



SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

September 27, 1977

128-4

Mr. William Batten
Chairman and Chief Executive Officer
New York Stock Exchange, Inc.
11 Wall Street
New York, New York 10005

Dear Mr. Batten:

Section 31(b) of the Securities Acts Amendments of 1975 (the "1975 Amendments") sets forth one of several procedures for the Commission to use in insuring compliance by national securities exchanges and registered securities associations with the Securities Exchange Act of 1934 as amended by the 1975 Amendments (the "Act"). Pursuant to that section, on December 1, 1976, the Commission gave written notice to the New York Stock Exchange, Inc. ("NYSE") concerning certain of its rules which appeared not to comply with the Act. ^{1/} In that notice, the Commission requested the NYSE to make a preliminary written presentation detailing, for each rule cited, the proposed amendments which the NYSE had filed or intended to file to bring the rule into compliance with the Act or, for any rule believed by the NYSE to be in compliance with the Act, the basis for concluding that no further action by the NYSE was necessary.

The NYSE responded to that notice in a letter dated February 1, 1977. Thereafter, the Commission's staff and the NYSE's staff held discussions during which extensive consideration was given to the need for amendments to the rules cited in the notice, including the rules relating to the comparison, clearance and settlement of securities transactions ("transaction completion rules"), and to the form that amendments to those rules should take. In addition, by letter dated June 3, 1977, the NYSE informed the Commission of the NYSE's intention to submit, pursuant to Rule 19b-4 under the Act, proposed amendments to some of the transaction completion rules cited in the December 1,

^{1/} Securities Exchange Act Release No. 13027 (Dec. 1, 1976), 41 PR 53557 (1976).

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1976 notice and raised questions concerning the Commission's determination that certain other rules did not comply with the Act.

To date, the Commission has not received the rule submissions contemplated by the NYSE's letter and, in their absence, must recognize the possibility that they will not be determined by the Commission to comply fully with the Act. Also, the Commission does not agree with contentions made by the NYSE that the remaining NYSE rules cited in the December 1, 1976 notice comply with the Act. Accordingly, this further notice and opportunity for hearing applies to all transaction completion rules identified in the December 1, 1976 notice which have not been amended to conform to the Act and includes the rules discussed in the NYSE's June 3, 1977 letter.

Pursuant to Section 31(b) of the 1975 Amendments, after the one hundred and eightieth day following the NYSE's receipt of notice specifying the respects in which the NYSE is not in compliance with the Act, the Commission may, by order and without regard to the provisions of Section 19(h) of the Act, suspend the NYSE's registration or impose limitations on the NYSE's activities, functions and operations if the Commission finds, after notice and opportunity for hearing, that the NYSE's organization or its rules do not comply with the Act. The Commission today is giving further notice and opportunity for hearing (as described below) with respect to the transaction completion rules cited in the December 1, 1976 notice as not being in compliance with Sections 6(b), 11A(c)(5) and 17A(a)(2) of the Act.

The action taken today with respect to the transaction completion rules is intended to speed elimination of the adverse effect which they have had on the development of a national clearing and settlement system. Prompt action on those rules is necessary to conform them to the objectives of achieving efficiencies in securities clearance and settlement and fostering competition among brokers and dealers, registered clearing agencies and registered transfer agents sought to be achieved through the Commission's action in granting registration as a clearing agency to the National Securities Clearing Corporation ("NSCC"), Securities Exchange Act Release No. 13163 (Jan. 13, 1977), 42 FR 3916 (1977) and through the standards for

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the registration of clearing agencies currently under consideration by the Commission, Securities Exchange Act Release No. 13584 (June 1, 1977), 42 FR 30066 (1977).

Further notice is not being given at this time with respect to the other NYSE rules cited in the December 1, 1976 notice. They will be the subject of an interim statement, intended to facilitate additional consideration of the issues they present, before any further Commission action as to those rules is taken pursuant to Section 31(b) of the 1975 Amendments.

Pursuant to this notice, the Commission is giving the NYSE the opportunity within 45 days from the date of this notice either to submit, pursuant to Rule 19b-4 under the Act, proposed rule changes conforming the transaction completion rules to the Act or to present data, views and arguments explaining why the transaction completion rules are in compliance with the Act. If the Commission concludes upon its review of any such proposed rule changes and data, views, and arguments that the NYSE's organization or the transaction completion rules do not comply with the Act, the Commission shall take such further action under Section 31(b) of the 1975 Amendments as appears warranted.

The following is a review of the statutory provisions relating to the clearance and settlement of securities transactions and a description of ways in which the transaction completion rules do not comply with those provisions. 2/

2/ The discussion of the NYSE's rules contained in this letter describes their purported effect and is not intended to suggest that they would currently be legally binding on NYSE members or others to the extent the rules do not comply with the Act.

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Statutory Provisions

Section 11A(c)(5) of the Act stipulates that "[n]o national securities exchange or registered securities association may limit or condition the participation of any member in any registered clearing agency." Sections 6(b)(5) and 15A(b)(6) of the Act require that the rules of a national securities exchange and of a national securities association be designed "to foster cooperation and coordination with persons engaged in regulating, clearing, settling . . . and facilitating transactions in securities . . .," and Sections 6(b)(8) and 15A(b)(9) of the Act prohibit the rules of national securities exchanges and associations from imposing any burden on competition not necessary or appropriate in furtherance of the purposes of the Act. These sections complement Section 17A(a)(2) of the Act, which directs the Commission "to use its authority under [the Act] to facilitate the establishment of a national system for the prompt and accurate clearance and settlement of transactions in securities . . ." having due regard for, among other things, the maintenance of fair competition among brokers and dealers, clearing agencies and transfer agents.

The rules of the NYSE contain strictures which hinder the development of a national system for the clearance and settlement of transactions in securities by, among other things, tying the clearance and settlement of securities transactions to the market in which those transactions occur.

1. Direct restrictions on the clearance of exchange contracts

The NYSE rules contain restrictions upon the freedom of members to choose among clearing agencies and persons for the comparison, clearance and settlement of exchange contracts or presumptions which have a similar restrictive effect. Article XII, Section 3 of the NYSE Constitution provides that absent a stipulation or agreement otherwise, delivery and payment on exchange contracts must be made through the NSCC, and a party to an NYSE contract who is not a participant in NSCC must have his contract cleared or settled by a participant in NSCC. Rule 138 prohibits an original party to an exchange transaction from giving up for clearance purposes the name of a non-NYSE member. Similarly,

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Rule 411.60 requires that the executing member who clears the trade must, when it is not a member of the Stock Clearing Corporation Division of NSCC ("SCC Division") have the trade cleared or settled by a clearing member of the SCC Division.

These rules do not comply with the Act because they restrict the ability of exchange members to compare, clear or settle exchange transactions through a registered clearing agency other than the SCC Division or through a broker-dealer who is not both an NYSE member and a member of the SCC Division, or to resort to any other mutually agreed upon means. Two fundamental characteristics of the national system are that parties be free to choose the location for comparing, clearing and settling securities transactions and that their choice be subject to competitive factors such as the amount of fees charged and range of services offered.

In Securities Exchange Act Release No. 13163, the Commission identified as an objective of the Act the ability of a national clearing and settlement system to process securities transactions by means, including book entry movement, suitable to the character of the issues processed. In that release the Commission specified also that a national clearing and settlement system should enable participants to compare, account for and settle through one entity all trades in securities included in the system, regardless of the location of the other party to the trade or the market in which the trade was executed ("one account processing"). Achievement of one account processing requires either that each side of the transaction be able to be compared, cleared and settled through the facilities of a single registered clearing agency or through the facilities of one of two interfaced clearing agencies.

Accordingly, the foregoing rules should both be consistent with the Act's policy favoring competition among brokers and dealers and among registered clearing agencies and provide that all transactions in securities eligible for comparison, clearing and settlement through all registered clearing agencies providing those services be submitted to one or more of them for processing. Securities not eligible for comparison, clearing and settlement at all registered clearing agencies providing those services should be compared, cleared and settled by mutual agreement of the parties to the transactions.

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2. Mark-to-the-market payments

Rule 165 requires mark-to-the-market payments on contracts not included in the Continuous Net Settlement ("CNS") System of the SCC Division to be paid directly, or through the SCC Division to the other party or be deposited with the SCC Division. Rule 167 requires, in the latter case, that any such deposit by a non-clearing member be made by a clearing member of the SCC Division. Similarly, Rule 412 provides that certain charges for the money amount of fail-to-receive contracts arising from the operation of that rule be made through the SCC Division. These rules do not comply with the Act because they limit a member's participation in a clearing agency other than the SCC Division and thereby contravene the provisions of Sections 6(b)(5), 6(b)(8) and 11A(c)(5) of the Act. To be consistent with those sections, the NYSE's rules should permit NYSE members to make such deposits, payments or charges to or through any clearing agency through which the members elect to compare, clear and settle exchange contracts.

3. Priority to the SCC Division

Article XI, Section 3, Second, of the NYSE Constitution provides the SCC Division a priority over other creditors ^{3/} in the distribution of proceeds from the transfer or sale of an NYSE membership. This priority is designed to assure the SCC Division a source of funds with which to satisfy liabilities incurred by the exchange member to the clearing agency. The priority, however, is unnecessary and in contravention of the national clearance and settlement system envisioned by the Congress in adding Section 17A to the Act.

^{3/} The exchange is given first priority in the distribution of the proceeds.

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First, as a registered clearing agency under the Act, NSCC is a self-regulatory organization which is required to safeguard funds and securities 4/ and to that end, is required to adopt 5/ and enforce rules. 6/ Accordingly, NSCC can protect itself against liabilities arising from participant default by enforcing its clearing fund rules and mark-to-the-market procedures. With this protection, it should be unnecessary for the clearing agency to depend on the proceeds from the sale of an exchange membership to satisfy the clearing agency's claim against the member.

Section 6(b)(5) of the Act provides that a national securities exchange shall not be registered if the rules of the exchange regulate, by virtue of any authority conferred by the Act, matters not related to the purposes of the Act or the administration of the exchange. Inasmuch as the rule establishing the priority does not appear necessary for the clearing agency's protection, it represents an attempt to regulate by virtue of the authority conferred on the NYSE by the Act matters whose regulation by the NYSE is not necessary and therefore is not related to the purposes of the Act and is not related to the administration of the NYSE.

4/ Subparagraph 17A(b)(3)(A) of the Act, in pertinent part, provides that a clearing agency shall not be registered unless the Commission determines that "[the] clearing agency is so organized and has the capacity . . . to safeguard securities and funds in its custody or control"

5/ Subparagraph 17A(b)(3)(F) of the Act, in pertinent part, provides that a clearing agency shall not be registered unless the Commission determines that "[t]he rules of the clearing agency are designed . . . to assure the safeguarding of securities and funds which are in the custody or control of the clearing agency"

6/ Subparagraph 17A(b)(3)(A) of the Act, in pertinent part, provides that a clearing agency shall not be registered unless the Commission determines that "[the] clearing agency is so organized and has the capacity . . . to enforce . . . compliance by its participants with the rules of the clearing agency" and Section 19(g)(1)(C) of the Act requires a registered clearing agency to enforce compliance by its participants with its rules, absent reasonable justification or excuse.

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Second, the priority rule discriminates, on its face, against registered clearing agencies other than the SCC Division by excluding other clearing agencies to which an NYSE member may have liabilities from participation in the asset represented by sale proceeds of an exchange membership.

4. Requirements for comparison, clearance and settlement of exchange contracts

Numerous NYSE rules impose requirements which vary depending on whether exchange transactions are cleared through the SCC Division or elsewhere. Rules 132 and 133 ^{7/} prescribe different comparison requirements for NYSE contracts cleared through the SCC Division and those cleared elsewhere. Similarly, Rules 134 and 135 prescribe requirements for resolving differences and omissions that are different for transactions cleared through the SCC Division and those not so cleared. Rule 136 prescribes the method for comparison of transactions excluded from clearance through the SCC Division and not compared through the Clearing House Comparison services of the SCC Division. Rule 137 requires the exchange of written contracts on certain transactions that are not cleared through the SCC Division. Rule 152 provides that a loan of securities not delivered when due becomes a failure to deliver that may be canceled by mutual consent unless it has been cleared through the SCC Division.

Several NYSE rules prescribe delivery requirements for contracts which are not deliverable through the CNS System of the SCC Division. These rules include Rule 141 which allows a buyer or seller to send to the other party a "fail to deliver" confirmation while the contract remains open if delivery has not been made on due date; Rule 181 which allows the receiver of stock to choose between delivery by certificates or by transfer; Rule 189 which prescribes the

^{7/} Rule 133 also relates to transactions not cleared through the Clearing House Comparison Service of the SCC Division.

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unit of delivery which a buyer must accept; and Rule 190 which prescribes an identification requirement for the party making delivery of a failure to deliver item. Also included in this category of rules are Rules 282 and 284 which prescribe the close-out procedure for unfulfilled contracts; and Rule 288 which requires a member receiving notice of contracts closed out under the SCC Division rules to transmit the notice to successive parties. Rule 295 specifies the requirements for closing out exchange contracts included in the SCC Division's CNS System.

Rules which require compliance by NYSE members with the rules of the SCC Division attempt to regulate matters pertaining to the operation of the SCC Division. If compliance with those rules is necessary to carry out the purposes of the Act, the rules should be adopted and enforced by the registered clearing agency to whose operations they apply 8/ rather than by the NYSE. 9/ Because regulation of these matters by the NYSE is unnecessary, the rules which purport to effect that regulation are attempts by the NYSE to regulate, by virtue of the authority conferred on it by the Act, matters whose regulation is neither related to the purposes of the Act nor concerned with the administration of the NYSE.

Rules which require NYSE members to comply with specified NYSE procedures if certain actions are not effected through, or in accordance with the rules of, the SCC Division (as opposed to through, or in accordance with the rules of, any registered clearing agencies) limit or condition the participation by NYSE members in registered clearing agencies other than NSCC in a manner that contravenes Sections 11A(c)(5) and 17A(a)(2) of the Act.

5. Assignments

Several NYSE rules limit the parties who can execute and guarantee assignments and powers of substitution. Rule 196 requires SCC, any nominee of Central Certificate Service, Inc. ("CCS") (or its successor) or NSCC, among

8/ Subparagraphs 17A(b)(3)(A) and (F) and Section 19(g)(1)(C) of the Act, supra notes 4, 5 and 6.

9/ Section 6(b)(5) of the Act, supra p. 7.

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others, to execute a blank power of substitution when their names have been inserted in an assignment or in a power of substitution. Rule 200 gives SCC, NSCC, officers or employees of SCC or NSCC, and a nominee of CCS, authority relating to assignments and execution of powers of substitution by facsimile signatures. Rule 209 prescribes the persons who may guarantee the signature to an assignment of a certificate not in the name of (or who may guarantee the signature to a power of substitution not executed by) a member, member organization, nominee of CCS (or its successor), and Rule 211 prescribes the persons who may guarantee a certificate with an assignment or power of substitution executed or guaranteed by a member or member organization not having in the vicinity of the NYSE an office at which settlement of exchange contracts is regularly effected.

The requirements these rules prescribe for the assignment of certificates delivered in settlement of contracts are matters that are within the province of another self-regulatory organization (i.e., the registered clearing agency through which the member elects to clear or settle). Accordingly, they do not conform to Section 6(b)(5) of the Act because they are attempts to regulate by virtue of the authority conferred on the NYSE by the Act matters whose regulation by the NYSE is not necessary and therefore is not related to the purposes of the Act. By not allowing for the settlement of exchange contracts other than through NSCC and certain of its operational and corporate affiliates and by perpetuating limitations on signature guarantors that may no longer be universally required by transfer agents, these rules also impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Act.

6. Compliance with, and reference to, SCC Division Rules

The NYSE rules require compliance with certain provisions of the SCC Division Rules. Rule 143 makes orders issued by, or contracts reported by, the SCC Division binding and enforceable upon members and member organizations for whom the SCC Division acts. Rule 176 reserves to the SCC Division the right to change the delivery time for certain securities not to be delivered to

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SCC. Rule 180 states that securities not delivered within specified time frames and included in the CNS System of the SCC Division may be closed out in accordance with the SCC Division rules and also states that the party in default on a contract not included in the CNS System of the SCC Division is liable for damages and that the contract may be closed as provided in Rule 284. Rule 183 requires that payment on deliveries through the SCC Division are to be made in conformity with its Rules. Rule 194 requires that sales tickets of securities cleared or deliverable through the SCC Division be delivered in accordance with its Rules. Rule 281 requires a member who has an exchange contract with a suspended member for the purchase, sale, or loan of securities to close out such contract in accordance with the Rules of the SCC Division if such rules are applicable. Rule 285 requires that notice that a contract is to be closed out because of non-delivery, including such a notice under the SCC Division's Rules, shall be transmitted to the member owing securities. Rule 287 states that contracts closed pursuant to the SCC Division's Rules are for the account and liability of succeeding parties in interest.

Rules which require compliance by NYSE members with the rules of the SCC Division attempt to regulate matters pertaining to the operation of the SCC Division. If compliance with those rules is necessary to carry out the purposes of the Act, the rules should be adopted and enforced by the registered clearing agency to whose operations they apply rather than by the NYSE. Because regulation of these matters by the NYSE is unnecessary, the rules which purport to effect that regulation are attempts by the NYSE to regulate, by virtue of the authority conferred on it by the Act, matters whose regulation is neither related to the purposes of the Act nor concerned with the administration of the NYSE.

Rules which require NYSE members to comply with specified NYSE procedures if certain actions are not effected through, or in accordance with the rules of, the SCC Division (as opposed to through, or in accordance with the rules of, any registered clearing agencies) limit or condition the participation by NYSE members in registered clearing agencies other than NSCC in a manner that contravenes Sections 11A(c)(5) and 17A(a)(2) of the Act.

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7. Transfer Agents

NYSE Rule 496 restricts competition among transfer agents by imposing limitations on the persons who may qualify as independent agents acting as, or in lieu of, a New York City transfer agent for securities listed on the NYSE.

Paragraph (1) requires an issuer to maintain an office in lower Manhattan for the receipt and redelivery of securities. This provision imposes an inappropriate or unnecessary burden on the ability of transfer agents located outside of New York City to compete with transfer agents located in New York City. Paragraph (2) requires the transfer agent to provide 48-hour turnaround measured between delivery and redelivery at the lower Manhattan office. This provision limits the ability of transfer agents that are geographically distant from New York City to compete with other transfer agents, and may require the former transfer agents who attempt to compete to incur increased costs and to give preferential treatment on virtually a preemptive basis to items that fall within Rule 496. In view of the Commission's recently adopted Rules 17Ad-1 through 7, under the Act, 17 CFR 240.17Ad-1 through 240.17Ad-7, it no longer appears to be necessary or appropriate to maintain this requirement. Paragraph (3) requires a transfer agent operating under Rule 496 to have capital, surplus (both capital and earned), undivided profits, and capital reserves of at least \$10,000,000. This requirement does not provide flexibility for adjustments in the requirement for transfer agents which have an amount of business and exposure that would make it reasonable to require either a lower amount of assets or alternative measures such as insurance coverage. This requirement, therefore, may impose a burden on competition that is unnecessary or inappropriate in furtherance of the Act. Paragraph (8) requires a transfer agent operating under Rule 496 to maintain a minimum insurance coverage of \$25,000,000 to protect securities in transit or in process. This flat, minimum requirement does not provide for insurance coverage reasonably related to a transfer agent's exposure and, for transfer agents whose exposure is at a level that would justify a smaller insurance requirement, imposes a burden on competition not necessary or appropriate in furtherance of the Act. Rule 496 also does not comply with Section 17A(a)(2) of the Act which directs that the Commission,

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having due regard for competition among transfer agents, establish a national system for the clearance and settlement of securities transactions.

The following rules ("additional rules") were not cited in the Commission's December 1, 1976 notice but, during the Commission's review of the transaction completion rules, have been identified as additional transaction completion rules which are not in compliance with Sections 6(b), 11(a)(c)(5), and 17A(a)(2) of the Act. Article XIV, Section 5 allows the suspension or expulsion of a member, allied member or approved person for making a misstatement upon a material point to any subsidiary of the exchange. This rule does not conform to Section 6(b)(5) of the Act because it is an attempt to regulate by virtue of the authority conferred on the NYSE by the Act matters whose regulation by the NYSE is not necessary and therefore is not related to the purposes of the Act. Rule 7 defines "exchange ticket" to mean an exchange ticket as prescribed in the rules of the SCC Division; and Rule 376 provides that, unless the parties agree otherwise, payments between members on account of commissions on business when a principal is given up are to be made through the SCC Division of NSCC as prescribed in its rules. These rules place a burden on competition among brokers and dealers and among clearing agencies in the provision of clearance services that is not necessary or appropriate in furtherance of the Act.

As is evident, the additional rules and the transaction completion rules are integrally related. In order to expedite and simplify the NYSE's and the Commission's consideration of those rules, the Commission requests that the NYSE take action simultaneously with respect to both groups of rules. Should the NYSE be unable to accede to the Commission's request, the Commission will proceed through other means, including Section 19(c), to conform the additional rules to the Act or take such other action, including proceedings pursuant to Section 19(h) of the Act, as may appear warranted.

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The Commission and its staff are available to provide whatever interpretive advice or other guidance the NYSE may reasonably require in completing the process of conforming its rules to the Act and otherwise complying with the Act and the terms of this notice.

By the Commission.

Sincerely,

George A. Fitzsimmons
Secretary

NARA-CP

RG 226: UD-UP Entry 1

Subj. Folios 34-81

Box 25, Folder "New York Stock Exchange Volume 30"