STATEMENT OF JOHN R. EVANS, COMMISSIONER, SECURITIES AND EXCHANGE COMMISSION, BEFORE THE SUBCOMMITTEE ON SECURITIES OF THE SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS ON SENATE BILL 2058

July 11, 1973

Mr. Chairman and members of the Subcommittee, I am pleased to be here this morning to testify for the Securities and Exchange Commission 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. At the outset, I would like to state that I am authorized to say that 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, non-discriminatory 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 the depository function is relatively new. A clearing agent settles transactions between member broker-dealers. Offsetting transactions between broker-dealers are netted out and 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 a buyer.

At present, these functions are uncoordinated. Each of the major exchanges and the National Association of Securities Dealers, Inc., has a separate clearing agency for transactions between their members. In addition, each corporate issuer 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 to 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 redound 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. Eventually these costs must be borne by investors. 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 has to be in a position to oversee the whole process. The Commission presently has authority over the execution of transactions, over clearing and over settlement. 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, sale 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 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 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 have greater expertise

(e.g., 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, examination and enforcement. As I recall, this approach was discussed at length during Senate hearings last year, 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 record-keeping 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, 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 S. 2058 as an acceptable proposal and, if it is adopted by the Congress, we will cooperate with the bank regulatory agencies in this joint effort.

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 non-bank 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 non-bank subsidiaries acting as clearing agencies or transfer agents.

I do not recall any discussion as to whether the appropriate regulatory agency of a non-bank 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 non-bank 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. 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 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 prerequesite 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 nd settlement of securities transactions. The Commission does not seek to limit entry to a clearing agency or depository; rather it seeks to ensure, as a matter of policy, that all broker-dealers and other financial institutions will have access to such entities on a reasonable and non-discriminatory 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 inadequate 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 decision-making 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 non-discriminatory 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 would have to be incurred to achieve it. 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.

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 impose periodic reporting requirements

based upon the number of record holders of securities. If the "street name" study legislation is enacted, we believe that these two areas are closely related and that it would be appropriate to combine them into 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 members of the Subcommittee may have.