank's foreign branches.*

The Federal Reserve System Banks, as fiscal agents of the United States, have for many years issued, registered, redeemed and paid interest on securities of the U.S. Treasury and other agencies of the federal government. They also hold securities owned by banks, some of which are pledged for various purposes.

The Federal Reserve System also has experienced in actually operating interregional depositories—their 12 Federal Reserve Banks—and a book-entry system.

Book-Entry Experience of the Federal Reserve

In 1921, the Federal Reserve Banks introduced facilities for making telegraphic transfers of Treasury securities between such banks in the 12 Federal Reserve districts. This was in reality the first nationwide system of interconnected regional depositories.

In 1965, this wire transfer facility was significantly enlarged when the Federal Reserve Bank of New York entered into an arrangement with several banks in New York City under which such banks opened with it clearing accounts for Treasury securities. The establishment of these clearing accounts permitted the participating banks to "settle" once a day, on a net basis, their wire transfers as custodians for out-of-district banks. This system was later extended to include the settlement of wire transfers of Treasury securities among all participating banks.

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* It is anticipated that the New York State Banking Department and the Federal Reserve Bank of New York will make their annual examination of DTC on a joint basis, as they do with respect to a number of other banks in New York. The nature of the examination will be similar to that indicated above.

In 1968, all the Federal Reserve Banks instituted a book-entry system for the custody of Treasury securities owned by member banks, by governmental agencies and by agencies of foreign banks. A distinguishing feature of this system is that it does not merely immobilize issued and outstanding certificates—it eliminates most of them.

The Federal Reserve Bank of New York subsequently expanded this system to include Treasury securities held by member banks for their dealer departments and for all non-bank dealers; it has recently announced the expansion of the system to include such securities held by member banks in trust and customer accounts as well as securities of various agencies of the federal government. It is expected that, based on the New York Federal Reserve Bank's experience, this expanded book-entry system will shortly be adopted by the other Federal Reserve Banks.

The Federal Reserve Bank of New York currently holds some $150 billion of Treasury securities in its certificateless system (1972 Annual Report). The other Federal Reserve Banks hold another $30 billion. The system routinely handles 15,000 or more transactions per week with a market value of as much as $25 to $30 billion. As a result, the value and number of Treasury securities out "on the street" have been vastly reduced and should, before this year is out, be further reduced.*

The experience which the Federal Reserve System has in operating its security depository and in operating a telegraph or wire securities transfer system, a form of "interface", provides a substantial body of knowledge and expertise as does its current development of techniques for more rapid payments and movement of funds. It will also provide additional assurance to banks located in states other than those in which depositories are located.

This, we submit, is the federal regulatory agency best suited to encourage the deposit of securities by institutions and to assure adequate safeguards.

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* Page 44 of the Federal Reserve Bank of New York Annual Report for 1972 states: ". . . the number of definitive securities handled declined 25.6 per cent . . . as a result of the continued expansion of the book-entry procedure and the government securities clearing arrangements."

S. 2058 Does Not Give Bank Regulatory Authorities a Sufficient Role in the Development of Depositories

S. 2058 does not sufficiently reflect the finding that "the bank regulatory agencies must play a major role in the development of a national clearing system."* It provides broad SEC rule making powers with respect to clearing agencies but is virtually silent as to rule making by federal bank regulatory authorities for depositories that are banks. Of even greater concern is the delegation to SEC of rule making as to safeguards for securities and funds in custody of bank depositories (Section 17A(f)). This is particularly anomalous in view of the wealth of experience and staff, described above, available in the Federal Reserve System, of which all three operating depositories are or will become members, and the expectation, in which we concur, that the Federal Reserve System will conduct regular examinations of those depositories (Section 17A(o) and (p)) and have disciplinary jurisdiction over them (Section 17A(1)).

We believe that a securities transaction processing bill should have two objectives: (1) the prompt and accurate processing and settlement of securities transactions and (2) the financial and physical integrity of the processing institutions so as to assure that they will be able to answer for securities on deposit or in process of settlement. Our concern is that if there is to be legislation it should make clear that the first objective should not be achieved at the expense of the second.

It can be hoped, and no doubt expected, that two agencies giving different priorities to the two objectives can readily agree upon solutions to specific problems which appropriately balance conflicting considerations. However, this may not always be easy. Consider, for example, the following hypothetical illustrations:

1. Depositories A, B and C each receive applications from newly organized Depository D to become a participant. D urges A, B, and C

* Senator Williams for himself and Senators Brooke, Stevenson, Tower and Bennett, *Congressional Record* June 22, 1973, p. S. 11730.

also to become participants in it so as to expand the immobilization of certificates and the book-entry system.

A, B and C, after reviewing D's operations, safeguards, and financial resources, believe that they would incur undue financial risks in cross-participation with D until its house is in better order.

Expanding the modern system for processing and settling securities transactions argues that D become a member of the system quickly; safeguarding securities and funds suggests delay until D meets further conditions.

2. If some participants typically want immediate transfer to others by book-entry of the securities they deposit and any of the deposited securities are rejected by the transfer agents, the depository could suffer a loss if the participants do not have other securities of the same issue on deposit to cover the transactions and are unable to redeem the rejected securities.

The depository could protect itself from this risk with a rule that such participants would not receive credit for deposited securities—and, hence, be unable to redeliver them—until they had cleared transfer. Such a rule would slow deliveries for these participants and increase fails. Yet, a depository must limit its risk exposure. The two conflicting objectives must be sensibly balanced.

Broadly stated, the regulatory structure of an integrated national depository system should not invite the possibility that a market oriented rule maker might require a depository to increase its capacity to handle larger volumes of transactions at the price of an unwise increased risk to participants.

We believe your committee agrees with this approach and think it should be articulated in provisions of any legislation and reflected in the allocation of regulatory responsibility. Specifically, federal responsibility for rules dealing with the safeguarding of securities and funds should be

assigned to the Federal Reserve System, which is safety-minded, for bank-chartered depositories. In addition, we would recommend that the statement of purpose in Section 2 of the Securities Exchange Act of 1934 and other points at which reference is made to policy of the legislation contain language with respect to "the safekeeping of funds and securities" to parallel "the prompt and accurate processing and settlement of securities transaction".

S. 2058 grants to the SEC authority to register depositories (Section 17A(a)(1)), to review their rules (Section 17A(c)), and to prescribe rules for them (Section 17A(f)), even if the depositories are chartered as banks or trust companies. The complete delegation of rule making authority over depositories to the SEC is mitigated only by Section 17A(p), requiring merely that the SEC consult with bank regulatory authorities before taking action—with the sole decision-making authority still lodged in the SEC.

The Midwest and Pacific bank-chartered depositories are planning to become members of the Federal Reserve System. DTC enjoys this status already. While we can conceive of some "safekeeping" operations of relatively narrow scope in connection with clearing activities, we do not believe that it will be practicable to develop a comprehensive securities depository for an entire financial community that is not chartered as a bank. And we see strong reasons why all bank-chartered depositories should become members of the Federal Reserve System.

That being the case, we believe that S. 2058 should give the Board of Governors of the Federal Reserve System jurisdiction over those of the rules of its depository members which bear most directly on the responsibilities that the Board will assume. In offering our suggestions, we have leaned over backwards in trying to leave with the SEC jurisdiction over other matters that might be relevant to developing a nationwide securities transaction processing system.

Our suggestions of the division of rule making jurisdiction between the SEC and the Board are set forth below:

	Federal Reserve Member	Non-Federal Reserve Member
Depository's registration, and rules for registration.	SEC	SEC
Depository rules regarding:		
Compatibility with rest of the securities processing system	SEC	SEC
Reasonable non-discriminatory access	SEC	SEC
Safeguards for securities and funds	FRS	SEC
Representation of users	FRS	SEC
Equitable allocation of charges for services	FRS	SEC
No price fixing of participant's services to others	FRS	SEC
Disciplinary power over bank participants	FRS	SEC
Disciplinary power over broker/dealer participants	SEC	SEC
Disciplinary procedures as to depositories	FRS	SEC
Depository Examination	FRS	SEC

The foregoing is translated into suggested language changes in S. 2058 in the attachment.

Bills introduced in the Congress characteristically appear to treat depositories as securities industry instruments with the SEC having virtually the entire regulatory cognizance. One can understand the "systems concept" that suggests that one agency—the SEC—should have sole authority over programs to solve the nation's securities handling problems. One can also understand a Congressional desire to hold only one federal agency responsible for all securities handling matters. However, as any experienced manager knows, not all concepts can be followed straight through to desired procedural improvements. In our view a sounder and more effective pattern of regulation would result from the allocation of responsibility we propose.

Other Provisions of S. 2058 Requiring Change

Eligibility of Participants in Depositories

Section 17A(c)(2) of S. 2058 requires that *all* registered brokers, dealers, members of national securities exchanges, associations, clearing agencies, depositories and investment companies, and *all* banks, be eligible participants under the rules of a depository, subject to (i) operational capacity, (ii) the posting of a bond or deposit bearing a reasonable relationship to past positions and transactions and (iii) denial of participation for the duration of a suspension or expulsion from another depository or clearing agency. Only potential participants *other* than those listed above may be restricted on the basis of financial condition and conviction of certain crimes.

We are very glad to see that "standards of operational capacity" have been added in Section 17A(c)(2) to the eligibility requirements which a depository's rules may encompass. This is a significant improvement over S. 3876. Without an operational test, participants without the necessary procedural skills could adversely affect the operations of an entire depository.

Since depositories are essentially mutual service organizations, they will be no sounder than their participants. Moreover, financial risks engendered by the inclusion of participants unable to meet reasonable standards of solvency and character will directly affect all other participants. Yet, under S. 2058 considerations of financial condition and prior criminal activity or affiliations may not be weighed in considering the largest group of users, enumerated above. It is difficult to conceive of another industry in which solvent and reputable members must, by law, stand at risk of the insolvent or disreputable.

It is recognized that each of the entities listed in categories A through D in Section 17A(c)(2) is subject to some degree of regulation which may be concerned with its financial condition and lack of criminal activity. In the absence of a violation of depository rules, the proposed structure requires a depository to rely upon various regulators to assure that financial ability is

present in the participants, notwithstanding the lack of experience of certain of such regulators with depository procedures. This could require a depository to await findings of inadequacies in this area while the safety of all participants in the depository would dictate immediate action by the depository.

BASIC urges that if there is any depository legislation it permit the application of reasonable standards concerning financial condition and character in determining eligibility of all participants. The application of these standards by the depository would be subject to review by regulatory authorities and, probably, by the courts.

Financial condition. No matter what safeguards a depository sets up, it and its users will probably never be able completely to insulate themselves from all risk of loss if a participant becomes insolvent and cannot make good on its transactions with the depository. One risk pattern may be mentioned:

> Securities are deposited and credit is given; the securities are redelivered to another upon instruction of the depositing participant; they are subsequently rejected by the transfer agent because the securities are in some way defective. If the depository participant is insolvent and unable to accept redelivery of the securities, the depository faces some risk of loss. It may also have a loss if such a participant is unable at the end of the day to pay the amount it owes the depository for the net of the day's transactions.

Therefore, the credit of a participant is important to the depository (and to the other participants who are, in essence, co-insurers against losses from such risks). As discussed below under "Character", the posting of a bond or making of a security deposit does not provide adequate protection since a single user can generate risks to the depository and the other participants that exceed the bond of that user. Depositories should be allowed to establish rules, subject to regulatory review, as to financial responsibility of participants to protect against undue credit risks. Depositories should have the power to reject (again, subject to regulatory review) persons with, for example, a record of financial instability.

Character. Unrestricted access to a depository could facilitate disposition of stolen securities. One possible pattern is:

> A participant deposits, for example, $2 million worth of stolen securities which on their face are in good order and receives credit for the deposit before the securities clear transfer. (Brokers' quick turnaround requirements are such that usually they cannot await transfer before they redeliver.) The participant then orders book-entry delivery of the securities he has just deposited against payment to another participant, receives the $2 million in cash by the end of the day, and leaves the country. Twenty-four hours thereafter, the transfer agent rejects the certificates as stolen.

Other patterns of illegal activity which would victimize a depository and its participants are confined only by the limits of the ingenuity of those whose character is so inclined.

The use of a reasonable bond or deposit simply cannot protect a depository fully. Under the formula currently being utilized by DTC—2½% of average daily cash debits plus cash credits—a participant could receive and deliver against payment $2 million in securities each way daily for a contribution to the protection fund of $100,000. If the formula percentage were much higher, it could work a hardship on many participants. Further, a bond or deposit based upon the scale of past transactions does not protect against sudden changes in volume of use; a participant who operated on a $2 million scale in the past could jump to $10 or $20 million, or more, the next day. Thus a participant could engage in reckless or illegal activities which would not be protected against by his deposit and bond alone and all other participants would in such event bear the loss.

Well-managed brokers and banks exposed to risks like these attempt to ascertain the character of those with whom they do business and reject those whose credentials are not satisfactory. Both brokers and banks should know their customers. While they all sometimes make mistakes—and depositories will, too—depositories should not by law be required to eliminate character as a consideration of eligibility.

We wish to make it clear that by espousing this position as to "access" the intent is not to restrict the number of responsible depository participants. Quite the contrary is the case. As stated earlier, DTC plans to increase substantially the number of participants. The success of DTC and other

depositories in further immobilizing the physical movement of securities hinges on their abilities to attract and hold a greater number of participants and securities rather than a lesser number, to increase its volume of book-entry transactions and so lessen the number of securities transactions settled by physical delivery of securities.

Our concern is that if depositories cannot restrict access on the basis of financial ability and character, the number of participants will not increase due to the fear of potential participants that there is inadequate protection against participation by those who would create significant risks for all. *Thus the success of the depository system depends upon the existence of adequate standards for access, not on the elimination of such standards.*

Management Participation

Section 17A(c)(3) of S. 2058 gives participants who are not shareholders of the depository authority over important corporate actions by requiring their "fair representation" in the adoption and amendment of rules, the selection of officers and directors and in all other phases of administration.

This would conflict with a basic principle of corporate law, and depositories, as corporate entities, are established under such laws. The basic principle is that shareholders shall elect directors who shall manage the business. In the case of the New York depository, the New York Banking Law provides that "the stockholders shall elect directors" at their annual meeting (Section 7003(1)), that the directors shall elect officers (Section 7013) and that "[t]he affairs of every [banking] corporation shall be managed by a board of directors . . ." (Section 7001(1)). Moreover, every director of a bank or trust company in New York must be a "stockholder" of the bank or trust company (Section 7001(4)) or have made an equivalent investment in the bank or trust company (Section 14(1)(b) and New York Banking Board General Regulation 27.3). In addition to conflict with statutory provisions, Section 17A(c)(3) would raise questions as to the ability of directors to carry out their fiduciary responsibilities.

Non-shareholder participants are separately protected by the regulatory authority's review of a depository's rules and procedures. The proposed rules of DTC also provide that all participants be advised of any proposed amendment to the rules, so that participants may comment on them to DTC and its regulatory agencies.

BASIC has met the objective of user participation in management by recommending that each participant, or the securities exchange or association of which he is a member, be entitled (though not required) to purchase voting stock in the trust company in proportion to his use of the depository's services. The use of services could be measured by a combination of the fees paid to the depository for transaction services and the value of securities left in its custody. Together with cumulative voting for directors, this procedure assures minorities of shareholding participants of a voice at the Board of Directors level. For example, if the depository has 15 directors, as planned by DTC, holders of less than 7% of the depository's stock, acting together, can assure the election of a director of their choice.

The availability of ownership rights to users, whether they be brokers, dealers, investment companies, securities exchanges or associations, banks or insurance companies,* adequately ensures a depository's responsiveness to the needs of users.

Duplicate Examinations

Section 17A(1) of S. 2058 gives enforcement authority over depositories that are banks to the appropriate bank regulatory agency. Section 21 of the 1934 Act, which is not modified by S. 2058, gives substantially the same authority to the SEC.

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* The Uniform Commercial Code currently requires that all the capital stock of a depository be held by a national securities exchange or association. The pending revision would require that 90 per cent or more of the stock of a depository be held by or for (i) national securities exchanges or associations registered under federal law, (ii) registered brokers, dealers or investment companies, and (iii) institutions which are themselves subject to either state or federal supervision or regulation under banking or insurance laws. Any remaining stock may be held only by individuals who purchased it only in such amounts as are necessary for qualification as directors of the depository.

With regard to this potential duplication, the August 2, 1972 Report of the Committee on Banking, Housing and Urban Affairs stated on page 5:

> "The SEC's general investigative powers under Section 21 of the Securities Exchange Act of 1934 extend to all violations of that Act, and therefore, to violations of the newly added provisions relating to clearing agents and transfer agents. It is not contemplated, however, that these powers would be utilized in the day-to-day supervision of clearing agencies and transfer agents which are organized as banks. Rather, it is expected, that they would be used in coordination with, or to facilitate the exercise of the enforcement powers granted to, the bank regulatory agencies under these provisions."

Senator Bennett reemphasized this point in the floor debate on S. 3876 (*Congressional Record,* August 4, 1972, p. S 12786).

We interpret the foregoing as an expression of intent that SEC investigations under Section 21 of depositories organized as banks would not be routine, but carried out only under exceptional circumstances. We would hope that the legislative history of S. 2058 would repeat the point and make even clearer that in only unusual and unforeseen situations would the SEC examine bank-chartered depositories under Section 21. Otherwise, depositories could be subjected to undesirably duplicative investigations.

Considering the nature and functions of comprehensive securities depositories and the undisputed capability of the Federal Reserve System and state banking authorities to examine them, as set forth above, there is no doubt in my mind that such bank regulatory authorities should have prime responsibility for depository examination. In other than an exceptional situation, I can see no reason for SEC examinations. If this is also the intent of S. 2058, it is important that such intent be made clear in the legislative history, if not in the bill itself.

Conclusion

We recognize that the development of legislation on the regulation of depositories is a complex matter. With the variety of regulatory authorities already involved with the many elements of the financial community, and

varying ideas as to how the securities handling problem should be solved, there are bound to be conflicts among proposed solutions. We appreciate the diligence with which the Subcommittee on Securities has sought a compromise in S. 2058, particularly in the respective jurisdictions of the SEC and bank regulatory authorities in regulating depositories.

Our comments and suggestions have been offered in the same attempt at compromise, and to modify S. 2058 so that it will produce a healthier climate for the growth of comprehensive securities depositories that immobilize certificates and effect transfers of securities transactions by book-entry. This is a climate in which "the safekeeping of funds and securities" parallels as an objective that of "the prompt and accurate processing and settlement of securities transactions."

Depositories can be further successfully developed without new legislation. If it is the will of the Congress that there be new legislation, however, we believe that S. 2058—modified as we have suggested—is the best approach that we have yet seen.

The following text of S. 2058 incorporates the changes with regard to depositories that are banks or trust companies suggested in the preceding Statement of Herman W. Bevis. Deletions are indicated by brackets and additions are italicized.

A BILL

To amend the Securities Exchange Act of 1934 to provide for the regulation of clearing agencies and transfer agents, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. Section 2 of the Securities Exchange Act of 1934 (15 U.S.C. 78b) is amended by striking the word "and" immediately before the phrase "to impose requirements necessary to make such regulation and control reasonably complete and effective," and by adding the following immediately after that phrase: "and to provide for the development of an integrated national system for the prompt and accurate processing and settlement of securities transactions,".

SEC. 2. Section 15A (k)(2) of the Securities Exchange Act of 1934 (15 U.S.C. 78o-3(k)(2)) is amended by inserting after clause (D) the following:

"(E) the time and method of making settlements, payments, and deliveries and of opening, maintaining, and closing accounts."

SEC. 3. Section 3(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)) is amended by adding at the end thereof the following new paragraphs:

"(22) The term 'clearing agency' means any person who acts as an intermediary in making payments or deliveries or both in connection with transactions in securities or who provides facilities (A) for comparison of data respecting the terms of settlement of securities transactions, (B) to

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reduce the number of settlements of securities transactions, or (C) for the allocation of securities settlement responsibilities. Such term also means any person who acts as a custodian of securities in connection with a system which permits securities so held to be transferred, loaned, or pledged without physical delivery of securities certificates, or which otherwise permits or facilitates the settlement of securities transactions or the hypothecation or lending of securities without physical delivery of securities certificates. The term 'clearing agency' does not include (i) Federal Reserve Banks, Federal Home Loan Banks, Federal Land Banks, and (ii) banks, brokers, life insurance companies or their registered separate accounts, registered open end investment companies or unit investment trusts, building and loan, savings and loan, and homestead associations, and cooperative banks by reason of lending, fiduciary, correspondent, or safekeeping functions commonly performed by them on the date of enactment of this paragraph.

"(23) The term 'participant', when used with respect to a clearing agency means any person who uses a clearing agency or securities depository for the purpose of settling or comparing transactions in securities or making or receiving payment for or delivering, lending, or hypothecating of securities. Such term does not include a person whose only use of a clearing agency or securities depository is through another person.

"(24) The term 'transfer agent' means any person who engages on behalf of an issuer of securities, or on behalf of itself as an issuer, of securities in (A) countersigning such securities upon issuance; (B) monitoring the issuance of such securities with a view to preventing unauthorized issuance, a function commonly performed by a person called a registrar; (C) registering the transfer of such securities; or (D) exchanging or converting such securities. The term 'transfer agent' does not include any person who performs such functions solely with respect to variable annuity contracts issued by insurance companies.

"(25) The term 'appropriate regulatory agency', when used with respect to a clearing agency or transfer agent required to be registered under this title, means:

"(A) the Comptroller of the Currency, in the case of a national bank or a bank operating under the Code of Law for the District of Columbia, or a subsidiary of any such bank;

"(B) the Board of Governors of the Federal Reserve System, in the case of a State member bank of the Federal Reserve System, a subsidiary thereof, a bank holding company, or a nonbank subsidiary of a bank holding company;

"(C) the Federal Deposit Insurance Corporation in the case of a bank insured by the Federal Deposit Insurance Corporation (other than a member of the Federal Reserve System) or a subsidiary thereof; and

"(D) the Commission in the case of all other transfer agents and clearing agencies *and for the purposes of Sections 17A(i), (j) and (1)(2) of this title, whenever the subject of a disciplinary action, suspension, expulsion or denial of participation is a broker, a dealer, or a member* of a national Securities exchange.

As used in this paragraph, the terms 'bank holding company' and 'subsidiary' have the meaning given them in section 2 of the Bank Holding Company Act of 1956, as amended.

"(26) The term 'rules of a clearing agency' means the clearing agency's constitution, articles of incorporation, by-laws, or rules or instruments corresponding to the foregoing, and its stated policies and practices relating to its organization, participation, rules of procedures, financial condition, methods of safekeeping, settling, hypothecating, lending and accounting for funds and securities, and similar matters.".

SEC. 4. Section 15(c) of the Securities Exchange Act of 1934 (15 U.S.C. 78o(c)) is amended by adding at the end thereto the following new paragraph:

"(6) No broker or dealer shall make use of the mails or of any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any security (other than an exempted security or commercial paper, bankers' acceptances, or commercial bills) in contravention of such rules and regulations as the Commis-

sion shall prescribe as necessary or appropriate in the public interest, for the protection of investors or for the development of an integrated national system for the prompt and accurate processing and settlement of securities transactions to regulate the time and method of making settlements, payments, and deliveries and of opening, maintaining, and closing accounts. Nothing in this paragraph shall be construed (A) to affect the authority of the Board of Governors of the Federal Reserve System, pursuant to section 7 of this title, to prescribe rules and regulations for the purpose of preventing the excessive use of credit for the purchase or carrying of securities, or (B) to authorize the Commission to prescribe such rules or regulations for such purpose."

SEC. 5. The Securities Exchange Act of 1934 is amended by inserting after section 17 (15 U.S.C. 78q) the following new section:

"PROCESSING OF SECURITIES TRANSACTIONS

"SEC. 17A. (a)(1) Except as otherwise provided in this subsection, it shall be unlawful for any person, directly or indirectly, to make use of the mails or any means or instrumentality of interstate commerce to perform the function of a clearing agency with respect to any security (other than an exempted security) unless such person is registered under this section. The Commission, by rules and regulations or by order, upon its own motion, or upon application, may conditionally or unconditionally exempt any person, security, transaction, or clearing agency, or any class or classes of persons, securities, transactions, or clearing agencies from any provision or provisions of this section or of any rule or regulation prescribed under this section if the Commission finds that the application of such provision or provisions to such person, security, transaction, or clearing agency or class or classes of persons, securities, transactions, or clearing agencies is not practical or not necessary or appropriate in the public interest or for the prompt and accurate processing and settlement of securities transactions.

"(2) The Commission shall include in its annual reports to Congress required by section 23(b) of this title information concerning the number of requests for exemptions from this section received, the number granted, and the basis or bases upon which any exemptions were granted.

"(b) Any clearing agency may be registered for the purposes of this section by filing with the Commission a registration statement in such form as the Commission may prescribe containing the rules of the clearing agency and setting forth such other information and accompanied by such other documents as the Commission may, by rule, require.

"(c) An applicant shall not be registered as a clearing agency unless the Commission finds that—

"(1) such clearing agency is organized and operated so as to facilitate the prompt and accurate settlement of securities transactions, to safeguard funds and securities held for the accounts of participants, to comply with the provisions of this title and the rules and regulations thereunder, and to carry out the purposes of this section;

["(2) the rules of the clearing agency provide that all (A) registered brokers or dealers or members of a national securities exchange, (B) other registered clearing agencies, (C) registered investment companies, (D) banks (as defined in section 2(a)(5) of the Investment Company Act of 1940), and (E) such other persons or classes of persons as the Commission may from time to time designate by rule as appropriate to the development of an integrated national system for the prompt and accurate processing and settlement of securities transactions are eligible to become participants in such clearing agency, subject only to such other rules of the clearing agency as are expressly permitted under this paragraph. The rules of the clearing agency may condition participation upon compliance with standards of operational capacity which the Commission has, by rule, found to be necessary to assure the prompt and accurate processing of securities transactions, and upon the deposit with the clearing agency of an amount or the posting of a bond with the clearing agency in an amount which bears a reasonable relationship to the value of positions maintained by and transactions processed for the participant; and such rules may deny participation to persons who have been expelled or suspended by a registered clearing agency during the period of such expulsion or suspension;]

"(2) the rules of the clearing agency, as approved or originated by the Commission are designed to promote the prompt and accurate processing and settlement of securities transactions, to foster cooperation and coordination with national securities exchanges, national securities associations, other clearing agencies, brokers, dealers, banks, registered investment companies, and with other persons engaged in the processing and settlement of securities transactions, and to protect investors and the public interest, and do not have the effect of unfairly discriminating in the admission of participants or among participants in the use of such clearing agency, provided, however, that the rules of the clearing agency may condition participation upon compliance with standards of operational capacity which the Commission has, by rule, found to be necessary to assure the prompt and accurate processing of securities transactions; and may deny participation to persons who have been expelled or suspended by a registered clearing agency during the period of such expulsion or suspension; and

["(3) the rules of the clearing agency assure a fair representation of its shareholders (or members) and participants in the adoption of rules of the clearing agency and any amendment thereto, the selection of its officers and directors, and in all other phases of the administration of its affairs;]

"(3) the appropriate regulatory agency has determined that the clearing agency is so organized and possesses such operational capacity as to be able to perform the functions of such a clearing agency and to provide adequate safeguards for securities and funds which are in its custody or control, and that the rules of such clearing agency, as approved or originated by the appropriate regulatory agency, are designed—

"(A) to provide safeguards for securities and funds which are in its custody;

"(B) to afford an opportunity for its voting stock to be owned by or on behalf of participants in reasonable proportion to their use of

the clearing agency's services, provided, however, that such opportunity shall not be afforded any person not qualified to hold the shares of the clearing agency under the applicable law, including the Uniform Commercial Code;

"[(4)] (*C*) [the rules of the clearing agency] *to* provide for the equitable allocation of dues, fees, and other charges among its participants;

"[(5)] (*D*) [the rules of the clearing agency do not impose] *to prohibit the imposition of* any schedule of prices, or fix rates or charges, for services rendered by its participants;

["(6) the rules of the clearing agency are designed to promote the prompt and accurate processing and settlement of securities transactions, to provide safeguards for securities and funds which are in its custody, to foster cooperation and coordination with national securities exchanges, national securities associations, other clearing agencies, brokers, dealers, banks, registered investment companies, and with other persons engaged in the processing and settlement of securities transactions, and to protect investors and the public interest, and do not have the effect of unfairly discriminating in the admission of participants or among participants in the use of such clearing agency;]

"[(7)] (*E*) [the rules of the clearing agency] *to* provide that its participants shall be appropriately disciplined for any violation of its rules by expulsion, suspension, fine, or censure; and

"[(8)] (*F*) [the rules of the clearing agency] *to* provide a fair and orderly procedure with respect to the disciplining of participants and the denial of participation to any person seeking participation therein. In any proceeding to determine whether a participant should be disciplined, such rules shall require that specific charges of any rule violation be brought; that such participant shall be notified of and be given an opportunity to defend against such charges; that a record

shall be kept; and that a determination to take disciplinary action shall be supported by a statement setting forth—

"[(A)](*i*) any act or practice in which such participant may be found to have engaged, or any required act or practice which such participant may be found to have omitted;

"[(B)](*ii*) the specific rule or rules of the clearing agency which any such act or practice, or omission to act, is deemed to violate; and

"[(C)](*iii*) the penalty imposed and the reasons therefor. In any proceeding to determine whether a person shall be denied participation, such rules shall provide that the prospective participant shall be notified of, and be given an opportunity to be heard upon, the specific grounds for denial which are under consideration, that a record shall be kept, and that the determination to deny participation shall be supported by a statement setting forth the specific grounds on which the denial is based. Notwithstanding any other provision of this section, the rules of the clearing agency may provide for the temporary suspension of a participant, the prohibition of such participant's use of the clearing agency, and the closing of its accounts pending determination on the merits of any disciplinary proceeding if, in the opinion of the clearing agency, such suspension, prohibition on use and closing of accounts are necessary for the protection of the clearing agency or its participants, or for the protection of investors or to facilitate the orderly and continuous performance of the clearing agency's services. The rules of the clearing agency shall afford the participant an expedited hearing on the merits in the case of any temporary suspension.

"(d) The Commission shall, upon the filing of an application for registration pursuant to subsection (b), publish notice of the filing and afford interested persons a reasonable opportunity for comment. Within sixty days of such filing, the Commission shall:

"(1) by order grant such registration if the Commission finds that the requirements of this section are satisfied, or

"(2) institute an appropriate administrative action to determine whether the application should be denied. After notice of the grounds for denial under consideration and opportunity for hearing, the Commission shall by order grant such registration unless it finds that a requirement of this section is not satisfied, in which case the Commission shall by order deny such registration. The Commission shall conclude administrative action and issue an order granting or denying the application within one hundred and eighty days of the filing of the application unless the Commission finds good cause to extend such period and publishes its reasons therefor.

"(e) A clearing agency registered under this section may, upon such terms and conditions as the Commission may deem necessary in the public interest, for the protection of investors, or to assure the prompt and accurate processing and settlement of securities transactions, withdraw from registration by filing a written notice of withdrawal with the Commission *and by deliverying a copy thereof to the appropriate regulatory agency, if other than the Commission.* If the Commission finds that any registrant or person for whom an application of registration is pending is no longer in existence or has ceased to do business in the capacity specified in the registration statement, the Commission shall by order cancel or deny the registration.

"(f) No clearing agency registered under this section shall, directly or indirectly, participate in the processing or settlement of any transaction in a security (other than an exempted security), or engage in any other activity as clearing agency in contravention of such rules and regulations [as the Commission shall prescribe as] necessary or appropriate in the public interest, for the protection of investors or to effectuate the purposes of this section *(1) as the Commission shall prescribe with regard to matters set forth in subsection (c)(2), or (2) as the appropriate regulatory agency shall prescribe with regard to matters set forth in subsection (c)(3).* [with regard to minimum standards for the performance of functions, measures and personnel standards

for safe handling and custody of securities and funds, operational compatibility of and cooperation by the clearing agency with other persons involved in the securities handling process, and the prompt and accurate processing and settlement of securities transactions.]

"(g)(1) Each registered clearing agency shall file with the Commission, in accordance with such rules as the Commission may prescribe, *and deliver a copy to the appropriate regulatory agency, if other than the Commission,* copies of any proposed changes in, additions to, or amendments to the rules of the clearing agency *regarding matters set forth in subsection (c)(2)* accompanied by a summary statement of the basis and purpose for such proposed change, addition, or amendment. *Each registered clearing agency shall file with the appropriate regulatory agency, in accordance with such rules as such agency may prescribe, and deliver a copy to the Commission, if the Commission is not the appropriate regulatory agency, copies of any proposed changes in, additions to, or amendments to the rules of the clearing agency regarding matters set forth in subsection (c)(3) accompanied by a summary statement of the basis and purpose for such proposed change, addition, or amendment.* No such proposed change, addition, or amendment shall become effective except in accordance with the provisions of this subsection.

"(2) The Commission *or the appropriate regulatory agency, as the case may be,* shall, upon the filing of a proposed change in, addition to, or amendment to the rules of a clearing agency, publish notice of such proposal together with the clearing agency's statement of basis and purpose, and shall afford interested persons a reasonable opportunity for comment on the proposed change, addition, or amendment. Within thirty days of such filing the Commission *or the appropriate regulatory agency, as the case may be,* shall—

> "(A) by order declare such change, addition, or amendment effective if *it* [the Commission finds] that the rules of the clearing agency as so changed are not inconsistent with the requirements of this section relating to the registration of clearing agencies or with the purposes of this section and are not otherwise inconsistent with the public interest, or

"(B) institute appropriate administrative action to determine whether the proposed change, addition or amendment in whole or in part, should be disapproved. Within one hundred and twenty days of the filing of the change, addition or amendment of Commission *or the appropriate regulatory agency, as the case may be,* shall conclude administrative action and shall, by order, declare such change, addition or amendment effective unless it finds that the rules of the clearing agency as so changed are inconsistent with the requirements of this section relating to the registration of clearing agencies or with the purposes of this section, or are otherwise inconsistent with the public interest, in which case the Commission *or the appropriate regulatory agency, as the case may be,* shall by order disapprove such change, addition or amendment.

If the Commission *or the appropriate regulatory agency, as the case may be,* does not declare the change, addition or amendment to be effective or institute administrative action for its disapproval within thirty days of the date it is filed, the change, addition or amendment shall become effective on such thirtieth day with the same force and effect as though it had been declared effective by the Commission.

"(h) Each clearing agency shall at the time of filing a registration statement pursuant to subsection (b)[,] *or* a notice of withdrawal of its registration pursuant to subsection (e), [or copies of any proposed changes in, additions to, or amendments to its rules pursuant to subsection (f),] file copies of such documents with the appropriate regulatory agency.

"(i) If any registered clearing agency takes any disciplinary action against any participant therein, or denies admission to any person seeking participation therein, such action shall be subject to review by the appropriate regulatory agency, on its own motion, or upon application by any person aggrieved thereby filed within thirty days after such action has been taken or within such longer period as the appropriate regulatory agency may determine. Application to the appropriate regulatory agency for review, or the institution of review by such agency on its own motion, shall not operate

as a stay of such action, unless such agency otherwise orders, after notice and opportunity for hearing on the question of a stay (which hearing may consist solely of affidavits and oral arguments).

"(j)(1) In a proceeding to review disciplinary action taken by a registered clearing agency against a participant, after notice and opportunity for hearing and upon consideration of the record before the clearing agency and such other evidence as it may deem relevant—

"(A) if the appropriate regulatory agency finds that such participant has engaged in such acts or practices, or has omitted such acts, as the clearing agency has found him to have engaged in or to have omitted, and that such acts or practices, or omissions to act, are in violation of such rules of the clearing agency as have been designated in the determination of the clearing agency, it shall by order so declare and affirm the action taken by the clearing agency or, if appropriate, modify the sanctions or penalties in accordance with paragraph (2) of this subsection, or

"(B) if the appropriate regulatory agency finds that the evidence does not warrant the finding required in clause (A), or if such agency determines that such acts or practices as are found to have been engaged in are not prohibited by the designated rule or rules of the clearing agency or that such act as is found to have been omitted is not required by such designated rule or rules, the appropriate regulatory agency shall by order set aside the action of the clearing agency.

"(2) The appropriate regulatory agency may, having due regard to the public interest, if it finds that any penalty imposed by a registered clearing agency upon a participant is excessive or oppressive, cancel, reduce, or require the remission of such penalty.

"(k) In any proceeding to review the denial of participation in a registered clearing agency, if the appropriate regulatory agency, after notice and opportunity for hearing and upon consideration of the record before the clearing agency, determines that the specific grounds on which such

denial or bar is based exist in fact and are valid under this section, it shall by order dismiss the proceeding. In the absence of such a determination, the appropriate regulatory agency shall by order set aside the action of the clearing agency and require it to admit the applicant to participation therein.

"(l) The appropriate regulatory agency, after appropriate notice and opportunity for hearing, is authorized, by order, if such action appears to be necessary or appropriate in the public interest or for the protection of investors or to carry out the purposes of this section—

"(1) to suspend for a period not exceeding twelve months or revoke the registration of a registered clearing agency or impose limitations upon the activities, functions, or operations of such clearing agency, if the appropriate regulatory agency finds that such clearing agency has violated any provision of this title, or any rule or regulation thereunder, or has failed to enforce compliance with its own rules, or has engaged in any other activity tending to defeat the purposes of this section;

"(2) to suspend for a period not exceeding twelve months or expel from a registered clearing agency any participant therein, if the appropriate regulatory agency finds that such participant has violated any provision of this title or any rule or regulation thereunder or any rule of the clearing agency; and

"(3) to remove from office any officer or director of a registered clearing agency who, the appropriate regulatory agency finds, has willfully failed to enforce the rules of the clearing agency, or has willfully abused his authority.

"(m) If a proceeding under subsection (l)(1) of this section results in the suspension or revocation of the registration of a clearing agency, the appropriate regulatory agency may, upon notice to such clearing agency, apply to any court of competent jurisdiction specified in section 21(e) or 27 of this title for the appointment of a trustee. In such event, the court may, to the extent it deems necessary or appropriate, take exclusive jurisdic-

tion of the clearing agency involved, and the books, records, and assets thereof, wherever located; and the court shall appoint the appropriate regulatory agency or a person designated by the appropriate regulatory agency as the trustee with the power to take possession and to continue to operate or to terminate the facilities of such clearing agency in an orderly manner, for the protection of participants and public investors, subject to such terms and conditions as the court may prescribe.

"(o) Each registered clearing agency shall make, keep, and preserve for such periods such accounts, correspondence, memorandums, papers, books, and other records, and furnish such copies thereof and make such reports and supply such information and documents as the Commission by its rules and regulations may prescribe as necessary or appropriate to keep current or to supplement the registration statement and documents filed pursuant to subsection (b), to facilitate cooperation among clearing agencies and the prompt and accurate settlement of securities transactions, [to assure the safekeeping of funds and securities held for the accounts of participants,] or for the protection of investors, or the public interest[.], *and as the appropriate regulatory agency by its rules and regulations may prescribe as necessary or appropriate to assure the safekeeping of funds and securities held for the accounts of participants.* The Commission shall promptly furnish to the appropriate regulatory agencies all reports which it receives from registered clearing agencies pursuant to this section. All accounts, correspondence, memorandums, papers, books, and other records of a clearing agency shall be subject at any time to such reasonable periodic, special, or other examinations by examiners or other representatives of the appropriate regulatory agency as such agency may deem necessary or appropriate in the public interest, for the protection of investors or to carry out the purposes of this section. The appropriate regulatory agency shall make a full and detailed report of any examination made of a registered clearing agency and shall promptly furnish to the Commission a copy of any such report. *The Commission shall promptly furnish to each of the appropriate regulatory agencies specified in clauses A through C of section 3(a)(25), a copy of its full and detailed report on any examination of a clearing agency for which*

it is the appropriate regulatory agency having banks as participants, and to the appropriate regulatory agency for any clearing agency examined by it under section 21 of this title.

"(p) The agencies enumerated in section 3(a)(25) of this title shall consult and cooperate with each other and shall advise one another promptly of the pendency or determination of any proceedings, of the promulgation of any rules, and of the entry of any order relating to a clearing agency, participant, class of clearing agencies, or class of participants. At least fifteen days prior to the issuance for public comment or adoption of any proposed rule or regulation regarding clearing agencies, whether pursuant to this title or otherwise, the agency contemplating issuance or adoption of any such rule or regulation shall first consult with and request the views of each of the other agencies enumerated in section 3(a)(25) toward the end that rules and regulations applicable to banks registered as clearing agencies may be, to the maximum extent practicable, in accord with both sound banking practices and a sound system for the prompt and accurate processing and settlement of securities transactions. Nothing in this section shall impair the authority of any State banking authority or other State or Federal regulatory authority having jurisdiction over a person registered as a clearing agency from making or enforcing rules governing such person which are not inconsistent with this section or any rules or regulations promulgated hereunder.

"(q) The Commission shall, on or before December 31, 1976, take such steps as are within its power to bring about elimination of the stock certificate as a means of settlement among brokers or dealers of transactions consummated on national securities exchanges or by means of the mails or other means or instrumentalities of interstate commerce. Commencing in 1973 and ending in 1976, the Commission shall report annually to the Congress (1) the steps it has taken and progress it has made toward elimination of the stock certificate as a means of settlement, and (2) its recommendations, if any, for further legislation to eliminate the stock certificate.". (Sections 6 to 10, inclusive, of S.2058 deal with subjects on which BASIC does not comment, and have not been reproduced here.)

Senator WILLIAMS. Now, Mr. Leon Kendall, president, Securities Industry Association. We welcome you and your associate again to our committee, Mr. Kendall, and look forward to your statement.

STATEMENT OF LEON KENDALL, PRESIDENT, SECURITIES INDUSTRY ASSOCIATION, ACCOMPANIED BY ROGER E. BIRK, VICE PRESIDENT AND DIRECTOR OF OPERATIONS, AND JAY L. CHALMERS, SENIOR VICE PRESIDENT, LEGG, MASON, BALTIMORE, MD.

Mr. KENDALL. Mr. Chairman, our statement will be read by my associate, Roger Birk, who is a member of our operations committee, as well as the director of the Securities Industry Automation Corp. and the National Clearing Corp. Also accompanying us is the chairman of our operations committee, Mr. Jay Chalmers, of Legg, Mason & Co. in Baltimore.

Mr. BIRK. Thank you.

My name is Roger E. Birk. I appear before this committee on behalf of the Securities Industry Association. I am also a director of the Securities Industry Automation Corp., and the National Clearing Corp. In my professional affiliation I am vice president and director of operations of Merrill Lynch, Pierce, Fenner & Smith, Inc. Accompanying me today are Jay Chalmers, senior vice president of Legg, Mason & Co., Inc. in Baltimore and chairman of the SIA's operations committee, and Leon T. Kendall, SIA's president.

Senator, the SIA appreciates this opportunity to address itself on behalf of its brokerage firm members to the proposals now before your subcommittee on clearance and settlement of securities transactions. In introducing S. 2058, Senator Williams said:

> The first purpose of the bill is to create a system of regulation and decision-making which extends to every facet of the securities handling process—corporate issuers, transfer agents, clearing agencies and depositories. Only by the creation of a central unifying authority in operational matters can paper handling problems be squarely addressed.

We support S. 2058. We strongly urge Congress to act on the legislation in this session, for its implementation can enhance materially the ability of our industry to make sound decisions on operational issues. It can serve to strengthen the performance of public securities markets.

The nature of the operational problems which were visited upon the securities business during the late 1960's has been well documented during previous hearings before this subcommittee. Our purpose today is not to add to that already extensive record. However, our testimony would be incomplete if we did not set before you our judgments as to the extent to which our industry has been successful in overcoming these difficulties. We also wish to point out why further progress and resolution of the operational challenge requires a coordinated and modern regulatory apparatus capable of overseeing a fully integrated, lower cost national securities processing network.

As SIA noted in May 1972 when it appeared before this committee, the causes of the securities transaction processing problem were twofold: paper and the segmentation of the securities processing industry itself.

On the paper side, the documents and procedures in use during the 1960's were too old fashioned, too slow, too complex. They did not permit the prompt, efficient handling of the enormous upsurge in volume experienced during the bull market of the 1960's. Since the late 1960's, when the problem was first identified, the brokerage community has made significant strides forward in its capacity to process securities. Let me list just some of these improvements for you. (1) Securities firms have upgraded significantly the caliber and capabilities of the operations work force. Between 1966 and 1971, stock exchange firms added 2.3 operations and administrative-support personnel for each new saleman. The percentage increases were 52 percent in the operational and support area versus a 37 percent gain for the sales force. Training of supervisory and clerical personnel has been upgraded markedly. Clerical turnover in New York City has been reduced from 55 percent per year and more in 1968–70 to under 40 percent in mid-1972, and is markedly lower in many firms.

(2) Firms have modernized operating systems through major investments in automation. A survey of seven large firms last year revealed that their computer capacity has increased by 80 percent over the level that existed in 1968. The number of programers employed by these firms, a sign of the quality of such effort, has more than doubled in the same period. Joint industry activities, such as the NYSE's direct mail clearing facilities, the Midwest Service Bureau, and the Pacific Clearing Corp. have provided expanded operational capacity for most firms.

(3) The industry has created a series of new centralized facilities designed to simplify the settlement of securities transactions and to immobilize stock certificates.

(a) The Depository Trust Co. (formerly Central Certificate Service of the New York Stock Exchange) has reduced the physical handling of securities in transactions between brokers and is on the way to doing the same in the settlement of transactions with banks.

(b) The National Clearing Corp. (NCC), created by the NASD, is producing needed improvements in processing of over-the-counter securities.

(c) The New York and American Stock Exchanges merged their stock clearing operations into the Securities Industry Automation Corp. (SIAC) to eliminate duplication and standardize industry clearing efforts.

(d) The SIA Securities Processing Committee, made up of representatives of both national and regional firms, is at work on the goal of a single, cost effective clearing and depository system.

(4) Reporting and internal control systems have been upgraded materially throughout the industry, so management can be made quickly cognizant of potential problems in the operational area.

(5) Interrelationships between banks and brokers in the processing of securities transactions have been enhanced through a number of cooperative programs. The Joint Industry Control Group has effected improved EDP procedures in the receipt and delivery of securities, transfers and dividends. The CUSIP numbering system with its standard identification for securities is operative. BASIC contributed a number of studies and recommendations that materially aided this cooperative effort.

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(6) In the area of rulemaking, the SEC, the exchanges, and the NASD, have made important changes in the interest of safeguarding customers securities, as well as to streamline operational activities.

(a) The net capital rule of the New York Stock Exchange was modified last year to reduce the maximum capital ratio and to provide an early warning system when a firm's ratio reaches 10 to 1. Also, securities differences and aged dividend receivables produce a mandatory charge against capital, whereas previously there was discretion in treating such items.

(b) SEC rules were adopted to require all firms to physically count securities in their possession, at least quarterly. New rules on segregation of customers' funds and customers' securities were adopted.

(c) Rules required monthly reports to be submitted to the exchanges and the NASD on operational performance, capital strength, and profitability.

(d) In the over-the-counter area, the NASD has effected rules on mandatory buyins of OTC securities and introduced new standards through its National Clearing Corp.

The partial listings of firm and industry actions attached to this statement as appendix A and B indicate that a great deal has been done to upgrade operational facilities and to assure that the difficulties which occurred in 1967 and 1968 will not be repeated. Our industry today is able to handle with facility much higher volumes than it could in 1968. Robert Gardiner, chairman of SIA, before the House Securities Subcommittee last year expressed the view that securities firms were capable of handling without an operational jam daily trading volume in a magnitude well above 20 million shares on the NYSE, 10 million on the AMEX, and 15 million in NASDAQ securities. This would be nearly twice the volume that caused the industry to operate on a 4-day trading week and under shortened hours in the late 1960's. We believe his estimate continues to be a reasonable assessment of the capacity of the operations side of our industry.

One cannot, however, make such a statement without some concern for the current profitability problems of our industry. These improvements have not occurred without the addition of new costs to securities firms. These costs have been introduced in the interest of better customer service. Furthermore, inflation over the past several years has added to the burden on the operations and administrative budgets of securities firms.

Thus, a great deal has been done to overcome the so-called paperwork crisis. More can and should be done to solve problems in the area of segmentation. Segmentation of the industry refers to the fact that the clearance and settlement of every securities transaction demands prompt and coordinated action by a number of different organizations, each functioning within the processing network. These various participants include brokerage firms, banks, transfer agents, depositories, the exchanges, public corporations, institutional investors, and banknote printers.

This operational segmentation follows through to the regulatory area as well. There are perhaps a dozen noncoordinated entities sharing the regulatory responsibility for securities transaction processing. None presently has the authority to exercise the leadership needed to set the standards for successful modernization of our system for com-

pleting securities trades. There is a need to convert today's self-limiting segmented system into a coordinated whole, into a modernized unity consistent with the speed and efficiency being built into securities processing by today's operations managers.

Turning to the specific legislation before this committee, we find ourselves in agreement with the approach to the segmentation problem proposed in S. 2058. We believe it identifies the need to give a single agency the primary responsibility over all organizations in the clearance, transfer, and depository process and feel that the Securities and Exchange Commission is the appropriate body to vest with such responsibility. The SEC is already clearly identified in the public mind as the primary body responsible for such efforts. S. 2058 also balances the need for regulatory unity with the need for efficiency which flows from allowing the various rules and regulations as they apply to banking institutions to be administered through already established lines of examination and enforcement via the Federal Reserve, the Controller of the Currency, and the FDIC. However, we must express some apprehension as to how the coordination of powers given to banking authorities in the individual 50 States will work in practice. We would hope that the outcome will be to enhance rather than inhibit the early resolution of the segmentation question.

Section 17A of the bill deals with depositories and clearing units under a single set of legislative provisions. It is imperative that the main effort in the banking area be to get securities held by banks and bank trust companies into a common depository with those held by broker-dealers. Nothing in S. 2058 should deter the earliest possible action here. The comments of BASIC strike us as a reasonable approach to the depository issue and we would have no objection to separate treatment for depositories. As to the ownership of depositories, we subscribe to the concept that they should be user-owned and managed and not tied to stock exchanges. If such ties are necessary for the time being as a matter of State law, so be it, but let's not tie to that. We do not necessarily regard the areas of clearance and depository as a function of a particular securities market. It is the goal of SIA and its member organizations to form a single central clearance and depository system with potential for input and access across the Nation. Such a system is viewed as capable of serving all individual stock exchanges as well as the OTC market.

Senate bill 2058 directs the SEC to take such steps as it can to bring about elimination of the negotiable stock certificate as a means of settlement among brokers. Immobilization of the stock certificate is not only a desirable but an absolutely necessary objective of a modernized securities processing system.

Senate bill 2058 takes note of the fact that the practice of "street name" registration, which serves many useful purposes, may also be creating problems in communications between corporations and their shareholders. A study and report by the SEC on this matter is certainly appropriate, but again we would urge that the Commission be allowed sufficient time so that it can do its work adequately.

We strongly support the proposal in S. 2058 which would prevent the application of State and local transfer taxes simply because the transfer is effected through the facilities of a clearing agency located in the taxing jurisdiction. This provision would add materially to the development of a truly national clearing and depository network.

In closing, may I state that the Securities Industry Association enthusiastically endorses the main objective of the legislation you are considering here today. No group has a stronger interest in a modernized efficient securities processing system than our brokerage members. These organizations are the primary point of contact with the investing public. When in the past our individual or institutional customers were beset by errors or delays because the system as a whole broke down, our customer goodwill was injured. Brokerage firms must pay the overtime, pay the cost of corrections, put up the extra capital, submit to the new rules and restrictions, pay for the operational experiments, and repair the damaged public image inflicted on our industry. The securities industry has done a great deal to improve its operational capacity and performance. But, as we hope we have made clear, many things need to be done that the industry cannot do entirely by itself. Early action on this legislation will go a long way toward correcting that situation.

[Appendixes A and B follow:]

APPENDIX A—OPERATIONAL IMPROVEMENTS AND PROCEDURES IMPLEMENTED WITHIN SECURITIES FIRMS, 1966–73

Instituted operations training program:
- In-house program.
- Industry-wide orientation programs—SIA, NY Institute of Finance, others.
- Supervisory seminars.
- Executive management training.

Established internal audit departments.
Developed error control procedures.
Developed message switching and order match system.
Established operations control departments to alert senior management daily of operations status.
Instituted daily monitoring of stock record, fails to receive and deliver, money flows.
Installation of private voice and telex grade communications systems between member firm operating units.
Increased use of uniform securities identification procedures.
Implementation of securities validation procedures.
Increased use of microfilming techniques for research of stock record differences, transfers and the locations of securities.
Instituted daily credit department customer activity reports.
Developed branch operations checklists.
Upgraded physical security measures:
- Screening of Incoming Visitors.
- Badges.
- Finger-printing.
- Hiring of Security Professionals.

APPENDIX B—OPERATIONAL IMPROVEMENTS IMPLEMENTED BY MAJOR SECURITIES INDUSTRY ORGANIZATIONS, 1966–73

American Stock Exchange (ASE):
- Feedback and analysis of control statistics (FACS).
- Joint regulatory report (NYSE & ASE).
- North American Rockwell Report (Oct. 1969).

Banking and Securities Industry Committee (BASIC):
- CUSIP implementation.
- Forms standardization (Transfer Instruction—Delivery Ticket—Comparison—Reclamation Form).
- Comprehensive securities depository system.
- Uniform stock transfer rejection form.
- Uniform transfer requirements.
- Uniform reclamation or rejection form.

Depository Trust Company (Formerly CCS):
- Establishment of regional depositories.
- Institutional delivery service (IDS).
- Pre-authorized delivery quantity service (PDQ).
- Collateral loan program.
- Institutional PDQ.
- Interface with other depositories.

New York Stock Exchange (NYSE):
- Adopted rule 387—(Timely Transmission of P&S Confirmation Data to C.O.D. Customers).
- Amended rule 201—(Good Delivery Rule).
- Rule 496 (NYC Transfer Drops For Out of Town Banks).
- Joint regulatory report (NYSE & ASE).
- Customer complaint form.
- Mandatory "buy-in" form.
- Adopted rule 412 (Transfer of Customer Accounts Standardization).

National Clearing Corporation (NCC):
- Envelop delivery service.
- Trade comparison.
- Transfer service.
- Bond trade comparison and clearance.
- Intercity clearing.

Regional Exchanges:
- Immobilization of stock certificates (book-entry).
- Direct mail clearing.
- Delivery of securities to financial institutions via National Clearing Corporation.
- Continuous-net-settlement service.
- Margin clearing accounts.
- Locked-in-trades.
- Transfer Agency Depository (TAD).
- Free stock transfer service.
- Facility management for National Clearing Corporation (NCC).
- Institutional clearing programs.
- Daily mark-to-the market.

Securities & Exchange Commission (SEC):
- Rule 17a–13: Require mandatory quarterly count of all securities held in physical possession and the mandatory quarterly verification of all securities in:
  - a) Transfer.
  - b) In transit.
  - c) Borrowed.
  - d) Pledged.
  - e) Deposited.
  - f) Fail to receive.
  - g) Fail to deliver.
- Rule 15C3–3: 1) Requires cash reserve formula. 2) Requirement to obtain possession of securities sold for a customer within 10 business days after settlement date. 3) Mandatory buy-in of short securities differences with 45 days after count or verification.

Securities Industry Automation Corporation (SIAC):
- National stock transfer service.
- Dividend settlement clearance.
- Broker originated window ticket (BOWT).
- Correspondent delivery & collection service (CDCS).
- Locked-in-trade (In Planning Stage).

Senator WILLIAMS. Thank you very much, Mr. Birk.

This, of course, is a statement that will be most useful to committee members and, as we proceed in writing up this legislation, helpful to the Members of the Senate when we go to the floor. It certainly comes from high authority and it is a strong and persuasive statement.

I am impressed with the appendix A which describes the operational improvements and procedures implemented within the securities firms through the period 1966 to 1973, and even though you are

on a wave of improvement you see that this legislation is still necessary.

Mr. BIRK. That is correct.

Senator WILLIAMS. I appreciate it again.

I wonder, Mr. Birk, as an operations officer of an individual securities firm, could you describe for us the economic consequences of the operational segmentation which as you have described as characterizing the current status of the securities industry's paper processing efforts and its regulation?

Mr. BIRK. Senator, are you referring to what might be saved, on the cost—is that your question?

Senator WILLIAMS. Yes.

Mr. BIRK. We have given some thought to that question. Although we do not have specific numbers, as the bill is proposed, which would unify all the clearing and depository systems and would probably get rid of the certificate between settlements on the Street, so to speak, we can certainly see a 25- to 30-percent saving in the home office or the back office expense, as a result of this kind of unifying action.

Mr. Chalmers, do you want to comment?

Mr. CHALMERS. I concur with Mr. Birk's judgment. Within the home office itself we should have a saving of somewhere between 25 to 30 percent with the implementation of a single clearing and depository facility.

Senator WILLIAMS. That is a significant percentage.

Mr. CHALMERS. Yes.

Mr. BIRK. One further point, we have been paying for the establishment and maintenance of as many as 12 or 13 different systems, but perhaps more significantly, we have been paying rather dramatic interest costs as a result of our inability to move securities promptly due to segmentation. This is probably the most significant cost.

Senator WILLIAMS. Well, do you have anything further? Thank you very much, gentlemen.

[Discussion off the record.]

Senator WILLIAMS. We shall reconvene here with the statement and appearance of Mr. Bernard O'Connor, president of U.S. Banknote Corp.

Mr. O'CONNOR. I am senior vice president, not president.

Senator WILLIAMS. All right.

STATEMENT OF BERNARD O'CONNOR, SENIOR VICE PRESIDENT, U.S. BANKNOTE CORP., ACCOMPANIED BY WILLIAM J. VANDEN HEUVEL, COUNSEL

Mr. O'CONNOR. This is Mr. William Vanden Heuvel, my codirector.

Senator WILLIAMS. Very nice to have you. The forum is yours, sir.

Mr. O'CONNOR. Senator, we would like to talk about certain aspects of S. 2058, particularly in connection with the SEC taking steps to bring about the elimination of the negotiable stock certificate as a means of settlement among brokers or dealers of transactions consummated on national securities exchanges or by means of instrumentalities of interstate commerce, the study and investigation of so-called street-name registration problem; and the empowering the SEC to prescribe the form or format of the stock certificate.

While we do not object to the overall goal of this proposed legislation, we do wish to call attention to segments which could adversely affect the investor.

I will subsequently, in my testimony, discuss measures that are necessary to protect the individual investor.

We last appeared before your subcommittee on September 30, 1971. At that time we pointed out that the stock certificate, a readily negotiable instrument, is a permanent authentic detailed record of shareholder ownership. Today we reaffirm that position.

An investor having the stock certificate need not be concerned if his broker fails or even if any computer fails. He is assured of receiving—directly from the issuing corporation—all communications including those required by the SEC. A recent article in the New York Times touched on other reasons why the stock certificate is desirable—the pride of possession—using stock for collateral.

Many brokers urge their customers to take delivery so the brokers can avoid the responsibility of dividends, proxies, safe storage, and monthly statements.

The distrust because of continuing failures and threats of failures in the street is heightened just by reading the newspapers. For example, the Wall Street Journal reported on June 11, 1973, that, as an aftermath of the Weis securities fiasco, the SEC met privately with exchange officials to review the exchange's surveillance program (or early warning system). A SEC enforcement official was quoted as saying, "If you've got fraudulent statements, I guess a guy can beat the system."

This meeting wasn't an alarmist step indicating any failure of the exchange's early warning system. Eleven days later, on June 22, 1972, the New York Times reported that "Nine member firms have been placed under special, intensive surveillance by the New York Stock Exchange because of financial difficulties and some of them probably will have to be liquidated" according to a big board official. These nine firms were among 68 member firms that had been placed on the early warning list.

In the same article it was reported that one member firm allegedly spread false rumors about another member firm's financial condition.

This environment demands the protection of the small investor—not with SIPC, but with his stock certificate.

(2) In 1971 we pointed out the vulnerability of the computer, particularly in two areas: fraud and manipulation. I suppose this point could be currently confirmed just by equity funding. However, now some 140 cases of computer abuse have been documented by a specialist in computer-related crime. These cases included vote fraud, manipulation for profit, manipulation for theft of services, theft of confidential information, and vandalism. The perpetrators or suspects were a policeman, claims and welfare employees, private citizen, elected official, and electronic data processing employees. Interestingly, not one computer abuse was discovered through routine audits or checkups. Every time, the guilty party was uncovered through some chance event—like the teller for a savings bank in New York charged with embezzling $1,500,000. He was dicovered when police raided a bookmaking operation and found his name as a $30,000-a-day bettor.

(3) In our previous appearance here we pointed out that the depository concept as well as the proposed certificateless society poses serious problems.

One involves street name layering superimposed on the present nominee practice. This will further remove and alienate the investor from the corporation (or corporations) in which he owns stock, and make a mockery of shareholder democracy. This problem, acknowledged in your proposed legislation requiring a study by the SEC, makes the retention of the stock certificate increasingly important.

(4) In 1971 we proposed, as a feasible and sensible intermediate paperwork system, the adoption of a man and machine readable stock certificate—readable by means of optical scanning—together with standardization of supplementary forms involved in the stock processing procedure. It is interesting to note that the New York Depository now is using the optical scanning technique for the control and movement of stock certificates in its possession.

As we emphasized before—and our viewpoint applies more so today—in any of the studies relating to the securities industry problems there has been little, if any, representation by corporations or the average shareholder. Reecntly, at the initiative of the American Stock Exchange Listed Company Advisory Committee, corporations have organized to make known their concern about the withdrawal of the small investor from the marketplace, the ever-shrinking number of stockholders, the liquidity of the stockmarket, and the drying up of the new issue market.

The fact is that in this intervening period the market has been inactive—small investors have looked elsewhere and the new issue market is at its lowest ebb for many years.

The small investor unfortunately has no organized representation and while many reasons are given for his absence from the market the fact remains that he has deserted it.

The exchanges and some member firms are developing public relations programs to bring him back.

In this connection, let me quote a few pertinent excerpts from a recent study on small investors conducted for the New York Stock Exchange. The study points out, among other facts, that small investors tend to view the securities industry with an air of caution, particularly in regard to the industry's financial stability—two-thirds feel that their stock certificates are safer in their own hands than in their brokers' custody.

We strongly suggest that one way to bring the small investor back is to assure him that he will receive his evidence of proprietary ownership, the stock certificate, and not be at the mercy of irresponsible brokers and computers. Computers have yet to convince us that they are fraud proof.

Speaking directly to your proposed legislation:

(1) You direct the SEC to bring about the elimination of the stock certificate as a means of settlement in brokers or dealers transactions. Your introductory statement to the legislation says that this provision would in no way preclude the individual shareholders from demanding and receiving certificates as proof of ownership of the shares. This legislation, in our opinion, falls short in one important aspect. The legislation must spell out the automatic right of the investor to receive his

stock certificate. I respectfully submit that such language must be a part of any legislation that is ultimately developed.

The reasons are real. Under the provision related to the elimination of certificates in broker or dealer transactions, the investor will be induced not to take his stock certificate, particularly by those broker-dealers who become members of depositories. If this be so, then this legislation will be misused to accomplish the immediate transition to a certificateless society. In reality, the selling investor will give up his certificate for cancellation and the buying investor will be induced to leave his stock with his broker. So the "street" will be able, unless specifically regulated, to effect by indirection what obviously is not intended by your proposed legislation. This is similar to the use of tax loophole laws for benefits beyond which they were intended at the time of passage.

Our other objection is to the word "demand." It doesn't clearly identify the mechanics by which the investor makes his demand. More importantly, why does he have to demand? Certainly much legislation has been passed to protect the consumer—even against himself.

Our position is clear—the investor must be protected like any other consumer in his inherent right to receive, promptly, whatever he purchases.

Failure to provide this protection to the public will cause the same relative chaos that occurred in the 1969–70 era when the SEC was inundated with complaints of individuals demanding their stock certificates.

(2) Your proposed legislation authorizes the SEC to make a study of street name registrations. This important study should be completed before a final decision is made relative to the elimination of certificates in broker-dealer transactions. We make this suggestion because the study will delve into the very heart of corporate-stockholder communications gap, which is seriously affected because of street name registrations.

(3) Another provision of your proposed legislation requires that securities be in a form or with a format as prescribed by the SEC. In our opinion the SEC has long had the right to develop the form or format of the stock certificate. The history over recent years has indicated their all-too-ready acceptance of the punchcards, which proved unworkable. Later, under Commissioner Casey, the SEC readily endorsed the total certificateless society.

A very current development—and I don't know, Senator, whether your subcommittee or the SEC are aware of this next point: A very current development is the use of the single denomination certificate which today is actually being used, on a pilot basis, despite a critical, objective report that it is extremely vulnerable to alteration by fraud artists. Therefore, we suggest that any further development in the form or format of the stock certificate be required to be reported by the SEC to your committee prior to adoption—in the public interest. We, of course, will make our proposals directly to the SEC at the proper time.

We feel that your proposed legislation is an honest attempt to attain your objective in an orderly fashion, through long-range, well-conceived planning. However, we feel very strongly that in planning for the future you cannot ignore what will happen tomorrow.

Many significant contributions could be made now for over 30 million constituents who will be affected by your legislation. We urge the adoption of our proposal that investors be given the legislative right to receive their stock certificates without demanding them.

Your bill authorizes the SEC to straighten out the securities industry. But while this is going on, the Commission should be subject to another mandate—protecting the rights of investors, particularly the small investors. Increased concern for them should ultimately result in decreased apathy they now manifest toward the "Street."

In essence, we are requesting that you insure your concern for the individual investor by guaranteeing him protection in the legislation.

Thank you very much for your kind attention.

Senator WILLIAMS. Well, we appreciate your statement, Mr. O'Connor. I'll tell you, I have to leave. There is a vote in progress, one that is important to some of my other work.

You are familiar with how we handled the stock certificate in terms of the individual investor last year?

Mr. O'CONNOR. That is correct.

Senator WILLIAMS. And we still subscribe to that principle. We did in that bill and we do in this bill allow individual investors to hold certificates. We certainly will include it in our report, unless the bill language is changed, that might in terms of an option. You put it in terms of a mandate, however, a mandate that the investor must get his certificate.

Mr. O'CONNOR. Yes. In that connection, we strongly feel while your introduction covers the point of demand and receive, the legislation does not; and therefore, you have what I analogize as a tax loophole situation. I can see and virtually predict that there will be misuse now even though your legislation requires further legislation for ultimate elimination. You ask the SEC for recommendations, if any, for further legislation to ultimately eliminate the stock certificate, if I understand it correctly.

Senator WILLIAMS. Well, yes, in the broker-dealer transaction. That is a significant link. The bill says: "To bring about elimination of the stock certificate by means of a settlement among brokers or dealers in transactions consummated on national securities exchanges."

Mr. O'CONNOR. Your last subparagraph has words to the effect "and recommendations, if any, for further legislation to eliminate the stock certificates."

Senator WILLIAMS. As a means of settlement, yes, and the last sentence, "recommendations, if any, for further legislation"—another step—"to eliminate the stock certificate." I certainly agree with you that the "street name" study should antedate any conclusions here, no doubt about that. I wish we could discuss this further but this vote is one that I have to make. Thank you very much.

[Recess]

Senator WILLIAMS. Mr. Peter Del Col, president of Bradford Computer & Systems, Inc. We are pleased to have you.

STATEMENT OF PETER DEL COL, PRESIDENT, BRADFORD COMPUTER & SYSTEMS, INC., ACCOMPANIED BY LLEWELLYN P. YOUNG, VICE PRESIDENT AND COUNSEL

Mr. DEL COL. Mr. Chairman, I am president of Bradford Computer & Systems and with me today is Llew Young, vice president and counsel of Bradford. I would like to take a minute and explain what Bradford does and why it is vitally interested in this legislation. Bradford began operations in February of 1968. In the first 11 months of its existence it had revenues of under $1 million. At the present time, its rate of annual revenues is well over $40 million. This pattern of growth tells a great deal about what has happened in securities processing during these years. Bradford, through a number of joint ventures with major banks, is among other things the largest transfer agent in the world. It services some 1,200 corporations and their approximately 6 million shareholders, including some 1 million mutual fund shareholder accounts.

Bradford entered securities processing through the servicing of mutual fund shareholders. It was 1969, and many transfer agents were having serious difficulties with their mutual fund shareholder servicing. The books of the funds were out of proof, shareholders were plagued with errors and delays, and the transfer agent business was showing large losses. The small shareholder, who couldn't get delivery of his shares, was the first victim of the paper crunch. Bradford stepped in with its newly formed subsidiary, Bradford Mutual Fund Services, Inc., and took over the shareholder servicing for a handful of funds. It was a success from the start, and today Bradford services some 45 funds. The reasons for its success are several. First, it developed an excellent computer-clerical operating system. Second, it was staffed with dedicated, enthusiastic people. Lastly, it did the shareholder servicing on the simplest machines that would do the job, at centers dedicated solely to shareholder servicing. It was a professional performance. Many banks, on the other hand, had treated shareholder servicing as a stepchild, to be done on the banks' gigantic computer complexes only after all of the other and more profitable banking matters had been attended to. Bradford had only one matter to attend to—shareholder servicing.

In 1971 Bradford entered stock transfer for commercial companies with another subsidiary, owned largely by it and partly by Marine Midland Bank. This subsidiary took over the corporate agency division of Marine Midland, including that division's personnel. Marine Midland remained the named transfer agent, but Bradford did the actual work.

This joint venture with Marine Midland was followed in March of 1972 by a similar arrangement with Bankers Trust Co. In December 1972 a similar arrangement was made with Franklin National Bank. Most recently, in April of this year, a similar arrangement was made with Mellon Bank in Pittsburgh. In connection with each bank, Brad-

ford operates a facility dedicated entirely to stock transfer. At one of these facilities Bradford took over a stock transfer department that was servicing 725,000 shareholder accounts with close to 500 employees. At the present time this facility services 1,400,000 shareholder accounts with less than 250 employees.

The chief reason for Bradford's success in stock transfer operations is that it provides all shareholders with complete shareholder services. This is the same small shareholder that the industry has been prone to forget in the past few years, and who recently has begun to forget the industry. A transfer agent can and should do much more than just transfer stock. Bradford is gradually becoming a shareholder servicing agent. It is providing, and planning to provide, individual shareholders with a number of important services which the securities industry, as it is currently constituted, has found unfeasible or uneconomic. These services include investment of dividends and cash payments for individual shareholders through bulk purchases; custody safekeeping in the form of certificateless book-shares, regardless of the size of the individual shareholding; gradual liquidation and systematic withdrawal of proceeds of sale for retirement or other purposes; and direct book-share transfers through debit/credit entries without certificate issuance—unless requested.

Because of the severe back-office crisis, the last few years have seen accelerated attempts to modernize the system of buying and selling securities and delivering certificates. Particularly to brokerage houses and banks which execute large trades, it has become clear that the financial risks involved in long delays in getting certificates out of some transfer agents could not continue. Some other safe entity had to be created in which existing certificates could be warehoused under one name and transfers among the warehousers—more properly, settlements—accomplished by bookkeeping entries of debits and credits—very much like the wheeling from one cage to another of the gold bars in the mythical balance of payments room of the Federal Reserve.

But 2 years ago the only entity legally able to run a depository warehouse was a stock exchange, through a subsidiary called a clearing corporation under a State's Uniform Commercial Code. While brokerage houses could use that warehouse, banks were unwilling to relinquish custody of their enormous security holdings to a depository over which they had no control and no part of the action. So the securities and banking industry pushed for amendments to the Uniform Commercial Code in various States—and have in part succeeded—to allow banks and certain other regulated industries—insurance companies and mutual funds—which hold large blocks of securities to run the warehouses in connection with the stock exchanges.

Under the pressures of their own immediate needs and the desire to get a quick handle on part of the problem, the use of the warehouse was limited exclusively to owners of stock of the warehouse corporation—not everyone is eligible. In fact, over 30 million shareholders are not eligible. And the actual custody of the certificates will largely be farmed out to the bank owners of the warehouse—a piece of the action. All that this means is that certain institutions store in a central warehouse stock certificates held in their own or nominee name.

There was no time 2 years ago to think of the individual stockholder who has the identical interest in avoiding delays, loss and theft of

his smaller certificate. And there was no time then to think beyond storage to the elimination of stock certificates. This committee must pause over the interests of the small stockholder and give him the same options that the warehouse gives to financial institutions, and perhaps more. It is essential to analyze the securities industry, not by add-ons to the traditional ways that transfer agents and brokers handle securities, but from an objective viewpoint of what is the most efficient and cheapest way to accomplish securities processing and transfer and at the same time to protect and involve the small investor. The depository warehouse is only the first step down that road; the next is contained in our comments on the current legislation.

Against this background, let me explain Bradford's reaction to S. 2058. Bradford strongly supports the registration and regulation of transfer agents and clearing agencies. It asks only that the regulation be consistent and that it be uniformly enforced and applied across the board to all engaged in securities processing, including banks and their subsidiaries, companies doing their own recordkeeping, professional independent transfer agents, stock exchange subsidiaries, and brokerage houses and their subsidiaries in the securities clearing business.

In one respect, Bradford believes that S. 2058 in its present form falls short of its goal, "to provide for the development of an integrated national system for the prompt and accurate processing and settlement of securities transactions."

Let me illustrate my point by telling you that at each of Bradford's stock transfer facilities the largest account by far is an anonymous account that goes by the name of CEDE & Co. As you know, CEDE is the nominee name for the Depository Trust Co.—hereinafter called DTC—formerly known as the Central Certificate Service, Inc. These CEDE accounts are getting bigger every day. This bill seems primarily designed to implement one or more DTC's to facilitate securities settlements between brokers. Bradford believes this is not enough. The small shareholder should also be served. While DTC may facilitate—at considerable expense, I might add—the settlement of securities transactions as between brokers, it does little to stem the flow of paper stock certificates among investors. We as a transfer agent are constantly peeling shares from a big CEDE jumbo certificate and giving DTC the change, or adding shares to a CEDE certificate and giving DTC a superjumbo. After all, a securities transaction results in the transfer of a security from one investor's portfolio to another investor's portfolio. So long as these portfolios take the form of the stock certificates, we still have the paperwork blizzard with all of the real or potential errors, delays, and expense that are involved.

The transfer agent has a unique potential capacity to solve this problem through the use of book shares and book-share transfers. The transfer agent and its records are at the heart of the flow of securities. With book-share transfers, no paper stock certificates are involved unless the shareholder insists. Transfers are executed through debit and credit entries on the transfer agent's books. With street name and nominee name certificates, the real flesh-and-blood shareholders are getting more and more remote from the corporations which they own. This book-share approach to recordkeeping will assist materially in bringing the corporation and its owners together.

Book shares are not a novelty. Most of the more than 8 million shareholders of mutual funds do not have certificates unless they specifically request them. Bradford estimates that over 1 million shareholders are currently availing themselves of dividend reinvestment and cash payment plans that utilize book shares rather than certificates. This is one reason why these plans can be operated so inexpensively and accurately. DTC uses book shares and makes book-share transfers for brokers, but not for investors. Securities held by brokers for customer are book shares—except that they are on the broker's books, not the corporation's books. If transferred agents whose procedures and records meet the standards contemplated by S. 2058 are empowered to transfer shares on their records through the use of book-share entries, a vast amount of paperwork and errors and expense and delays can be eliminated.

The legislation in its present form perpetuates the preoccupation with broker-dealer settlements and does not make provision for the needs of the average individual investor. In Bradford's view, S. 2058 should be amended in such a manner as to provide the individual investor with a securities processing system offering him the same opportunities and advantages that DTC offers to the professionals.

Annexed to my statement is an appendix setting forth the language of the amendments that Bradford recommends. Simply stated, the amendments would authorize a transfer agent to maintain a system to effect the transfer, loan, or pledge of securities without the physical delivery of securities certificates, by means of appropriate entries on its books. This is precisely the system now maintained by DTC for brokers and institutions. Each broker has a book-share account with DTC. As part of the settlement of a securities transaction, DTC transfers shares from one broker's account to another broker's account. Physical certificates do not change hands.

Under the amendments that Bradford proposes the transfer agent would provide a similar system for the individual shareholder. Each shareholder now has an account with the transfer agent showing the certificates in his name and the number of shares. Instead of issuing a new certificate and canceling an old certificate each time securities are to be transferred—as is done now—the transfer agent would simply credit one shareholder account and debit another shareholder account. No certificate would be issued unless it were requested.

For example, if the investor's holdings were in book-share form, upon their sale by him they could be transferred directly to the account of the purchaser on the transfer agent's books. In the case of settlements between brokers, shares could be transferred by book entries either directly from one broker's account to another broker's account with the transfer agent or to and from a DTC account with the transfer agent. There would be no need for a vast paper flow into and out of jumbo certificates, with documents going through many hands and each time multiplying the opportunities for error and increasing the time and expense of a transfer.

Small investors need this service as much as the banks, brokers, and institutions. Certificates can be lost, mutilated, or stolen. The small investor cannot afford a custody account with a bank—but he could afford a book-share custody account with his transfer agent. The small investor is reluctant to trust his certificates to his broker for safekeeping—but book shares with his transfer agent are safe.

Bradford does not suggest that book-share transfers by transfer agents should be a substitute for DTC. It recommends them as a supplement to DTC. The present jumbo certificates could be replaced by book-share accounts with the transfer agent in the name of DTC. Broker-dealer settlements would continue to be made by DTC as in the past. The only difference is that the flow of certificates to and from DTC and the transfer agents would cease.

Bradford feels that future securities processing should not be structured in such a way as to confine it to the hands of a few major bureaucratic institutions. The average investor should not be saddled with the all or nothing risks of a single clearing system. When such a monopolistic clearing system made a mistake, it would have to be a beauty. The path should be kept open for private enterprise and the spirit of competition. Bradford as a transfer agent is prepared to effect book-share transfers in the manner that I have described the minute that a bill authorizing it becomes law. It is equipped to do so today.

Bradford's proposed amendments do not require transfer agents to effect securities transfers through book-share recordkeeping. They only permit them to do this. The proposed amendments do not legislate the elimination of the stock certificate—they merely establish the machinery for their eventual elimination, and in the meanwhile any shareholder who wants a stock certificate will get it.

[Appendix follows:]

APPENDIX

PROPOSED AMENDMENTS TO S. 2050

Insert after Section 17B(a)(3), line 11 of Page 23, the following:

"(4) Any transfer agent registered in accordance with this section shall, subject to such rules and regulations as the Commission may prescribe as necessary or appropriate, have the right to maintain a system either directly or through one or more affiliates to effect the transfer, loan or pledge of securities without the physical delivery of securities certificates by means of appropriate entries on its books, and any such transfer, loan or pledge shall have the same legel force and effect as if the same were carried out by a clearing agency or clearing corporation acting pursuant to applicable state law."

Delete the second "and" in line 21 of page 22.

Delete period in line 16 of page 22 and insert:

"and the maintenance of a system for effecting a transfer, loan or pledge of securities by bookkeeping entry."

Delete "or" in line 25 of page 3. Delete period after "securities" in line 25 of page 3 and insert:

"or (E) maintaining data processing or other bookkeeping records of holders of such securities and a system for effecting the transfer, loan or pledge of such securities without the physical delivery of securities certificates by means of appropriate entries on its books."

Senator WILLIAMS. Thank you very much, Mr. Del Col. You certainly have come into a tangled business with a very efficient system of meeting a particular need in the securities industry.

Mr. DEL COL. Thank you.

Senator WILLIAMS. When did we last talk? Was that last year or the year before?

Mr. DEL COL. About 2 months ago.

Senator WILLIAMS. Was it that—it seems like 2 years ago. A lot has happened. Let me ask you, where is your business operation?

Mr. DEL COL. We have facilities in New York City, in Manhattan. We have three facilities operating in Manhattan in separate locations. We have one facility operating in Pittsburgh and we have two facilities operating in Boston.

As a matter of corporate philosophy, we believe that small decentralized computer clerical operations are more profitable to manage and easier to manage than one huge centralized mass of clerks.

Senator WILLIAMS. Now, Mr. Bevis was talking about the depository transfer operation. You are talking about the same thing, aren't you?

Mr. DEL COL. Yes, sir. He used the term TAD.

Senator WILLIAMS. Have you seen his study?

Mr. DEL COL. No. I haven't seen his study or his "White Paper." It was a couple years before we became actively involved in this particular concept.

Senator WILLIAMS. I, of course, haven't seen it. He submitted it to us. We have it now in our records just as of this morning. I got the impression that he thought that this particular way station will be unnecessary if certain other things happen.

Mr. DEL COL. I disagree with him.

Senator WILLIAMS. Did you get from his statement this morning that he thought perhaps it should not be an operative method?

STAFF. No; I thought his point was that the TAD was not an alternative to——

Senator WILLIAMS. Of the comprehensive depository?

STAFF. Right. The transfer depository in BASIC's view is not really an alternative to the comprehensive depository.

Mr. DEL COL. My statement is identical in that respect, Senator. We are not suggesting it as a substitute for, but we just think that if a transfer agent were also—under the supervision of the SEC or the proper banking authorities—were also able to act as a depository, you would go a step further towards the ultimate objectives of the bill.

Senator WILLIAMS. Let me ask you this, and perhaps your attorney, too, could come in at this point. Just how varied are the corporate laws of the States with respect to the issuance and use of stock certificates? As varied as the number of States?

Mr. YOUNG. Senator, they are pretty much all governed by the Uniform Commercial Code, UCC, and to the extent that it is uniform they are all pretty much the same. Of course, court interpretation is sometimes very different in various jurisdictions.

Senator WILLIAMS. Now, how would you approach the book-share on this part of our problem—how does this relate to State law which in so many cases is uniform?

Mr. YOUNG. I think there is at least some doubt as to whether today you can effect a legal transfer and have a holder in due course and all the other benefits that flow from the language of the Uniform Commercial Code unless you do go through the motions at least of issuing a certificate. Now, opinions differ on that but in this area we thought it best to recommend the type of amendments which we have recommended to clarify any possible ambiguity.

Mr. DEL COL. The amendments which the CCS at the time obtained in each of the State's Uniform Commercial Codes was an amendment which gave to banks, insurance companies, and funds all the benefits

of the Uniform Commercial Code, to have book-share transfers in a depository. I don't know how many States, but many States.

We are suggesting that the transfer agent also have the power of a depository to make book-share transfers without actually issuing a certificate.

Right now, if a shareholder—and we have some shareholders—wishes to send his stock to me for deposit, I will give him in effect the equivalent of an inexpensive custody account from a bank point of view. It doesn't cost him anything. However, if he then wishes to sell that stock, I have to issue the stock again in his name and then he delivers the stock to the broker and the broker sends it back to me and then I cancel it and issue it in the broker's name and we have gone through a lot of paper for what could have been just the bookkeeping entry, and that is the essence of the transfer agent's depository, the bookkeeping entry concept.

Senator WILLIAMS. And you are asking that this Federal legislation preempt this area of State law?

Mr. DEL COL. No.

Mr. YOUNG. We think that in this area—I wouldn't go so far as to call it preemption because I think the fact that the States have in effect adopted book-shares for clearing corporations of the type of Depository Trust Co. indicates the flow of State law, the thinking of the State legislatures in this area. So I don't think this would be inconsistent with that trend.

Senator WILLIAMS. What you are asking is that Federal law be really permissive in a sense?

Mr. YOUNG. That is correct.

Mr. DEL COL. Yes.

Senator WILLIAMS. And you don't see that in the legislation as it is?

Mr. YOUNG. That we don't see, Senator.

Mr. DEL COL. It keeps referring to a depository and defining a depository as the Depository Trust Co., and all we are asking is that the power of a transfer agent be expanded somewhat to include transfer agent book-share transfers.

Senator WILLIAMS. The Uniform Commercial Code now recognizes this approach; right?

Mr. DEL COL. The book-share transfers in the case of a depository.

Senator WILLIAMS. And if accepted by the States you can operate?

Mr. DEL COL. Yes, sir.

Senator WILLIAMS. Under the book-share approach?

Mr. DEL COL. Yes, sir.

Senator WILLIAMS. You don't know how many States have done this?

Mr. YOUNG. I have no idea, Senator.

Mr. DEL COL. But the impetus is coming from the groups that are pushing the depository trust companies.

Senator WILLIAMS. I am still not quite clear. Even then it doesn't reach the transfer agent, does it?

Mr. DEL COL. Because no one has ever thought of a transfer agent as a kind of depository before. It is a definitional problem, Senator. We feel that the transfer agent can provide some services and we feel that they can provide these services to individual investors, the same kind

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of service that the Depository Trust Co. provides the brokerage community or the institutional investor. In order to do that, we would like to be classified as in the nature of a depository, not because we are a depository, but because the legislation in the Uniform Commercial Code as it is currently written states that a depository may make book-share transfers.

Senator WILLIAMS. Now, who would you like to evaluate your character, the SEC or the Federal Reserve?

Mr. DEL COL. Bradford also has a subsidiary called the Bradford Trust Co. I'm afraid if this is passed everybody will be evaluating our character. I don't see how we are not going to be evaluated by every category.

Senator WILLIAMS. Now, quite frankly, your activity seems to me out of character with our general approach here of logical authority within the SEC to find the operationally best ways. That's what we are trying to do. We don't tell people how the new systems are to operate or even describe the new systems, but we give the SEC the authority to lead this industry into operationally effective and efficient systems.

Mr. DEL COL. Yesterday, I believe, Senator, the SEC endorsed this as a concept for improving securities processing and as a step toward the objective of the bill, and you asked them if they were suggesting any proposed amendments to the legislation to meet this thing and they said that Bradford would suggest the legislation—the amendments to the legislation tomorrow.

Senator WILLIAMS. Yes, that's true. Now, we will have to get their comments for our record on this.

Mr. DEL COL. We just feel that this is another approach which will be of some benefit, which will, of course, have to be regulated and will have to come under the overall scheme of things as the SEC sees it, but we just don't want it precluded in the legislation and we think it would be precluded inadverently unless it is specifically mentioned. There are a lot of services that could be offered to the individual shareholder if you could keep the certificates. There may be smaller institutions which do not wish to join the depository as it's constituted who may wish just to deposit their shares with the transfer agent. They may want to do both.

Senator WILLIAMS. When you say "institutions," who do you mean?

Mr. DEL COL. A brokerage house.

Senator WILLIAMS. Thank you, gentlemen. This concludes these hearings.

[Whereupon, at 12:30 p.m., the hearing was adjourned.]

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July 12, 1973

The Honorable Harrison A. Williams, Jr.
Room 352
Russell Senate Office Building
Washington, D.C.

RE: S. 2058-To Amend The Securities Exchange Act Of 1934 To Provide For The Regulation Of Clearing Agencies And Transfer Agents, And For Other Purposes

Dear Senator Williams:

The Conference of State Bank Supervisors (CSBS) is pleased to have the opportunity to express its views regarding S. 2058 which is now being considered by the Senate Securities Subcommittee. This bill, which extends to virtually all aspects of the securities handling system - corporate issuers, transfer agents, and depositories serving clearing agency functions, seeks to prevent a recurrence of the financial and operational problems which plagued the securities industry during 1968-1972 forcing a large number of broker-dealers into liquidation and causing considerable financial loss to customers of the securities markets.

The CSBS congratulates the Subcommittee for its efforts to provide for the development of a highly efficient, coordinated system for the prompt and accurate processing and settlement of securities transactions. We concur with the comments made by you at the time of introducing S. 2058 that the bank regulatory agencies must play a major role in the development of such a clearing system for securities transactions. The CSBS, whose regular members are the primary regulators of the nation's approximately 9000 state-chartered banks, is committed to assuring that the financial institutions under state supervision carry out any function in a securities clearing system approved by Congress in a manner consistent with sound banking practices.

1015 EIGHTEENTH STREET, N.W. • WASHINGTON, D.C. 20036 • (202) 296-2840

The Conference desires to comment specifically on those sections of S. 2058 that pertain to banks functioning as transfer agents and deal with "clearing agencies," which term includes depositories designed to immobilize as many stock certificates as possible in securities transactions.

Banks for many years have served as transfer agents for corporations, and their transfer functions have been supervised by the appropriate federal bank regulatory agencies and by state banking departments. It is only recently, however, that we have seen financial institutions playing a role as depositories for collecting and immobilizing stock certificates in the clearing and settlement of securities transactions. There are today three of these regional depositories. The Depository Trust Company, a limited purpose trust company operating under New York State law, is primarily regulated by the New York State Banking Department, with membership in the Federal Reserve System. Depository is now fully operational. The Midwest Securities Trust Company is also functioning as a depository under state charter and the Pacific Securities Depository is moving forward in its operational efforts.

Under S. 2058 the Securities and Exchange Commission is the primary regulatory agency for all clearing agencies, but examination and enforcement responsibilities are delegated to the appropriate Federal bank regulatory body for those clearing agencies which fall within their respective jurisdictions - the Comptroller of the Currency with respect to national banks, the Federal Reserve System with respect to State member banks, the FDIC with respect to State nonmember banks, and the SEC with regard to all other clearing agencies.

The bill contains provisions designed to assure cooperation among the appropriate Federal bank regulatory agencies. As you pointed out in introducing this bill, through such cooperation the bill seeks to avoid duplicate oversight by the agencies regulating and enforcing compliance by clearing establishments.

In line with the above, of particular interest are the provisions of S. 2058 appearing on page 21 which state:

> "Nothing in this section shall impair the authority of any State banking authority or other State or Federal authority having jurisdiction over a person registered as a clearing agency from making or enforcing rules governing such person which are not inconsistent with this section or any rules or regulations promulgated hereunder."

CSBS considers the above provision to be highly desirable. It is believed, however, that to be truly meaningful and effective, the objective of avoiding unnecessary and duplicate regulatory oversight must embrace not only the appropriate federal regulatory agencies, but extend to cooperation between these agencies and the State banking departments as well. Only in this manner can such unnecessary and duplicate oversight, with its attendant undue burdens on financial institutions functioning as clearing agencies be fully avoided. For this reason CSBS believes that the following language should be added to the above-mentioned provision:

> The Commission and the Federal bank agencies enumerated in Section 3(a)(25) shall take into consideration with regard to their compliance and enforcement activities, any program of examination and enforcement carried out by a State banking authority to insure compliance by financial institutions with the provisions of this section and the rules and regulations promulgated thereunder and shall seek as an objective the avoidance of duplicate regulatory oversight and undue burden upon financial institutions serving as clearing agencies.

The wording suggested above as an addition to the language presently in S. 2058 is similar to that contained in S. 3412 which was introduced March 23, 1972, by Senators Bennett, Tower and you at the request of the Securities and Exchange Commission.1/ S. 3412 was one of several bills considered by your Subcommittee during 1972 dealing with the clearance and settlement of securities transactions.

1/ S. 3412, Sec. 11(a), pps. 14 and 15.

The suggested language would not in any manner compromise the objectives of S. 2058.

The suggested language would have the salutary effect of confirming the fact that the appropriate Federal regulatory agencies in their discretion may accept the examination reports of a State banking department in lieu of conducting their own examination.

This is consistent with the provisions of the Federal Reserve Act[2/] which specifically provide that the Federal Reserve may accept reports of examinations made by state authorities in lieu of conducting their own examinations; language in the Federal Deposit Insurance Act[3/] implies the right of the FDIC similarly to accept examination reports made by state authorities in lieu of conducting its own examinations.

CSBS believes that the above suggested language should also be added to the provisions of S. 2058 that appear on page 27, lines 6 through 12 as they pertain to a State banking department's program of examination and enforcement dealing with a bank registered as a transfer agent. The rationale for directing that unnecessary duplicate regulatory oversight be avoided where it affects depositories in also applicable where such duplication would affect banks functioning as transfer agencies in the securities clearing process.

CSBS believes that S. 2058 would be strengthened by the modifications suggested above and we recommend that they be incorporated into this bill.

Cordially,

Lawrence E. Kreider

Lawrence E. Kreider
Executive Vice President-Economist

LEK:bg

2/ 12 U.S.C. §326

3/ 12 U.S.C. 1817 (a)(2)

AMERICAN SOCIETY OF CORPORATE SECRETARIES, INC.

One Rockefeller Plaza, New York, N.Y. 10020

July 10, 1973

The Honorable Harrison A. Williams, Jr.
United States Senator
United States Senate
Washington, D. C. 20510

Dear Sir:

This refers to your letter of June 29, 1973 to Mr. John S. Black, of the American Society of Corporate Secretaries, and a reply dated July 6, 1973 signed by Mr. Haworth White, Assistant Executive Director of that organization.

As Mr. White indicated in that correspondence, your invitation to comment on this proposed legislation is very much appreciated by the Society. The undersigned has just been appointed Chairman of the Stock Exchange Committee, and I have prepared a statement which is appended to this letter. As indicated in the aforementioned statement, it represents essentially a reiteration and reaffirmation of the position taken by the Society as filed with your Committee in May, 1972 by Mr. Robert S. Sonneman, then Chairman of the Society's Stock Exchange Committee. Mr. Sonneman's statement was in response to your invitation to comment on three proposed bills, S.2551, S. 3297 and S.3412, which were being considered at that time by the Senate Banking Committee. It is my understanding that the thrust and objectives of those three bills are covered essentially in Bill S.2058.

Thank you very much for the opportunity to comment on this legislation.

Sincerely yours,

Matthew F. Kane, Chairman
Stock Exchange Committee

Attachments

THE AMERICAN SOCIETY OF CORPORATE SECRETARIES, INC.

One Rockefeller Plaza
New York, N.Y. 10020

STATEMENT

Submitted to Senate Committee on Banking, Housing and Urban Affairs

Concerning S.2058

The American Society of Corporate Secretaries, Inc. appreciates the opportunity to submit a written statement of its position on the proposed Bill concerning the processing of securities transactions, S.2058, being considered by the Senate Committee on Banking, Housing and Urban Affairs.

In May, 1972, the Society submitted to this Senate Committee a statement relating to proposed Bills S.2551, S.3297 and S.3412. Since it is the Society's understanding that essential features from the three aforementioned Bills are now included in S.2058, this statement reiterates and reaffirms the position of the Society as reflected in that May, 1972, statement, copy of which is attached.

The American Society of Corporate Secretaries, Inc. is a membership corporation organized in October, 1946, and includes among its membership more than 2,100 Corporate Secretaries and other corporate officers of some 1,400 corporations. Substantially all the corporations represented among its membership are listed on a registered national stock exchange or otherwise come within the purview of the Securities and Exchange Commission under the Securities Exchange Act of 1934.

In substantially all the corporations represented in the Society the issuance and transfer of corporate securities is the responsibility of the Corporate Secretary. In the case of smaller corporations, the Corporate Secretary himself normally effects such issuance and transfer. In the case of larger

corporations, he delegates it either to a professional transfer agent, usually a bank or trust company, or to a group of corporate employees who report directly to him.

Thus, the members of the Society are directly concerned with, and well informed regarding, the varied problems relating to the issuance and transfer of corporate securities.

In addition, Corporate Secretaries are also well aware of the financial and cost aspects of the issuance and transfer of corporate securities, since it is the corporate issuer who bears all the expense involved therein, and that expense is usually a part of the budget of the Corporate Secretary. Unfortunately, however, the corporate issuer has seldom been consulted as to its views concerning, or as to the effect upon it, of the many and diverse proposals to deal drastically with the form and handling of corporate securities which have been presented from many diverse sources during the past few years -- in spite of the fact that it must pay the bill. The Society wishes to emphasize that point very strongly, because it is so generally overlooked.

Accordingly, it is gratifying to the Society to have the Senate Banking Committee recognize the vital interest of the corporate issuers in proposals affeting the processing of corporate securities.

During recent years the Society has taken an active role in cooperating with the efforts of various interested parties designed to improve the processing of corporate securities. It has cooperated with the Banking and Securities Industry Committee (BASIC) in many of the studies conducted by BASIC, and BASIC has, on various occasions, acknowledged the value of the assistance and information which the Society has furnished it.

The Society has, in general, actively supported BASIC and the New York and American Stock Exchanges in their work toward the establishment of a comprehensive depository system. It has, however, continued to emphasize, both to BASIC and to the Stock Exchanges, that a satisfactory means of communication between the corporate issuer and the beneficial owners of the stock held in the depository must be developed. The Society, accordingly, is pleased to note that Section 8 of S.2058 recognizes that problem and proposes affirmative action toward its solution.

The Society has also worked closely with the New York and American Stock Exchanges in improving the processing of stock transfers in various ways, including promoting the use among its members, and acceptance by the financial and securities communities, of the unlimited or so-called "jumbo" certificate. As a result of their combined efforts, the "jumbo" certificate by itself has accomplished a very substantial decrease in the volume of paper work involved in stock transfers. One member of the Society, which handles its own stock transfers and has actively promoted the use of the "jumbo" certificate, has computed that it effected a reduction of more than 75% in the volume of certificates processed in 1971, as compared with 1967, from the use of "jumbo" certificates.

The Society arranged with the New York Stock Exchange for one of its members to begin the use, in August, 1971, of a single form of certificate to replace the three forms of certificate, namely less than 100 share, 100 share and more than 100 share, which have been in general use for many decades. As a result of that experiment and other studies carried out by members of the Society and the Stock Exchanges, the general use of a single form certificate will probably be approved by the Exchanges in the very near future. An acceptable single form certificate will greatly increase the speed and efficiency of the stock transfer operation.

The Society has also worked closely with the New York Stock Exchange to combine the stock transfer and registrar functions in a single institution.

The Society suggests that the following conclusions may be validly drawn from the foregoing:

First, Corporate Secretaries and corporate issuers of securities are vitally interested in, and financially affected by, the proposed legislation being considered by the Committee, and

Second, Corporate Secretaries have been fully aware of the "paper work problems" in securities processing, and they and the corporate issuers they represent have been actively engaged in recent years in improving the processing of securities.

Accordingly, the Society trusts that its opinion on the proposed legislation will be given due consideration by the Committee.

Briefly stated, the Society opposes the adoption of S.2058, except for the provisions of Sections 8 and 9 of the Bill, which it supports.

The Society believes that BASIC and the Stock Exchanges have made substantial progress toward their objective of establishing a workable comprehensive stock depository system and that their program should be encouraged and supported. Setting up a competing organization at this stage, as proposed, would be harmful.

The Society also doubts the need, or desirability, of the regulatory authority over clearing agencies proposed and opposes those provisions thereof.

The Society does, however, support the provisions of Sections 8 and 9 of S.2058. The Society has, on many occasions, emphasized that the depository system must be accompanied by provision for communication between the corporate issuer and the beneficial owners of the stock held in the depository system. The exemption from State transfer taxes provided by Section 9 of S.2058 is also essential for a comprehensive depository system.

The Society opposes Sections 1 through 7 of S.2058 because it does not consider it either necessary or appropriate for the SEC to assume control and administration of the entire securities processing system in the United States and to regulate and control all the minute details thereof as would be permitted by the Bill. Any effort by the SEC to involve itself in the detailed operation of stock transfer agents would not only not be helpful, but probably would be counter-productive.

In addition, the Society strongly opposes one other provision of the Bill which is neither necessary nor desirable.

Section 7 would make it unlawful for all issuers subject to the 1934 Act "to issue, either originally or upon transfer, * * * securities in a form, or with a format which contravenes such rules and regulations as the Commission may prescribe * * *"

During the past few years there have been presented from time to time various proposals to alter the form of the stock certificate, including replacing it with a punch card, making it machine readable, changing its size, and eliminating it completely. The proponents of those so-called reforms did not mention, and probably did not even consider, the costs of their proposals. A drastic alteration in the form of the stock certificate would require, if it were to be at all effective, the replacement of outstanding certificates by the new form of certificate. Otherwise, two parallel systems of securities processing would have to be maintained.

And, any attempt so to replace the outstanding certificates in any period of time less than five years would be catastrophic in its effect upon the processing of securities.

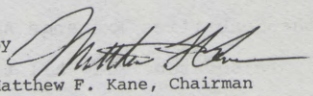
The outstanding certificates for stock listed on the New York Stock Exchange alone aggregate in the hundreds of millions, if not in the billions. American Telephone and Telegraph alone has approximately 3,750,000 common and preferred stockholders holding more than 19,000,000 separate stock certificates. The physical job of preparing new certificates to replace those certificates, and the time and work involved in accomplishing the replacement, staggers the imagination. The cost thereof would also be fantastic. The cost of the issuance of a single stock certificate, including the cost of the certificate itself, the processing and the record entries, runs between $1 and $2 per certificate.

The Society submits that the power to impose dislocations and costs of that magnitude upon American business corporations should not be granted to the SEC or to any other regulatory authority without a very strong showing of the need therefor and the manner in which the power will be exercised.

The Society repeats its appreciation for the opportunity to present a statement of its position on the Bill being considered by the Committee, and would be pleased to expand or explain any aspect of its position with respect to which the Committee may desire clarification.

Respectfully submitted,

American Society of Corporate Secretaries, Inc.

By 

Matthew F. Kane, Chairman
Stock Exchange Committee

THE AMERICAN SOCIETY OF CORPORATE SECRETARIES, INC.
One Rockefeller Plaza
New York, N. Y. 10020

STATEMENT

Submitted to Senate Committee on Banking, Housing and Urban Affairs

Concerning

S.2551, S.3297 and S.3412

The American Society of Corporate Secretaries, Inc. appreciates the opportunity to submit a written statement of its position on the three proposed Bills concerning the processing of securities transactions, S.2551, S.3297 and S.3412, being considered by the Senate Banking Committee.

The American Society of Corporate Secretaries, Inc. is a membership corporation organized in October, 1946, and includes among its membership more than 2,100 Corporate Secretaries and other corporate officers of some 1,400 corporations. Substantially all the corporations represented among its membership are listed on a registered national stock exchange or otherwise come within the purview of the Securities and Exchange Commission under the Securities Exchange Act of 1934.

In substantially all the corporations represented in the Society the issuance and transfer of corporate securities is the responsibility of the Corporate Secretary. In the case of smaller corporations, the Corporate Secretary himself normally effects such issuance and transfer. In the case of larger corporations,

he delegates it either to a professional transfer agent, usually a bank or trust company, or to a group of corporate employees who report directly to him.

Thus, the members of the Society are directly concerned with, and well informed regarding, the varied problems relating to the issuance and transfer of corporate securities.

In addition, Corporate Secretaries are also well aware of the financial and cost aspects of the issuance and transfer of corporate securities, since it is the corporate issuer who bears all the expense involved therein, and that expense is usually a part of the budget of the Corporate Secretary. Unfortunately, however, the corporate issuer has seldom been consulted as to its views concerning, or as to the effect upon it, of the many and diverse proposals to deal drastically with the form and handling of corporate securities which have been presented from many diverse sources during the past few years -- in spite of the fact that it must pay the bill. The Society wishes to emphasize that point very strongly, because it is so generally overlooked.

Accordingly, it is gratifying to the Society to have the Senate Banking Committee recognize the vital interest of the corporate issuers in proposals affecting the processing of corporate securities. In that connection, there is attached hereto a copy of the statement submitted by the Society, at the request of Senator Williams, for inclusion in the record of the hearings held by the Sub-Committee on Securities on September 30 and October 1, 1971.

During recent years the Society has taken an active role in cooperating with the efforts of various interested parties designed to improve the processing of corporate securities. It has cooperated with the Banking and Securities Industry Committee (BASIC) in many of the studies conducted by BASIC, and BASIC has, on various occasions, acknowledged the value of the assistance and information which the Society has furnished it.

The Society has, in general, actively supported BASIC and the New York and American Stock Exchanges in their work toward the establishment of a comprehensive depository system. It has, however, continued to emphasize, both to BASIC and to the Stock Exchanges, that a satisfactory means of communication between the corporate issuer and the beneficial owners of the stock held in the depository must be developed. The Society, accordingly, is pleased to note that Section 5 of S.3297 recognizes that problem and proposes affirmative action toward its solution.

The Society has also worked closely with the New York and American Stock Exchanges in improving the processing of stock transfers in various ways, including promoting the use among its members, and acceptance by the financial and securities communities, of the unlimited or so-called "jumbo" stock certificate. As a result of their combined efforts, the "jumbo" certificate by itself has accomplished a very substantial decrease in the volume of paper work involved in stock transfers. One member of the Society, which handles its own stock transfers and has actively

promoted the use of the jumbo certificate, has computed that it effected a reduction of more than 75% in the volume of certificates processed in 1971, as compared with 1967, from the use of "jumbo" certificates.

The Society arranged with the New York Stock Exchange for one of its members to begin the use, in August, 1971, of a single form of certificate to replace the three forms of certificate, namely less than 100 share, 100 share and more than 100 share, which have been in general use for many decades. As a result of that experiment and other studies carried out by members of the Society and the Stock Exchanges, the general use of a single form certificate will probably be approved by the Exchanges in the very near future. An acceptable single form certificate will greatly increase the speed and efficiency of the stock transfer operation.

The Society has also worked closely with the New York Stock Exchange to combine the stock transfer and registrar functions in a single institution.

The Society suggests that the following conclusions may be validly drawn from the foregoing:

First, Corporate Secretaries and corporate issuers of securities are vitally interested in, and financially affected by, the proposed legislation being considered by the Committee, and

Second, Corporate Secretaries have been fully aware of the "paper work problems" in securities processing, and they and the corporate issuers they represent have been actively engaged in recent years in improving the processing of securities.

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Accordingly, the Society trusts that its opinion on the proposed legislation will be given due consideration by the Committee.

Briefly stated, the Society opposes the adoption of S.2551, S.3297 and S.3412, except for the provisions of Sections 5 and 6 of S.3297, which it supports.

The Society believes that BASIC and the Stock Exchanges have made substantial progress toward their objective of establishing a workable comprehensive stock depository system and that their program should be encouraged and supported. Setting up a competing organization at this stage, as proposed by S.2551, would be harmful.

The Society also doubts the need, or desirability, of the regulatory authority over clearing agencies proposed by S.3297, and opposes those provisions thereof.

The Society does, however, support the provisions of Sections 5 and 6 of S.3297. The Society has, on many occasions, emphasized that the depository system must be accompanied by provision for communication between the corporate issuer and the beneficial owners of the stock held in the depository system. The exemption from State transfer taxes provided by Section 6 of S.3297 is also essential for a comprehensive depository system.

The Society opposes S.3412 because it does not consider it either necessary or appropriate for the SEC to assume control and administration of the entire securities processing system in the United States and to regulate and control all the minute details thereof as would be permitted by S.3412. Any effort by

the SEC to involve itself in the detailed operation of stock transfer agents would not only not be helpful, but probably would be counterproductive.

In addition, the Society strongly opposes two other provisions of S.3412 which are neither necessary nor desirable.

Section 8 of S.3412 would make it unlawful for all issuers subject to the 1934 Act "to issue, either originally or upon transfer, * * * * securities whose form or format contravenes such rules and regulations as the Commission may prescribe * * * * "

During the past few years there have been presented from time to time various proposals to alter the form of the stock certificate, including replacing it with a punch card, making it machine readable, changing its size, and eliminating it completely. The proponents of those so-called reforms did not mention, and probably did not even consider, the costs of their proposals. A drastic alteration in the form of the stock certificate would require, if it were to be at all effective, the replacement of outstanding certificates by the new form of certificate. Otherwise, two parallel systems of securities processing would have to be maintained.

And, any attempt so to replace the outstanding certificates in any period of time less than five years would be catastrophic in its effect upon the processing of securities.

The outstanding certificates for stock listed on the New York Stock Exchange alone aggregate in the hundreds of millions, if not in the billions. American Telephone and Telegraph alone

has approximately 3,750,000 common and preferred stockholders holding more than 19,000,000 separate stock certificates. The physical job of preparing new certificates to replace those certificates, and the time and work involved in accomplishing the replacement, staggers the imagination. The cost thereof would also be fantastic. The cost of the issuance of a single stock certificate, including the cost of the certificate itself, the processing and the record entries, runs between $1 and $2 per certificate.

The Society submits that the power to impose dislocations and costs of that magnitude upon American business corporations should not be granted to the SEC or to any other regulatory authority without a very strong showing of the need therefor and the manner in which the power will be exercised.

Furthermore, the decreased use of the stock certificate resulting from its elimination as a means of settlement between brokers and dealers, as proposed by S.3297, would in and of itself make it unnecessary to make drastic changes in the form of the stock certificate.

S.3412 would also authorize the SEC to establish requirements for "operational compatibility of the transfer agent with other persons involved in the securities handling process." That is a very vague and broad grant of power which, again, if not exercised with great caution, could prove very disruptive and expensive. And, here again, the cost of any such measures would ultimately be borne by the corporate issuer.

Senate Committee on Banking, Housing and Urban Affairs

Subcommittee on Securities

Hearings, September 30 and October 1, 1971

Statement of Position of

American Society of Corporate Secretaries, Inc.

Regarding Stock Certificates

Corporate issuers are in general agreement with the concept of the expanded depository system proposed by BASIC.

They believe that any attempt to legislate the stock certificate out of existence in the near future would be a serious mistake.

They believe that a reduction of 80 to 90 per cent. in the issuance of stock certificates will result from:

1. The expanded depository system proposed by BASIC.
2. Greater acceptance and use of the jumbo stock certificate.
3. Bulk segregation of securities by fiduciaries.

Accordingly, they oppose further consideration of a machine-readable certificate, at least until the full effect of the foregoing has been achieved.

They support the consolidation of the transfer and registrar functions in the same entity through the elimination of the New York Stock Exchange requirement for a separate registrar.

They make the following affirmative recommendations:

1. The expanded depository system proposed by BASIC should be accompanied by a centralized proxy solicitation system to replace the present unsatisfactory system of proxy solicitation by brokers and to assure adequate means of communication between corporate issuers and their stockholders.

2. Corporate issuers should be directly represented on any committee, group or task force created to consider or propose solutions of the problems associated with stock certificates.

The Society repeats its appreciation for the opportunity to present a statement of its position on the three Bills being considered by the Committee, and would be pleased to expand or explain any aspect of its position with respect to which the Committee may desire clarification.

Respectfully submitted,

American Society of Corporate Secretaries, Inc.

by Robert C. Sonneman

Robert C. Sonneman, Chairman
Stock Exchange Committee

Memorandum of the American Stock Exchange, Inc.
Regarding S. 2058 (Regulation of Clearing Agencies,
Securities Depositories and Transfer Agents)

The American Stock Exchange is pleased to submit its comments on S. 2058.

The Exchange strongly supports the general aim of this legislation, "to provide for the development of an integrated national system for the prompt and accurate processing and settlement of securities transactions." Consistent with this view we believe there are aspects of the legislation which should be given further examination--and on which we comment below--in order to implement this goal in the most efficient and least expensive way.

We note also that Chairman Needham of the New York Stock Exchange testified on July 12 before this Subcommittee in favor of the creation of a central national facility for clearing and settling securities transactions. We believe this goal is consistent with the purpose of the proposed legislation and would like to record our concurrence with the suggestion that the Subcommittee give close attention to this proposal, as a means of achieving an integrated national system within the shortest possible time, and within the self-regulatory ambit.

Below are brief comments on those aspects of the legislation which we believe merit further examination by the Subcommittee.

Regulatory oversight over clearing agencies, as opposed to securities depositories, should be entrusted solely to the SEC. Clearing corporations have historically been established and operated by SEC-regulated

stock exchanges or by the NASD, and their operations are integrally linked with trading in securities over which the SEC has been entrusted by Congress with sole supervisory power. But depositories have appeared only recently and require the support of many types of financial institutions, particularly banks. Various governmental agencies already have primary responsibility for supervising these institutions. We recognize the appropriateness of providing for regulatory authority in the banking authorities in the case of securities depositories. However, we feel that to follow this pattern in the case of clearing agencies would open the way to inconsistent application of rules in the area of the trading markets which the SEC is statutorily responsible to oversee.

While all existing clearing agencies are affiliated with exchanges or the NASD, and therefore, under the provisions of the bill, would be regulated by the SEC, any clearing agency which might be established in the future as a subsidiary of a bank would be regulated by one of the banking authorities. Such fragmented regulation of clearing agencies would necessarily result in increased expense both for the regulators and the regulated. Fragmented regulation would fail to take advantage of the extensive and continuous development and expertise of the SEC in this consistently changing process.

The SEC should not have direct rulemaking authority in the settlement process nor power to enforce clearing agency rules. Settlement is an integral part of the intricate and complex trading process which the Securities Exchange Act of 1934 recognizes as the province of the self-

regulatory agencies. More than that, throughout the various operational crises which, in part, have led to this legislation, the industry's clearing corporations have performed efficiently, effectively and free of major problems. We believe, therefore, that the operations of clearing agencies underscore the importance of preserving the values of self-regulation--flexibility, ability to act promptly, greater expertise of the self-regulators, reduced governmental costs. Certainly legislation providing for SEC oversight over the clearing agencies is appropriate, but to blur the line between the two levels of regulation will produce unnecessary cost and confusion.

Access and financial standards. We feel that a clearing agency should have the power to impose greater financial standards on access than the mere posting of a bond. Far more important is the financial responsibility of the potential participant, whose activity is likely to fluctuate on a moment-to-moment basis, and whose instability may imperil all investors and brokerage firms whose transactions are involved.

Control by participants. The implementation of the bill in this area may cause needless complexities and run counter to the corporate laws under which the agencies are organized, which vest the responsibility of managing corporations in the board of directors and mandate election of the board by shareholders. We are not, of course, opposed to user participation in key policy-making roles--as witness, for example, the framework of SIAC and the Depository Trust Company, in whose

development we were deeply involved, and in which users participate as board members, but not necessarily as stockholders.

Apart from these problems, we call the Subcommittee's attention to the problems which would be created if this legislation were to require, as it apparently might, existing clearing agencies, integrally linked with exchanges in terms of their trading rules, to be separated into a series of separate entities, independently operated. Integration of the trading process with the clearing process is essential. We are concerned lest this integration be lost.

These are the basic questions we would raise concerning the proposed legislation, whose general goals we support.

A final word is appropriate regarding the recent New York Stock Exchange proposal. We believe that such an entity--a national facility for clearing and settling securities transactions, compatible with existing facilities--could be developed within the existing self-regulatory framework of the Securities Exchange Act of 1934, in a manner which would accomplish the goals which the Subcommittee seeks to achieve, and which would be controlled by its users subject to SEC oversight. We believe that the expertise exists in our own organization and throughout the securities industry which would permit rapid development of such an entity, and we would be glad to aid in its construction. The Exchange hopes that the Subcommittee will seriously consider this approach as a means of achieving rapidly the end it desires to accomplish.

July 11, 1973

STATEMENT OF THE ALIA TO THE SUBCOMMITTEE
ON SECURITIES OF THE SENATE COMMITTEE ON BANKING,
HOUSING AND URBAN AFFAIRS
ON S. 2058

This Statement is submitted by the American Life Insurance Association ("ALIA") in support of S. 2058, with certain modifications. Our Association has an aggregate membership of 350 life insurance companies in the United States and Canada which account for approximately 92 percent of the legal reserve life insurance business written in the United States. These companies account for substantially all of the variable contract business conducted in this country today.

As the ALC-LIAA (predecessor associations of the ALIA) previously indicated in their statement of May 26, 1972 to the Subcommittee on S. 3412, S. 3297 and S. 2551, the life insurance industry supports the principal objective of the legislation being considered--to establish a national system for the efficient handling and processing of securities transactions.

We believe that S. 2058 resolves many of the technical problems that concerned our member companies in connection with the previous bills. However, there are several issues that have not been resolved by S. 2058, and we address our Statement to these problem areas.

1. Life Companies as Broker-Dealers - Section 4

Section 4 of S. 2058 would subject life companies or their affiliated broker-dealers to SEC regulation in connection with their handling and settlement of

variable annuity transactions. We believe that this is totally inconsistent with the Congressional intent as expressed in the Securities Investor Protection Act of 1970 ("Act"). Section 3(a)(2) of this Act provides that all persons who are registered as brokers or dealers under the 1934 Act or are members of a national securities exchange shall be members of SIPC, except for persons whose business as a broker or dealer consists exclusively of, among other things, the sale of variable annuities. Moreover, Section 11(b) of the Act provides that the SEC "shall compile a list of unsafe and unsound practices by members of SIPC" (emphasis added), and report to Congress as to, among other things, its recommendations for additional legislation. It is most significant that the Congressional concern for unsafe and unsound practices of broker-dealers, including the processing of securities transactions, was limited to members of SIPC. Consequently, we believe that any legislation which emanates from the SIPC legislation, 1/ should be consistent with that legislation and its intent, particularly with respect to variable annuities which, as the SEC indicates, are not processed in the national securities markets.

In the case of variable annuities, we believe that the broker-dealer exemption under the Act was granted by Congress principally because of the limited nature of the securities transactions, which do not give rise to the

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1/ See Statement of former SEC Chairman William J. Casey before the Subcommittee on Securities on S. 2551, S. 3297 and S. 3412, May 9, 1972, at 1.

risks and abuses at which the Act was directed. Variable annuity contracts are not negotiable or fungible and contractholders' checks are frequently made out directly to the life company, so that the broker-dealer affiliate may not be involved. Life companies and their broker-dealer subsidiaries promptly transmit all funds and deliver all securities in connection with these transactions. The Commission has recognized these factors in granting life company broker-dealers certain exemptions from three rules (under the Securities Exchange Act of 1934) emanating from the SIPC legislation--Rule 17a-13, Rule 17a-5, and Rule 15c3-3. These exemptions also apply to broker-dealers of registered open-end investment companies or unit investment trusts.[2/]

In the case of variable life insurance, the 1970 Act and the related SEC rules preceded the issuance of the product and, therefore, do not contain a specific reference to such contracts. The SEC ruled on January 31, 1973 that, among other things, variable life insurance contracts are securities which must be registered under the Securities Act of 1933.[3/] We believe that the basis for exempting broker-dealers who limit their transactions to variable annuities and certain redeemable investment company securities from SIPC and the related SEC regulation applies with equal force to variable life products.

2/ See Securities Exchange Act Release Nos. 9376, 9658 and 9775, respectively.

3/ See Securities Act Release No. 5360, at 2.

Consequently, we recommend (see Attachment A) that Section 4 be amended to provide limited exemption for broker-dealers whose business as broker or dealer is restricted to the sale of variable contracts (including variable life insurance) or redeemable securities of registered investment companies. The exemption would not constitute a full exemption for such broker-dealers from proposed paragraph (6) of Section 15(c) of the 1934 Act, but merely an exemption from the provision with respect to the regulation of such broker-dealers in their processing of variable contracts and certain investment company securities.

In any event, we urge the Subcommittee to include in its Report on the bill that the additional regulatory authority granted the SEC under Section 4 is not intended to nullify the exemptions granted broker-dealers that limit their transactions to variable annuities and other specified securities, or to preclude further exemptions for such broker-dealers under this provision.

2. Definition of Terms - Section 3

Generally, Section 3 of S. 2058 contains express exclusions from the definitions of "clearing agency"(including a person performing a depository function) and "transfer agent" for those life companies that may technically fall within the definitions solely by reason of their administering variable annuities or performing fiduciary and other specified functions. The exclusory provisions raise two problems.

First, we believe that Section 3 should be amended so that the exclusory language encompasses insurance companies processing variable life contracts. Our position is based on the fact that the rationale for excluding life companies, in connection with the processing of variable annuities, from the terms of Section 3 is equally relevant to variable life insurance. Transactions in variable life contracts will not be effected on national securities exchanges or in the over-the-counter markets. Rather, such contracts will be exclusively between the life company (or its affiliated broker-dealer) and the contractholder. The contracts, based on the longevity of a particular individual, will not possess the characteristics of negotiability and fungibility necessary for trading in a public, secondary market, although in certain cases the contracts may be assignable. As the SEC indicated, in its testimony before this Subcommittee, the legislation is not intended to reach securities such as "annuity contracts issued by insurance companies" which do not "get into the securities processing area, although through a series of definitions" they may be encompassed in the bill. 4/

Therefore, we recommend (see Attachment B) that the exclusion from the terms "clearing agency" and "transfer agent" be expanded to encompass persons who may fall within the scope of the definitions by reason of functions commonly performed by them in connection with "variable contracts or policies issued by insurance companies."

4/ See testimony of Mr. Pickard of the SEC staff, Transcript of Hearing on Clearance and Settlement of Securities Transactions, August 14, 1972, before the House Subcommittee on Commerce and Finance, at 36.

Second, while the exclusory language of Section 3 would provide relief for many life companies, it does not clearly encompass a subsidiary of a life company performing the processing functions with respect to variable annuities. We recommend (see Attachment B) that the exclusory language in paragraph (22) for insurance companies be similar to that contained in Title IV of H. R. 5050, with certain modifications. Thus, the exclusion would apply to "any person" who performs the functions of a clearing agency with respect to variable contracts issued by insurance companies. In this manner, a subsidiary of a life company could qualify under the exclusion.

3. Participation of Life Companies in the Clearing Agency or Securities Depository -Section 5

Life companies purchased and sold approximately $11 billion of common stock in 1972. Therefore, it is anticipated that such companies will be major participants in clearing agencies or depositories established for the purpose of facilitating securities transactions. A number of major life companies already have under consideration the formation of a regional depository.

Section 5 in effect would require--in Section 17A(c)(2) under the 1934 Act--that the rules of clearing agencies provide that registered investment companies and banks, among others, are eligible to become participants in such entities. Furthermore, paragraph (3) of Section 17A(c) requires that shareholders and "participants" in the clearing agency be fairly represented in such entities with the right to participate in the selection of officers and directors and "in all other phases of administration of its affairs."

Since life companies are major financial intermediaries and potentially a significant factor in the development of regional depositories, we recommend (see Attachment C) that the Subcommittee specify the eligibility of insurance companies to become participants in securities depositories or clearing agencies in the same manner that banks and registered investment companies are specified in Section 17A(c)(2). We believe that the inclusion of insurance companies is particularly important in view of the privileges that are afforded "shareholders" and "participants" in the depository under Section 17A(c)(3).

4. The "Form or Format" of the Variable Contract - Section 7

It is our understanding that Section 7 of S. 2058--adding a new subsection (j) to Section 12 of the 1934 Act--is principally concerned with the regulation of stock certificates. Section 7 appears to give the SEC authority to regulate the form or format of variable annuity contracts issued by life insurance companies and their separate accounts registered under the Investment Company Act of 1940. These variable annuities are securities which would be required to be registered under Section 12 of the 1934 Act except for the exemption provided in Section 12(g)(2)(B).

Here again, we do not believe that there is a necessity for the Commission to determine the form of variable annuity contracts or variable life insurance contracts which are not traded in a public exchange market and do not possess the qualities of negotiability and fungibility of stock certificates.

We recommend (see Attachment D) that Section 7 be amended so that the provision is inapplicable to variable contracts or policies issued by insurance companies.

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Attachment A

ALIA Proposed Amendment to S. 2058 *

Life Company Broker-Dealers - Section 4

SEC. 4. Section 15(c) of the Securities Exchange Act of 1934 (15 U.S.C. 78o(c)) is further amended by adding at the end thereto the following new paragraph:

"(6) No broker or dealer shall make use of the mails or of any means or instrumentality of interstate commerce to effect any transaction in , or to induce or attempt to induce the purchase or sale of, any security (other than an exempted security or commercial paper, bankers' acceptances, or commercial bills) in contravention of such rules and regulations as the Commission shall prescribe as necessary or appropriate in the public interest, for the protection of investors or for the development of an integrated national system for the prompt and accurate processing and settlement of securities transactions to regulate the time and method of making settlements, payments, and deliveries and of opening, maintaining, and closing accounts. Nothing in this paragraph shall be construed (A) to affect the authority of the Board of Governors of the Federal Reserve System, pursuant to section 7 of this title, to prescribe rules and regulations for the purpose of preventing the excessive use of credit for the purchase or carrying of securities, or (B) to authorize the Commission to prescribe such rules or regulations for such purpose. Notwithstanding the foregoing, the provisions of this paragraph with respect to the regulations of broker-dealers as to the time and method of making settlements, payments, and deliveries and of opening, maintaining, and closing accounts shall not apply to persons whose business as a broker or dealer consists exclusively of the sale of (i) variable contracts or policies issued by insurance companies; or (ii) redeemable securities issued by registered open-end investment companies or unit investment trusts."

* The amended portion of the provision is underlined.

Attachment B

ALIA Proposed Amendment to S. 2058

1. Exclusion from the Terms "Clearing Agency" and "Transfer Agent" - Section 2

"SEC. 2. * * * (22) * * * The term 'clearing agency' does not include ... and (iii) any person who performs such functions solely with respect to variable contracts or policies issued by insurance companies; _/

(24) * * * The term 'transfer agent' does not include any person who performs such functions solely with respect to variable contracts or policies issued by insurance companies."

_/ The reference to "life insurance companies or their registered separate accounts" could be deleted from subsection (ii).

2. Exclusion from Provisions with respect to Transfer Agents - Section 6

"SEC. 6. The Securities Exchange Act of 1934 is further amended by inserting after Section 17A (added by Section 5 of this Act) the following new Section:

TRANSFER AGENTS

SEC. 17B(a) * * * (3) The provisions of this section shall apply only to securities and to persons performing the function of transfer agent with respect to securities which are registered under section 12 of this title or which would be required to be so registered except for the exemption from registration provided in subsection (g)(2)(B) or (g)(2)(G) of that section. The provisions of this section shall not apply to variable contracts or policies issued by insurance companies."

Attachment C

ALIA Proposed Amendment to S. 2058

Participation of Life Companies in Securities Depositories or Clearing Agencies - Section 5

"SEC. 17A. * * * (c) An applicant shall not be registered as a clearing agency unless the Commission finds that -

* * *

(2) the rules of the clearing agency provide that all (A) registered brokers or dealers or members of a national securities exchange, (B) other registered clearing agencies, (C) registered investment companies, (D) insurance companies, (E) banks (as defined in section 2(a)(5) of the Investment Company Act of 1940), and (F) such other persons or classes of persons as the Commission may from time to time designate by rule as appropriate to the development of an integrated national system for the prompt and accurate processing and settlement of securities transactions are eligible to become participants in such clearing agency, subject only to such other rules of the clearing agency or securities depository as are expressly permitted under this paragraph."

Attachment D

ALIA Proposed Amendment to S. 2058

Form of Certificate - Section 7

SEC. 7. Section 12 of the Securities Exchange Act of 1934 (15 U.S.C. 781) is amended by inserting after subsection (i) the following new subsection:

"(j) It shall be unlawful for an issuer, any class of whose securities is registered under this section or which would be required to be so registered except for the exemption from registration provided by paragraph (2)(B) or (2)(G) of subsection (g), by the use of any means or instrumentality of interstate commerce, or of the mails, to issue, either originally or upon transfer, any such securities in a form or with a format which contravenes such rules and regulations as the Commission may prescribe as necessary or appropriate for the prompt and accurate processing of transactions in securities. The provisions of this subsection shall not apply to variable contracts or policies issued by insurance companies."

CORPORATE TRANSFER AGENTS ASSOCIATION

NEW YORK, N. Y.

July 10, 1973

The Hon. Harrison A. Williams, Jr.
Chairman, Sub-Committee on Securities
Committee on Banking, Housing and Urban Affairs
United States Senate
Washington, D. C. 20510

Dear Senator Williams:

Thank you for the opportunity to submit a statement concerning S.2058. My Statements are general, however, I will be happy to clarify any comment on which you or your staff might require more detail.

S.2058 provides for division of regulatory responsibilities between the Securities and Exchange Commission and other Federal agencies. We feel it would be wise to give one agency, the Securities and Exchange Commission, the power and authority over all transfer agencies for the sake of uniformity and to better protect the investing public.

The bill also provides for operational compatibility of transfer agents with other persons involved in the securities handling process. Such a requirement could cost all issuer corporations, banks, brokers, clearing houses and depositories dearly to convert already developed highly sophisticated systems and could cause the Securities Industry to abort plans and methods already developed by joint industry committees.

Regulation of the form and format of securities is fraught with peril. Many corporations each have hundreds of thousands of certificates outstanding, numerous of which will not be presented for transfer in a lifetime. In addition, corporations have many thousands of dollars of certificate supplies on hand. A drastic change in form and format would cost American shareholders millions of dollars and could cause delays in processing since dual facilities would have to be maintained to handle old and new certificate formats.

We appreciate the opportunity to comment on the proposed legislation and offer our assistance in any way possible.

Very truly yours,

E. J. BROWN
President
% Phillips Petroleum Company
80 Broadway
New York, N. Y. 10005

EJB;cmn

THE FIRST NATIONAL BANK OF BOSTON

EUGENE M. TANGNEY
Senior Vice President

July 12, 1973

Honorable Harrison A. Williams, Jr.
United States Senate
Committee on Banking, Housing and
Urban Affairs
Washington, D. C. 20510

Dear Senator Williams:

Reference is made to your letter of June 29, 1973, concerning an invitation for The First National Bank of Boston to submit a written statement concerning S. 2058; a bill to amend the Securities Exchange Act of 1934 to provide for the regulation of clearing agencies and transfer agents and for other purposes.

The First National Bank of Boston believes the elimination of the stock certificate is an achievable goal and has developed the Transfer Agent Depository System (TAD), which provides both the system and method to achieve this goal. This system is designed to function in a similar manner to that of a checking account in a commercial bank. Ownership of money is reflected in a commercial bank's demand deposit accounts by means of electronic characters stored on magnetic tapes and is transferred from one person to another with the use of a check. Likewise, ownership of capital stock or debt equity is reflected on the Transfer Agent's computers in electronic characters on a magnetic tape. Although the systems cannot function identically, we have incorporated many of the features of demand deposit accounts into our Transfer Agent Depository system.

We applaud the work of the New York Stock Exchange and the Central Certificate Service, now the Depository Trust Company, in fulfilling what we believe to be the interim goal of immobilizing the stock certificate. We follow with great interest the work of the National Coordinating Group for Comprehensive Securities Depositories, and hopefully will participate with them in further developing the TAD concept. This concept will be a considerable aid in completing the interim goal, the immobilization of the stock certificate.

The TAD concept as developed in this Bank allows for the book entry of ownership of stock certificates, and allows the transfer of ownership, the acceptance and processing of deposits and withdrawals, as well as the handling of deposited securities pledged as loan collateral. I have included a detailed description of our plan, the brochure "T.A.D/Tomorrow's Way Today" which outlines in some detail how the TAD system operates.

Boston, Massachusetts 02106 - Telephone 434-6566 (Area Code 617)

We have entered into a pilot project of the Transfer Agent Depository system with the cooperation of the Boston Stock Exchange and the South Shore Publishing Company of Scituate, Massachusetts. The results are most encouraging. Since the initial announcement to the shareholders on April 2, 1973, 35.1% of the shareholders have surrendered their holdings which represents 43.3% of the outstanding shares and 23.7% of the outstanding certificates. Based on these results, we have requested the New York Stock Exchange and Depository Trust Company to allow us to place First National Boston Corporation (our parent company) in a transfer agent depository status.

Discussions are now being held with both the Midwest and Pacific Coast Depositories to act in a transfer agent custodian capacity, and we hope to be operational with both by early Fall.

Discussions are also being held with the National Clearing Corporation in order that we may offer the Transfer Agent Depository system to a number of over-the-counter companies for whom we currently act as transfer agent. They estimate that it will be three or four months before our system will be able to interface with their trading mechanism.

Turning to other areas of S. 2058, we feel that bank transfer agents, which are presently regulated by the bank supervisory agencies, and are familiar with safe handling and custody of securities and have performed transfer functions for some time do not need new rules and regulations by an agency of the government that is not familiar with the internal operations of banks. We do believe that the SEC should have authority to establish standards to permit the efficient interchange of information between depositories, banks, brokers and transfer agents, but these standards should be established after consultation with bank supervisory agencies. As relates to non-bank transfer agents, who presently are not supervised, these agents should come under the jurisdiction of the SEC. As far as the registration of transfer agents goes, we do not see the need for well-established bank transfer agents to go through the necessary format of registration as contemplated in this bill, but if complete registration of transfer agents within the United States is considered desirable then such registration should be completed by the bank regulatory agencies.

Banking has a unique relationship to its supervisory agencies. These agencies are staffed by individuals who are familiar with bank operations and procedures and have, over a number of years, fulfilled their responsibility in a noteworthy fashion. To expedite the implementation of the

THE FIRST NATIONAL BANK OF BOSTON

provisions of this bill concerning bank transfer agents, we feel that it would be far more efficient to have the jurisdiction for both the registration and supervision of bank transfer agents fall under the appropriate bank regulatory agency's jurisdiction.

We feel that the definition of Transfer Agent as proposed in S. 2058 should be expanded to include Transfer Agent Depositories, and that bank Transfer Agent Depositories should be regulated in the same manner as bank transfer agents, as long as they conform to the SEC rules for operational compatability and further that the enforcement of these operational compatabilities should come under the appropriate bank regulatory agencies.

We appreciate this opportunity to express our views on this legislation and hope that the Committee finds it helpful.

Sincerely

Eugene M. Tangney

Air Mail
Special Delivery

T.A.D. / TOMORROW'S WAY TODAY

Modernization of the Securities Transfer Process
THE TRANSFER AGENT DEPOSITORY

THE FIRST NATIONAL BANK OF BOSTON



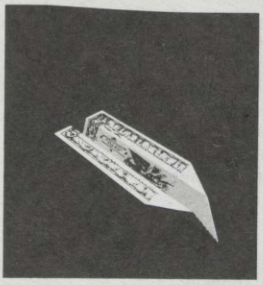
There is no area of the securities business which offers more opportunity for reducing costs as well as exposure to the kind of disruption which resulted in loss to customers during the 1969–1970 period, than the improvement and modernization of the systems for clearing, settlement, delivery and transfer of securities. It was the archaic method of achieving this simple objective which nearly drowned the financial community in a tidal wave of uncontrolled paper.*

The aftermath of this "tidal wave"—financial disaster for individuals and brokerage houses—forced the financial industry to adopt emergency, temporary measures and to seek a permanent solution for the evidence of transfer of private capital. Since that time, committees and study groups, both government and private, have proposed interim and permanent solutions. The proposals have one solution in common: **the elimination of the stock certificate must be the ultimate goal.**

We, at The First National Bank of Boston, propose that now is the time for ultimate solution. We are convinced that a Transfer Agency Depository System is the only system so far proposed which can effectively solve the problems by gradual elimination of the stock certificate. It is, furthermore, a system which can function efficiently and effectively with the current depository systems. This feature makes the changeover from current procedures less radical than it otherwise might be.

Despite the crisis of 1968 and the lessons presumably learned, the stock-transfer business is still conducted through the issuance, possession, transfer, and cancellation of stock certificates. The number of steps involved in this process is overwhelming; the steps themselves are tedious, repetitive, and offer innumerable opportunities for error. The already involved process is further burdened by the transactions ancillary to stock transfer and ownership—payment of dividends, tax forms, proxies, annual meetings, splits, mergers, etc. The flow chart on page 10 is a discouragingly realistic presentation of twentieth-century stock-transfer methods.

*Securities Exchange Commission. *Study of Unsafe and Unsound Practices.* p. 57



This situation is made even more complicated by the fact that in the majority of transactions the only purpose of the stock certificate is to provide the transfer agent with information for the registration of the transfer. The stock certificate, while it does not prove ownership by itself, does require issuing, inspection, registration, cancellation, storage, etc., and invites large-scale theft, fraud, and unauthorized manipulation as little or no verification is made as to ownership when certificates are used as collateral.

The members of the financial industry and the general public are all too aware of these facts and the subsequent problems. Changes must be made in the method of transferring and recording ownership of securities if the business is to remain in the private sector. To this end, the return of public confidence is imperative. Immobilization of the stock certificate, followed by its gradual elimination must, therefore, be the objective for all concerned. A Transfer Agent Depository (TAD) as conceived by The First National Bank of Boston provides both the system and the method for attaining this end.

The Transfer Agent Depository system is one which provides all of the advantages of certificates while eliminating the disadvantages. The individual clearly owns his securities. He receives a statement within a few days after the trade is settled as opposed to waiting weeks for certificates to be delivered to him. This statement clearly shows his ownership of shares in the company as well as historical information. It describes each transaction and reflects whole shares held in certificate form and whole shares held by the transfer agent in book form as well as any fractional shares which may be held by the transfer agent as a result of dividend reinvestment or cash investments by the individual. A lender has bona fide collateral by assignment, and the broker's problem of fails is minimized. Under TAD, the certificate is immobilized at the point of origin (with the transfer agent) because it is not physically issued. Transfer of ownership is achieved by computerized bookkeeping, and records are maintained and updated on a computer file. A stock certificate may still be issued, however, if and when insisted upon. Up-to-date TAD files allow lenders to verify their protected positions, thus making certificates valueless in case of theft.

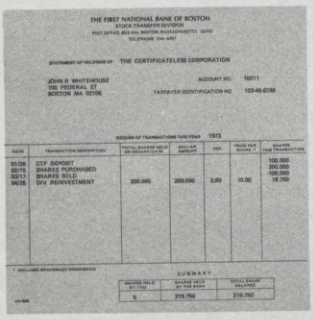
The TAD system may be effectively used by corporations, banks, transfer agents, brokers, and individual shareholders. The benefits are impressive:

For the corporation

- Reduced costs—mail insurance, certificate, registrars' fees
- More direct lines of communication with stockholders
- Substantial reduction in clerical processing costs

For banks, brokers, and transfer agents

- Substantial reduction in clerical processing costs
- Speedier issuance and transfer processing
- Losses through fraud and theft will virtually disappear with immobilization and elimination of the stock certificate
- Reduction in audit requirements because of elimination of inventories of stock certificates
- Requirements for costly vault space will be greatly reduced
- The issuance of statements to involved parties will permit rapid transaction identification and correction of errors
- Substantial elimination of fails and dividend claims



THE FIRST NATIONAL BANK OF BOSTON
STOCK TRANSFER DIVISION

THE CERTIFICATELESS CORPORATION

JOHN R. WHITEHOUSE
700 FEDERAL ST
BOSTON MA 02106

ACCOUNT NO. 10011
TAXPAYER IDENTIFICATION NO 123-45-6789

RECORD OF TRANSACTIONS THIS YEAR 1973

DATE	TRANSACTION DESCRIPTION	TOTAL SHARES HELD BY INSTITUTION	SHARES AMOUNT	FEE	PRICE PER SHARE $	SHARES THIS TRANSACTION
01/09	CTF DEPOSIT					100,000
03/15	SHARES PURCHASED					200,000
03/17	SHARES SOLD					-100,000
04/25	DIV. REINVESTMENT	300,000	200,000	2.00	10.00	19,750

SUMMARY

SHARES HELD BY YOU	SHARES HELD BY THE BANK	TOTAL SHARE BALANCE
0	219,750	219,750

For the stockholder

- Protection from loss of certificates and illegal manipulation
- Reliable collateral for loans
- Better communication with corporations for information on annual meetings, splits, mergers, new issues, etc.
- Up-to-date statements showing the status and activity of his account
- More rapid securities transactions
- Elimination of safekeeping of his stock certificates
- No tying up of his securities due to broker failure

The flow chart on page 11 illustrates the working of the TAD system and is an interesting contrast to the flow chart of current procedures on page 10. The TAD system would work as described in the following paragraphs.

Buying Customer/Broker Transactions

The basic procedure for placing a buy order will not change from current practice. The customer places his order to buy with his broker. The broker transmits the order to the market place where the trades are matched. He confirms the trade price, amount due, number of shares purchased, date, commission, etc., to his customer. The broker prepares a trade confirmation ticket with the CUSIP number, price, amount due, number of shares, registration and/or delivery instructions, which is then sent to a clearing house or a central/regional depository for comparison and processing.

Selling Customer/Broker Transactions

The basic procedure for placing a sell order is essentially the same as it is at present. A difference occurs when a customer does not have his shares in certificate form. In such a case, the broker may contact the transfer agent directly for confirmation of ownership or, when his knowledge of the customer's holdings is sufficient, he may proceed with the processing of the sell order. When the order is complete, the broker sends the trade detail and transfer-debit instructions and guaranteed stock power to the clearing house for matching to the corresponding buy detail.

Borrower/Lender Transactions

Under TAD, when a shareholder wishes to use his securities as collateral for a loan, he provides an assignment of interest, stock power, and/or hypothecation agreement to the lender. The assignment of interest is forwarded to the transfer agent who verifies ownership, places escrow (stop) restrictions against the account, and forwards statements to both the borrower and the lender. When a loan is repaid, the lender notifies the transfer agent. The escrow restrictions are removed from the file, and statements are sent to both parties. A stolen certificate thus cannot be assigned as collateral without the real owner and the lender being informed immediately by means of TAD statements.

The Function of the Clearing House

Under the proposed TAD system, the functions of the clearing house are quite simple and efficient. Each clearing house will prepare a special contract sheet or transfer authority sheet for each security to show, by CUSIP number, the total number of shares purchased and sold by each broker, by broker numbers. Individual customers will be shown in a similar manner.

Transfer agents receive copies of these transfer authority sheets or computer tapes for each corporation they represent.

Transfer procedures are both simpler and more accurate because the transfer authority sheets are balanced and proved at the clearing house, as well as by the brokers when they check money settlements. If certificates are involved in a sale, the broker sends them to the clearing house with the transfer instructions. The clearing house forwards the certificates to the transfer agent for cancellation, and book shares are recorded in the purchaser's name, unless he specifically requests certificates.

The Function of a Central or Regional Depository

The Central Certificate Service as it now exists, or regional/national depositories being proposed, can function within the Transfer Agent Depository system. The purpose of such depositories should be simply a bookkeeping service. The depositories would deposit issues directly with the transfer agents and receive statements of holdings by issue on a daily basis. This is

not a change in procedure but one which is in current use. We are told that IBM acts as transfer agent depository for Merrill Lynch. Each day, Merrill Lynch sends certificates received to IBM and is issued a statement of holdings. When an individual requests a certificate, Merrill Lynch sends registration instructions and a stock power to IBM. An immediate transfer is made from Merrill Lynch's nominee to the individual without the necessity of having a debit certificate.

The Function of the Transfer Agent

When the transfer agent receives a transfer authority, he prepares (by data processing) "statements" reflecting the increases and/or decreases to the specific accounts and mails them to both the buying and selling stockholder or to his broker. This statement is similar to a mutual fund statement or a no passbook savings account notice. It provides a final audit verification and notification to buyers and sellers that the transaction has been properly executed.

When certificates are registered in broker, street name, or even nominee name, the processing is the same as for individual accounts. The TAD system allows brokers to deposit certificates with the transfer agent and enables them to order out certificates or to transfer book shares from an existing balance account. This results in almost instant transfers. Such a processing method will gradually eliminate the need for brokers to handle certificates in the routine course of trading activities. Possibilities for loss or theft are thus further eliminated.

At present the Transfer Agent Depository is a composite of theory and practice. It is not only an ultimate solution but a live working system that is gaining acceptance from various organizations. The Federal Reserve system of book-entry transfers of government debt obligations is a certificateless Transfer Agent Depository. The mutual fund industry has for several years systematically eliminated the need for a certificate and has been very successful in doing so. In fact, 95 percent of mutual fund shareholders in 1960 held certificates; today only 10 percent request certificates at time of purchase. The expanding number of Dividend Reinvestment Programs for major corporations, expanding because shareholders are demanding it of the corporations, dispels a great deal of the theory that "Aunt Minnie" will not give up her certificates. AT&T's program, with probably the largest number of such "Aunt Minnie" shareholders, is extremely successful. Under this program, rather than receiving dividend checks directly, the stockholder authorizes automatic reinvestment of dividends through a bank with trust powers. The shareholder receives a statement showing his holdings, *not* a certificate. In fact, AT&T has received thousands of requests from shareholders to deposit their certificates and provide a statement, which tends to discredit the "shareholders-demand-certificates" belief. Other major corporations with Dividend Reinvestment Programs have had similar experience.

Q: Will the TAD system be expensive?

A: The TAD system would cost far less than the proposed depository or the machine-readable alternative, although machine-readable documents could be used within the TAD system. Most major transfer agents and brokers now own or lease the essential data-processing hardware. The only new costs associated with the Transfer Agent Depository are programming costs. These costs would be far outweighed by the potential benefits.

Q: How long will it take to implement TAD?

A: We feel that a realistic time frame for development and implementation of the system would not exceed 24 months.

Q: What about reliability?

A: The equipment for a TAD system is in use and has been found to be extremely reliable. The controls would be much the same as they are under the current system from the transfer agents' point of view. The broker would have "to know his customers" or verify the customer's holdings with the transfer agent prior to accepting a sell order. The Transfer Agent Depository is the system least likely to be affected by equipment failure, i.e., computer down-time because transfer agents are not all physically located in one area. The equipment failure affecting any one agent would not affect another in any significant way.

Q: Can TAD be implemented without unduly disrupting the normal flow of business?

Answers to questions most commonly posed about TAD

A: The TAD system will not be implemented by the immediate, total abolition of the certificate, but rather by issuing statements instead of certificates. This would be done gradually, i.e., much in the same manner as the Federal Reserve's bookkeeping entry system. It is assumed that certificates would be deposited with transfer agents on a gradual basis. As a result, there should be little or no flow disruption in the offices of broker-dealers or exchanges.

Q: Doesn't the implementation of TAD call for a high degree of coordination?

A: Yes, indeed it does. It will demand the coordinated efforts of all segments of the financial world to insure uniform procedures.

Q: To what extent would the development of a TAD system further the implementation of uniform procedures of accounting?

A: A TAD system would require uniform accounting methods, especially by the various clearing houses and the brokerage industry. It would eliminate a number of bookkeeping methods now employed and require uniform procedures of accounting.

Q: How may the public be informed as to the benefits of a certificateless system in order to obtain the necessary public acceptance?

A: The public could be informed as to the benefits of a certificateless society through direct mailings by transfer agents to shareholders, much in the same way as Dividend Reinvestment Programs have been introduced.

BUYS AND SELLS	Present Transfer System	Transfer Agent Depository System
Selling Customer Contacts Broker	Yes	Yes
Buying Customer Contacts Broker	Yes	Yes
Brokers contract for buy & sell	Yes	Yes
Selling broker confirms customers holdings with Transfer Agent	No	Optional
Brokers confirm trade detail with respective customers	Yes	Yes
Brokers deliver trade detail to Stock Clearing Corp. if applicable	Yes	Yes
Stock Clearing Corp. nets trades	Yes	Yes
Selling customer delivers certificates to broker	Yes	No
Delivering broker sends certificates to receiving broker	Yes	No
Receiving (buying) broker delivers certificates to transfer agent for transfer	Yes	No
Transfer Agent returns transferred certificates to receiving broker	Yes	No
Broker delivers certificates to customer	Yes	No
Buying Broker delivers transfer instructions, in addition to trade detail, to Stock Clearing Corp.	No	Yes
Stock Clearing Corp. delivers transfer authorities to Transfer Agent	No	Yes
Statements reflecting transfer are sent to Broker and/or customers by Transfer Agent	No	Yes

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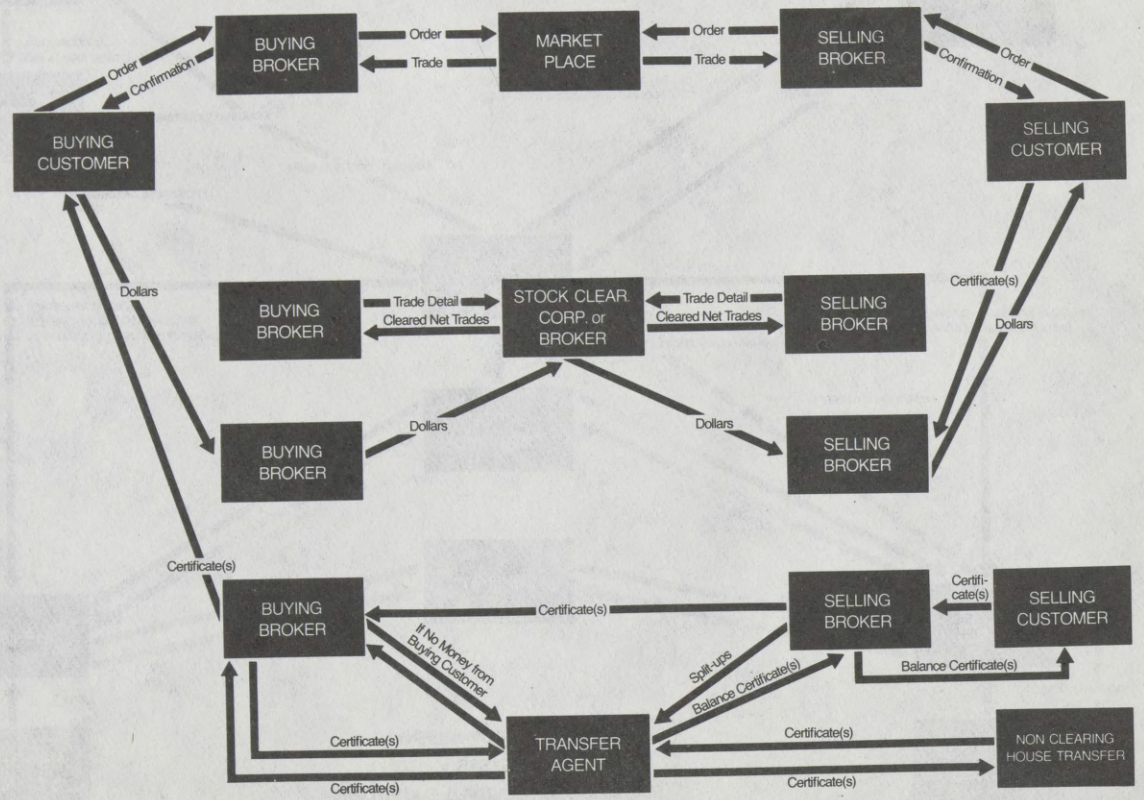
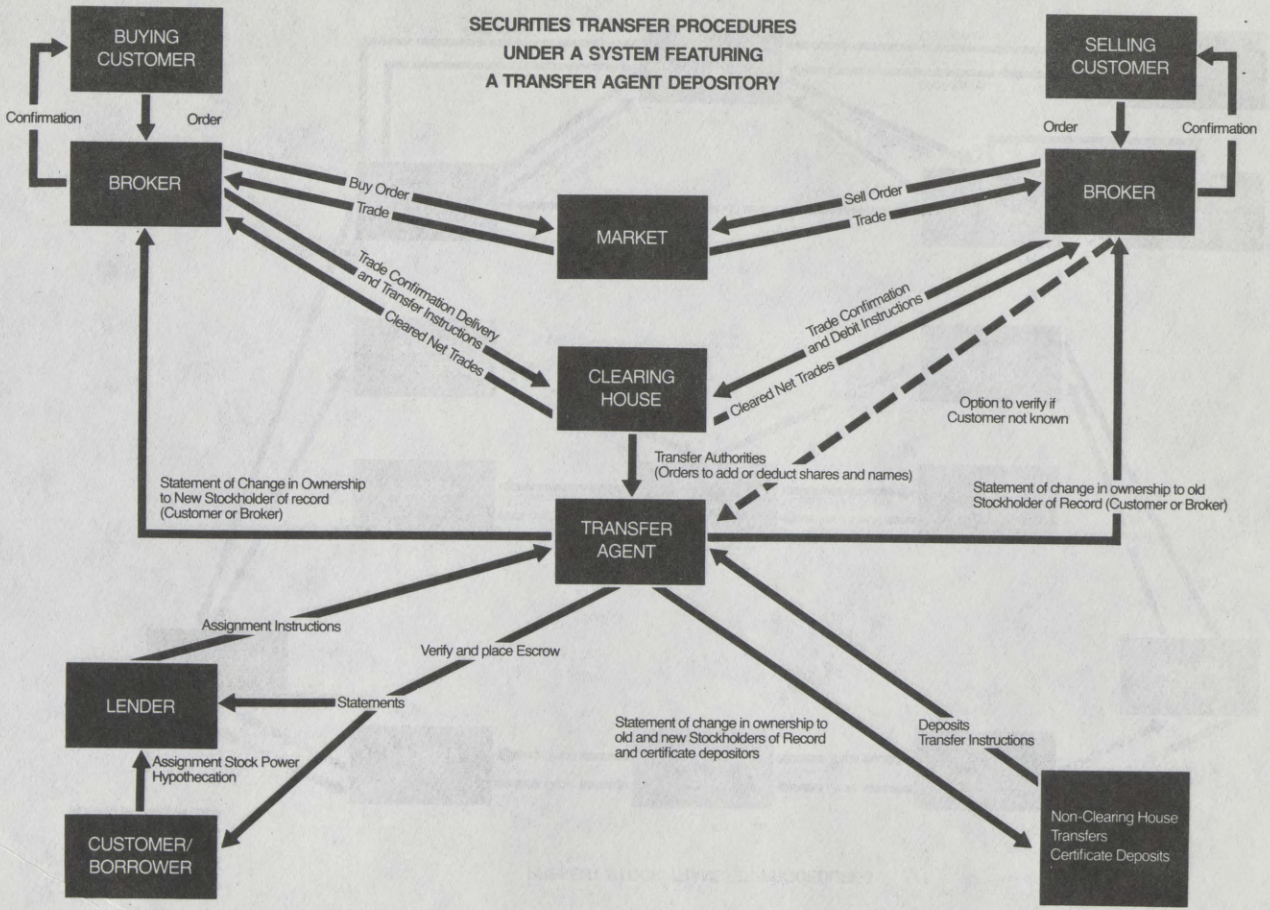
	Present Transfer System	Transfer Agent Depository System
NON CLEARING HOUSE TRANSFERS		
Certificates are delivered to Transfer Agent	Yes	No
Transferred certificates are returned to delivering party	Yes	No
Transferred certificates are sent to Transfer Agent	No	Yes
Statements reflecting new holdings are sent to shareholders	No	Yes
LOANS		
Lender verifies borrower's holdings with Transfer Agent	No	Yes
Transfer Agent places escrow restrictions on borrower's account	No	Yes
Upon advice of the lender, escrow restrictions are removed	No	Yes

PRESENT STOCK TRANSFER PROCEDURES




SECURITIES TRANSFER PROCEDURES
UNDER A SYSTEM FEATURING
A TRANSFER AGENT DEPOSITORY
BUYING CUSTOMER
Confirmation
Order
BROKER
Buy Order
Trade
MARKET
Sell Order
Trade
SELLING CUSTOMER
Order
Confirmation
BROKER
Trade Confirmation Delivery and Transfer Instructions
Cleared Net Trades
CLEARING HOUSE
Trade Confirmation and Debit Instructions
Cleared Net Trades
Option to verify if Customer not known
Transfer Authorities
(Orders to add or deduct shares and names)
Statement of Change in Ownership to New Stockholder of record (Customer or Broker)
TRANSFER AGENT
Statement of change in ownership to old Stockholder of Record (Customer or Broker)
Assignment Instructions
Verify and place Escrow
LENDER
Statements
Assignment Stock Power Hypothecation
CUSTOMER/ BORROWER
Statement of change in ownership to old and new Stockholders of Record and certificate depositors
Deposits Transfer Instructions
Non-Clearing House Transfers Certificate Deposits

THE FIRST NATIONAL BANK OF BOSTON
STOCK TRANSFER DIVISION
POST OFFICE BOX 644, BOSTON, MASSACHUSETTS 02102
TELEPHONE 434–6497

STATEMENT OF HOLDINGS OF THE CERTIFICATELESS CORPORATION

JOHN R WHITEHOUSE
100 FEDERAL ST
BOSTON MA 02105

ACCOUNT NO. 10011

TAXPAYER IDENTIFICATION NO 123-45-6789

RECORD OF TRANSACTIONS THIS YEAR 1973

DATE	TRANSACTION DESCRIPTION	TOTAL SHARES HELD ON RECORD DATE	DOLLAR AMOUNT	FEE	PRICE PER SHARE *	SHARES THIS TRANSACTION
01/26	CTF DEPOSIT					100.000
02/15	SHARES PURCHASED					200.000
03/17	SHARES SOLD					-100.000
04/25	DIV REINVESTMENT	200.000	200.000	2.50	10.00	19.750

* INCLUDES BROKERAGE COMMISSION

SUMMARY

SHARES HELD BY YOU	SHARES HELD BY THE BANK	TOTAL SHARE BALANCE
0	219.750	219.750

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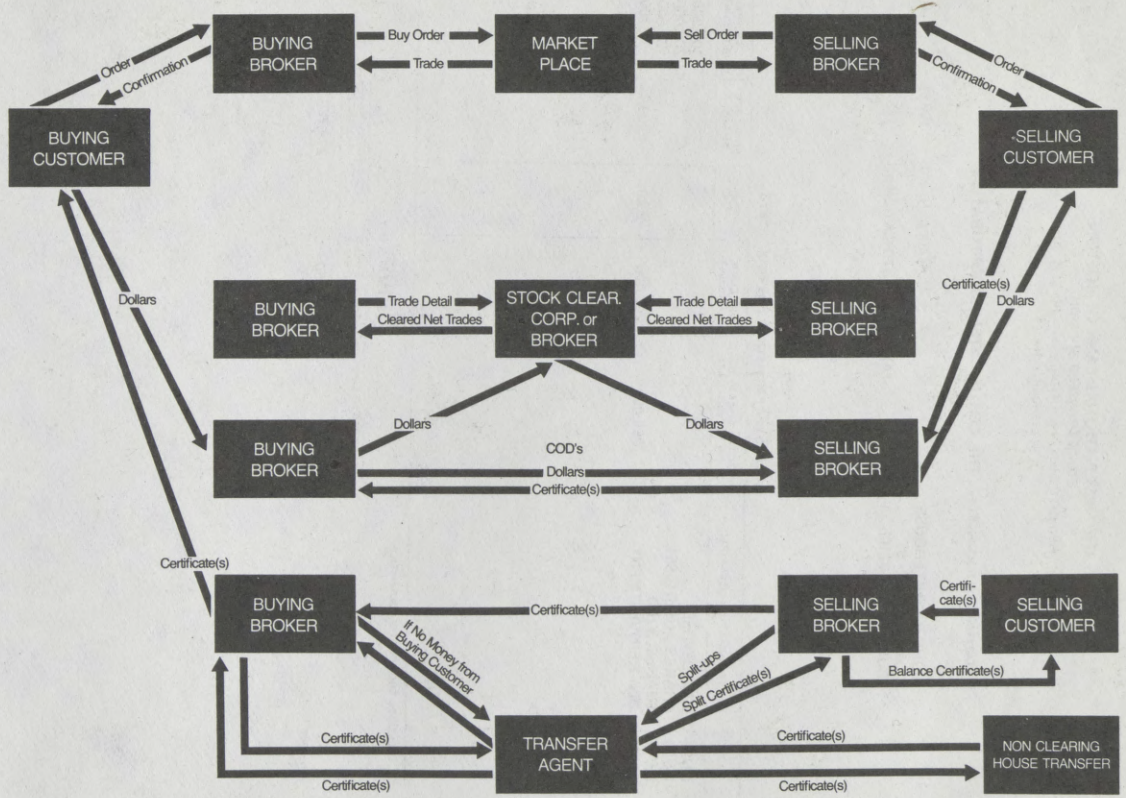
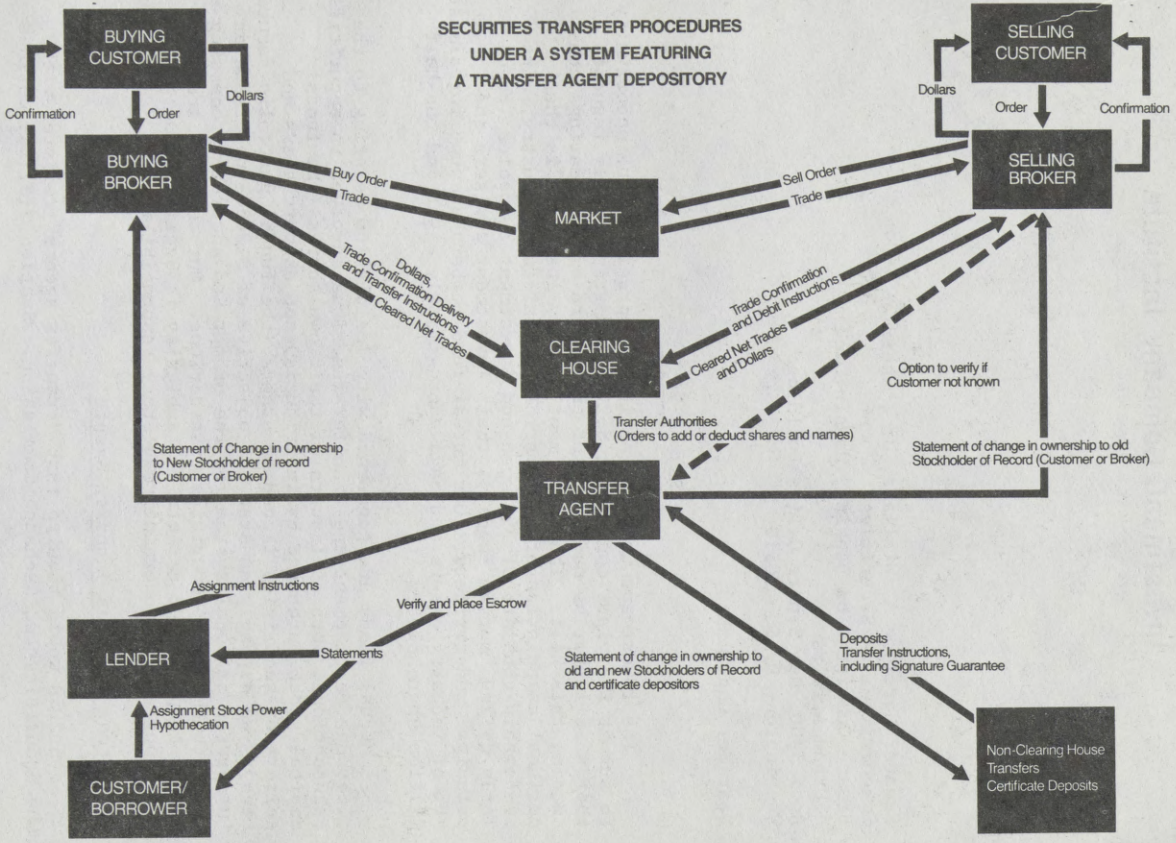
PRESENT STOCK TRANSFER PROCEDURES




SECURITIES TRANSFER PROCEDURES
UNDER A SYSTEM FEATURING
A TRANSFER AGENT DEPOSITORY
BUYING CUSTOMER
Confirmation
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BUYING BROKER
Buy Order
Trade
MARKET
Sell Order
Trade
SELLING CUSTOMER
Dollars
Order
Confirmation
SELLING BROKER
Dollars, Trade Confirmation Delivery and Transfer Instructions
Cleared Net Trades
CLEARING HOUSE
Trade Confirmation and Debit Instructions
Cleared Net Trades and Dollars
Option to verify if Customer not known
Transfer Authorities
(Orders to add or deduct shares and names)
Statement of Change in Ownership to New Stockholder of record (Customer or Broker)
TRANSFER AGENT
Statement of change in ownership to old Stockholder of Record (Customer or Broker)
Assignment Instructions
Verify and place Escrow
LENDER
Statements
Statement of change in ownership to old and new Stockholders of Record and certificate depositors
Deposits
Transfer Instructions, including Signature Guarantee
Assignment Stock Power
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Investment Company Institute
1775 K STREET N. W., WASHINGTON, D. C. 20006
(202) 293-7700

ROBERT L. AUGENBLICK
PRESIDENT
BRUCE B. ROBE
EXECUTIVE VICE PRESIDENT

July 9, 1973

Senator Harrison A. Williams, Jr., Chairman
Subcommittee on Securities
Senate Committee on Banking, Housing and
Urban Affairs
Room 5300, New Senate Office Building
Washington, D. C. 20510

Dear Mr. Chairman:

Re: S.2058

The Investment Company Institute appreciates the opportunity to submit its views concerning S.2058 and respectfully requests that this letter be made part of the record of the hearings concerning this bill. The Investment Company Institute is the national association of the American mutual fund industry. Its membership consists of 390 open-end investment companies (popularly called "mutual funds"), their investment advisers and principal underwriters. Our mutual fund members account for almost 90% of industry assets and have approximately eight and one-half million shareholders.

Mutual funds are concerned with legislation relating to the clearance, settlement and transfer functions involved in securities transactions, both as issuers of their own shares (the funds' capital stock purchased by individuals) and as purchasers and sellers of securities issued by others (the funds' portfolio securities). We strongly endorse the objective of S.2058--to create an integrated national system for the prompt and accurate processing and settlement of securities transactions. Our comments are intended to point out a technical ambiguity in Section 3 and to set forth our views concerning regulatory responsibility.

1. Mutual Funds as Transfer Agents

S.2058 would require that "transfer agents" register with the Securities and Exchange Commission. Section 3(a)(24) defines

the term "transfer agent" to include an issuer which engages in "countersigning", "monitoring the issuance of" and "exchanging" its securities. This definition may thus be broad enough to encompass most mutual funds, even though the vast majority of mutual funds employ other entities to act as their transfer agents.

A mutual fund employing the services of a transfer agent but not itself performing true transfer agent functions might fall within the technical language of Section 3(a)(24) merely because a fund officer countersigns and monitors the issuance of the fund's shares based on the books and records prepared by the fund's transfer agent. In addition, many mutual funds permit their shareholders to "exchange" their shares through their transfer agents for those of other funds in the same complex.

We believe that a mutual fund which employs the services of a registered transfer agent should not itself be required to register as a transfer agent. Dual registration of a mutual fund and its transfer agent would not advance the public interest, would be unnecessary and would subject the fund to inappropriate regulation and expense. We therefore suggest that the section of the final bill adopted by the Subcommittee defining the term "transfer agent" contain the following exemption:

> "The term 'transfer agent' shall not include any issuer which employs any other entity registered as a transfer agent to perform such functions with respect to such issuer's securities."

2. Jurisdiction over Clearing Agencies and Transfer Agents

S.2058 would divide jurisdiction over clearing agencies and transfer agents between the SEC and the various bank regulatory agencies.

Section 5 of the bill provides that all clearing agencies must register with the SEC. Furthermore, the Commission would be granted substantial authority over the activities of such clearing agencies. However, Section 5, after granting the SEC primary authority, delegates certain supervisory responsibilities to the various federal banking authorities based on whether a particular clearing agency is a banking organization.

The entire clearance and settlement process is so closely related to the trading of securities and to the regulation of the securities markets that such activities should not be placed under the regulatory jurisdiction of different agencies. The Securities and Exchange Commission presently has regulatory jurisdiction over issuers, broker/dealers and national securities exchanges and is seeking to coordinate the various activities of all securities exchanges and markets. A number of registered national securities exchanges and other entities are proposing the creation of their own securities depositories. The operations of these proposed depositories must be coordinated with the operations of the securities markets since clearance and settlement are part of the necessary final steps in completing securities transactions. One important aspect of this coordination is that securities depositories adopt fair and equitable policies with regard to ownership, participation and fees, and there is need for uniformity in regulation of the various depositories which may be organized.

In the case of transfer agents, regulatory jurisdiction is more drastically bifurcated than in the case of clearing agencies. Neither initial registration nor supervisory jurisdiction is centralized in any one regulatory agency. The agency with which a transfer agency registers would depend upon whether the particular registrant is a banking or non-banking institution. While the SEC would be given authority to adopt rules governing all transfer agents with respect to standards for the performance of transfer functions and certain related matters, jurisdiction over compliance by bank transfer agents with the rules is shifted to the various banking authorities. We believe that these provisions are unnecessarily cumbersome and could lead to uneven regulatory oversight.

We do not believe that the overlapping and divided jurisdiction over transfer agents and clearing agencies created by the proposed bill is appropriate in the public interest. Section 1 of the bill would amend the Securities Exchange Act of 1934 to add as a regulatory goal the "development of an integrated national system for the prompt and accurate processing and settlement of securities transactions". While we wholly subscribe to the desirability and indeed necessity of such a goal, we find it curious that a bill in furtherance of an "integrated national system" would divide and disperse among a number of agencies the regulatory and supervisory responsibilities for such a system.

We therefore conclude that a functional approach to regulation requires that the Securities and Exchange Commission be the sole regulator of clearing agencies and transfer agents whether or not such entities are banks, trust companies or some other kind of entity. This will insure uniformity in regulation, record-keeping, inspection and compliance standards, and an even-handed imposition of costs.

We endorse Section 17A(q) directing the Securities and Exchange Commission to take such steps within its power to bring about the elimination of the stock certificate on or before December 31, 1976. We believe that the elimination of the stock certificate can be an important step in ensuring that a back-office crisis such as occurred in years 1968-1969 does not reoccur. Mutual funds as issuers of their own shares (the funds' capital stock purchased by individuals) have been highly successful in eliminating stock certificates. Mutual fund shareholders have readily accepted the concept of "book shares" to such an extent that in recent fund offerings approximately 90% of shareholders accepted "book shares" rather than request the delivery of a physical stock certificate. We believe this experience of the mutual fund industry is applicable to the general securities industry.

We appreciate this opportunity to submit our views concerning S.2058.

Sincerely yours,

Robert L. Augenblick

Robert L. Augenblick

STATEMENT OF THE
PACIFIC STOCK EXCHANGE, INC.
REGARDING S. 2058
SUBMITTED TO THE SENATE COMMITTEE
ON BANKING, HOUSING AND URBAN AFFAIRS

THOMAS P. PHELAN
President
PACIFIC STOCK EXCHANGE, INC.

July 11, 1973

The Pacific Stock Exchange ("PSE") welcomes this opportunity to present its views concerning S. 2058.

PSE has for some time supported the basic regulatory approach embodied in S. 2058. PSE believes that legislation dealing with securities processing should give the Securities and Exchange Commission ("Commission") effective rule-making authority with respect to clearing agencies, depositories, and transfer agents.

PSE believes that, with respect to depository systems, it is important that the Commission be given sufficient authority, without giving it so much control over day-to-day operations that banks and other financial institutions, accustomed to dealing with different regulatory bodies, will be unwilling to participate in the development of depositories.

S. 2058, in our view, provides the proper mix of responsibilities, as the Commission is given rule-making authority, while inspection and enforcement responsibilities are delegated to bank regulatory agencies for depositories that become members of the Federal Reserve System.

S. 2058 contains one final provision which is very important and which the PSE believes should be incorporated in whatever legislation is passed to deal with the problems of securities clearance and settlement. Section 9 of S. 2058 addresses the problem of state securities transfer taxes and personal property taxes, which if they are not modified may pose an insuperable obstacle to the development of a

national network of securities depositories. The real problem is the New York Stock Transfer Tax. The New York Transfer Tax, with its extraordinary extra-territorial reach, has for long enough stood as a barrier to interstate commerce. It should not now be allowed to prevent the development of a national depository network, which is so important to the progress of the securities industry.

The purpose of Section 9 of S. 2058 is thus highly commendable. The PSE believes, however, that the section is worded in such a way that its interpretation will prove difficult. Apparently the standard to be applied is a constitutional standard as to whether, assuming the depository facilities were not located in the taxing state, there would be a sufficient nexus between the taxing state and the transaction to justify taxation. Reference to a constitutional standard, which is vague and confused, makes the operation of the section much more uncertain, and for this reason might delay development of a national depository network until the issue can be clarified in court. We would suggest that the language of Section 9 of S. 2058 be replaced by the following language, which is much more explicit in its effect:

> "(c) No state or political subdivision thereof shall impose any tax on any change in beneficial or record ownership of securities effected through the facilities of a registered national securities clearing agency or any nominee

thereof or custodian therefor or upon the delivery or transfer of securities to or through or receipt from such agency or any nominee thereof or custodian therefor, unless such change in beneficial or record ownership or such delivery or transfer of securities occurs as a result of a sale of securities or an agreement to sell securities made within the taxing State or political subdivision, or unless the securities are transferred upon the books of the issuer thereof at an office located within the taxing State or political subdivision, or unless the securities are transferred upon the books of a transfer agent for such securities at an office located within the taxing State or political subdivision. No State or political subdivision thereof shall impose any tax on securities which are deposited in or retained by a registered national securities clearing agency or any nominee thereof or custodian therefor, unless the beneficial owners of such securities are either residents or domiciliaries of the taxing State."

Last year the Pacific Clearing Corporation, the clearance and depository subsidiary of PSE, submitted its views on S. 3876, H.R. 14826 and H.R. 14567 to the Commerce and

Finance Subcommittee of the House Committee on Interstate and Foreign Commerce. Since our views on these issues have remained the same, and since the questions posed by S. 2058 are essentially the same as the questions posed by S. 3876, we are submitting this statement to the Senate Committee at this time as Appendix A to this Statement.

Respectfully submitted,

PACIFIC STOCK EXCHANGE, INC.

By: THOMAS P. PHELAN
President

STATEMENT OF THE

PACIFIC COAST STOCK EXCHANGE CLEARING CORPORATION

SUBMITTED TO THE

COMMERCE AND FINANCE SUBCOMMITTEE

OF THE HOUSE COMMITTEE

ON INTERSTATE AND FOREIGN COMMERCE

Appendix A

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I.

INTRODUCTION

The Pacific Coast Stock Exchange Clearing Corporation ("PCSECC") appreciates the opportunity to submit its views to this Subcommittee on three bills dealing with securities clearance, S. 3876, H.R. 14567 and H.R. 14826.

PCSECC, as an outgrowth of its clearance activities, currently operates a securities depository as a subdivision. This depository, begun only about a year ago, already holds securities valued at approximately $800,000,000. It is planned that in the near future this Depository will be expanded substantially as securities currently held by banks in a fiduciary capacity are brought into the Depository. Toward this end, PCSECC has been actively cooperating with a number of major West Coast banks in planning an expanded Western regional depository. PCSECC is also actively cooperating with CCS and the Midwest Stock Exchange's Clearing Corporation, in planning the development of a national system of depositories linked by contra-accounts. In addition we have taken an active part in the work of the National Coordinating Committee for a Comprehensive Securities Depository. PCSECC wants to emphasize, however, that this statement does not necessarily reflect the view of any entity other than itself.

II.

VIEWS OF THE PACIFIC COAST STOCK EXCHANGE CLEARING CORPORATION ON S. 3876

The PCSECC believes that any legislation dealing with the processing of securities transactions should give the Securities and Exchange Commission ("Commission") effective rule making authority with respect to clearing agencies, depositories, and transfer agents. The Commission, by virtue of its experience and its existing regulatory responsibilities, is the logical agency to exercise overall rule making authority over the process of securities clearance, settlement, and transfer.

PCSECC also recognizes that banks, which are important participants in the systems that are planned for improving securities clearance and settlement, have legitimate reasons for preferring that the regulation of systems in which they participate be in the hands of bank regulatory agencies. It has been the experience of the PCSECC that the Western banks have been eager to cooperate in the development of an expanded depository system. This spirit of cooperation is best fostered by a bill, such as S. 3876, which gives enforcement and inspection authority to bank supervisory agencies in the case of banks acting as depositories, clearing agents, or transfer agents.

The PCSECC believes that, of the three bills currently under consideration by this Subcommittee, S. 3876 represents the most viable approach to the problem of regulating securities clearance and settlement. The Commission is given rule-making power in connection with the activities of clearing agencies, depositories, and transfer

agents, while inspection and enforcement powers with respect to institutions which are regulated by federal banking authorities is left to the federal banking authorities. This is the division of regulatory responsibility which the PCSECC supports.

III.

VIEWS OF THE PACIFIC COAST STOCK EXCHANGE CLEARING CORPORATION ON H.R. 14826 and H.R. 14567

The PCSECC does not oppose either H.R. 14826 or H.R. 14567. We do, however, believe that S. 3876 represents a better approach than either of the two House bills. A national system of securities clearance, settlement and transfer will have to involve financial institutions outside the securities industry which are not accustomed to regulation by the Securities and Exchange Commission. In order to attract the cooperation of such institutions, it is important to provide a regulatory framework with which they will feel comfortable. We believe that this goal is best achieved by S. 3876.

IV.

VIEWS OF THE PACIFIC COAST STOCK EXCHANGE CLEARING CORPORATION ON THE TYPE OF CLEARANCE AND SETTLEMENT SYSTEM THAT SHOULD BE FOSTERED BY REGULATION

Neither S. 3876 nor H.R. 14826 and H.R. 14567 say anything very specific about the design of a national system of clearance and settlement. The PCSECC believes that this is as it should be.

Rather than Congress prescribing solutions, it is better for private industry groups, subject to the ultimate supervision of the agencies to which Congress entrusts authority in this area, to develop acceptable solutions through an evolutionary process. We do believe, however, that Congress should closely monitor the progress that is made.

For this reason, we believe it will be useful to the Subcommittee if we briefly outline what we believe should be the design of a national system of clearance and settlement. First, we believe that the development of depositories represents the best near term solution to the problems of clearance and settlement. Elimination of the stock certificate would be very difficult to accomplish before securities have been immobilized in a depository environment.

Second, we believe that it would be a serious mistake for the nation to be dependent on one securities depository which in turn is dependent upon one source of power and one labor market. Moreover, one depository would tend to centralize too much financial power in one region of the country. The PCSECC believes that it is much preferable to develop a national system of securities depositories, linked by contra-accounts and thus able to accomplish delivery of securities and cash settlement between regions of the country by book-entry methods.

Third, such a national depository system can be created very quickly by interfacing the existing depositories in New York and California, as well as the depository that is being created by

the Midwest Stock Exchange in Chicago. Thus the first order of business for the nation's clearing corporations and depositories, and for the banks interested in this area, is to develop a system of interface between depositories. The PCSECC has consequently been engaging in detailed discussions with representatives of New York's Central Certificate Service and the Midwest Stock Exchange Clearing Corporation. Though some technical and legal roadblocks have emerged, we hope that in the next few months depositories will have contra-accounts with each other. Then we will have the beginnings of a national system of clearance and settlement.

V.

CONCLUSION

The PCSECC hopes that this statement will be of assistance to the Subcommittee in its difficult task of providing for the regulation of the systems for securities clearance and settlement which are currently being developed.

SHIELDS & COMPANY
INCORPORATED
MEMBERS PRINCIPAL SECURITIES EXCHANGES
44 WALL STREET
NEW YORK, N.Y. 10005

July 11, 1973

Subcommittee on Securities
Committee on Banking, Housing & Urban Affairs
U.S. Senate
Washington, D.C. 20510

Attention: Alton B. Harris, Esq.

Gentlemen:

I am pleased to be able to respond to the invitation of your Chairman to express my views on S.2058 concerning the clearing and settling of securities transactions.

First, I wish to state that I am in general support of the objectives of the bill and believe that, if enacted in its present form, it would represent a first major step in the resolution of many operational problems which have plagued the securities industry for many years.

At the same time, I wish to point out to the Subcommittee that certain important areas remain unresolved, especially with respect to the lack of a cohesive, national system for effecting timely transfers of the securities of the more than thirty thousand issuers of corporate securities throughout the nation. We have developed systems to transfer money electronically, but do not seem to be in a position, under the proposed legislation, to issue and cancel certificates at various regional locations throughout the country. Regardless of standards of performance which may be imposed by the proposed statute, geography and the requirement to deal with physical certificates for cancellation and issuance inherently delays the system and may be the seed for a new operational problem of the future.

Also, at the present time, the legal documents which are required to effect transfer in certain trust, estate, and other "legal" forms vary not only from state to state, but also within a state, from transfer agent to transfer agent. It is my belief that your legislation should speak more directly to this problem, with a view toward standardizing the bases under which transfers of securities are made. Additionally, there are presently no standards for acceptance of signature guarantees, except by informal organizations which appear to be exercising powers which the law may not have granted them. I enclose a

notice from the New York Stock Exchange, Inc., which illustrates that the Stock Transfer Association, Inc. and the Corporate Transfer Agents Association, Inc. assume power to review NYSE forms. The present system may be discriminatory with respect to broker/dealers which are not members of the New York or certain other exchanges.

In the definition of transfer agents, you have excluded both dividend paying agents and interest disbursing agents. I believe this is a defect which should be rectified if we are to include the entire universe of securities processors under a single new system.

While recognizing the fact that exempt securities are exempt from certain SEC regulations, it appears to me to be wrong not to avail yourself of this opportunity to include the more than one million issues of securities, the cost of issuance of which is paid by the taxpayer, within a system of clearance and depository facilities. These securities might be phased into the system over a longer period of time, but presently remain the most difficult to process for both banks and broker/dealers.

Finally, I would like to address the question of the diversity of regulatory bodies which will be dealing with this inter-industry problem. As I have testified before, the best solution would be to create a federally chartered, privately owned corporation to operate and regulate the clearance and depository system, as well as certain ancilliary functions.

In the absence of that solution, a single regulator should be selected to make the rules for all participants and to enforce them. Divided regulation, regardless of requirements for "cooperation", is unequal regulation. The systems for regulating banking participants in this national scheme are totally different from those of the Commission. Methods of discipline, disclosure of discipline, and related issues may be treated unequally and unfairly with divided regulatory responsibility.

It is my belief that the one area of regulation over the securities industry by bank regulators, Regulation T of the Board of Governors of the Federal Reserve system, has not worked as well or been administered as effectively as if it were the responsibility of the Commission. For example, we have recently seen severe dislocation of many investors by the recent amendment to Regulation T prohibiting "same day substitution" for accounts with less than 40% equity. As a result, many customers have been unable to upgrade their portfolios because of their inability to replace securities without payment of additional money at a time when they are unable to afford it.

Much comment has been seen in the press and in correspondence related to this area, but no action as yet has been either taken

or proposed by the Federal Reserve Board. It might be interesting for the Subcommittee to review the rule change processes within Regulation T for the past several years to examine the responsiveness of the bank regulator to the needs of a different industry.

Conversely, a recently proposed rule of the Commission, Rule 15c3-3 under the Securities Exchange Act of 1934 was not given appropriate attention by the bank members of the financial industry. Certain provisions related to the buying in of exempt securities, which would have had a serious effect on bank municipal bond operations, became the subject of a last minute decision by the Commission. As of this date, that portion of the rule is still suspended by order of the Commission because of the inability to balance the needs for investor protection of the securities industry against the requirements of the banking industry.

I do not bring these points up to be disruptive or critical of the agencies involved. I speak to them primarily to illustrate that cooperation, in my judgment, cannot be legislated, but will exist only with true motivation for benefits to be received by both parties. As a result, it is my conclusion that, failing the establishment of the kind of entity I have proposed before your Subcommittee two years ago, that the selection of the Commission as the regulator for all phases of securities processing would be preferable to the approach taken by S.2058.

I shall be happy to amplify, either in writing or in person, the views expressed in this letter.

Again, I would like to thank the members of the Subcommittee for the two opportunities I have had to testify in person before them, and to express my appreciation for this opportunity of commenting on your legislation.

Very truly yours,

Junius W. Peake
Senior Vice President
Administration & Operations

JWP:mae

Enclosure

S. L. CIRCULAR NO. 132

NEW YORK STOCK EXCHANGE, INC.

Division of Stock List

July 3, 1973.

To Members and Managing Partners/Officers of Member Organizations:

On July 2, 1973, WALSTON & CO., INC. a member organization changed its corporate name to duPONT WALSTON INCORPORATED and will continue to do business under the name of duPONT WALSTON INCORPORATED.

An Indemnity Agreement has been executed and filed with the Exchange by the continuing organization whereby deliveries and transfers of securities assigned by WALSTON & CO., INC. when presented or delivered on and after July 2, 1973, by other than duPONT WALSTON INCORPORATED will be accepted without the statement "Execution Guaranteed" endorsed thereon. This form of procedure has been previously approved by The Stock Transfer Association, Inc. and the Corporate Transfer Agents Association, Inc.

* * * * * * * * * * *

For the purpose of aiding in the transfer of securities with assignments or powers of substitution signed manually or with the mechanically reproduced facsimile signature of WALSTON & CO., INC. and bearing the statement "Execution Guaranteed" endorsed thereon by duPONT WALSTON INCORPORATED, a signature agreement has been filed with the Exchange whereby duPONT WALSTON INCORPORATED has adopted as and for its signature, the signature of WALSTON & CO., INC., including specifically the mechanically reproduced facsimile signature, specimens of which were previously furnished transfer agents.

This method has been adopted to induce the acceptance of securities bearing such endorsements by transfer agents and by member organizations for delivery purposes in conformity with the provisions of Rules 204 and 205 of the Board of Directors. The procedure has the approval of the Board of Directors of The Stock Transfer Association, Inc. and the Corporate Transfer Agents Association, Inc.

RICHARD M. DREW
Director - Operations

NOTE: duPONT GLORE FORGAN INCORPORATED is continuing as a separate member organization.

Inquiries should be directed to 623-5040.

THE STOCK TRANSFER ASSOCIATION, INC.

Established 1911

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BRUCE B. UPSHALL
Assistant Vice President, Corporate Services
Canada Permanent Trust Company
Toronto, Canada

July 13, 1973

Honorable Harrison A. Williams, Jr.
Chairman, Subcommittee on Securities
Committee on Banking, Housing and Urban Affairs
United States Senate
Washington, D.C. 20510

RE: S.2058

Dear Senator Williams:

The Stock Transfer Association, Inc., wishes to acknowledge receipt of a copy of S.2058 and to express its appreciation for the invitation of the Subcommittee on Securities, under date of June 29, 1973, to submit a written statement concerning this bill.

As you and your Subcommittee know, The Stock Transfer Association, Inc., was invited to appear and testify at legislative hearings held on May 10, 1972, by your Subcommittee in respect of proposed bills S.3412, S.2551 and S.3297 (92nd Cong., 2nd Sess.) and at legislative hearings held on September 8, 1972, by the Subcommittee on Commerce and Finance of the House Committee on Interstate and Foreign Commerce in respect of proposed bills H.R.14567, H.R.14826 and S.3876 (92nd Cong., 2nd Sess.). At both such appearances, we offered certain suggestions for improving the proposed legislation from the standpoint of the transfer agent, but our remarks were directed principally at the inclusion of transfer agents, and their functions, in such proposed legislation.

Recently, The Stock Transfer Association, Inc., was invited by the Subcommittee on Commerce and Finance of the House Committee on Interstate and Foreign Commerce to make written comments on H.R.5050 (93rd Cong., 1st Sess.). The comments

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Toronto, Canada

set forth herein, with the exception of the remark made in the concluding sentence of the eighth paragraph hereof, are virtually identical to the comments made by us, under date of May 4, 1973, in respect of that proposed legislation.

Before both the House Subcommittee and your Subcommittee during the last session, we expressed our view that the necessity of regulation of transfer agents by way of Federal legislation, as well as how much and what type of regulation, were debatable subjects. We pointed out that certain parallel developments in the securities industry and the stock transfer field--namely, the expansion of securities depositories such as Central Certificate Service, increased use of JUMBO certificates, revisions of rules of the New York Stock Exchange relating to deliveries of securities, improved technology and the adoption of uniform procedures through the efforts of the Banking and Securities Industry Committee--had very significantly reduced the possibility that the public and the securities industry would ever again witness the abnormal conditions and resulting delays in processing securities transfers which arose during the period 1968-1970.

In the last six months, further developments in the securities industry have compelled us, as transfer agents, to give renewed consideration to the question of the need, whether at this time or in the future, for Federal legislation regulating the activities of transfer agents. We no longer believe that regulation of transfer agents is a debatable subject but have concluded that regulation simply is not necessary.

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Since our appearance on May 10, 1972, the securities industry has seen a most remarkable growth of the securities depository and much wider use of the JUMBO certificate. These alone have reduced the number of transfers to a staggering degree. In addition, the securities industry is now faced with the fact that the volume of sales on national exchanges is low and will very likely remain low as testimony to the diminishing interest in public securities markets of the non-institutional investor.

It appears to us obvious that the combination of efforts aimed at reducing the number of transfers with market conditions having such consequences will greatly affect the stock transfer function. The burdens of the transfer agent promise to be greatly reduced, and efficient performance should, therefore, always be within control. We believe that Federal legislation should not now supplant the very productive efforts of the securities industry itself or the natural adaptation of the stock transfer field to market conditions.

If it is determined that legislation regulating transfer agents is, nevertheless, necessary, we firmly believe that enforcement of any promulgated regulatory measures affecting bank transfer agents and examination of compliance therewith by bank transfer agents must be left to bank regulatory agencies, which have prior experience in such areas and the capability of handling such matters effectively. This scheme was embodied in S.3876 and H.R.16946, and we found it to be sound. We do not object to

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Established 1911

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concentration of rule-making authority in the Securities and Exchange Commission; nor do we object to concentration of enforcement and supervisory authority with respect to non-bank transfer agents in the Commission. As between the respective approaches in this regard taken by H.R.5050 and S.2058, therefore, we find that of S.2058 to be preferable.

We have already voiced our concern, both before your Subcommittee and the House Subcommittee on Commerce and Finance, about any specific grant to the Securities and Exchange Commission of authority to prescribe rules and regulations relating to the form or format of the stock certificate. We re-express our concern now. Requirements of this nature could very easily impose undue burdens on issuers as well as transfer agents and result in the elimination of all but a few organizations able to perform the stock transfer function.

In conclusion, while the Stock Transfer Association does not now believe that Federal regulation of transfer agents is necessary, it wishes to re-pledge its full cooperation should legislation be enacted and re-state its desire to participate to the fullest possible extent in the development of measures implementing such legislation.

Very truly yours,

Thomas W. Stanley
President

TWS/gb

FEDERAL DEPOSIT INSURANCE CORPORATION, Washington, D.C. 20429

OFFICE OF THE CHAIRMAN

JUL 16 1973

Honorable John Sparkman
Chairman, Committee on Banking, Housing
and Urban Affairs
United States Senate
Washington, D. C. 20510

Dear Mr. Chairman:

This refers to your July 2, 1973 letter requesting a report on S. 2058, 93d Congress, a bill "To amend the Securities Exchange Act of 1934 to provide for the regulation of clearing agencies and transfer agents, and for other purposes." The bill is substantially similar to S. 3876 which was passed unanimously by the Senate during the 92d Congress.

With respect to the clearing agency function, S. 2058 would grant to the Securities and Exchange Commission the substantive rulemaking authority over all clearing agencies, and such agencies would be required to file registration statements with the SEC. Administrative disciplinary and review proceedings and other enforcement responsibilities would be conferred upon the "appropriate regulatory agency" which, in the case of an insured bank acting as a clearing agency, would be the Comptroller of the Currency, the Federal Reserve or the FDIC.

The SEC and the bank regulatory agencies would be required to exchange copies of reports concerning clearing agencies where appropriate and to notify each other of actions taken with regard thereto. The SEC and the bank regulatory agencies would also be required to consult with and request the views of each other before issuing any proposed rule for public comment or adopting any such rule.

We agree with the general thrust of these provisions regarding the regulation of clearing agencies, but would recommend that the last sentence of the proposed section 17A(o) requiring the appropriate regulatory agency to make a full and detailed report to the SEC of any

examination of a registered clearing agency be amended to limit this reporting requirement to information relating to the clearing agency function insofar as insured banks are concerned, so as not to imply that unrelated information developed in the course of a general examination of the insured bank need also be reported to the SEC.

As to the transfer agency function, S. 2058 would require registration statements to be filed with the appropriate regulatory agency but, as with the clearing agency function, substantive rulemaking authority would be lodged exclusively with the SEC. The three Federal bank regulatory agencies would be consulted by the SEC in the exercise of its rulemaking authority and the bank regulatory agencies would have the enforcement responsibility with respect to insured banks acting as transfer agents, except that the second sentence of the proposed section 17B(j) appears to give the SEC a residual, concurrent enforcement jurisdiction with respect to banks acting in this capacity. That subsection seems to grant the SEC power to enforce compliance "by any person with the requirements imposed under this section." We recommend that the breadth of the term "by any person" does not seem fully to conform to the concept of lodging exclusive enforcement jurisdiction in the Federal bank regulatory agencies with respect to insured banks acting as transfer agents. We therefore recommend that subsection (j) be amended so as definitely to preclude the possible construction that the SEC is being given concurrent enforcement authority with respect to insured banks acting in this capacity.

The Corporation in the past has strongly recommended that the Federal bank regulatory agencies be granted the same enforcement tools as would be granted by the proposed legislation to the SEC. To this end we recommend that the proposed section 17B(j) be amended to give the Federal bank regulatory agencies enforcement authority similar to that granted therein to the SEC. That subsection might be amended to read as follows:

> "(j) The appropriate regulatory agency may, after appropriate notice and opportunity for hearing, by order, censure or bar or suspend or place limitations upon any transfer agent, or any officer, director, or employee of any transfer agent, or revoke the registration of any transfer agent, if such agency finds that such censure, barring, suspension, placing of limitations, or revocation is in the public interest or for the protection of investors and that such transfer agent or any officer, director, or employee thereof has willfully violated or is unable to comply with any provision of this section or any rule or regulation promulgated thereunder pertaining to such transfer agent or any officer, director, or employee thereof."

If amended as recommended above, the Corporation would support enactment of S. 2058.

Sincerely,

(Signed) Frank Wille

Frank Wille
Chairman

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