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EFFICIENCY IN TRANSFERRING SECURITIES

An Address by

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Securities and Exchange Commission

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NEW YORK REGIONAL GROUP
AMERICAN SOCIETY OF
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Recently, the other Commissioners and I had the pleasure of dinner with the officers and directors of your national society in Washington. I have always had considerable admiration for the organized corporate secretaries, both nationally and the few local chapters that I have had a chance to get to know. Your society over the years, and currently, has displayed a sense of moderation, responsibility and professional competence that the Commission has found refreshing and valuable.

At this recent dinner, however, I learned some other things. For one, I encountered some discontent with your society's name. The observation was made by some of your officers that people generally get a mistaken connotation from the term "corporate secretaries" and therefore, among other things, expect you, collectively at least, to be a good deal prettier than is the sad truth. With this observation I must agree. But I am also sure, as asserted, that the duties of many of your members extend significantly beyond those typical of the corporate secretary, even when properly understood.

This does not lead me to encourage you to change your name. I have a fondness for anachronistic names that smell of history and origins - - except possibly when they are distressingly long, like the Pennsylvania Company for Insurances on Lives and Granting Annuities of Philadelphia, now known as the First Pennsylvania Bank. However, this particular problem, I am grateful to acknowledge, is none of my affair. I just hope you do not select some awful acronym with a vaguely obscene flavor so common today, or the kind of popular euphemism that turns obstacle courses into confidence courses, janitors into engineers, and Commissioners into experts.

The other theme that was dominant at our dinner was the prospect of your society's playing a more active role in matters concerning our securities markets. I learned much of this from sitting next to Harold Glasser and later from reading an address of his, kindly sent to me by Sam Black. As I said at the time, this seems quite proper and desirable, and when you think of it, long overdue - - especially in these times when, in some respects, one might even say too late. A great deal of the record on market structure questions is already in, and positions on many aspects have become rather firm. Nevertheless, by no means have all the decisions been made, and your society would speak with a welcome voice on those questions still being deliberated. I very much encourage your involvement, as Mr. Glasser urges - - and I say this ingenuously, because I have no idea how you will come out or what positions you will take.

Even though you are not all presently corporate secretaries, or, if you are, you have broader responsibilities than a narrow connotation of the term would suggest, I trust you retain enough interest in the technical aspects of that job for it to be appropriate for me to talk about securities processing and the involvement of the stock transfer process in pending legislation and in the move toward a central market system - - a subject on which your Society has expressed its views before Congress and elsewhere. I don't mean to get involved in the myriad technical problems of adequate documentation, etc., important as they may be in particular cases but rather to talk about the broader economic and regulatory aspects of the overall process.

I am sure it is not necessary to spend much time with this audience pointing out some of the difficulties and frustrations in our present stock transfer procedures. You all

lived through the late sixties and the great back office crunch of those days, when everybody agreed that the securities processing system had virtually broken down, and the only major point of dispute was who was more responsible for the mess - - the back offices of the brokerage firms or the stock transfer agents. Delays and loss of securities produced not just annoyance in all quarters, but financial distress on the part of many persons, especially brokers, and it contributed to the ultimate demise of more than one hundred brokerage firms.

While the situation has improved in important respects, it has not by any means disappeared. Last May, as I am sure you recall, Weis Securities, Inc. went out of business, thus gaining the dubious honor of being the first major stock exchange member to be liquidated under the Securities Investor Protection Act. The liquidation process has evoked substantial criticism from the press and elsewhere; some of it may be justified and some of it probably is not; but most of it has been directed at the length of time required to deliver to customers their funds and securities. In discussing these delays, a variety of problems perhaps could be cited, including poor books and records and lack of experienced personnel to help the trustee, but there was one central bottleneck concerning which SIPC trustees have expressed general agreement - - the inability to process stock certificates through transfer agents with sufficient promptness.

I realize that in the list of complaints generated, legal problems and physical problems were mixed. They should not be confused in any effort to work toward greater efficiency in the area. A transfer agent may have facilities that are fully adequate for prompt transfers and, nevertheless, delay transfer for a substantial period of time due to a lack of proper documentation or other legal problems. While one may become impatient

with what appears to be an overly meticulous view as to what constitutes proper documentation, one does have to remember that the risk a transfer agent may run in making a mistake can be quite out of proportion to the small revenue involved.

As to other physical or operation problems, we do not entertain the notion that the SEC, by regulatory fiat, can simply order a new and more efficient system for the transfer of securities. But, there do appear to be appropriate roles that the government can and should play.

One such role is an analysis of operational difficulties, their causes and possible remedies. For that reason, the Securities Investor Protection Act, passed in December, 1970, directed the Securities and Exchange Commission to undertake a study of broker-dealer practices that had proven troublesome and to recommend to Congress additional legislation needed to eliminate any problems revealed by the study. Following this directive, the Commission submitted to the Congress, in December, 1971, its Study of Unsafe and Unsound Practices of Brokers and Dealers.

The Commission's study concluded that the serious operational problems experienced by the securities industry from 1968 through 1970, especially the industry's inability to process customer transactions accurately and promptly, evidences a need for more scrutiny and control by the federal government in this area than that which presently exists. Transfer functions, for example - - an activity not presently subject to pervasive regulation by the Commission - - was found to have been handled efficiently by some transfer agents as well as some issuers that had acted as their own transfer agents, where appropriately automated transfer systems had been employed. But many transfer agents, including some of the largest, were found to have been substandard in the

performance of their functions and to have been significant contributors to the paperwork crunch of the period. Of course, the Commission did not purport to blame transfer agents for the entire 1968-1970 paperwork crisis - - inadequate back office personnel and procedures of brokerage firms also contributed substantially to the debacle.

In 1972, the Commission recommended to Congress legislation concerning the processing of securities transactions, which among other things, provided for the regulation of transfer agents and also of those entities performing securities depository and clearing agency functions. In addition to the Commission's proposed legislation, a number of bills regarding this subject were introduced in both the House and Senate in 1972. While legislation was not then enacted, several bills, particularly, S. 2058 and H.R. 5050, are presently pending which, among other things, incorporate provisions for the regulation of transfer agents, clearing agencies and securities depositories.

The Commission neither envisions nor desires elaborate regulatory requirements for transfer agents. Rather, the opposite is true. What is contemplated, in brief, is the establishment of minimum standards for performance of transfer functions, measures to assure the safe handling and custody of securities and funds, and steps to assure operational compatibility of the transfer agent with other persons involved in the securities handling process. In many cases, these standards presently could be met by better transfer agents, and will have only minor impact. If, in certain instances, there is a greater dislocation, it will be because some entities are clearly operating below par.

In any event, I believe there will be a significant countervailing benefit to any dislocation which might occur, which perhaps has not been fully recognized. If transfer

agents have been slow to respond to orders from broker-dealers, the public and SIPC trustees, in part, it is because they go through elaborate procedures. The establishment of standards and rules would allow the development of guidelines for handling transfers, which could benefit customers, broker-dealers and trustees by significantly reducing delays, and could benefit the transfer agent community by establishing standards for the performance of functions, and which would assure that transfer agents serve the public appropriately.

I have directed my attention initially to the effect of the proposed legislation on transfer agents, but, it is apparent that regulation of transfer agents is only a segment of a problem of considerable scope. This is the urgent need to develop an integrated national system for the prompt and accurate processing of securities transactions. Depositories, clearing agencies and transfer agents must not only operate individually in a prompt, safe, and accurate manner, cognizant of the public interest, but they must also coordinate into a smooth functioning and efficient nationwide system for handling investors securities.

In addition to the benefits to investors, such a system has the potential for significant processing economies, which would benefit all elements of the system.

Processing economies, the public interest, protecting investors against loss of securities and cash, the need to maintain the financial and operational responsibility of broker-dealers, the need for greater confidence in our securities markets, and, indeed, the development of a central market system, all require present action building toward a nationwide securities processing system.

Recently, in his statement to the Secretary of the Treasury, published two weeks ago as "Public Policy for American Capital Markets", Professor Lorie expressed the view

that the general objective of public policy for our capital markets is to have markets that operate fairly and efficiently. Efficiency involves both efficiency in the determination of prices of securities - - meaning the ability of capital markets to function so that prices of securities react rapidly to new information - - and also efficiency in transferring the ownership of securities. As to this latter point, he states:

“It is desirable that the cost of transactions be low . . . Transaction costs have three main components: the cost of brokerage, the cost of using the capital and bearing the risks which are necessary when market makers maintain inventories, and the cost of physically effecting transfers of ownership. This last cost is large - - unnecessarily large.

“Although there have been improvements in the machinery for making such transfers, the current system is far from optimum in view of the capabilities of existing technology. Efforts by the New York Stock Exchange, the regional exchanges, and the National Association of Securities Dealers to develop new systems for clearing and settling transactions have progressed, but the efforts have been incomplete and have fallen far short of what is achievable.”

It was not Professor Lorie’s assignment to spell out in detail how efficiency in this area can be improved. He merely referred to some of the activities now going on, and emphasized their importance in the overall picture. He does add, however:

“All institutions which participate in any aspects of the process of buying and selling securities and effecting transfers of ownership should be subject to the authority of the SEC. Whether the institutions be broker-dealers, banks, depositories, non-bank transfer agents, or others, the SEC should have the authority to impose their rules, ascertain their degree of compliance, and impose appropriate sanctions. . . .”

I realize that this is a subject on which your Society and we disagree. Indeed, in statements before Congress you have gone so far as to say that you do “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 . . . 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”. It is our continued belief that central federal oversight of the entire process is desirable. If we are ever actually given the authority and responsibility, we fully intend not to exercise it in a counter-productive manner.

Quite apart from any legislation expanding our powers - - and it is not really my purpose to belabor this issue today - - we are making substantial progress toward the goals, as expressed by Professor Lorie, of greater efficiency and reduced costs in transferring the ownership of securities, with methods that take full advantage of the capabilities of modern day technology. But beyond these goals, it seems to me that the development of a national securities processing system entails two additional principal evolutionary developments - - increased communications between issuers and their actual shareholders (that is, the beneficial owners of the securities), and reduced securities movements.

The first is one to which you as corporate officers are undoubtedly particularly sensitive.

Rapid and efficient dissemination of information by a corporation to its beneficial owners is essential as the economic and other issues facing corporations and shareowners become more complex. At the same time, the securities industry has taken steps to immobilize the stock certificate, which tends to separate the beneficial owner from the issuer. In order to alleviate the need for customer signature and physical delivery, certificates are held by broker-dealers in street name. Street name registration creates some communication problems, but, when broker-dealers and banks place their securities

in depositories and clearing agencies, thus further immobilizing the certificate, the communications problem is intensified.

An example of the communication problem is a shareholder with apparent unlimited economic potential called "CEDE & Co." To the uninformed, the shareholder called CEDE & Co. appears to be gobbling up more and more of corporate America. This CEDE & Co. is, of course, the nominee of Depository Trust Company, ("DTC"), the largest depository for securities in this country, presently holding in excess of \$70 billion worth of corporate stock. CEDE's holdings belong ultimately to tens of thousands of beneficial owners. Shares held in a depository are generally placed in such a single nominee name in order to facilitate transfer among participants. As the securities industry proceeds toward the full utilization of depositories and clearing agencies, however, the difficulty of communication with actual shareholders becomes more acute. The dissemination of proxy material, financial reports and other communications to shareholders is more involved, with attendant increased possibilities of error or delay. It also becomes extremely difficult for a corporation to identify the beneficial owners of the corporation's shares.

In addition to DTC, there are two other depositories in the United States and several clearing agencies which, by serving to reduce certificate movements, are playing an increasingly important role in the securities handling process. We are rapidly approaching the point where, due to the widespread use of street and nominee names, the activity in a corporation's stock in the trading markets will not be reflected on the corporation's ownership records.

Both the Senate and the House have recognized this problem in the proposed legislation being considered. Were S. 2058 or H.R. 5050 enacted, the Commission would be directed to study the practice of registering securities other than in the name of the beneficial owner to determine whether such registration is consistent with the policies and purposes of the Securities Exchange Act, and, if consistent, whether steps can be

taken to facilitate communications between corporations and shareholders, while at the same time retaining the benefits of such registration. The Commission would be required to report to the Congress its preliminary findings within six months of enactment of the legislation, and its final results and recommendations within one year of enactment.

DTC and other depositories, clearing agencies, and bank nominees may be increasing the problem of communication with shareholders, but they are among the principal prospects for improving securities processing by eliminating physical movements of securities. There has been debate in recent years regarding whether it would be better to reduce the movement of securities by immobilizing the certificate or by eliminating it, but there is no disagreement that the physical delivery of stock certificates should no longer function as a means of completing securities transactions.

In this regard, both H.R. 5050 and S. 2058 direct the Commission, on or before December 31, 1976, 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 and dealers.

In short, the bills in Congress seek the best of both worlds, the immobilization of the certificate, and an unencumbered line of communication between actual shareholders and issuers. As objectives they are beyond dispute, and the Commission supports them.

Regardless of whether the pending legislation is enacted, there will be a continuing impetus from the industry for the immobilization or elimination of the stock certificate, and from issuers and the public for better communications. There are a number of possible solutions. One, which is already employed by DTC, is to furnish issuers, on a periodic basis, with a list of the participants who hold that issuer's stock in DTC, and the amounts of such holdings. This is only a partial solution to the question of corporation-to-shareholder communications and does not provide the issuer with the names of its beneficial owners. A longer term solution might be the implementation of transfer agent depository systems, commonly referred to as TADS, in which the transfer agent and custodial functions are combined. Under the TAD system, no stock certificate

is issued, and the transfer of ownership is accomplished not by physical delivery of a certificate but rather by bookkeeping entry. With proper safeguards, the TAD system could greatly facilitate corporate communications as well as make depository services available to individual investors and smaller institutions whose participation in securities markets may not be sufficiently active to justify their assuming the obligations of a participant in a pure depository.

Another approach which, although theoretically possible, is not actively being considered at this time, is to have the depository function as a transfer agent. An issuer could designate a depository to perform the function of co-transfer agent for the securities of that issuer. Such a move would solve the problem of communications between depositories and transfer agents, at least, and could lead to cost savings since the need for issuance of new stock certificates would greatly diminish.

Finally, we must not ignore the possibility that a novel computer-based approach may be developed in the course of the Commission's study of the ownership of securities in nominee name (if legislation is enacted), or through the efforts of the numerous other groups which are studying the issue, including the speculations of such industry figures as Frank Weil and Junius Peake.

These are problems of major proportions and dealing with them is like trying to unravel the Gordian knot. At the same time the stakes are high - - the problems discussed today, and others facing the Commission - - such as the central market system, broker-dealer financial responsibility - - all have at their core the issue of fair and efficient markets and investor confidence in those markets. Without the confidence of the investing public, the markets do not function. Of that we must never lose sight.

It therefore places a heavy duty upon all of us concerned with our capital markets in these urgent times to continue to work intelligently and constructively together. That is the way our capital markets of the past and present have been built and that is how the capital market of the future will be built.

The government can set targets and apply goads and incentives but, with or without legislation it cannot do the job not without our present, and I trust our future, devotion to reliance on the private sector wherever possible.

While we may assert our separate views on jurisdictional matters before Congressional committees, we must not let these differences divert us from the task at hand. We need not wait for legislation nor can legislation, however wise and desirable, solve our problems.

It is important to consider what is going on regardless of our disputes on the Hill. Consider what voluntary and self-regulatory efforts are achieving. The Banking and Securities Industry Committee, with which this Society has worked, is responsible for DTC, which is now working with the Midwest and Pacific depositories toward a nationwide, compatible and interfaced depository system. The several stock exchanges with clearing affiliates and the NASD have formed a working committee with the Securities Industry Association which is making important progress toward a national clearing system.

Right now, these are the vehicles of progress in operation. I have great confidence in them. I fully expect great strides toward Professor Lorie's policy objectives of maximum efficiency in transferring securities to be right in front of us. We must let nothing divert us from achieving this vital underpinning to a healthy capital structure.