STATEMENT OF JOHN R. EVANS, COMMISSIONER, SECURITIES AND EXCHANGE COMMISSION, BEFORE THE SUBCOMMITTEE ON COMMERCE AND FINANCE OF THE COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE OF THE HOUSE OF REPRESENTATIVES ON TITLE IV OF H.R. 5050

September 11, 1973

Mr. Chairman and members of the Subcommittee, I have the privilege of appearing before you today on behalf of the Securities and Exchange Commission to discuss our views regarding Title IV of H.R. 5050. At the outset, I would like to state that the other members of the Commission have considered and approved this statement.

The provisions of Title IV of H.R. 5050 would, among other things, provide the Commission with additional authority over the processing of securities transactions and would provide a particularly comprehensive and effective regulatory framework for the development of an integrated national system for the prompt and accurate processing of securities transactions. We believe, however, that these objectives could be more appropriately achieved by a slightly different approach which would utilize the expertise and manpower of both the Commission and the federal bank

regulatory agencies, and avoid duplicate regulatory efforts.

Our specific suggestions to accomplish these objectives are more fully set forth in our comments on Title IV, which were submitted to the Subcommittee on July 20, 1973.

The principal entities engaged in the processing of securities transactions are depositories, clearing agencies, transfer agents and broker-dealers. These entities perform an important and distinct function in the settlement and clearing process, but their activities are not coordinated into a smooth functioning, efficient nationwide system for the handling of investors' securities.

In general, this situation is the result of various diverse developments in the securities industry which have, independently of one another, led to different approaches in attempting to meet securities processing needs. For example, apart from the consolidation of the clearing operations of the New York and American Stock Exchanges, each major exchange and the National Association of Securities Dealers, Inc., has a separate clearing agency for transactions between its 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 have been of more recent origin, but there has been a definite tendency toward separate and independent depository systems. Interface between these clearing and depository systems, to reduce costs and improve transaction capabilities, has been slow and difficult.

We believe that coordination of the activities of these entities is necessary and fundamental to provide adequate facilities to meet the needs of the nation's investors for processing securities transactions. There is no doubt that an adequate interface among these entities must be developed. The Commission is, of course, concerned about the rapidly rising costs of doing business in the securities industry and their adverse effects upon profits and services of the brokerage community. Creation of an integrated securities processing system would provide potentially important economies which would benefit all participants -- broker-dealers, banks, other institutions and individual investors.

Processing economies, the public interest, our concern for 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 the expectation that the markets of the future will be required to handle greater volume with greater sophistication, all require present action toward building a nationwide system for handling securities transactions.

We believe that to achieve this, a single public regulatory body must be in a position to oversee the entire process, and we further believe that the Commission can best perform that function. Presently, the Commission has authority over the execution of transactions, as well as over clearing and settlement functions. We believe that this authority should be strengthened and extended to transfer activities. These segments of the transaction process are inextricably related, and we strongly believe that the Commission should have the authority necessary to guide the development of a modern system and sufficient flexibility to allow and encourage private sector innovation.

As the Subcommittee is aware, a number of bills dealing with securities processing have been presented before both Houses of Congress during the past two years. Last year, H.R. 14567 was introduced on behalf of the Commission. This

year, H.R. 5050 is presently being considered by this Subcommittee as is S. 2058, which has been approved by the Senate. A central issue in the consideration of these various legislative proposals has been the extent to which the authority to examine clearing agencies, securities depositories and transfer agents organized as banks, and to enforce the standards applicable to these entities, should be vested in either the bank regulatory agencies or the Commission. The approach embodied in S. 2058 provides for rulemaking power shared by the Commission with the federal bank regulators in the establishment of standards applicable to banking entities involved in the processing of securities transactions. This divided rulemaking authority, we believe, could prove unwieldly at a time when cogent, decisive action is essential.

Under Title IV of H.R. 5050, the Commission would be the sole regulator of clearing agencies, depositories and transfer agents. We recommend, however, that certain regulatory responsibilities in this area be divided between the Commission and the bank regulatory authorities. Specifically, the Commission recommends that depositories and clearing agencies, which are inextricably a part of the securities

handling process and which traditionally have been subject to regulatory oversight by the Commission, continue to be under the Commission's jurisdiction regardless of whether they are organized as banks. Thus, without precluding supervisory oversight by banking authorities where a depository is a bank and, in fact, recommending cooperation between the Commission and the bank regulatory authorities, the Commission believes that it should retain authority to inspect depositories, to require reports from them, and to enforce compliance by depositories with regulations to be promulgated by the Commission. Where depositories are organized as banks, however, the Commission believes that bank regulators should not be preempted from responsibility in such areas as safekeeping of funds and securities, security and financial responsibility. To the degree their expertise can be utilized within the framework of the Commission's primary responsibility for the regulation of depositories, we would welcome such assistance. With regard to transfer agents which are not banks, the Commission should have full responsibility for setting standards and insuring compliance with those standards. In the case of transfer agents which are banks,

the Commission proposes that, while it should have the authority to set standards, the registration, inspection and enforcement responsibilities should be undertaken by the federal bank regulatory authorities. The Commission believes that this division of responsibilities for bank transfer agents should be considered by the Subcommittee. Although H.R. 14567, which we proposed last year, contemplated that the appropriate bank regulatory authorities would set the recordkeeping and reporting requirements for bank transfer agents, the Commission now believes that, in order to achieve uniformity in recordkeeping and reporting, this authority should rest with the Commission.

We believe the approach which I have briefly outlined gives proper recognition to the resources and skills of bank regulators and at the same time places upon the Commission the responsibility and authority to accomplish the objectives of achieving an integrated, nationwide system for clearance and settlement of securities transactions.

In view of the breadth of the bill and the length and specificity of the Commission's prior written comments on it, I will limit myself to a discussion of a few other important areas covered in Title IV.

We note that it is possible for a transfer agent to perform the functions 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 because, at their inception, depositories were assigned different functions. 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 assumption of the obligations of a participant in a pure depository. We believe that the bill should be modified to make clear that the combination of depository and transfer agent services in one institution is permitted.

We note also that the provisions of Title IV contemplate that a clearing agency or securities depository will be a self-regulatory organization. As the Subcommittee is aware, certain privately-owned entities will be encompassed by the definition of a clearing agency and depository. Some of these organizations, particularly certain clearing organizations, have not been self-regulatory bodies and, under the bill, probably should not be. The bill does provide the Commission with broad exemptive powers which could be used to exempt such entities from any clearing agency or depository requirements which we deem to be inappropriate or unnecessary to carry out the purposes of proposed Section 17A of the Act.

Subsection (d) of proposed Section 17A would require the Commission to find as a prerequisite to registration that a securities depository or clearing agency meets the criteria set forth in this subsection. Subsection (d)(2) would require the rules of the clearing agency or securities depository to provide that certain enumerated classes of persons, and others designated by the Commission, are eligible to become participants, subject only to certain exclusionary rules permitted by that subsection. The Commission believes that

the bill should be amended to permit clearing agencies and securities depositories, by rule, to impose criteria for participation in a clearing agency or securities depository, applicable to all participants, in addition to those set forth in Subsection (d)(2) of proposed Section 17A, provided that 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 primary purpose of the Commission's suggestion in this regard is not to unnecessarily restrict entry to a clearing agency or securities depository, but rather to ensure that all broker-dealers and other financial institutions will have access to such entities on a reasonable and non-discriminatory basis, and at the same time to protect the financial integrity of these entities and their participants.

Subsection (k) of proposed Section 17A would, among other things, require clearing agencies and depositories to submit rule changes along with a summary statement of the changes, and the basis therefor, to the Commission. It would also require all rule changes to be published

for comment. As a general proposition, a proposed rule change would become effective sixty days after such publication, unless the Commission by order disapproves it. In our view, public notice and an opportunity for comment are desirable. We believe, however, that the securities 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 securities depository or clearing agency has obtained comments, the Commission should not be required to duplicate that effort unless, in its discretion, it believes it appropriate to do so. Additionally, the clearing agency or depository should be required to send copies of the comments received to the Commission with the filing of the proposed rule change. Finally, as noted previously, this Subsection generally would make such rule changes effective within sixty days after publication, unless the

Commission disapproves such changes. Under the Subsection, as drafted, the Commission would not be permitted to extend this period unless it instituted public administrative proceedings concerning such changes. We do not understand what the Subcommittee intended when it referred to the institution of "public administrative proceedings." We assume that the Subcommittee simply intended that the Commission be authorized to obtain further opinions and views from the public and did not envision any requirement that a formal adjudicatory-type proceeding be held in connection with what the Subcommittee recognizes is intended to be administrative rulemaking or policymaking. Nevertheless, we believe the requirement that public administrative proceedings must be instituted, if the Commission has not completed review within 60 days of publication, is unduly burdensome, particularly in view of the fact that public comment is required. The restriction is not likely to aid significantly in the administrative decision-making process.

Subsection (r) of proposed Section 17A would require the Commission to take whatever steps 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 adapt to circumstances not now foreseeable and 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. If Congress fixes a definite timetable, of course, the Commission will undertake to meet it.

Section 405 of H.R. 5050 would amend Section 24 of the Securities Exchange Act which deals with the confidential treatment of matters filed with the Commission. This provision creates a problem. The proposed Securities Processing Act (H.R. 14567) which we submitted last year, contained a provision on confidential treatment which was designed to deal with possible special problems of confidentiality applicable to clearing agencies, depositories and transfer agents which will need to have special security measures to protect the valuable property in their custody and will, of course, have to keep these security measures confidential. In H.R. 14826, which was also considered last year, and in Section 405 of H.R. 5050, the provisions concerning confidential treatment contained in H.R. 14567 were transformed

into an amendment to Section 24 of the Securities Exchange Act of 1934, which applies to all questions of confidential treatment arising under that Act, particularly registration statements and reports of corporate issuers. While the provisions of Section 405 of H.R. 5050 are appropriate for the special problems of security measures by clearing agencies, depositories and transfer agents, they are, in our judgment, quite inappropriate for other types of filings by issuers and broker-dealers under the Exchange Act, which are covered by Section 24, for the reasons set forth in our specific written comments on H.R. 5050. As to the latter type of filings, the existing provisions of Section 24 have worked well, and there seems no need to disturb them in legislation dealing with securities processing. We accordingly suggest that the provisions of Section 405 be made applicable only to registrants under the securities processing title; that is, clearing agencies, depositories and transfer agents, by making that section applicable to these agencies only, and that Section 24 of the Securities Exchange Act be retained in its present form.

Section 408 of the bill would amend Section 28 of the Act to provide an exemption from state and local taxation on changes in beneficial or record ownership of securities effected through the facilities of a registered clearing agency or depository, or upon the delivery or transfer of securities effected through such agency or depository, unless such changes would otherwise be taxable if the clearing agency or depository were not located within the jurisdiction of the taxing authority. We strongly endorse this provision.

Finally, I wish to discuss an area which is not covered by Title IV, but is related to the processing of securities transactions and which has been of concern to the Commission in recent months; that is, independent service bureaus. As you know, broker-dealers, among other things, are required to maintain current books and records. Some service bureaus provide broker-dealers with recordkeeping services. My comments are limited to those service bureaus which provide recordkeeping capabilities only, since those that also handle customers' funds and securities have been required to register as broker-dealers with the Commission. Financial, operational or other difficulties encountered by service

bureaus may place a broker-dealer in violation of his responsibilities to keep current books and records and lead to a temporary halt in operations of the broker-dealer and inhibit his ability to complete obligations to customers unless he is able to obtain other means of keeping current books and records. This could result in a very grave situation for broker-dealers using the service and their customers. We have encountered several instances where the financial difficulties of service bureaus have resulted in broker-dealers being faced with the prospect of not having current books and records. Fortunately, these situations have been successfully contained. The use of these service bureaus may enable groups of smaller broker-dealers to have their necessary recordkeeping performed more efficiently and economically and, consequently, we do not wish to discourage the use of such service bureaus. However, as pointed out above, the collapse of a service bureau may create a serious problem. Consequently, the Commission should have authority to regulate such service bureaus with the view to avoiding such emergencies. We would be happy to assist the Subcommittee in framing a provision which would provide the Commission with such authority.

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