BASIC—Interindustry Teamwork

BANKING AND SECURITIES INDUSTRY COMMITTEE

Sponsored by

American Stock Exchange, Inc.
National Association of Securities Dealers, Inc.
The New York Clearing House Association
The New York Stock Exchange, Inc.

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INTRODUCTION

This volume was compiled by Herman W. Bevis, formerly Executive Director and member of BASIC. It has been reviewed by John M. Meyer, Jr., formerly Chairman and presently a continuing member of BASIC.

Summarizing in one place the ground covered, conclusions reached, and actions taken by BASIC has been done for several reasons. First, with the inevitable turnover of personnel in the banking and securities industries, without this volume and its appendices it is highly probable that not too much time would pass before fresh faces would start *de novo* going over the same ground that BASIC covered.

Secondly, BASIC's work has touched upon several aspects of an overall national system for the processing of securities transactions. Much remains to be done before the optimum system is developed, however. For those engaged in the future in further steps to modernize the system, some of BASIC's experiences and research may be of help.

For students of the extent to which the public sector, as opposed to the private sector, should be looked to for implementation of solutions to wide-ranging interindustry systems problems, BASIC's work is a detailed case history. BASIC was initially of the opinion that the interindustry securities handling and transaction problems could be solved by the private sector under existing state and federal regulatory laws. It soon became clear that many — most in the Federal Government, but not all — found it inconceivable that such an effort by the private sector could be successful without rather detailed federal agency participation under new regulatory law. That difference of view has not been resolved yet. Maybe this volume will help resolve it.

REPORTS OF CONGRESSIONAL HEARINGS CONTAINING REFERENCE MATERIAL

	Cited as
Subcommittee on Securities of the Committee on Banking, Housing and Urban Affairs, United States Senate	
Hearings September 23, 24 and 30 and October 1, 1971, "Securities Industry Study," Part 2	*Senate 1971 Hearings*
Hearings May 9, 10 and 11, 1972, "Clearance and Settlement of Securities Transactions"	*Senate 1972 Hearings*
Hearings July 11 and 12, 1973, "Regulation of Clearing Agencies and Transfer Agents"	*Senate 1973 Hearings*
Subcommittee on Commerce and Finance of the Committee on Interstate and Foreign Commerce, House of Representatives	
Hearings October 18, 19, 20, 26, 27; November 16, 17, 1971, "Study of the Securities Industry," Parts 3, 4 and 5	*House 1971 Hearings*
Hearings August 14; September 8 and 11, 1972, "Securities Processing Act"	*House 1972 Hearings*
Hearings June 5-8, 11-15, 27-29; July 19, 20, 27, and 31; August 1-3; and September 11-14, 1973, "Securities Exchange Act Amendments of 1973," Part 5	*House 1973 Hearings*

SOURCE DOCUMENTS REPRODUCED IN CONGRESSIONAL HEARINGS

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I

THE FORMATION AND DEVELOPMENT OF BASIC

Contents

I

THE FORMATION AND DEVELOPMENT OF BASIC

BASIC was an interindustry response to a serious national problem — the "paperwork crisis" in the processing of securities transactions. The formation of BASIC was by no means the first recognition of the seriousness of that problem. Nor was it the first interindustry effort at finding and effecting solutions. Since BASIC has had a fair measure of success in accomplishing its objectives, it may be of interest to describe briefly the formation and development of BASIC.

The "back office" problem

The volume of securities trading in the latter '60s outran the capacity of many firms' back offices to handle the paperwork necessary to complete the transactions.

The chaotic conditions that resulted have been well documented elsewhere, so that it is not necessary to dwell upon them here. Suffice it to say that, at the peak of the crisis, securities transactions by the hundreds of thousands involving hundreds of millions of dollars were inordinately delayed in completion, with some not completed at all. Unclaimed dividends, and unsatisfied dividend claims, soared. Errors were rife, and clerical talent in short supply. Trading days had to be eliminated, and trading days shortened. Firms failed solely because of the inadequacies of their back offices, and others were shaken for the same reason.

In short, a vital part of the financial mechanism in this country was in danger of being brought to its knees.

Early work on the paperwork problem

Many point out that back office problems have existed for years, that they were growing in the early '60s, and that it was only the 1968 volume that gave these problems the priority they had long deserved. Certainly, individual firms had commenced automation and other improvements before the widespread crisis. The self-regulatory bodies became more and more concerned and involved as the '60s wore on.

Several groups were formed in the '60s to deal with the problem of processing securities transactions, e.g.:

> In 1960, the New York Clearing House ("NYCH") Association formed a Securities Procedure Committee to consider the development of certain standards to assist in the processing of securities transactions. In February 1961, the Committee issued its "Uniform Procedures for Stockholder Descriptions and Addressing" which remains the authority in this field today. It also considered establishment of a standard code for identifying securities issues, but concluded that the national rather than local nature of this problem suggested that it be referred to the American Bankers Association ("ABA") for consideration.

Following the above NYCH action, in 1964 the ABA formed the Committee on Uniform Security Identification Procedures ("CUSIP") to develop the standard code for identifying securities issues. (Discussed in Chapter VIII.)

In June 1966, the Security Imprinting and Processing Task Force ("SIP") of the CUSIP was formed to develop man/machine-readable stock certificates. It expanded its scope to also include machine-processable accompanying documents. (See Chapter IX.)

In the first quarter of 1968, following discussions commenced in the latter part of 1967, the American Stock Exchange ("AMEX"), the National Association of Securities Dealers ("NASD"), the NYCH, and the New York Stock Exchange ("NYSE"), formed the Joint Industry Control Group ("JICG"). This group, on its own and through its subcommittees, dealt with a wide variety of interindustry problems and their solutions. JICG and its subcommittees each had co-chairmen and members coming equally from the securities and banking industries.

As an indication of the scope of JICG's coverage, the following were its subcommittees in latter 1969:

Delivery Problems Subcommittee
Collateral Problems Subcommittee
Transfer Problems Subcommittee
Credit Problems Subcommittee
CUSIP Subcommittee
Dividend Subcommittee[1.1]

The 1969 research studies

The year 1969 has to be the Year of Research insofar as the order taking, execution, and post-execution problems of the U.S. securities industry are concerned. The number of these studies – and their scope – testifies eloquently to recognition by the exchanges, NASD and others that a serious problem existed for which solutions were essential.

Among the studies made in 1969 were these:

The Multiple Causes of Fails in Stock Clearing in the United States, by Arthur D. Little, Inc. for NASD. Commenced in the summer of 1968, the report is dated April 1969. (Hereinafter referred to as "ADL NASD study." Reproduced in *House 1971 Hearings,* pp. 2413-2559.)

[1.1] At BASIC's request, JICG and several of its subcommittees continued in existence after the formation of BASIC. These groups not only worked on interindustry problems not being dealt with by BASIC, but acted as sounding boards and operations advisers for many of BASIC's proposals. In 1973, JICG was reorganized as the BASIC Steering Committee, reporting directly to BASIC.

Securities Industry Overview Study, by North American Rockwell Systems Company ("NAR") for AMEX. The study was made during February-August 1969, and the report bore the release date of September 1969. (Hereinafter cited as "NAR AMEX study." Reproduced in *House 1971 Hearings*, pp. 2055-2158.)

A Securities Handling System for the 1975 Era, by Arthur D. Little, Inc. ("ADL") for NYSE. Study commenced in April 1969 and the report issued as of November 1969. (Hereinafter cited as "ADL NYSE study." Reproduced in *House 1971 Hearings*, pp. 2560-2595.)

Paper Crisis in the Securities Industry: Causes and Cures, by Lybrand, Ross Bros. & Montgomery (an independent study). Report released in draft in latter 1969 and published early in 1970. (Hereinafter cited as "Lybrand study." Reproduced in *House 1971 Hearings*, pp. 2159-2305.)

Reducing Costs of Stock Transactions: A Study of Alternative Trade Completion Systems, by The Rand Corporation for AMEX, NASD, and NYSE. Commissioned in early 1969, the report was dated December 1970. (Reproduced in *House 1971 Hearings*, pp. 2596-2849, and *Senate 1972 Hearings*, pp. 156-168.)

Report of the New York Clearing House Special Committee to Study the Securities Industry, Part I dated January 6, 1970 and Part II dated February 24, 1970. This group reached conclusions and made recommendations after studying some of the reports cited above and utilizing the experience of its members and other information available for them. (Hereinafter cited as "NYCH Special Committee study." Reproduced in *House 1971 Hearings*, pp. 1995-2011.)

In the aggregate, the 1969 studies were massive. Dealing with all operating aspects of the securities industry, they identified problems and recommended courses of action to achieve both near and long-term solutions. The studies differed among themselves, however, as to the best way to reach the optimum state.

The conclusion in latter 1969 of the need for interindustry efforts

The earliest of the 1969 studies listed above, the ADL NASD study, dealt almost entirely with the broker/dealer industry, with particular emphasis on over-the-counter securities. Even in this context, however, the interindustry nature of the "fails" problem was brought out:

> "Proposed remedies for the fails problem become more effective as they include a larger number of broker/dealers and as they serve a greater proportion of the cities in the United States. Since banks have an important role in the

present stock clearing system, both in the movement of securities from one city to another and in the role of transfer agent, proposed remedies for the fails problem are more likely to be effective to the degree that they take into account the interests of the banks."[1.2]

On September 18, 1969, Ralph S. Saul, President of AMEX, made a speech before the Securities Industry Operations Conference in New York City. Drawing heavily on the NAR report, which had just been completed, he stated, in part:

"The keynote of this conference . . . should be to affirm the necessity and urgency for restructuring the system for processing securities — and to do so while the inadequacies of the present system are fresh in our minds and the financial community is in general agreement that change is necessary.

* * * * *

. . . Brokerage firms are not alone. We are dealing with a financial community. Banks are intimately involved. So are institutional investors, retail customers, transfer agents, the exchanges and their clearing and depository operations, and corporations. It follows that remedies to the major operating problems must be resolved in concert. We are operating a system, not a group of independent businesses.

* * * * *

During the past two years we have made significant breakthroughs in cooperative efforts to meet our operating difficulties . . . Perhaps the cooperative efforts of the financial community should take on a new dimension. One possibility would be an interindustry organization that has the powers, the budget, and the direction needed to accomplish those tasks involving the entire financial community . . ."[1.3]

Shortly thereafter, bankers reached much the same conclusion. The Special Committee of the NYCH stated:

"It is clear thar the Wall Street community has awakened to the perils of the increasing paper handling problem. In contrast to the situation several years ago numerous groups, task forces, committees and subcommittes representing various segments of the securities industry have been actively investigating operational problems and advocating various solutions for some or all of them . . .

In addition to these industry groups the Exchanges have engaged a number of consultants to advise them on various facets of the overall situation. At least one consulting firm has conducted an independent study and made recommendations . . .

. . . Very often the work of one group duplicates or at least overlaps that of another . . .

[1.2] *House 1971 Hearings,* p. 2489.

[1.3] The entire address is reprinted as Appendix A. The quotations are from pp. 2, 3, 8 and 9.

> To assure a consistent coordinated approach in arriving at solutions to securities industry operational problems an inter-industry control group should be formed consisting of top management representatives of the New York and American Stock Exchanges, the National Association of Securities Dealers and the Clearing House Banks. Close liaison should be maintained with other securities industry groups such as the regional Exchanges, the Association of Stock Exchange Firms, the American Bankers Association, and The Investment Bankers Association. Such control group should have an executive director with a full time staff . . ."[1.4]

Considering the foregoing examples of the line of thinking in latter 1969, it is not surprising that Messrs. Robert W. Haack, President of NYSE, and Ralph S. Saul, President of AMEX, met with the NYCH Clearing House Committee on December 3, 1969. (The Clearing House Committee consists of the Chief Executive Officers of the NYCH banks. These banks in latter 1969 were: Bank of New York, Bankers Trust, Chase, Chemical, Irving, First National City, Manufacturers Hanover, Marine Midland, Morgan Guaranty, and United States Trust. Added later were Franklin National and National Bank of North America.)

The subject of the discussion was the formation of an interindustry organization at top management level, as to which there was general agreement. There followed in December 1969 and January 1970 discussions and correspondence between Messrs. Haack and Saul and John M. Meyer, Jr., Chairman of the Clearing House Committee and of Morgan Guaranty. Richard B. Walbert, President of NASD, was being informed of developments throughout. By January 7, 1970, agreement was reached that the two industries would be represented on the interindustry committee by the Presidents of AMEX, NASD, NYSE, and three members of NYCH.

There was also discussion during this period of the selection of a full-time Executive Director for the Committee's work. After considering several possibilities, agreement was reached early in February 1970 with Herman W. Bevis, retired Senior Partner of Price Waterhouse & Co., that he would serve full-time as Executive Director.

Thus, about five months after Saul made his speech, and less than three months after the exploratory meeting of Haack and Saul with the Clearing House Committee, the minutes of the latter stated (February 25, 1970):

> "The Chairman reported that an accord had been reached between the President of the New York Stock Exchange, the President of the American Stock Exchange, the President of the NASD and the three bank chairmen who have been nominated by this Committee to serve on the top management group. The choice for executive director who will be a member of the joint committee and the role he will play in the organization have been agreed upon. After discussion the members concurred that Herman W. Bevis, former Senior Partner, Price Waterhouse & Co. be named executive director and that he become a member of the committee with a vote. Mr. Meyer will be Chairman of the group. All major decisions brought before the group will be agreed upon

[1.4] "NYCH Special Committee study," Part II, *House 1971 Hearings,* pp. 2008-2009.

unanimously before implementation. Mr. Bevis will be given wide latitude in selecting his own staff and charting the course of the interindustry effort to solve the problems that now exist on the 'street'."

BASIC is organized

The organizational meeting of BASIC was held on March 11, 1970 with the following as members.

Name	Affiliation
John M. Meyer, Jr., Chairman	Chairman, Morgan Guaranty Trust Company
Herman W. Bevis, Executive Director	Retired Senior Partner, Price Waterhouse & Co.
Robert W. Haack	President, New York Stock Exchange
William H. Moore	Chairman, Bankers Trust Company
Ralph S. Saul	President, American Stock Exchange
Richard B. Walbert	President, National Association of Securities Dealers
Walter B. Wriston	Chairman, First National City Bank

At this meeting, the Committee authorized a press release as to its formation (attached as Appendix B). It agreed to a general statement of its scope, which was this:

"Conceptually, the problem with which the Committee is concerned is the inability of the present system accurately to execute, record and settle securities transactions, transfers and dividend claims within acceptable limits of time and expense.

Within this whole problem area, the Committee's task is to identify *mutual* problems and seek solutions. This means that the Committee is not to concern itself with *intra* industry matters except to the extent that they overlap with *inter* industry problems."

Several other important decisions were made at the organizational meeting, such as: an unanimous vote of all members would be required to reach a Committee decision on a major matter; expenses of BASIC would be shared one-half by NYCH and the other half equally by AMEX, NASD, and NYSE; the Executive Director was authorized to recruit a Task Force of five to seven persons from the two industries; the leasing of office space was authorized; and it was agreed to retain legal counsel.

By June 1, 1970, a Task Force of six members had been recruited, as follows:

Name	Affiliation
Peter C. Campbell	Price Waterhouse & Co.
Arnold Fleisig	NYSE (formerly Bache & Co.)
David Fuchs	NYSE
Carl Hagberg	Manufacturers Hanover Trust Co.
William F. Jaenike	AMEX
Milan S. Soltis	Chase Manhattan Bank

The Task Force members were obtained on a leave-of-absence of approximately two years from their respective employers, who were reimbursed by BASIC for salary and fringe benefit costs.

The Executive Director and Task Force moved into leased space at 84 William Street on June 8, 1970.

To assist in dealing with the many important legal problems that were foreseen to be involved, the Committee retained Messrs. Sullivan & Cromwell. Participating in BASIC's work continuously from the outset was Hamilton F. Potter, Jr., a partner of S&C., and assisting him at various times were David L. McLean, William R. Brew, and Joseph S. Orban, Jr.

Identifying the problem areas and cataloging the solutions proposed by others

The minutes of the March 25, 1970 Committee meeting contains this statement:

> "The Executive Director reported that, not having been a part of either industry heretofore, his first action was to make a quick survey of the organizations attempting to improve the processing of securities transactions, and the approaches which they are taking.
>
> The concern with the problem is widespread – the research work which has already been done is enormous, and many improvements have already been effectuated.
>
> The Executive Director stated that he planned to consult with these organizations, in and outside of New York City, so as to take advantage of their research and accomplishments in making recommendations to BASIC. The Committee endorsed this approach."

The first job of the Task Force was to review the wealth of written material on relevant subjects. Some of this has already been metioned, but there was much more. The next job was to interview the several dozen people who were known to have given thought to the securities transaction processing problem and solutions for it. Those interviewed included, inside and outside of New York City, not only members of the Committee and their operations experts, but authors of published articles and of the aforementioned consultants' studies, executives of trade associations, and operating personnel in banks, brokerage firms and exchanges.

From the outset, and consistently thereafter, BASIC received excellent cooperation from industry people. One broker group was put together at the request of the Executive Director by Donald Arthur, Jr. of Clark, Dodge to inform and advise the Executive Director at monthly luncheons. The earlier group (it still meets in an expanded form) consisted of Arthur and the Executive Director; Roger E. Birk of Merrill Lynch; Richard Burdge of AMEX; Frank A. Digaetano of Bache; Richard B. Howland of NYSE; Thomas P. Lynch of E.F. Hutton; Carl W. Timpson, Jr. of Pershing; and Paul Tobin of Paine, Webber.

The foregoing exercises essentially confirmed the nature of the problem, and much as the Committee had described it at its first meeting. Where there was *not* agreement was in the appropriate solution or solutions. In no particular order, these were being advanced in early 1970 as partial or complete solutions to the securities transaction processing problem:

Adopt and require universal use of a man/machine-readable stock certificate.

Require universal use of CUSIP.

Speed up transfers; eliminate the independent registrar.

Abolish the stock certificate.

Build a computer network linking the entire financial community to effect all securities transactions.

Develop prototype internal systems for back offices of banks and brokers.

Retain consultants to study the problems.

Immobilize certificates and make book-entry transfers among the depositors in:

Transfer agent depositories.

Financial community depositories.

One broker depository module, one bank depository module, and one custody organization to hold certificates and to interconnect the other two.

Persuade banks and other members of the financial community to deposit securities in the Central Certificate Service ("CCS") of NYSE.

Eliminate the rejection of deliveries against payment (the "DKS" of COD deliveries).

Adopt and make mandatory the use of uniform forms and securities transaction records.

Adopt a uniform Financial Industry Numbering System ("FINS").

Not all the foregoing approaches were mutually exclusive, of course, and many were pursued by the BASIC Task Force, as reported in later chapters.

However, it was obviously necessary in the circumstances to establish some priorities for BASIC's work. At its first monthly meeting on March 25, 1970, the Committee decided to give high priority to studies of (a) the further immobilization of certificates in central depositories and (b) a system for man/machine-readable stock certificates and supporting documents. Assignment of these priorities did not preclude early work on some other potential improvements in the processing of securities transactions, as will be mentioned later.

Liaison with other interested parties

Almost as soon as the formation of BASIC was announced in March 1970, various interested groups petitioned that the seven-member Committee be expanded to include their representatives. Such petioning groups included associations representing brokerage firms, corporate secretaries, and transfer agents, as well as such financial communities as Chicago, California, and Boston.

The earlier of those requests for inclusion were relayed to the Committee at its May 27, 1970 meeting. The Committee considered this question carefully. The minutes of the meeting state:

> "The Committee indicated its concern over the need for effective communication with the interested parties in order to prevent any antagonism from developing as well as to insure national participation in solutions to the problems. A number of suggestions were voiced as to how this communication might be accomplished."

The Committee decided not to expand the number of its members — both in the interests of efficiency, decisiveness, and action, and because the dominant *initial* problem to be solved lay in New York City itself.

However, the Committee instructed the Executive Director to maintain close communications with all the groups which either had expressed interest or should be interested. This was done through numerous meetings with staff and members of about a dozen organizations representing broker/dealers, bankers, mutual funds, lawyers, issuers, and servicers. Further, from August 1970 until mid-1972, the Executive Director and Task Force held monthly one-day meetings with representatives of the financial communities in other cities — eventually including Boston, California, Chicago, Hartford, and Philadelphia. At these meetings, all of the plans, programs, research, and thinking of BASIC were discussed and ideas and information exchanged.

National Coordination Group for Comprehensive Securities Depositories ("NCG")

By the latter part of 1971, BASIC and its sponsoring organizations had reached general agreement as to the desirability and feasibility of immobilizing certificates in a comprehensive securities depository system ("CSDS"), and had agreed in principle on the nature of the comprehensive securities depository ("CSD") in New York. The next logical

(4)

step was to determine whether other financial communities would take similar steps, to the end that a CSDS would comprise a series of interconnected, locally-owned, regional depositories.

With the approval of the Committee, the Chairman and Executive Director discussed these possibilities with leaders of the financial communities of California and Chicago, who expressed considerable interest. As a result, NCG was formed in December 1971 with the following membership:

Name	Affiliation
John L. Perkins, Chairman	Executive Vice President (now President), Continental Illinois Bank and Trust Company
Herman W. Bevis	Executive Director, BASIC
George R. Becker	Chairman, Midwest Stock Exchange and Partner, Wayne Hummer & Co.
Gordon S. Macklin	President, NASD
John M. Meyer, Jr.	Chairman, BASIC
Thomas P. Phelan	President, Pacific Stock Exchange
Samuel B. Stewart	Senior Vice Chairman, Bank of America

As is developed in Chapter V, the California and Chicago members have played an active part in the development of CSDs in their respective areas.

The commitment of BASIC members

As of December 31, 1972, all Task Force members by then having returned to their respective employers (except for Campbell, who joined First Boston Corporation), BASIC's office at 84 William Street was closed. Bevis relinquished the title of Executive Director but continued as a member of the Committee. Otherwise, the Committee membership continued without change.

December 31, 1972 marked the end of the operational phase of BASIC. By that time, it had analyzed, reached conclusions on, had its recommendations accepted regarding, and saw implementation started on, most of the problems of processing securities transactions. True, the implementation of many solutions had not been completed, but BASIC considered itself from the outset as a problem-solving group (gaining acceptance of its solutions being part of its mission) and of creating the necessary machinery to achieve the solutions.

The active involvement of responsible leaders of the financial community that comprised the membership of the Committee is essentially what made BASIC's efforts productive. Four of the seven members of BASIC served from its beginning to year-end 1973. In April 1970, Walbert was replaced by Gordon S. Macklin for NASD; in June 1971, Saul was replaced by Paul Kolton for AMEX; and in September 1972, Haack was replaced by James J. Needham for NYSE.

Between March 11, 1970 and December 27, 1972, the Committee held 32 meetings. What with enforced absences because of business commitments (and, now and then, a

vacation) Committee members had an 82% attendance record at these 32 meetings. In the case of most absences, the next-in-line to the chief executive officer attended in the member's place. This is what made BASIC click.

Another – and indispensable – ingredient in the BASIC formula was financing. It was made clear from the outset that the supporting organizations were willing to underwrite whatever expenses of BASIC were reasonably necessary to get the objective accomplished. With neither the Chairman nor the Executive Director receiving compensation, BASIC had expended to December 31, 1973 near $1.5 million, as follows:

Item	Amount
Legal and consulting fees	$ 776,586
Reimbursement to employers re: Task Force members and secretaries	420,108
Rent	149,496
Office expenses and printing	80,369
Travel, lunches, and dinners	28,385
Telephone	8,976
Initial outfitting expenditures	30,185
Total	$1,494,105

What was done with this money, and the Committee members' time, is covered in the succeeding chapters.

II

EXPLORING THE FURTHER IMMOBILIZATION OF CERTIFICATES IN DEPOSITORIES

Contents

II

EXPLORING THE FURTHER IMMOBILIZATION OF CERTIFICATES IN DEPOSITORIES

Securities depositories were nothing new when BASIC entered the picture. NYSE had been operating CCS since 1968. The Federal Reserve Banks were operating a book-entry depository system for Treasury securities also, after pilot operations, since 1968. Securities depositories had been operating for decades in Europe. What, then, was the problem in early 1970? Essentially, it was that depositories in the U.S. were realizing only a tiny fraction of their potential for alleviating securities handling problems.

Support for further immobilization

There was widespread agreement in early 1970 that the immobilization of securities in depositories should be increased. NAR's report to AMEX stated:

> "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."[2.1]

ADL stated:

> "Our proposed approach for solving (the primary problems of the securities industry) involves the development of a system of depositories, within which ownership records can be transferred by electronic book entries."[2.2]

From Lybrand:

> "An effective central depository share-transfer system — one that embraces all shares in street name as well as shares actively traded in the public markets — would substantially remedy one of the industry's major operational problems."[2.3]

The NYCH Special Committee said:

> "The Committee unequivocally accepts and strongly recommends the concept of depositories. The depository concept is the best answer to securities handling problems. . . ."[2.4]

On January 29, 1970, the Executive Vice President of NYSE said in a speech:

> ". . . The depository concept . . . is the only way future paperwork can be avoided, short of the 'certificateless society.' And if the day ever comes when we do have a 'certificateless society,' the depository is the route by which we will get to it."

2.1 "NAR AMEX study," *House 1971 Hearings,* p. 2095.

2.2 "ADL NYSE study," *House 1971 Hearings,* p. 2562.

2.3 "Lybrand Study," *House 1971 Hearings,* p. 2272.

2.4 "NYCH Special Committee study," *House 1971 Hearings,* p. 1995.

2.5 Cunningham, R. John, "The Stock Certificate and the 1970's," Remarks to New York State Bar Association (unpublished).

In the light of the widespread agreement on the desirability – if not necessity – of expanding a depository system for stocks in early 1970, it is not surpsising that the Committee was able to conclude early that promised benefits from further immobilization of certificates in depositories suggested that this subject should have the highest priority among the solutions to be explored.

If there was so much agreement on the immobilization concept in early 1970, wasn't the securities handling problem virtually solved? Answer: No. Why Not? Well, for one thing, CCS had immobilized only a small fraction of the stocks that ought to be immobilized, and its input was not increasing very fast. For another, not *all* believed that depositories were the solution, for some were advocating that a better alternative was to eliminate the certificate. For still another, among those advocating depositories were differences as to the most desirable depository system.

Consideration of alternatives: eliminating the certificate; a securities transfer wire network; the Transfer Agent Depository ("TAD")

Among those concerned about, and commenting upon, the certificate handling problem in 1970 and thereafter were some who gave the impression that they advocated an abrupt "quantum jump" from the laborious certificate handling, which had continued from the last century up to date, to a system whereunder the certificate no longer existed as evidence of either ownership or transfer of ownership.

For example, Frank Zarb was writing in March 1971:

> "While the theory of eliminating the stock certificate is accepted by most people, the problems of implementing the mechanics of such a program are often cited as reasons why it cannot be accomplished over the near term. However, these problems can be dealt with, and with the necessary resources, the mechanics for creating a 'certificateless society' can be placed into motion within the next three years . . .
>
> * * * * *
>
> It should be noted that a considerable body of opinion within the securities industry believes the depository system is tantamount to elimination of stock certificates. This is not correct. The depository system, such as Central Certificate Service, is important as an intermediate and stop gap solution to security handling problems. It is the best answer we have now, and it should be supported by everyone. But even at its best, the depository is far from the complete answer. It is yesterday's answer to today's and tommorow's problems."[2.6]

[2.6] Zarb, Frank G., "Let's Abolish the Stock Certificate," *Institutional Investor,* March 1971, pp. 28 and 30.

Eli Weinberg of Lybrand testified in September 1971:

> "The depository has been a great step forward and has made notable contribution to the solution of the operations problems. However, past experience shows it too is vulnerable to sharp volume fluctuations, and there are strong indications it will never, even under the best of circumstances, encompass much more than 50 percent of all security transactions . . .
>
> * * * * *
>
> As a result of these and other related considerations, Lybrand has come to the conclusion that the most significant, long-term improvement in the security settlement process can come about through the elimination of stock certificates. Furthermore, we believe the present depository concepts will not achieve their stated objectives of elimination of certificate movement."[2.7]

The Subcommittee on Stock Certificates of The Corporation Law Committee of the American Bar Association was, in latter 1971, studying the legal implications of eliminating the stock certificate. Professor Thomas H. Jolls had been asking in print at least as early as July 1968 whether the certificate should not be eliminated.

Some of those who urged elimination of the certificate did not speak of substitute procedures to carry out functions now performed by possession and delivery of certificates; others did. The latter usually envisioned a wire network connecting all members of the financial community: broker/dealers; exchange facilities; banks; transfer agents; perhaps institutional investors; etc. Through this network, often with computer-to-computer transmission, orders would be relayed, trades executed and "locked in" (i.e., compared and confirmed at the time of the trade, not later as at present), security ownership accounts updated, and net cash receivable and payable determined. Such electronic communication would make same-day settlements quite simple. Take, for example, this statement of Robert R. Maller:

> "NASCLEAR is designed to provide for the settlement of security transactions between trading entities. This clearance would simultaneously transfer securities to one entity and provide a payment credit to the other. Transfer agents would be notified and where necessary receipts of ownership would be issued.
>
> The entire process would be accomplished via a series of computer networks which would be interconnected with all brokers, dealers, securities exchanges, institutions and banks."[2.8]

To those proposing certificatelessness and wire networks, the transfer agent ("TA") would maintain the centralized record of securities ownership. The name on the stockholder list would be that of the beneficial owner or, if he chose anonymity, that of the broker or bank with which he arranged to maintain his record of ownership. Such systems contemplated that TAs would receive appropriate authorizations to debit one account and credit another to effect securities deliveries.

2.7 Weinberg, Eli J., *Senate 1971 Hearings,* p. 96.

2.8 Maller, Robert R., "NASCLEAR: National Security Clearance System" (unpublished pamphlet), February 1970.

Others would allow those who wished, to receive and hold certificates. The remainder would be in a Transfer Agent Depository ("TAD"). The TAD would maintain one balance certificate for all shares immobilized in it. Transfers between owners of immobilized certificates would be made by book-entry upon appropriate authorization. The First National Bank of Boston was espousing that TAD concept in 1970.[2.9]

However, details of the proposal dealt mostly with the working relationship between one TAD and those who would lodge their certificates with it; many questions remained as to *a financial-community-wide TAD system* and the resulting multiple interrelationships among TADs for most fungible stocks, on the one hand, and all brokers, banks, and other financial institutions, on the other hand. A particularly knotty question not dealt with was how the cash side of deliveries against payment would be handled under a total TAD system. BASIC's Task Force was looking for a solution to the securities handling and transaction problem that could be applied to the whole financial community — and reasonably quickly. Accordingly, it explored the widespread systems aspect of the TAD proposal carefully.[2.10]

Some envisioned the comprehensive securities depository system — or CSDS — as being more workable. Each CSDS would interface with transfer agents ("TAs") on one side, balancing its security positions against TA records of securities in the name of the CSDS nominee. On the other side, a CSD would interface and balance with the members of the financial community who had deposited the securities with it.

The Task Force examined all the foregoing propositions very carefully and reported on them to the Committee. Many hours were spent with those espousing the several points of view. At an early point consideration was given to retaining consultants to assist in crystallizing the design for a securities handling and transaction processing system, but the Committee decided that the problem had been studied in this manner enough. BASIC dismissed as possibilities neither ultimate elimination of the certificate nor the ultimate effectuation of securities transactions through a comprehensive wire network, including computer-to-computer talk. But it disagreed sharply that these theoretical concepts could be translated into relief from the paperwork crisis in the near term, as some were stating.

Rather, BASIC reached the conclusion that the ultimate ideal system could be attained only through a series of carefully designed and constructed stages. Speaking primarily to the then vocal pressure to eliminate the certificate, the Executive Director in March 1971 made these comments:

> "Security transactions *could* be handled in much the same way as cash transactions. A Central Securities Depository could keep a record of shares outstanding for each issue, and who has these shares on deposit with it. The latter would be shown by Security Accounts. A depositor selling shares could

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[2.9] See, e.g., statement of Eugene M. Tangney of that bank at a Lybrand seminar, "Is the Stock Certificate Necessary," November 18, 1970. *House 1971 Hearings,* pp. 2395-2401.

[2.10] The TAD and other positions are discussed in a white paper entitled "TAD vs. CSDS, A Task Force Analysis of the 'Transfer Agent Depository' Idea in Relation to that of the Comprehensive Securities Depository System." The paper is dated July 19, 1971 and was approved for distribution at the Committee's July 1971 meeting. Reproduced in *Senate 1973 Hearings,* pp. 352-381.

write a 'securities check' authorizing his Security Account to be reduced by the shares sold . . .

* * * * *

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 . . .

* * * * *

BASIC is working on — and has already completed a great deal of legal and other exploratory work for — the first two essential stages of a comprehensive securities book-entry network. These stages correspond to the first two elements . . . 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 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 *are* 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.

Transition 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 of 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."[2.11]

The Task Force position paper analyzing TADs in comparison and contrast to a CSDS stated these conclusions:

"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 much more quickly (involving, as it does, only an extension of an already huge immobilization facility – CCS);

Accomplish the transition to the system of 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.

* * * * *

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 huge information center, CCS, that already exists – and works."[2.12]

BASIC reached a systems conclusion. It decided about March 1971 that the NYSE had, indeed, been on the right track with CCS as a depository interfacing with its participants, on the one side, and with TAs, on the other.

Conclusions as to a depository system

That securities depositories were a feasible and useful mechanism for alleviating securities handling and transaction processing problems had already been demonstrated by CCS, the Fed's book-entry system, and foreign depositories, by the time of BASIC's formation in early 1970. The Task Force work in 1970 and the first half of 1971 progressively confirmed that immobilization of certificates in comprehensive securities depositories – and effecting transfers of ownership by book-entry – (a) promised substantial and lasting relief from securities paperwork problems, (b) promised earlier relief of magnitude than alternatives being discussed, and (c) even promised to be a safe and orderly mechanism for progressing toward – and perhaps the quickest route to –

[2.11] Bevis, Herman W., "How Do You Get from Here to There in this Securities Industry?", Portion of Remarks to the American Society of Corporate Secretaries, Biltmore Hotel, New York City, March 17, 1971, p. 2, 3, 4 and 5. Attached as Appendix C.

[2.12] "TAD v. CSDS," *Senate 1973 Hearings,* pp. 352, 353, and 370.

such fascinating concepts as the certificateless society and the universal wire network for effecting securities transactions.

One national depository, or several interconnected regional ones?

Having decided that CCS should serve as a model for an expanded system, (as opposed to, for example, TADs), BASIC early faced the question of whether there should be a single national organization carrying out the depository function through branches, or several locally owned and managed regional depositories which were interconnected.

A single national depository organization operating branches in the major financial centers certainly sounded like the ideal – in theory. One system under one management, interlocked from coast to coast, with the same procedures for internal and external relationships, seemed to fit in best with the longed-for uniform national securities handling network of the future.

Such a system may yet come to pass. But in 1970 and the first half of 1971, with a sense of urgency for early action and accomplishment, there were questions like these:

> Will the several diverse financial communities allow a national depository organization to give priority to any particular cities, or must the whole national system be developed before the "start button" is pushed? (This was particularly relevant to New York City's problem, where two-thirds to three-quarters of the nation's securities handling problems centered.)
>
> Considering regional jealousies, would it be acceptable for New York representatives – with the lion's share of securities transactions and securities handling – to dominate the national depository? Conversely, if the several sensitive financial communities were to share more or less equally in the management and control of the national organization, would this be acceptable to New York – or even fair to it?
>
> Providing there was assurance that separate depositories could interface, might more be accomplished quicker if each financial community were given the responsibility of assessing its own requirements and local conditions and deciding whether (a) to establish its own depository or (b) have the members of its financial community tie in with depositories in other centers?
>
> If there were one national depository organization and depositories became the "in" thing, might not even the most marginal communities press for a branch, so that the branches might be proliferated like post offices?

The foregoing aspects were considered in the light of the developing experience in Canada. There, the objective *was* to establish from the beginning a national depository corporation with branches. Consultants were retained to make feasibility, design, and other studies for the national system. From day one, depositories would commence operations in Montreal, Toronto, and Vancouver, with provision for adding four or so cities to the system later. The thinking of the BASIC Task Force at the time was that,

even if a nationwide system could be developed and commenced in several cities in Canada as one project, larger volumes and other complications made this less feasible in the United States – even given the start already provided by CCS. (In due course Canada decided to draw back from an initial full-scale national project to more modest local steps.)

The Committee's provisional approach was indicated at its December 1970 meeting by this minute:

> **"Should the initial CSD relate only to the New York financial community?** While this question cannot be fully answered until the research on security movements is completed, the Committee believes it would appear logical to concentrate initial efforts in the N.Y. area, where the largest number of movements occur. However, the framework of the depository should accomodate the ultimate entrance of other areas into the depository system."

After considering all aspects, BASIC finally concluded to recommend a series of locally owned and operated regional depositories. It did so only after convincing itself that it was feasible to interconnect such separate depositories so that book-entry transfers of securities could be made from a participant in any one to a participant in any other. This decision did two important things: one, it enabled the Task Force to concentrate on the New York situation, which *had* to be solved if the nation's problem was to be solved; and, second, it enabled each financial community to proceed toward depositories at its own pace, without the whole system's having to wait until the last interested community was on line.

A depository for each industry, or an interindustry depository?

The Arthur D. Little report to the NYSE had made the following recommendation:

> "The overall securities handling system can be organized best in terms of three components or modules:
>
> –A Broker component that services the brokerage industry.
>
> –A Banking component that services the banking community and operates a wire network for security deliveries to customers.
>
> –A Custodian and Co-Transfer component, to control movement within, and into or out of the system, and to provide an effective interface between this system and systems that may be developed for other securities markets.
>
> This organization will permit other markets to participate in an NYSE Broker component, if desirable, or to develop their own procedures if interfacing through the Custodian is preferable."[2.13]

[2.13] "ADL NYSE study," *House 1971 Hearings,* p. 2562.

In early 1970, there were several who gave strong support to the idea that the banking and brokerage industries should each maintain a depository or depository system for its securities and for its purposes. This had appeal from certain standpoints: most "political" problems of getting the two diverse industries together would be avoided; differing, specialized services might be offered by each module; and the regulation of each might be tailored to that of its industry.

Bankers which whom the Task Force discussed the matter could think of no strong reasons for a separate "module" for their securities. Accordingly, consideration was narrowed to the possibility of banker participation in the "custodian component," which would be linked to a "broker component." As to this possibility the minutes of the December 1970 Committee meeting state:

> **"Should the security positions of brokers-dealers be in the CSD, or in an 'exchange module' with the aggregate positions of the module in CSD?** The Committee members expressed several opinions on this question but all agreed that they would be open-minded on the subject. However, several questions relating to the regulatory requirements of the exchanges, the interfaces with the clearing corporations, and uncertainty of the nature of future systems, could suggest the adoption of a modular system in the beginning. This question will be reconsidered when more information becomes available."

BASIC's Task Force explored the modular versus the single – or comprehensive – depository system carefully. The results of research and numerous inquiries were written up in a 47-page staff memorandumm dated October 19, 1970 entitled, "A Consideration of the Mechanics of Operation of Two Alternative Depository Systems." The memorandum is reproduced in Appendix D.

Difficulties were foreseen with the modular system. Procedurally, delivery-against-payment and collateral loan transactions between banks in one module and brokers in another would be more difficult to compare and consummate than in a single comprehensive depository (although not impossible in a highly automated, closely synchronized system). Duplication of facilities might mean more expense. Further, the time for development of the system would probably be longer than if CCS were made more comprehensive by broadening its list of participants to include the entire financial community.

By March 1971, the Committee had concluded to move forward with the interindustry depository concept rather than the modular one.

Research into depository benefits

CCS operations could be considered successful in early 1970. However, it was not being used by all eligible NYSE members (the only brokers eligible), and many of these users were depositing in CCS only a part of their holdings of eligible securities. No banks were depositors. CCS was largely a New York broker—NYSE facility.

The benefits of CCS to its users in early 1970 were demonstrable. However, so were its limitations. The most prevailing complaint of users was the absence from participation

of other broker/dealers, and banks; the users had to withdraw too many of the securities they deposited to make physical deliveries to these non-users. The non-users were not pressing for participation, undoubtedly for reasons they considered valid. So, the question naturally arose: How much would users and non-users benefit if *all* used the depository? No one could say with any specificity.

Commencing in latter 1970, the BASIC Task Force mapped out a plan for research studies to try to answer the above question. The first study was conducted in mid-January 1971 in the offices of cooperating banks and brokers: the then 10 NYCH banks and a statistical sample of 32 New York brokers. The Task Force inspected and tabulated some 60,000 receive and deliver tickets relating to physical movements of securities to answer the question of how many of these could have been accomplished by book-entry if certain assumed issues and members of the New York financial community were in CCS. The results were reported to the Committee at its March 1971 meeting. The study indicated that, of the movements of eligible securities inspected, the number effected by book-entry in a New York CSD would be more than doubled from CCS's then volume, to about half the total movements.[2.14]

The next study tried to explore the effect on the volume of transfers — on a national rather than New York City basis — through examination of transfer agents' journals. For a sample of 29,000 old certificates in 20 issues transferred in April 1971, the names in which old and new certificates were registered were tabulated. The assumption was that if both old and new certificates were in the names of brokers or banks, and these had been in a national depository system, a transfer (and a movement of securities) would not have had to take place. This research was reported on to the Committee at its July 1971 meeting. Subject to limitations cited in the study, it was indicated that a New York CSD (*all* New York banks and brokers participating) would reduce the then transfer volume (number of certificates handled) by some 40-50%; a national CSD would increase the reduction to some 55-70%.[2.15]

The most definitive study made of securities movements that could be eliminated by a CSDS involved examination of cancelled stock certificates. A total of 6,151 cancelled certificates, coming in for transfer in the April-June 1971 period, were inspected to determine — from endorsements, guarantees, tax stamps, etc. — through whose hands they had passed. The results of this study were reported at the September 1971 Committee meeting. Of the 22,796 physical movements of the 6,151 certificates, the study indicated that 74% would have been eliminated by a national CSDS in which all broker/dealers and banks were participants.[2.16]

In addition to statistical studies, a promising area for research was the securities depository evolution in other countries.

[2.14] The entire study, entitled, "A Profile of Securities Movements in New York City, Mid-January, 1971" is contained in *Senate 1971 Hearings,* pp. 304-311.

[2.15] The study, entitled, "Information Bearing on CSDS Derived from a Study of Transfer Journals," dated July 20, 1971, is attached as Appendix E.

[2.16] The entire study, entitled "Study of Cancelled Stock Certificates — Research Report," dated September 15, 1971, is contained in *Senate 1971 Hearings,* pp. 195-258 and *House 1971 Hearings,* pp. 1838-1868.

The proposed Canadian securities depository system, studies about which were commenced before the formation of BASIC, has been referred to. BASIC established early – and continued – a dialogue with relevant members of the Canadian financial community about the most promising courses to be pursued in the development of depository systems. Canadian depository officials furnished the Task Force with copies of their extensive consultants' reports as to depository concepts, systems design, and implementation plans. BASIC furnished the Canadians with all its papers and reports. Information and ideas were exchanged on a wide variety of detailed problems and questions.

A nation-wide securities depository system had operated in Germany under formal law since 1937, and informally since before the turn of the century. A similar system had been in operation in France since 1941. The Executive Director of BASIC visited Frankfurt and Paris in March 1971 to study these systems. He also reviewed the Euroclear System of Morgan Guaranty Trust Company in Brussels at the same time. The Executive Director reported to the Committee at its March 1971 meeting his principal conclusion from the trip, namely, that the European experience has proven that a comprehensive securities depository system can work effectively to produce dramatic benefits in the processing of securities transactions. Notes on the three European systems are reproduced in *House 1971 Hearings*, pp. 1509-1516.

In deciding whether to install any new system or expand an existing one, potential cost savings or cost increases are of course an important consideration. In looking at this aspect of a CSDS, BASIC had the advantage of a CCS which was already in operation. While the overall benefits – including cost savings – varied among its broker participants, they were demonstrable. Moreover, these broker participants were crying loudly for the banks, and other brokers, to become participants. They knew from their experience that this would multiply the CSD's benefits to them.

For the banks, the cost/benefit prospect was a different matter. When NYCH banks started a program of receiving deliveries from brokers through CCS (see next chapter), they withdrew all that was delivered to them. High withdrawal charges of CCS made this a costly process; banks' estimates were that receiving through CCS was costing two to four times that of receiving the same deliveries physically over-the-window. However, the banks continued the program of receiving through CCS as an investment in the future, when – they hoped – they would, as participants, not have to withdraw the securities but could take full advantage of the economies of book-entry.

But how much would full book-entry save a bank? The Task Force worked with three banks in researching this question in latter 1971. With many assumptions having to be made, the Task Force and the participating banks concluded that the latters' costs would be lowered considerably from those of a hand-delivery system with a full-fledged CSDS. BASIC, however, did not publish these studies because the extent of estimate and assumption involved made the resulting calculations far from firm.

The best clue in 1971 as to the cost savings to participants – banks and others – in a CSDS system came from the CSDSs in Germany and France. It was roughly estimated there that depository charges to participants were one-third to one-quarter of what the

costs of these participants would be to complete the same securities deliveries by physical movement of certificates.

Under the heading of research, one cannot overlook the unstructured conversations with involved and informed individuals about solutions to the securities handling problem. The people with whom the members of the Committee and its Task Force discussed this subject would be numbered in at least the hundreds. The number of conversations is larger.

* * * * *

BASIC had concluded that the comprehensive securities depository system was the route to follow. "Comprehensive" meant that the securities of all segments of a financial community should be in one depository, rather than segregated in industry "modules." It had also concluded that locally owned and operated regional depositories were a better bet than one national depository organization with branches. These conclusions were significant in themselves, but nowhere near the end of BASIC's job.

In New York City, there was the very substantial challenge of persuading the remainder of the financial community to place the securities they held alongside those of brokers in the New York depository. Beyond that, there was the matter of interesting other financial communities in comprehensive depositories, from the standpoint of either their constructing their own to interconnect and form a national system, or the individual members of these communities becoming participants in depositories in other cities. Finally, there were many questions to be answered and problems to be solved in converting CCS from a division of NYSE's Stock Clearing Corporation to the envisioned more widely owned CSD.

III

GAINING ACCEPTANCE OF THE COMPREHENSIVE SECURITIES DEPOSITORY IDEA IN NEW YORK

Contents

III

GAINING ACCEPTANCE OF THE COMPREHENSIVE SECURITIES DEPOSITORY IDEA IN NEW YORK

The scope of CCS in 1970

At the time BASIC was formed, CCS involved only brokers. As among brokers, only NYSE member firms were eligible. At the end of 1969, 292 of these firms had on deposit with CCS 464 million shares of stock. Many eligible firms at that time were depositing only a portion of the securities in their possession, holding back the remainder for quick delivery to non-CCS participants, or because they had not yet adapted their internal procedures to an interface with CCS, or because use of CCS was not economical in their particular situations.[3.1]

In early 1970, Richard B. Howland was engaged to run CCS. Under his direction, the expansion of CCS was rapid in broker/dealer use. Additional issues were made eligible for CCS on a phase-in basis: first, issues listed on AMEX; later, O-T-C issues. Phase-in of the latter is still going on. These and other developments rapidly increased the use of CCS by broker/dealers.

The question of "comprehensive" participation in CCS

Exploration of the several possible variations of depository systems in 1970 and the first part of 1971 was described in Chapter II. One of these variations was a New York comprehensive securities depository, in which banks and other non-broker/dealer members of the financial community would place securities alongside those of broker/dealers in CCS or its equivalent.

BASIC might have held back on exploring the feasibility and acceptability of a New York CSD until it decided which of the depository system concepts to pursue. It did not; it carried out these and a number of other studies in parallel. Accordingly, soon after BASIC's formation the Task Force commenced exploring whether NYCH banks would become participants in CCS (as the New York CSD) and, if so, under what conditions. Acting with a sense of urgency to ameliorate the paperwork crisis, the Task Force felt that, if the CSDS emerged as the most promising solution, early work on the New York CSD would gain time.

[3.1] Some measure of the early limited participation of broker/dealers in CCS may be gained from statistics developed by BASIC in January 1971 when 281 brokers had 553 million shares on deposit with CCS. At about that time, BASIC estimated that 337 New York broker/dealers held some 2.4 billion shares in 4,400 issues. (BASIC study entitled "New York Comprehensive Securities Depository — Estimated Securities Holdings of Potential Participants," attached as Appendix F.)

Initial bank involvement with CCS

Banks in New York City were, of course, well aware of the genesis and development of CCS. They were also well aware of the complaints of brokers using CCS that the latter's usefulness to them was severely limited because banks were not CCS participants; the brokers had to withdraw certificates physically from CCS to deliver them to banks on COD transactions or for collateral loans. Similarly, certificates were physically received from banks which then had to be processed and deposited in CCS. Discussions between CCS and banks about these problems commenced about the summer of 1969. The earliest bank involvements with CCS arising out of these discussions were with respect to (a) deliveries of eligible securities between banks and brokers via CCS, and (b) book-entry collateral loans.

In Mid-1969, banks and CCS officials commenced exploring ways by which deliveries between brokers and banks might be made via CCS. A procedure was envisioned whereby CCS broker members would deliver securities to and receive them from banks in CCS by book-entry. The cash side of these transactions would be incorporated in the daily settlements of CCS with the brokers and banks.

For brokers, these transactions would be handled like deliveries in CCS to other brokers, increasing and decreasing the brokers' securities positions in CCS. It was not contemplated that banks would leave securities delivered to them on deposit with CCS; rather, they would withdraw such securities each day, often by transfer. There were three principal reasons why the banks did not contemplate maintaining securities positions with CCS: (a) they were prevented by law from doing so for fiduciary securities; (b) their internal procedures would have to be altered radically to adapt to such an arrangement; and (c) whether or not they would run additional risks by leaving securities with CCS remained a question.

First National City Bank of New York pioneered the CCS broker-bank delivery plan. The bank's pilot operation, involving certain issues and brokers, went live on February 16, 1970, and continued on an expanding basis for several months. Citibank deemed the plan feasible and that it merited expansion into a full-scale operation, ultimately to cover all NYCH banks, all CCS members, and all CCS-eligible issues.

Citibank representatives reported on the pilot project to representatives of all NYCH banks at a meeting called for that purpose on May 26, 1970, which was attended by Task Force members. With the approval of the Committee given at its June meeting, the Executive Director of BASIC wrote on June 25, 1970 to the Executive Director of the NYCH in part as follows:

> "Streamlining procedures for the completion of securities transactions in all ways possible is a major purpose of the Banking and Securities Industry Committee. The delivery experiment of CCS, FNCB, and participating brokers is clearly in line with this purpose. Some clearing house banks are already known to be investigating the CCS-FNCB experience with a view of their adopting the practice of delivering through CCS. If other Clearing House

members have not already done so, they are urged to appoint an officer to do the same."

The program of bank-broker deliveries through CCS was expanded on a carefully phased basis to eventually involve all CCS members, all NYCH banks, and all eligible issues. In the interim period of some eighteen months before full participation was reached, however, many problems, procedures, and even human adjustments had to be worked out.

The book-entry collateral loan program was also being discussed in 1969. Under this program, brokers would pledge by book-entry specified of their securities on deposit with CCS as collateral for a loan from a bank. Substitution and release of collateral, upon appropriate authorization of the parties, was also effected by book-entry.

A pilot collateral loan operation was commenced in March 1970 involving 10 brokerage firms and First National City, Manufacturers Hanover, Marine Midland, and Morgan Guaranty as lending banks.

It was made a condition, in the earlier stages of the collateral loan program, that CCS would place with each lending bank, as subcustodian, CEDE (CCS nominee) certificates for at least the aggregate number of shares of each issue pledged by all CCS participants with such bank. The bank was also given blank stock powers, to the end that the bank could make physical delivery of the collateral in its possession, if the occasion required, without further action of either CCS or the borrower.

As the collateral loan program expanded, and particularly when more thinly held issues were added to the CCS eligible list, CCS's logistics problem of shifting CEDE certificates among lending banks to equal aggregate collateral became increasingly difficult. Accordingly, CCS commenced discussing with the lending banks the latter's giving up the possessory lien idea, and relying solely on the book-entry statutory lien under Section 8 of the Uniform Commercial Code ("UCC"). This proposition raised much the same questions as that of banks depositing custody or fiduciary securities in CCS, in that under both propositions certificates normally in bank vaults would be in the possession of CCS. Banks explored both propositions very carefully, as described later.

Looking toward attracting bank-held securities into a New York CSD, the broker-bank delivery and collateral loan programs gained valuable time in getting NYCH bank personnel acquainted with CCS, its people, its procedures, and – at least in certain limited areas –its potential. Going through these stages was essential to *any* bank involvement with CCS. But it was still a long way away from NYCH banks' depositing in CCS certificates for CCS-eligible securities that they held.

Put bank-held securities in CCS?

Even in early 1970, it was clear that the movement of physical certificates to complete securities transactions between banks and brokers in New York City was an important contributor to the paperwork problem, and that it had to be changed. How? The most direct solution would be for New York banks to deposit eligible securities that

they held in CCS (subject to certain changes in fiduciary laws, discussed in a later chapter.) Deliveries between brokers and banks could then be made by book-entry.

CCS was a division of Stock Clearing Corporation, which was a wholly-owned subsidiary of NYSE. Was it reasonable to consider that the NYCH banks might consider turning over to CCS certificates for the estimated $100-plus billion[3.2] of securities they were holding? A fundamental question here was whether CCS procedures and controls were such as to provide the best of all possible safeguards over the certificates in its possession as well as prompt and accurate processing of transactions.

To evaluate CCS procedures and controls for this purpose, Conrad Ahrens of Citibank, Arthur Ringler of Chemical, and Walter F. Thomas of Manufacturers Hanover were recruited as a CCS Evaluation Team in May 1970. In meetings with the Executive Director and Task Force of BASIC, the Evaluation Team agreed that the Task Force should reduce to writing a detailed description and evaluation of the procedures and controls of CCS. This was done.

The Task Force's memorandum of 61 pages, dated June 11, 1971, dealt with all major aspects of CCS operations as is indicated by these chapter headings:

I. Major control features.
II. Deposits.
III. Withdrawals by transfer.
IV. Withdrawal of Cede & Co. certificates.
V. Collateral loans.
VI. Deliveries via book-entry.
VII. Deliveries to custodian banks.
VIII. Dividend distributions.
IX. "What's to prevent" safeguards.

The memorandum has not been included in the appendices since many of the operations and procedures of the depository have since changed. As a result of the survey, the Task Force concluded that the controls and safeguards of CCS were the equal of any known large financial institution, and probably superior to many.

In 1970 and 1971, many other questions were raised by the banks and explored with them by CCS, the Task Force, and the Committee. The questions related to all types of bank-held securities – custody, fiduciary, and broker collateral – which might be deposited in CCS, whether as a division of SCC or a separate corporation. Among such questions were these:

What is CCS's liability in connection with its participation in securities transactions?

To what extent are certificates held by CCS subject to attachment?

What insurance coverage will there be for each of the various risks?

What is the amount, present and prospective, of the "clearing fund" (a form of mutual self-insurance against losses not otherwise insured)?

[3.2] See Supplement to Appendix E.

How can pledgee banks know that CCS holds securities equal to or exceeding all pledged collateral?

How can pledgee banks know that the four mechanical steps, required under UCC Section 8-320 to perfect a statutory lien, have been made by employees of CCS?

What protection does CCS have against fire, counterfeit securities, those with forged endorsements, duplicate pledging, etc.?

Can CSS confirm specifically identified securities as collateral?

What would be the position of a banks' statutory lien in the event of a third party action?

Where will CCS certificates be lodged? Will any be outside the downtown Manhattan area?

As to the proposal that banks relinquish their possessory lien and rely solely on a statutory lien on CCS-held securities, referred to earlier, the NYCH banks had by the end of 1971 satisfied themselves as to their protection under the proposed procedure. However, before putting the new program in effect, they took the precaution of ascertaining that the bank regulatory authorities would take no exception to the changes. One-by-one in latter 1971 and early 1972, the Federal Reserve Bank of New York, the Comptroller of the Currency, and the New York State Banking Department, gave their blessing in writing.[3.3]

The early idea that banks might begin depositing securities they held in CCS — as a division of Stock Clearing Corporation — was abandoned. This was not because of any discovered defect in CCS controls and safeguards. Rather, there arose, out of other discussions that had been going on, a consensus that banks, and any other non-broker/dealer potential depositors, would need to have a voice in the management and control of CCS. In no other way did they see that they could adequately discharge their continuing responsibilities to those whose securities they were holding.

A spin-off of CCS?

The thought that banks might turn over to a central securities depository certificates that they held originally met with a rather general negative reaction from bankers. How could they possibly be assured of the safety of tens of billions of dollars of securities with the certificates in the hands of another, as when they held the certificates themselves?

The initial skepticism — if not outright opposition to the idea — began relaxing as bankers became better acquainted with CCS through the broker delivery and collateral loan programs described above, and through assurances as to CCS controls and safeguards. However, the overriding reason for the change in attitude was undoubtedly the growing

[3.3] Banks' acceptance of a statutory, rather than possessory, lien opened up the broker collateral loan business to banks throughout the country. This is covered further in Chapter V. When this expansion occurred, one Federal Reserve Bank in a district outside New York temporarily demurred on allowing one of its banks to lend on collateral pledged by book-entry in CCS. When supplied with further information, however, the FRBK withdrew its objection.

conviction that bank participation in a CSDS was necessary to solve the securities industry's paperwork crisis. Accordingly, it must be rated as considerable progress that the NYCH banks came to entertain the notion that CCS might be spun-off from the NYSE into an entity in which the banks would deposit securities and become part owners.

A potential spin-off raised many problems. CCS was an integral part of the NYSE's widespread operations; separating and divorcing CCS's people, procedures, equipment, etc. would be traumatic. The brokerage industry's throughput of transactions in a CSD would be much greater than the banking industry's but the latter's securities holdings were larger than the former's. How does one translate these and other differing factors into a formula for joint ownership and control of a single entity?

There were many other questions as to a user-owned depository with which BASIC wrestled for more than a year. Some were:

Would stock ownership by a user be required, or made optional?

As the pattern of use changed, would ownership of stock be reapportioned and, if so, how?

Should cumulative voting be adopted to give minority owner groups a better voice in electing directors?

What should be the ownership and director representation during the transition period until comprehensive depository status is reached?

What should the dividend policy be – limited or unlimited?

How should NYSE be reimbursed for its expenditures to bring CCS into successful operation? What is a fair figure for its unreimbursed expenditures?

Should the spun-off depository provide a cash settlement facility?

Who should be eligible participants?

What securities issues should be eligible?

What program should be undertaken to secure necessary enabling legislation?

Should the depository be incorporated as a bank or ordinary commercial corporation?

What should be the depository's relationship to a national securities settlement system?

Who should be eligible to own stock?

It was understood that the regulatory authority having jurisdiction over the spun-off facility would be interested in and have views on a number of the foregoing questions. However, it had first to be determined whether the organizations sponsoring BASIC could agree on the guidelines for constructing a CSD in the first place. It was concluded that the best way to focus on and attempt to resolve the various questions was through a "Memorandum of Understanding."

The Memorandum of Understanding

The first point outline of a Memorandum of Understanding was developed by the Executive Director on March 3, 1971 and delivered to Howland of the NYSE on March 5. This outline was worked into a narrative document by counsel for the NYSE and BASIC. It was worked over and revised at each meeting of the Committee from March through July 1971 to accommodate suggestions from all the potential signatories, and others.

The final Memorandum of Understanding was signed on behalf of the eleven NYCH banks on August 12, 1971, AMEX on September 9, 1971, NASD on September 15, 1971, and the NYSE on September 22, 1971.

The Memorandum was not a binding legal document but rather, one of "good faith and best efforts." Nonetheless, considering that becoming full participants in a comprehensive depository was probably furthest from the thoughts of most New York bankers in early 1970, the document might be considered historic. In brief, as reported in *House 1971 Hearings* at p. 1322, it provided:

> "1. NYSE would place the operations of CCS in a separate subsidiary (CCS, Inc.) and be prepared to spin it off when the Uniform Commercial Code is amended to permit ownership of it by participants other than an exchange. Stock Clearing Corporation, of which CCS is now a part, would continue to compare, clear and settle trades and provide the other facilities and services (other than CCS) as at present.
>
> 2. Meanwhile, as an interim measure, NYSE as sole stockholder would agree to vote for directors in designated numbers nominated by AMEX, NASD and the banks.
>
> 3. All Parties agree to work for amendments to state laws to the end that fiduciary securities held by banks may be deposited in a CSDS.
>
> 4. The plan calls for incorporating CCS Inc. as a trust company under New York law, making it subject to regulation by the New York State Banking Department.
>
> 5. Eligible depositors would be confined to financial organizations under regulation or supervision of a federal or state authority. This would include broker-dealers, banks, mutual funds, insurance companies, and clearing corporations of NASD and exchanges if such direct depositor status fits best their clearing systems.
>
> 6. Immobilization of certificates to the greatest extent practicable being the objective, the pressures would be to make eligible as many issues as practicable, to make eligible as many depositors as practicable, and to immobilize certificates of smaller financial organizations in a CSDS via correspondents.
>
> 7. Interconnection with a national CSDS 'in order that securities ownership and transactions throughout the United States can be recorded by book entry' is a planned and announced objective.

8. The owners of the depository would be its users. It is to be non-ptofit, i.e., fees from users should approximately equal costs."[3.4]

[3.4] The Memorandum of Understanding is reproduced in full in *Senate 1971 Hearings,* pp. 343-346 and 364-377, and *House 1971 Hearings,* pp. 1922-1928. A press release about the Memorandum is contained in *Senate 1971 Hearings,* pp. 176-178.

IV

IMPLEMENTING THE NEW YORK COMPREHENSIVE SECURITIES DEPOSITORY IDEA

Contents

Name	Affiliation
Arnold Fleisig	BASIC Task Force
Fred J. Hampton	NYSE (CCS)
Robert Pearl	NYSE (Controller's Dept.)
James V. Reilly	NYSE (ESC, now SIAC)
Anthony M. Resca	Chemical
George N. Scandalios	Chase
William F. Sullivan	AMEX
George C. White, Jr.	Irving

The Group commenced work on September 29, 1971, and on October 12, 1971 moved into space rented from the Irving Trust Company. They were supervised through regular meetings by Bevis of BASIC, Howland of NYSE, and Joseph A. Rice of Irving Trust. James E. Buck of NYSE and Peter Campbell of the BASIC Task Force furnished considerable assistance. The Group, after submitting a series of interim reports or discussion papers, submitted its major report as of January 31, 1972, with a follow-up and final report dated March 28, 1972. An indication of the scope and complexity of the spin-off process can be gained from these headings in the Group report:

Settlement and central delivery:

System and facilities
Member billing
Data control
Expenses

Security and protection:

Record retention
Trash retention
Signing authorities
Security thefts
Computer processing
Security procedures manual
Security guards
Members' short positions
Claims against ex-participants
Insurance

Administrative services:

Auditing
Medical
Real Estate
Cafeteria
Personnel
Controller
Telephone
Reproduction
Mailing
Purchasing
Messenger
Central records
Work measurement
Executive

Computer processing:

Equipment
Systems development

Other:

Legal
Fee structure
Settlement fund
Intercompany accounting

IV

IMPLEMENTING THE NEW YORK COMPREHENSIVE SECURITIES DEPOSITORY IDEA

The Memorandum of Understanding was historic as an agreement in principle to form a comprehensive securities depository system ("CSDS"). As to the New York CSD, it dealt with a few matters in specifics, but mostly left many detailed decisions to be made, and steps to be agreed upon and taken, before the plan for a New York CSD could be said to have been implemented. A work plan drawn up in August 1971 listed about 75 steps to be taken to effect the implementation.

BASIC's Task Force worked on many of the implementation questions both before and after the Memorandum of Understanding was signed. Two other organized groups assisted for a time, as noted below. However, a lion's share of decisions and steps involved in the transition from CCS to an independent New York CSD, particularly in the operating areas, were made by officials and staff of NYSE and of the depository itself.

NYCH bank BASIC Liaison Committee

Immediately after the Memorandum of Understanding was signed, it was decided that it would be helpful to organize a committee of NYCH bank operating personnel to work with BASIC toward the New York CSD. Such a committee, the BASIC Liaison Committee, was formed and held its first meeting on September 7, 1971. The group was later renamed the Securities Committee, as it broadened its areas of interest beyond the depository itself.

The BASIC Liaison Committee met monthly with the Executive Director and some of the members of the Task Force. Information and ideas were exchanged on many of the subjects covered in this and other chapters.

The CSDS Implementation Group

An important question to be faced was how to effect a spin-off of CCS, an integral part of SCC's operations, into a separate corporation with a self-contained operation, ultimately to be independent of the NYSE except as the latter would be a part-owner of the New York depository's stock.

The Committee decided at its September 1971 meeting that there should be formed a CSDS Implementation Group to identify as many as possible of the problems involved and make recommendations as to their resolution. The Committee was informed at the October 1971 meeting that the Group had been recruited on a full-time, leave-of-absence basis, as follows:

Some important policy and organizational matters had not been resolved at the time the Implementation Group was at work so that, as to these matters, the Group had to proceed upon assumptions and could not be definitive in recommendations. Notwithstanding this limitation, the Group's work served to identify and focus attention on the large number of practical problems of the spin-off, and to hasten their resolution.

Much time was devoted by the Task Force to study of some of the foregoing topics both before and after the work of the implementation group. One other item may be singled out for brief discussion because of its continuing importance: withdrawal and circulation of depository nominee certificates.

Withdrawal and circulation of nominee certificates of a depository

CCS permitted its participants to withdraw certificates in its nominee name (CEDE & Co.) and deliver them, appropriately endorsed, to others. These withdrawals could be made in one to three hours. Studies made in the middle of 1971 and the latter part of 1972 indicated that brokers were making these quick withdrawals to deliver to banks (mostly non-New York) and to non-CCS brokers, mostly for stock loans.

The Task Force looked long and hard for an alternative to the endorsement, issuance, and circulation of CEDE certificates. In its first paper dated June 4, 1971 (attached as Appendix G), the Task Force pointed out that, if no CEDE certificate were ever circulated but only sent to transfer:

> Exposure to risk of loss from theft or disappearance of CEDE certificates would be sharply reduced. No longer would CCS need to maintain a large supply of small denomination certificates to supply withdrawal requests on short notice. All certificates could be of giant jumbo size.
>
> CCS costs would be reduced. Certificates in the vault would be sharply reduced, with resultant clerical and audit savings.
>
> There would be few dividend claims, for there would be no floating CEDE certificates.

The Task Force first looked at the idea of a non-negotiable CCS depository receipt to be issued in lieu of an endorsed CEDE certificate, and to be followed by certificates transferred into names as requested. There were circulated widely in the third quarter of 1971 two different variations of this proposal (one is included in Appendix G). Coast-to-coast responses pointed to a number of flaws: legal problems with fidicuary accounts, duplicate handling of transactions, substantial other procedural or systems problems, etc. The Committee in due course agreed with the Task Force that this approach should be dropped.

The Task Force then explored the idea of super-fast transfers as a replacement for CEDE certificate withdrawals. It set, as a basis for exploration, a four-hour transfer turnaround time for daytime transfers, plus an overnight transfer service. Discussions with transfer agents in the New York area indicated skepticism that such times were feasible,

but a willingness to try. Before setting up a pilot project along these lines, however, the Task Force explored with several brokers whether the super-fast transfer times would meet their requirements. In brief, even these short transfer times would not meet the brokers' requirements as well as the existing procedure of withdrawing endorsed CEDE certificates.

The Task Force next explored the possibility that the depository might become a co-transfer agent for its eligible issues. A paper dated May 12, 1972 on this idea is attached as Appendix H. This solution was discarded because of the potential procedural complexities, potential risk to the depository, and doubt as to whether even in-house transfer times would meet the brokers' withdrawal requirements.

Much of the foregoing exploration of solutions to the CEDE withdrawal problem was written up in a Task Force Research Report dated January 8, 1973, attached as Appendix I. Its conclusion was, essentially, that there is no feasible short-cut to the CEDE withdrawal problem. The answer was that those to whom CEDE certificates were being delivered must become CSDS participants so that they can receive delivery of their securities by book-entry.[4.1]

Could the depository be a trust company?

The early discussions of spinning-off CCS included consideration of whether the spun-off company could have the status of a trust company. If so, this would tend to engender confidence in the depository of the part of non-broker/dealer members of the financial community. The Chairman reported to the Committee at its June 23, 1971 meeting that an informal inquiry had indicated that the New York State Banking Department would be receptive to exploring such a proposal. Accordingly, the Memorandum of Understanding, then in the final drafting stages, stated that the depository "is to be created under the laws of such jurisdiction as the parties may agree, preferably as a trust company incorporated under the banking laws of the State of New York . . ."[4.2]

The State Banking Board promptly pursued this matter. On November 3, 1971, it amended its Supervisory Policy CB1, relating to approval of limited purpose trust companies, to read as follows:

> ". . . the Banking Board may charter a trust company for a limited purpose without the offering of significant commercial bank services only upon a showing that: such organization is in conformance with the policy of the Banking Law, is for a limited purpose such as the transfer of securities or related activities, and the public convenience and advantage will thereby be served. Any approval of such charter will be conditioned upon such restrictions on doing business that the Banking Board shall deem necessary and proper to achieve the purposes set forth."

The State Superintendent explained later:

[4.1] See Appendix I, pp. 14-15.

[4.2] Section II. 2 of the Memorandum. *Senate 1971 Hearings*, p. 366, or *House 1971 Hearings*, p. 1922.

"This amendment was adopted in response to various proposals designed to cope with the 'paperwork crisis' in the securities industry – a crisis arising from the breakdown of the traditional means by which Wall Street performed its stock delivery, transfer, payments and recordkeeping functions. The amendment indicated for the first time that the Banking Board would be receptive to applications for trust company charters for the limited purpose of offering stock transfer and related services, and which promote 'the public convenience and advantage'."[4.3]

Counsel for BASIC entered into discussions with officials of the New York State Banking Department to follow up on potential trust company status for the New York depository about the time of the foregoing Board action. Counsel for CCS was kept informed throughout. These discussions served to acquaint the Department with the nature of, and plans for, the depository and, on the other hand, to acquaint BASIC with Department considerations which should be taken into account.

As indicated, the focus of attention had been on limited trust company status for the New York depository throughout most of the discussions in 1971. Envisioned was a direct transfer of depository operations from CCS, as a division of SCC, to a trust company. However, in latter 1971 and 1972, there began to arise questions as to whether activation of a trust company might not be subject to undue delay.

This possibility was attributable not so much to the New York Banking Department, with whom discussions were proceeding satisfactorily, as to threatened federal legislation which might negate the benefits of trust company status. Moreover, in the light of the possible legislation, there was some question as to whether the SEC might clear rules of a depository that were compatible with the desired fiduciary character of a depository. (BASIC had consistently taken the position that, whether or not existing law so required, a New York CSD's rules should be cleared with the SEC, since that agency was heavily involved in the question of a system for processing of securities transactions, of which depositories were a part.)

As stated in explaining the work of the Implementation Group, the transfer of operations of CCS, a division of SCC, to a separate operating corporation would be complex in itself. Accordingly, in the light of the possible delay in activating a trust company depository, it was decided that – hopefully, only as a short interim step – CCS, Inc. would be formed as an ordinary business corporation. The spin-off to it of the operations of CCS would be made to gain time.

However, a spin-off involves many legal, financial, and operating changes. There needed to be on board the top management who could supervise such an operation.

Top management of the New York CSD

It had been evident, even before the Memorandum of Understanding was signed, that it was essential to decide early upon a person who would become Chief Executive Officer of CCS and, ultimately, the CEO of the independent New York CSD. Once agreed

[4.3] Press release, New York State Banking Department, February 27, 1973.

upon, he could take responsibility for supervising the transition and enable BASIC to move into the background insofar as the details of implementation were concerned (which BASIC had not considered to be within its frame of reference in any event).

The need for a CEO was first discussed by the Committee at its meeting on August 25, 1971, when the Chairman solicited names of prospective candidates. An extensive list of candidates was compiled, and two were subsequently interviewed. In February 1972, an executive search firm was retained to assist.

However, commencing in September 1971 – and of increasing concern thereafter – there appeared the threat that there might be new federal legislation regulating depositories. There were fears that the entire depository plan being developed by BASIC might be sidetracked by some plan devised by the SEC and the Congress. Bankers, particularly, were uncertain as to whether any new legislation that might evolve would produce a regulatory climate tending to instill confidence in depositories. (Regulation is discussed in Chapter VII.)

This uncertainty tended to defer a decision as to a new CEO for the New York CSD, for he would not be needed if CCS were to continue solely as a broker/dealer vehicle. However, in April 1972, it became known that William T. Dentzer, Jr. was leaving as Superintendent of the New York State Banking Department and might be available. Since he was unusually qualified in a number of respects for the CEO position, he was interviewed and was found to be interested. At a luncheon meeting on April 26, 1972, the Committee recommended to the NYSE that he be engaged. (The banker members of the Committee made clear at the meeting that, while to make the engagement of Dentzer feasible might involve some financial commitment on the part of NYCH banks, the latter could not become irrevocably committed to depository involvement until the regulatory climate was known.) Dentzer was engaged, and commenced work at CCS on June 1, 1972 as Chairman and Chief Executive Officer. At the same time, Diran M. Kaloostian was named President and Chief Operating Officer. Kaloostian had had several years' background as an official of NYSE, SCC, and CCS.

CCS, Inc. – an Interim Step

Howland of NYSE on October 20, 1971 requested NYSE's counsel to draw up the necessary papers to incorporate CCS, Inc. as a general business corporation. After the necessary research in consultation with counsel to BASIC, CCS, Inc. was incorporated on March 31, 1972.

Immediately after arrival on the first of June 1972, Dentzer proceeded with the many details involved in activating the corporation. CCS, Inc. held its first board meeting on July 19, 1972 which was notable in that, among those who had accepted directorships, were Elliott Averett, President of the Bank of New York and Walter F. Thomas, Vice Chairman of Manufacturers Hanover Trust Company. New York bankers had become connected with the New York depository officially! (William I. Spencer, President of First National City Bank of New York, was also shortly to join the Board.)

The Board of CCS, Inc. (still non-operating) held a number of meetings in the last half of 1972. Most of the agendas were devoted to technical and regulatory problems in a changeover from CCS to CCS, Inc. Perhaps the most important pending matter was clearance of proposed CCS, Inc. rules with the SEC. The initial approach was to clear with the SEC rules for CCS, Inc. sufficiently definitive that they could be adopted without substantive change by the prospective trust company. However, discussions with SEC staff in September and October quickly developed that clearance of such definitive rules might require months. (The SEC clearance is discussed below.)

Accordingly, it was worked out with the SEC staff that CCS, Inc. would submit as its proposed rules (with one noncontroversial change) the precise rules of SCC under which CCS had operated in the past and, accordingly, which presented no new questions. CCS, Inc. sent these rules to the SEC on November 2, 1972 and the SEC expeditiously cleared them on November 7.

The enormous work of effecting resolutions, legal papers, agreements, procedural changes, etc. having been completed, the operations of CCS were transferred to CCS, Inc. on January 12, 1973.

Clearance of DTC rules with the SEC

As mentioned above, it was felt that a trust company should not be activated as a depository until its rules and other pertinent legal instruments were cleared with the SEC.

Drafts of articles of incorporation, by-laws, and rules were drawn up in mid-1972. After a number of revisions, the drafts were circulated for comment among members of BASIC, NCG, and others in August 1972.

On September 15, 1972 these papers were filed with the SEC for review (as well as with State and Federal banking authorities). CCS and SEC personnel met on September 29 to discuss this filing, as a result of which the papers as revised in certain respets were refiled with the SEC on October 18. On November 8, 1972, an SEC release publicly solicited comments on the filing, and on November 10 CCS did the same in an extensive mailing to participants, potential participants, and other interested organizations. Ten letters of comment were received.

SEC staff questioned many items in the filings and subsequent revisions thereof, such as: whether broker/dealers would be owners direct or via their exchanges and NASD (this question was deferred for later consideration); in what funds settlements should be made; requirements for eligibility to become a participant; fines, disciplining, and appeal procedures, etc. The stickiest problem was that the SEC wished every registered broker/dealer to be eligible to be a direct participant in DTC whereas the latter wished, at least at the outset, only broker/dealers who were members of exchange or NASD clearing corporations to be eligible.

After more conferences, many telephone calls, and further written submissions to the SEC, the latter in an updated letter received by CCS, Inc. on May 8, 1973 cleared DTC's rules and other legal papers providing certain specified changes were made. Only one of these caused difficulty: a requirement that "access to DTC will be available to any

member of a registered national securities association or exchange and any broker or dealer registered with the Securities and Exchange Commission." This was to replace DTC's proposed rule restricting access to those broker/dealers who were members of a clearing corporation of an exchange or NASD.

The SEC letter was received during a period when there were all-too-often press reports on disciplined broker/dealers because they "failed to maintain current books and records properly, failed to prepare monthly computations of net capital and aggregate indebtedness," etc., etc. The 1972 Annual Report of SIPC contained 40 "illustrative examples" of reasons for failures of broker/dealer firms. In 13 of these, variations of the word "fraud" appeared, and in 11 variations of the term "inept management."[4.4]

In this atmosphere, it is not surprising that the Board of Directors of CCS, Inc. urged its Chairman to seek a hearing before the full Commission to avoid almost automatic participant status for any broker/dealer that might apply, as suggested in the SEC letter received May 8.

The Commission gave Dentzer a hearing on May 21, 1973. As a result, a compromise was agreed upon whereunder a financial institution, not otherwise qualified, could qualify if it demonstrates to the Board of Directors that its business and capabilities are such that it could reasonably expect material benefit from direct access to DTC's services. It was also agreed that the restriction on broker/dealer access would be reviewed in one year. The SEC confirmed this disposition of the final rule matter by letter dated July 12, 1973.

Formation of the Depository Trust Company

Throughout the CCS, Inc. and SEC rule-clearance phases, steps were being taken toward formation of the limited purpose trust company, on the assumption that all problems in connection with rules would eventually be resolved. Drafts of the "Certificate of Merit," required to accompany the application to the New York State Banking Department for a trust company charter, were commenced in latter 1971. A sketchy preliminary draft had been filed with the Department on March 31, 1972. Numerous revisions of and additions to the draft were made before and after the preliminary draft was filed to accommodate comments and suggestions from the Department as well as other interested persons.

In latter 1972 it appeared that clearance of DTC's rules by the SEC was imminent. Accordingly, a "Notice of Intention to Organize 'The Depository Trust Company,' " was filed on November 21, 1972, and on December 28 formal application for a trust company charter was filed with the New York State Banking Department, accompanied by the Certificate of Merit (running, with exhibits, to 287 pages).

On January 9, 1973, the New York State Banking Board, upon the recommendation of the Superintendent, approved the organization certificate of DTC, subject to the filing of certain technical documents and the answers to certain questions.[4.5] On February 27, 1973, the Superintendent publicly announced approval of the DTC charter. The first

[4.4] Securities Investor Protection Corporation, *Second Annual Report,* 1972, pp. 56-57.

[4.5] The latter are attached as Appendix J.

meeting of the Board of Directors of DTC (not yet operating as such) took place on March 20, 1973.

After receipt from the SEC on May 8 of clearance of DTC's rules, the transfer of operations from CCS, Inc. to DTC took place on May 11, 1973. Shortly thereafter, membership of the Board of Directors of DTC was completed as follows:

Officers

William T. Dentzer, Jr. – Chairman (formerly Superintendent of Banks, New York State)

Diran M. Kaloostian, Jr. – President

From banking industry

Elliott Averett – President, Bank of New York

William I. Spencer – President, First National City Bank

Walter F. Thomas – Vice Chairman, Manufacturers Hanover Trust Company

From brokerage industry

George E. Doty – Partner, Goldman Sachs & Co.

John T. Roche, Jr. – Vice President and Director, Kidder, Peabody & Co., Incorporated

Robert C. Van Tuyl – Chairman, Shearson, Hammill & Co., Inc. and Vice Chairman and Governor, American Stock Exchange

From exchanges and NASD

Samuel A. Gay – Senior Vice President, NYSE

David H. Morgan – President, National Clearing Corporation, a subsidiary of NASD

James J. Needham – Chairman, NYSE (formerly Commissioner, Securities and Exchange Commission)

Francis J. Palamara – Executive Vice President, NYSE

(See also Van Tuyl, above)

From insurance industry

R. Manning Brown, Jr. – Chairman, New York Life Insurance Company

From mutual fund industry

Hamer H. Budge – President, Investors Group of Companies (formerly Chairman, Securities and Exchange Commission)

Federal Reserve membership for DTC

Anticipating a New York trust company charter for DTC, the Chairman of BASIC held informal discussions with officials of the Federal Reserve System commencing about April or May 1972. No unusual difficulties for prospective Fed membership for DTC emerged from these talks.

After earlier talks between BASIC's counsel and officials of the bank, DTC applied to the Federal Reserve Bank of New York for membership in the Federal Reserve System on March 22, 1973. By letter dated April 23, 1973, that Bank granted membership subject to the completion of certain formalities.

The four-year development of the New York Depository

Shortly after CCS, Inc. became operational in January 1973, banks commenced pilot deposits of securities they held with the depository (such an operation had been commenced by First National City Bank of New York many months earlier and State Street Bank had deposited the securities it held for one mutual fund in May 1972). By these actions, the banks were taking the last step of involvement with the New York depository – leaving with it securities for which they were responsible. By the end of 1973, DTC held about $9 billion of securities for 12 New York banks and 9 banks in other states. While $9 billion is a large figure, it is probably less than 10% of the DTC-eligible securities these banks were holding. Very few securities held in a fiduciary capacity were deposited – none, it is believed, from NYCH banks. A contributing factor to the lack of acceleration in bank deposits was very probably the uncertainty of whether the nature and operations of the depository would be materially affected by federal regulatory legislation being considered in Washington.

Notwithstanding the tentative nature of bank deposits of securities in CCS, Inc.-DTC, the development of CCS into a comprehensive securities depository from early 1970 to the close of 1973 was impressive:

A limited purpose trust company charter, and membership in the Fed, had been obtained.

CCS operations had been spun-off, first to CCS, Inc., then to DTC (except for some remaining cross-servicing with SIAC and NYSE, soon to be reduced or eliminated).

DTC's Board of Directors had been formed to represent important elements of the entire financial community. Its chairman and CEO had been recruited from outside the financial community but with knowledge of it.

DTC's charter, by-laws, and rules had been cleared with the SEC.

CCS-CCS, Inc.-DTC operations had expanded radically, one index being from 464 million shares on deposit in December 1969 to 1.8 billion shares at December 31, 1973. Book-entry transfers grew from 3.4 million in 1969 to 11 million in 1973. In other respects, the growth during the four-year period was:

Eligible issues, from 1,212 to 4,729. With only NYSE issues eligible at the end of 1969, AMEX issues were added commencing in November 1970, then O.T.C. issues, those listed on the National Stock Exchange, and registered corporate bonds. At December 31, 1973, the breakdown of DTC-eligible issues was:

NYSE	1,444
AMEX	1,063
OTC	2,140
NSE	56
BONDS	26
Total	4,729

The total number of participants actually decreased from 292 at year-end 1969 to 270 at year-end 1973. However, the reduction was due in no part to the lack of usefulness of the depository to its participants but, rather, to the disappearance of brokerage firms from the participant list. Surviving brokerage firms maintained if not increased the participation of that industry in the depository, but depository participation was broadened thus:

	Year-end	
	1969	1973
Broker/dealers	292	244
Banks	—	21
Clearing corporations	—	5
	292	270

A "depository facilities" program had been developed with 30 banks in 18 states and the District of Columbia. Under this arrangement, deposits of securities in DTC are made at the bank, which promptly wires the deposit information to DTC for credit to the participant's account.

Book-entry pledged securities for collateral loans grew from nothing to a range in 1973 from $3.3 to $5 billion in daily value, involving 63 pledgee banks in 25 cities and 128 brokers. Items of collateral delivered by book-entry were 2 million in 1973.

DTC had expanded the application of modern communications technology to eliminate most Delivery Balance Order paper instructions, by substituting computer tapes, in a program called "PDQ." Toward the end of 1973, pieces of paper were being eliminated by this process at an estimated annual rate of 18 million. A pilot operation was commenced in August 1973 to link brokers, their institutional customers, and settling agent banks by electronic communication to capture and compare trades, and net and settle both delivery and payment. At year-end 1973, 50 broker/dealers, 30 institutions, and 4 bank agents were either using the system, testing it, or committed to near-term participation.

The scope of DTC's services was discussed in DTC's 1973 report as follows:

"A securities depository such as Depository Trust is not only, or even chiefly, a location where securities are safely held in custody. It is essentially an automated bookkeeping system providing a number of services stemming from the custody of securities.

Receive deposits of securities certificates from or for Participants

Deliver securities on deposit by book-entry between Participants

Receive and deliver *payment* for securities delivered by book-entry

Pledge securities of broker/dealer Participants for collateral loans from Pledgee banks by book-entry

Hold deposited securities in *custody*

Pass on to Participants cash and stock *dividends and interest* related to securities held in custody

Provide *proxies* to Participants so that voting rights in equity issues can be exercised

Arrange *transfer* of certificates into Participants' customer names

Arrange for *rapid withdrawal* of certificates on deposit for Participants (order-outs)

Provide for comparison, confirmation, and production of delivery and settlement instructions for any security, using the Institutional Delivery (ID) System's network for processing institutional trades involving a broker-dealer, an institution, and the institution's agent bank

Provide for *automatic book-entry delivery and payment* for securities processed through the ID System which the depository holds in custody"

At the close of 1973, not all of DTC's problems had been solved (nor opportunities realized). The limited deposit of bank-held securities has been mentioned, as has been the uncertainty of the nature of federal regulatory legislation (if any). All desired amendments to state Uniform Commercial Codes ("UCC") had not been obtained, as described in Chapter VI. A link-up with other depositories was only in the pilot state (see next chapter). Minor questions (such as details of reimbursement to NYSE of its CCS start-up costs, and depository ownership by broker/dealers direct or through their exchanges) remained to be thrashed out. Major areas of potential improvement in the processing of securities transactions, only briefly and generally considered so far, included: immobilization and book-entry for state and municipal bonds, and an international link-up of national depository systems.

But, by any test, the four years 1970-1973, inclusive, were fruitful in implementing the New York comprehensive securities depository idea. In reciting progress since the formation of BASIC, it is not intended to infer that such developments were by any means exclusively attributable to BASIC's work. In fact, many of them can be credited to the officers and staff of CCS, CCS, Inc., and DTC, with vigorous, pioneering assistance from exchanges and NASD, and brokers and bankers, not only in New York but in other parts of the country as well.

V

FORMING THE NATIONAL COMPREHENSIVE SECURITIES DEPOSITORY SYSTEM

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V

FORMING THE NATIONAL COMPREHENSIVE SECURITIES DEPOSITORY SYSTEM

Those who were researching the securities paperwork problem in 1969 seemed to be in complete agreement that the problem was national in scope. Solutions, therefore, would have to be of similar scope. Certainly, this was in BASIC's thinking from the outset.

Reference was made in Chapter I to overtures, soon after the formation of BASIC was announced, from trade associations, and financial communities in other cities, for membership on BASIC. The Executive Director and a Task Force member visited Chicago on April 30, 1970 and Los Angeles on July 28, 1970. In each place, they had all-day meetings with representatives from the local securities exchange and the principal banks.

In both California and Chicago, the local people voiced concern that, except for the participation of NASD, BASIC appeared to be a New York operation. With some expressions ranging from suspicion to downright distrust of the New York financial community, the general thesis seemed to be that their region's representatives needed to be on BASIC to safeguard their interests from New York inroads.

This line of argument was met with these points: if the attention of all is exclusively focused on solving the securities paperwork problem, progress cannot but benefit all; New York, with two-thirds to three-quarters of the entire nation's securities handling problem, *must* concentrate on its own problems first; solving New York's problem would be complicated and delayed greatly by having simultaneously to study the problems of all the other major financial communities in the country; enlarging BASIC by the addition of regional groups would increase the pressure of various national groups and associations to be included; inclusion of all such groups would result in an overly large and unwieldly Committee which would impede action; however, BASIC will keep all other interested communities informed of its thinking, plans, and progress and, if any of these appear to be inappropriate for an interface to form a national CSDS, BASIC would welcome such information and would certainly try to accommodate the factors involved.

The Executive Director recommended, and the Committee agreed, that the membership of BASIC not be expanded. He pointed to the number of associations, as well as financial communities, that were requesting membership or would request membership if others were added.

Interregional liaison

BASIC followed through on the mechanics for interregional liaison. Commencing in August 1970, the Executive Director and Task Force held monthly meetings with representatives of other financial communities. At the meetings there were represented sooner or later; Chicago, California, Boston, Philadelphia and Hartford. No other requests to participate were received; none would have been denied.

The representatives from other regions were furnished with the agendas and back-up material for all monthly meetings of the Committee, as well as any other information

developed by the Task Force. Task Force members listened carefully during the discussions for any suggestion that a planned aspect of a New York CSD might be incompatible with a CSD in another city. Two important questions of this character were raised: whether the plan for the New York CSD to settle the cash side of securities deliveries might be incompatible with Chicago's thinking that a depository should confine itself to securities deliveries[5.1]; and whether a transfer agent depository concept is not to be preferred over the CSDS concept. The Executive Director to this day has not been able to understand why the Chicago spokesman objected to New York's solution of its cash settlement problem, with New York retaining the flexibility to interface with a Chicago depository dealing in securities settlement only. As to TAD v. CSDS, this subject was covered in Chapter II.

The signing of the Memorandum of Understanding in August and September 1971 regarding a New York CSD has been mentioned. Paragraph II.9 of the Memorandum stated:

> "The Parties agree that the facilities and procedures of CCS, Inc. should be planned in anticipation that CSDS can interconnect with one or more similar depository systems that may be organized in other states or serve as a local depository for a national depository system which may include one or more depositories, in order that securities ownership and transactions throughout the United States can be recorded by book entry in an integrated depository system."[5.2]

BASIC's Task Force had been discussing internally and externally possible configurations of a national depository system almost from the start of its work. BASIC's Chairman was in touch with Stewart of B of A in September 1971 and Perkins of Continental Illinois in October 1971 about depositories in their respective areas.

After the signing of the Memorandum, the Task Force turned its thoughts to specifics of a national CSDS. For example, at the meeting with representatives of other regions on October 12, 1971, a list of 35 questions was discussed.[5.3] From these and other discussions, it became apparent that an "action" group like BASIC was now needed if comprehensive depositories in other regions were to move forward. Accordingly, at the October 27, 1971 meeting of BASIC, the Committee authorized the Chairman and Executive Director to discuss the idea with representatives of the financial communities of California and Chicago.

Formation of the National Coordinating Group

BASIC's Chairman worked out a meeting of the intercity representatives in Chicago on November 9, 1971, to be held in the office of John H. Perkins, then Executive Vice

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[5.1] See correspondence between Phillips M. Montross of the Midwest Stock Exchange and the Executive Director, attached as Appendix K.

[5.2] See Memorandum of Understanding in *Senate 1971 Hearings*, pp. 371-372, or *House 1971 Hearings*, pp. 1922-1928.

[5.3] Attached as Appendix L.

President (now President) of Continental Illinois Bank. Besides Perkins and the Chairman and Executive Director of BASIC, others attending were:

Samuel B. Stewart, Senior Vice Chairman, Bank of America
Richard D. Jackson, Executive Vice President, Wells Fargo Bank
Thomas P. Phelan, President, Pacific Stock Exchange ("PSE")
Michael E. Tobin, President, Midwest Stock Exchange ("MSE")
Phillips M. Montross, President, Midwest Stock Exchange Clearing Corporation ("MSECC")
Joseph P. Coriaci, Vice President, Continental Illinois Bank

The discussion of the group was along these lines:

1. Is there agreement that the current methods of handling certificates and processing securities transactions present a national problem that must be solved? (Answer: "Yes")
2. If so, is there agreement that the immobilization in depositories of certificates held by the entire financial community and the transfer of ownership by book-entry to the maximum extent possible, represents the most promising solution to the problem? (After discussion of alternatives, the answer: "Yes")
3. If so, should the depository system be (a) a national corporation with branches in the cities, or (b) a series of locally owned and operated regional depositories, interconnected to permit nationwide book-entry transfers of securities ownership? (The conclusion: The latter.)
4. With general agreement on the foregoing, what steps can be taken to bring the desired solution into being?

It was decided to form the National Coordinating Group for Comprehensive Securities Depositories ("NCG"). Each region was requested to select two persons to serve on NCG, the membership of which was shortly firmed up as listed in Chapter I. Perkins agreed to serve as Chairman and Coriaci as Secretary, (Later, Dentzer, Chairman of DTC, and William L. Somerville, Chairman, Executive Committee, Canadian Depository for Securities, were added to NCG's membership.)[5.4]

NCG at work

NCG held its first meeting on February 7, 1972. Five more meetings were held in 1972 and three in 1973 to December 31. Meeting locations varied among Chicago, New York, and San Francisco. The Group has concentrated on three main subjects: formation of regional depositories in California and Chicago; depository interface matters; and pending federal legislation.

Perkins, Stewart, or Coriaci testified on behalf of NCG about depository legislation in the four hearings held by the Senate and House Subcommittees in 1972 and 1973. Federal legislation matters are covered in Chapter VII.

[5.4] Copy of a letter from Perkins to Chairman Moss dated December 23, 1971, announcing formation of NCG and including a copy of the press release, appears in *House 1971 Hearings,* pp. 1534-1536.

As to the two proposed new regional depositories, NCG urged that the banking and securities industries in each area form committees to research, develop, and implement depository plans. What has been accomplished in this respect is summarized below.

For studying interface matters, NCG at its May 25, 1972 meeting decided to form a "Working Committee." Those serving on the Working Committee at various times in 1972 and 1973 have been:

Name	Affiliation
Joseph P. Coriaci, Chairman	Continental Illinois Bank, Chicago
Albert M. Anderson	MSECC, Chicago
Arnold Fleisig	BASIC and DTC, New York
John P. Griffiths	Wells Fargo Bank, California
William F. Jaenike	BASIC and AMEX, New York
Phillips Montross	MSECC and Phillips Montross and Company, Chicago
David H. Morgan	NASD, Washington
James V. Reilly	NYSE and DTC, New York
Kenneth S. Uston	PSE and PSD, San Francisco
George C. White, Jr.	Chase Manhattan Bank, New York

The Working Committee met several times in 1972 and 1973. Much of its study has been carried out by subcommittees. Among the subjects involving, or possibly involving, depository interface covered by the Working Committee have been these (not listed in any particular order):

Insurance	Operating hours; days
Financial Industry Numbering System ("FINS")	Proxies
Standard Funds for Settlement	Dividends
Communications Technology	Nominees
Records and forms	Short positions
Legal questions	Limits on interdepository positions
Eligible depositors	CUSIP numbers
Eligible issues	Certificate level control
	Carriers and couriers for securities

After consideration, the Working Committee concluded that many of the foregoing items were "depository firing line" matters. In other words, they could be best worked out by operating personnel of the depositories, with NCG to be involved only if some difference needed to be arbitrated. Other of the subjects, not urgent (like uniform insurance), remain under study.

The Midwest securities depository

As mentioned, BASIC's Chairman and Perkins were discussing a potential Chicago CSD in October 1971. Subsequently, a committee of the Chicago clearing house banks

was formed to explore the subject along with the MSE. In early 1972, the group retained Phillips Montross, former President of MSECC and then head of his own consulting firm, to research the comprehensive depository and make recommendations.

Montross submitted his report in August 1972. Numerous discussions among the Chicago interindustry group then ensued, in the course of which a memorandum of understanding was developed. This memorandum in its final form was signed in May and June 1973 by American National Bank, Continental Illinois, First National of Chicago, Harris Trust, LaSalle National, Midwest Stock Exchange, and Northern Trust. Among other provisions, the memorandum indicated the intent of the signatories to commit up to $1 million in the development of a Chicago CSD.

Meanwhile, in November 1972 MSE forwarded to the SEC a statement of plans for a future depository trust company and its proposed rules. The rules were cleared by the SEC in April 1973. During 1972 also, discussions were held between the Chicago group and the Illinois Commissioner of Banks and Trust Companies as to trust company status for the expanded depository.

The foregoing developments culminated in the transfer, on June 11, 1973, of MSECC's depository operations to Midwest Securities Trust Company ("MSTC"), an Illinois trust company.

The Pacific securities depository

The Pacific Stock Exchange (then the Pacific Coast Stock Exchange) established a securities depository in September 1971 as a division of the Exchange's Clearing Corporation. By the end of December 1971, 20 participating firms were housing $225 million in 3,875 issues of securities with the depository.[5-5]

Within weeks of the November 9, 1971 meeting in Chicago where it was decided to form NCG, the California financial community formed both a policy group and a task force on the depository. The objective was to consider ways and means of making PSE's depository comprehensive, i.e., housing securities held by banks and other members of the financial community in addition to those of broker/dealers.

The California task force, made up of one representative from each of five California banks and one from PSE, commenced work full-time about the first of January 1972. During the course of a week of information gathering in New York, it spent the day of January 31 with BASIC's Task Force. On March 8, 1972, the task force submitted its recommendations, including a draft memorandum of understanding, to the policy committee. The recommendations were approved.

Consideration then proceeded to the corporate form the comprehensive depository should take. After exploring several possibilities, and discussions with State officials, it was decided that the depository would be incorporated as a trust company under California law. The requisite application was filed with the State Superintendent of

[5-5] Pacific Coast Stock Exchange, *1971 Annual Report,* p. 6.

Banking in latter 1972. The submission was approved by the Superintendent a few weeks later. However, the trust company was not activated at that point.

In July 1973, PSD submitted to the SEC proposed Articles of Incorporation, By-laws, and Rules of the proposed Pacific Securities Depository Trust Company ("PSD"). By that time, agreement in principle had been reached that the major California banks would contribute $2.26 million to the development of PSD.

In 1973 PSD suffered some economic and procedural setbacks. PSE and California bank officials initiated inquiries with DTC as to whether the latter could and would place a securities depository facility of its own in California to replace PSD. The California and New York facilities would be closely interconnected, with California transactions processed on the New York computers. However, at year-end 1973 these discussions were not being pursued, and PSE officials were stating that a locally owned and managed California depository would be developed.

Consideration of local depositories by other cities

As has been mentioned, representatives from Boston and Hartford were among those who met monthly with BASIC's Task Force over an extended period of time. Groups in both cities commissioned studies to determine whether a local securities depository should be created. The BASIC Task Force cooperated with both groups. At this writing, it is not known whether either city will go forward with its own depository, or whether the local financial institutions will become participants in CSDs in other cities.

Inquiries about depositories were also received by BASIC's Task Force from Denver, Detroit, Omaha, Philadelphia and Winston-Salem. The Chairman and Executive Director visited Philadelphia on February 8, 1972 to discuss the depository subject with bankers, brokers, and exchange personnel in that city. So far as is know, none of the cities named has made a study of the feasibility of a local comprehensive depository.

Funds settlement for intercity securities transactions

Whenever the buyer and seller of securities are in different cities, the payment side of a delivery-against-payment ("DVP") transaction has to be worked out. One aspect of the problem is how to match the delivery and the payment, so that the seller does not give up securities until he receives payment, and vice versa for the buyer.

Another aspect is the time of availability of funds received by the seller, and whether this is the same time as when the buyer loses availability of funds. Involved in the latter question is whether a "funds float" is created and, if so, who benefits and who loses.

When BASIC's Task Force first considered the interconnection of regional depositories, it ran into the question of how DVP would work in the settlement of interdepository transactions. The New York depository planned to settle the cash side of its

book-entry deliveries, making easier the matching of deliveries and payments. At various stages, the California and Chicago depository plans provided for settlement of the cash side of book-entry securities deliveries outside the depository.

The Task Force studied this potential variance in cash settlement procedures among depositories carefully. Without pressing other depositories to use the CCS plan, the Task Force raised questions as to how a system would work which separated delivery from payment. A memorandum dated April 10, 1972 on the subject is attached as Appendix M. In the pilot interface between the Chicago and New York depositories at year-end 1973, the interdepository deliveries were being made "free," i.e., the parties involved were settling the cash side of the securities transactions outside the depository system.

On the critical subject of the funds that should be used to settle securities transactions, an in-depth study was made by a Funds and Settlement Subcommittee of NCG, composed of Griffiths, Chairman, Coriaci, White, John C. Gammage of Shields & Co., Jerome L. O'Brien, formerly Vice President of MSECC then Vice President of National Clearing Corporation ("NCC"), and Kenneth S. Uston, Senior Vice President, PSE. The subcommittee's report, approved by NCG's Working Committee and NCG is exhaustive. It deals with the entire subject of the type of funds in which securities transactions should be settled within the financial community in the United States. (It recommends that the settlement be in "next day" or "clearing house" funds, rather than "federal" or "same day" funds.)[5-6]

Other funds settlement questions have arisen with respect to settlement payments to DTC by out-of-state participants. In connection with the review of DTC's rules by the SEC, but also before, DTC's rule requiring payment to it in NYCH funds was questioned. Why, it was asked, should not DTC accept settlement checks drawn on a bank outside New York which produces Federal funds to DTC's bank-of-deposit at the same time as NYCH funds?

This involved matter was researched by the Executive Director at the request of DTC. The conclusion in a memorandum dated March 13, 1973, attached as Appendix N, was that there were good reasons for not changing DTC's rule.

Can a depository interface with different types of clearing systems?

CCS was formed to be used by NYSE member firms. NYSE's Stock Clearing Corporation used the Daily Balance Order ("DBO") method of clearing and settling trades. Early in the consideration of a possible CSDS, there arose the question of whether a depository could also interface with a "net-by-net" or "continuous net settlement" ("CNS") system. Perhaps ahead of this question, however, was that of where the clearing process stopped and where the depository function started.

[5-6] The entire report of "Standardization of Funds Settlement for Securities Transactions" is reproduced in *House 1973 Hearings,* pp. 1853-1871.

The Task Force soon found that there was no independent authority for a clean-cut dividing line between clearing and depository functions.[5-7] The Executive Director, at a conference called for December 8, 1970, put the following statements and question before exchange and NASD representatives:

Trading, Clearance, Settlement, and Custody Functions (NYSE)

Step	Action
I.	Securities are traded between two parties.
II.	The trades are compared; those agreed enter the netting process.
III.	Trades are netted. Balance orders are issued for net security movements and cash by each party.
IV.	Parties deliver securities against payment. (Assume both parties are in the depository.)
V.	Security positions in the depository are updated.

Question re: a Comprehensive Securities Depository

Which of the foregoing steps are to be carried out within the depository? Which outside, and by whom?

At that conference, Pacific Coast Exchange and NASD representatives thought that Steps IV and V should be accounted for in a depository. The Midwest Exchange representative, however, would confine the depository's function to Step V.

It was clear, then, that in contemplating the coexistence of clearing and depository systems, those planning the latter simply had to decide at what point depositories would enter the transaction consummation process. BASIC decided that the New York CSD would enter the picture at the point where a delivery of securities was required to be made. (In addition, of course, the depository would also carry out the custody function.) The New York CSD would also equip itself to settle the cash side of securities deliveries, as well as handle those that were "free."

The foregoing scope of the New York CSD would enable it to furnish all the essential book-entry and custody services needed by the non-broker/dealer members of the financial community. It would also enable it to interface with any clearing system for trades among brokers/dealers. Whether the latter settled trade-by-trade or after any degree of netting, whenever a securities delivery had to be made, the depository could effect it upon the appropriate authorization.

It should be noted that the foregoing decision as to the scope of the New York CSD did not preclude any broker/dealer clearing system from also furnishing a depository

[5-7] See, for example, testimony on this question during the *Senate 1972 Hearings*, some of which is quoted in Chapter VII.

service. In fact, at one time or another, the Midwest and Pacific exchanges and NCC have considered a combined clearing-depository service. A decision to do this, as opposed to interfacing the clearing system with a "pure" depository, turns on the relative value of the service to the clearing members – and the relative cost.

Interface with NCC

About the time BASIC was formed, NASD had completed the design phase of its Continuous Net Settlement system ("CNS") and was proceeding toward implementation. Commencing in August 1970 and consistently thereafter, NASD-NCC and BASIC's representatives considered carefully whether a CSDS might conflict in any important respect with CNS.

Even after both systems were in the development stage, it was often not clear that a CSDS could, in all respects, meet the CNS system's requirements for custody, book-entry, deposit, and withdrawal of CNS members. Extensive discussions were carried out between DTC and NCC officers and employees on the interface requirements during 1973. At the close of 1973, a plan had been worked out to commence the DTC-NCC interface in May 1974.

Interface with Chicago

Not long after CCS commenced operations in 1968, Midwest and New York exchange people were in discussions about possible ways and means of extending the New York depository's services to Chicago. Nothing came of these early discussions, but consideration of possible Chicago-New York book-entry delivery of securities continued.

In the 1970-1973 period, the interface discussions were carried out mostly between CCS-DTC and Midwest Stock Exchange Clearing Corporation ("MSECC") representatives. BASIC was involved very little. However, it was pertinent that NCG was pressing the principle that intercity use of book-entry should be expanded.

On September 6,1972, MSECC became a participant in CCS. In July 1973, Midwest Securities Trust Company ("MSTC") commenced an interface with DTC, to some extent leaving securities on deposit with the latter. However, DTC did not immediately commence leaving its securities on deposit with MSTC, since it had not satisfied itself as to the attendant risks involved.

About year-end 1973, MSTC and DTC had worked to a pilot operation of a two-way interface. It seemed probable that Chicago-New York book-entry securities transfers would expand fast from there.

Interface with California

CCS and DTC discussions about interface with California were more or less concurrent with those with Chicago. In due course, the Pacific Stock Exchange Clearing Corporation ("PSECC") became a participant in DTC.

The Pacific Securities Depository ("PSD") had not, at year-end 1973, been activated as a limited purpose trust company under banking law. DTC had received legal advice

which had the effect of making it not practical procedurally for DTC to leave its securities in the custody of a non-bank depository, such as PSECC was operating. However, based upon the Chicago-New York experience, it remained only for the Pacific depository to be established as a trust company for the interface to be commenced.

1973 discussions of a national securities processing system

In the third quarter of 1973, the Securities Industry Association ("SIA") explored, through its Securities Processing Committee, the broad outlines of a national securities processing system. At about the same time, NYSE's Securities Industry Automation Corporation ("SIAC") came out with a similar proposal.

These studies were confined largely to broker/dealer clearing systems and, therefore, outside BASIC's interindustry terms of reference. However, to the extent that any proposed system would undertake depository functions, there was a question of whether these would conflict with, or complement, a CSDS. At year-end 1973, design of the proposed SIA system had not been firmed up to the point where this question could be answered. (SIAC's proposal presented no conflict with a CSDS.) Whatever the changes in the nation's broker/dealer clearing systems that might emerge from the efforts of SIA and others, there was every reason to believe that a CSDS system could handle the resulting required securities deliveries.

Book-entry collateral loans

A depository's book-entry collateral loan program is an excellent illustration of how rapidly a depository can become a multi-state operation.

Under this program, a broker/dealer depository participant makes arrangements for a collateral loan with a bank who is a member of the depository's collateral loan program. Such arrangements having been made, (a) the broker/dealer instructs the depository to transfer by book-entry to the collateral account of the lending bank specified securities; (b) the depository confirms that the broker/dealer has to his credit the necessary security positions, blocks the collateral in favor of the bank, so endorses the pledge papers, and transmits them – by hand or facsimile transmission – to the lender; and (c) the lender grants the loan. The depository returns collateral to the borrowing broker/dealer's account only upon its release by the lender.

Reference has been made to commencing the collateral loan program by CCS first with pilot, then definitive, operations with NYCH banks. A crucial procedural stage was passed when the NYCH banks satisfied themselves and their bank regulators that the banks could rely on the statutory lien on CCS-held securities, and no longer needed to require that CCS's CEDE certificates be in their hands to establish a possessory lien.

Until the sufficiency of the statutory lien safeguard had been established to the satisfaction of the lending banks, there was only a small scope for non-New York banks to make collateral loans to New york brokers. Before that, Manhattan was where most of

the physical certificates were housed, and that was where most of the broker/dealers' collateral loans were consummated.

Substitution of a satisfactory statutory lien for a possessory lien opened up the opportunity for any bank in the United States to join the collateral loan program of CCS, or that of any other depository. As stated in Chapter IV, bank pledgees in DTC were located in 25 cities at the close of 1973.

The pledge, release, and substitution of collateral securities by book-entry is an important benefit from securities immobilization. The rapidity with which the book-entry collateral loan program has become multistate shows the feasibility of fast expansion of immobilization to other bank-held securities (for collateral was formerly physically held by banks) throughout the United States.

Depository receiving and forwarding agents

Another facet of the extension of book-entry benefits throughout the country is exhibited by a depository's appointment of banks in other cities as receiving and forwarding agents. DTC calls these "depository facilities." Under this arrangement, a depository participant may deliver certificates to the depository agent in a distant city. After examination for good delivery, the agent promptly communicates the pertinent information about the deposit to the depository. This having been done, the participant can instruct the depository to make delivery of the deposited securities on its behalf. The agent sends the certificates to the depository, to be transferred into the depository's nominee, by courier or mail.

The value to a broker/dealer participant of this service is clear; he no longer has to finance securities that he acquires in a distant city until he can physically move them to the city of delivery. DTC's depository facility program has expanded fast. By the close of 1973, there were 30 banks in 18 states and the District of Columbia participating.

Toward the national CSDS

The developments to date prove the feasibility of a national CSDS. Whether the CSDS will be comprised of three, ten or some other number of CSDs, there is no technical reason to prevent — and strong economic reasons for — immobilization in CSDs of securities held by all financial communities in the United States.

Members of the various financial communities with larger volumes of securities transactions can become direct participants in depositories. Those with smaller volumes (and, it usually follows, less than the required expertise) can still immobilize the certificates through correspondents — much the way they handle securities transactions now.

VI

REMOVING LEGAL OBSTACLES TO COMPREHENSIVE SECURITIES DEPOSITORIES

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REMOVING LEGAL OBSTACLES TO COMPREHENSIVE SECURITIES DEPOSITORIES

Any solution to the securities handling problem had to contemplate one or more of: (a) facilitating the handling of certificates; (b) reducing the volume of certificates handled; or (c) eliminating certificate handling entirely. When BASIC was formed in early 1970, there was much talk of making the certificate man/machine-readable to facilitate certificate handling. This subject is covered in Chapter IX.

Reducing the handling of certificates – or eliminating the handling entirely – meant that fewer beneficial owners of securities, or their fiduciaries or custodians, would pass along certificates to complete securities transactions which, in turn, would mean that such persons would retain possession of fewer certificates. If the certificates were eliminated entirely, *no* persons would pass along certificates or have possession of them. Potential solutions to the paperwork crisis along these lines raised the question: What legal obstacles lie in the way of eliminating certificates, or immobilizing them extensively in comprehensive central depositories?

Survey of laws that contemplate possession of certificates or transfer of possession

BASIC and its legal counsel decided quickly that a survey was needed to indicate the scope and magnitude of the legal problems involved in immobilizing or eliminating certificates. At its third meeting, held on April 22, 1970, the Committee authorized such a survey. At its May 1970 meeting, the Committee accepted this plan:

> "Mr. Potter reported on the progress of the legal team which is studying the problems of bank participation in CCS. The team has the goal of identifying all legal problems, proposing solutions and developing means of effecting these solutions by January 1, 1971.
>
> Legal techniques will be sought that favor neither industry over the other and that will favor no particular geographical area. The focus will be to allow for immobilization but eventually to eliminate the certificate. A solution will be sought that will allow both systems."

Because of the size of the task involved and in the interests of time, the survey was divided among a number of law firms. Further, because participation by NYCH banks in any solution was essential and because their respective legal counsel would have to be satisfied that any plan for certificate elimination or immobilization did not expose banks to undue additional risks, it was decided to use NYCH banks' counsel.

Those participating in the survey were:

Coordinator:
Sullivan & Cromwell (counsel to BASIC)

Participating:
Carter, Ledyard & Milburn
Cravath, Swaine & Moore
Davis, Polk, & Wardwell
Milbank, Tweed, Hadley & McCloy
Shearman & Sterling
Simpson, Thacher & Bartlett
Sullivan & Cromwell
White & Case
Winthrop, Stimson, Putnam & Roberts

Each firm was assigned a subject area to explore in the laws of the states and the Federal government. Where the topic was complex, the states were divided among two firms. The firms were not to develop exhaustive treatises or firm opinions (which would have, among other things, required consultation with counsel in each state). Rather, an indication was needed of the nature and extent of the legal obstacles to either immobilization or elimination of certificates.

Survey assignments were handed out in July 1970. By the end of the year, the law firms had completed the project. Their memoranda, the equivalent of about 500 double-spaced typewritten pages, contained such titles as these:

Survey of state law relating to possession, registration and delivery of stock —
- Fiduciaries, bank and individual
- Uniform gift to minors
- Voting trustees
- Attachment, sequestration, liens, jurisdiction, bonding
- State agencies — "doing business' deposits; abandoned property; funds of local government or agencies; funds for government or or agency employees; etc.
- Possession of certificates by or for, e.g.: cemetary associations, insurance companies, private insurance or retirement funds, etc.

Corporate laws concerning stock certificates —
- Representation of shares by certificates and obligatory issuance of certificates by corporation
- Discretionary issuance of certificates by corporation
- Receipt and surrender of certificates by shareholders
- Contents of certificates

The stock certificate as a conveyor of information under State and Federal law

Sections of the Investment Company Act of 1940 affected by the establishment of a central depository system

Availability and utility of attachment of corporate shares as a jurisdictional and/or security device —
- Corporate stock as attachable property
- The mechanics of attachment —
  - The "situs" problem before the uniform laws

The "situs" problem under the Uniform Stock Transfer Act and the Uniform Commercial Code ("UCC")
State statutory patterns

Effect of elimination of stock certificates on taxes on transfer of stock –
Taxes on transfer
Situs of certificate
Collection of the tax
Taxes on issue

Effects of a computerized stock transfer and depository system upon rights of claimants to stock in a bankruptcy of a stock broker

Applicability of Article 8 of the UCC to a depository system

It was clear from the survey and other information at hand that some changes in important state laws would be required before the desired extent of immobilization of certificates in a CSDS could be reached – notably fiduciary laws affecting banks, and the New York State transfer tax. It had been known from the outset that an effective CSDS would require broadening the ownership provisions of the UCC for depositories. But the survey made crystal clear – if such was not evident already – that compulsory elimination of the certificate would cause problems with a whole host of additional state laws which were built around an assumption of the certificate's existence.

Broadening the ownership of securities depositories (UCC Section 8-102 (3))

Prior to the activation of CCS in 1968, it had been necessary for the NYSE to secure amendments to Section 8 of the UCC in every state in the nation. That effort was commenced in 1962 and the last state amendment was not obtained until 1970. The amendment, which added Section 8-320 to the UCC, had the effect of legally validating the transfer of ownership or pledge of securities by depository book-entry in lieu of the delivery of physical certificates.

There were safeguards set up in this book-entry amendment, however. Book-entry transfer of securities ownership was legalized only if the book-entry was made by a depository (called a "clearing corporation" and defined in Section 8-102(3) of the UCC) which was a subsidiary of a registered national securities exchange or association. This ownership restriction was logical when the UCC amendment was drafted, since book-entry transfers were being contemplated only between broker/dealers.

The reason for broadening ownership – The paperwork crisis of 1968-69 had made it clear that, for depositories to be fully effective in solving the securities handling problem, the book-entry system started by CCS must be extended beyond broker/dealers to the entire financial community. Of greatest importance was that banks be included in the book-entry system, since banks had custody of a large portion of the securities in the financial community and processed most of the transactions between broker/dealers and their institutional customers. Even brokers did not find it economically viable to place *all* their securities holdings in a depository devoted to brokers alone, for they would then be

required to make extensive withdrawals of physical certificates to effect COD deliveries to banks. (Many still withhold part of their securities from depositories for this reason.)

Banks, after overcoming initial shock at the idea of giving up to *any* outside organization possession of certificates covering securities for which they were responsible, began considering conditions under which they could give up such possession and at the same time meet their responsibilities as fiduciaries and custodians. One such condition was that the CSD be incorporated under banking law and subject to regulation by banking authorities (already discussed in Chapter IV and further covered in Chapter VII). Another condition was that prudent discharge of their responsibilities required that banks participate in the ownership and control of the CSDs that they use.

The last called for an amendment to Section 8-102(3) of the UCC. The first thought of some members of the Committee was that, in lieu of necessary changes in the UCC and other state laws, it might be best to ask the Congress to preempt state law as necessary and to clear the way for an effective CSDS by one federal law. Others on the Committee, however, pointed out that a federal law would have to set up conditions for depositories in financial centers other than New York, that their situations had not been specifically researched, and that a depository bill in the Congress on what would to its members be an innovative step might be mangled by well-intentioned but ill-advised amendments. Those opting for amendment to state law prevailed, recognizing that BASIC would have to deal with many legislative jurisdictions but that, at the same time, a flexible, step-by-step approach would minimize the perpetuation of initial errors in plowing virgin ground as well as allowing for modifying the nature of depositories to meet local conditions. Moreover, there was a line of legal thought that the New York depository might be able to operate successfully with the necessary amendment to Section 8-102(3) only in New York. However, passage of the amendment in the other states would, at a minimum, be desirable.

The Committee, at its meeting on November 24, 1970, approved the approach to the states to amend Section 8-102(3) of the UCC on ownership of depositories. It decided, however, that time was too short to attempt to secure amendments in 1971 legislative sessions, and to aim for the 1972 sessions.

To do this all the spadework on the amendment, back-up materials and supporting endorsements had to be completed by about the first of December 1971.

Obtaining endorsements and other support for the amendment – The UCC amendment, and a memorandum explaining its nature and purpose, went through several drafts in discussion with legal counsel for NYCH banks, exchanges, and other interested parties. (A proposed amendment to the New York State fiduciary law, discussed later, was being developed at the same time.)

After legal counsel were satisfied with the draft, it was submitted to Professor Herbert Wechsler, Chairman of the Permanent Editorial Board for the Uniform Commercial Code. This Board, established by agreement of the American Law Institute and the National Conference of Commissioners on Uniform State Laws, has the function of approving amendments to the UCC when appropriate. Few state legislatures would consider such an amendment without the endorsement of the Board.

BASIC's counsel discussed the amendment at length with the Board's Chairman, its counsel, Carl W. Funk, and others interested in the UCC. Out of these discussions came an important suggested change. The initial draft of the proposed amendment would have permitted any one of a national securities exchange or association, bank, broker, insurance company, or registered investment company, to own a depository giving the benefits of book-entry transfers.

It was pointed out that, even though regulated, a single owner (say, a bank, insurance company, or broker) could be irresponsible or even fraudulent with resulting loss to depositors. The initial draft of the UCC amendment was changed to provide that none of the regulated entities, other than a registered national securities exchange or association (already empowered to do so), could own more than 20% of the depository's stock. The amendment as changed, therefore, required at least five regulated owners to be involved if a registered securities exchange or association was not. The change was entirely compatible with BASIC's philosophy of depositories as mutual service facilities, owned and managed by their users.

The amendment of UCC Section 8-102(3) received the endorsement of the Permanent Editorial Board. The amendment (and the fiduciary law change) were also taken up by BASIC's counsel with officials of the New York State Banking Department, the Chairman of the New York Commission on Uniform Laws, the Secretary of the New York State Surrogates' Association, the Banking Law Committee of the New York State Bar Association, the Banking Law Committee of the New York County Lawyers' Association, the Committees on Banking Law and State Legislation of the Association of the Bar of the City of New York, and the New York State Bankers Association. The proposed amendment received endorsement or "no objection" positions from all of these.

Thereafter, efforts were made to secure endorsements of the amendments from every possible authoritative source. In due course, these were received in writing for publication from: the Chairman of the SEC; the North American Securities Administrators; the American Bankers Association; the American Society of Corporate Secretaries; the Securities Investor Protection Corporation ("SIPC"); the Securities Industry Association; and others. Many of these organizations also gave valuable assistance in specific situations in several states.

Taking the amendment to state legislatures – By November 1971, legislative counsel had been retained to assist in moving the UCC and fiduciary law amendments through the New York State legislature. Sponsors for the two bills were then found in the two legislative houses, who in November 1971 were briefed and supplied with all needed back-up material. The bills as introduced bore the date of January 5, 1972 (prefiled).

There followed during the next four months or so many personal and telephone conferences with legislators and their staffs, as well as with the interested supporting organizations. The UCC amendment had passed both houses by the first week in May and was signed by the Governor on May 22, 1972.

Meanwhile, as soon as the needed clearance and support had been obtained in New York for the UCC amendment, the program to secure the same amendment in the other states was commenced. On December 1, 1971, a telegram, a letter and supporting

material were sent to the Securities Commissioners of the other states (except Delaware where special arrangements were being made). The Commissioners were asked to arrange introduction of the UCC amendment in their respective legislatures. Legal counsel followed up the mailings during the next couple of weeks by direct telephone calls to the office of each Commissioner who had been sent the proposed amendments and supporting material.

The initial December broadside to the State Commissioners was, of course, only the beginning of a tedious and laborious campaign to develop interest in, and active sponsorship for, the amendment. In a number of states, the Securities Commissioners picked up the ball and effectively ran with it. In many, however, it was necessary to search for alternative sponsorship from among bankers, brokers, their state associations, other state government departments, etc. BASIC's counsel, assisted by members of BASIC, and by the NYSE and DTC and working through hundreds of telephone calls and letters, and several personal visits, eventually homed in on one or more persons in almost all the states who were actively interested in pressing passage of the amendment. Testimony was asked for and given in several states. The amendment was non-controversial and technical; creating understanding and overcoming apathy and inertia among financial industry people and state legislators was the principal problem.

The first state to sign the UCC amendment into law was Kentucky — on March 29, 1972. Since then, progress in amending the Code was as follows:

	Cumulative				
		Companies with NYSE listing incorporated in these states		DTC-eligible issues of companies incorporated in these states	
	No. of states	No.	%	No.	%
By 6/30/72					
Conn., Del., Hawaii Ky., Md., N.Y., Va.	7	807	59		
7/1-12/31/72					
Cal., Ill.	9	939	66		
1/1-6/30/73					
Ariz., Ark., Colo., Ga., Ind., Me., Mich., Nev., N. Mex., N.C., N.D., R.I., S.C., S.D., Tenn., Texas, Wash., Wyo.	27	1,125	76	2,311	77
7-1-12/31/73					
N.H., N.J., Oreg., Utah	31	1,187	80	3,739	85

The slow and laborious job of "mopping up" the remaining non-enacting states continues.[6.1] However, the back of the problem has been broken. In latter 1973, the aid of corporations incorporated in non-enacting states in securing the amendment was solicited by DTC.

At year-end 1973, DTC commenced taking steps to implement the long-desired broadening of its ownership, even though a small percentage of its eligible issues would be from non-enacting states. DTC put before its participants, pledgee banks, and issuers the legal questions which might be raised about book-entry transfers of securities from the non-enacting states. However, on an assumption that an examination of these questions will lead to the conclusion that the risks would be *de minimus,* it appeared that the user-owner principle for depositories was near implementation.

Enabling fiduciaries to deposit securities in a depository

The survey of state laws, referred to earlier, revealed that in many states a bank or other person holding securities in a fiduciary capacity is rigorously confined as to who may have possession of the relevant certificates. For a fiduciary bank, the practical, if not the legal, effect has been that the bank itself retains possession. Some fiduciary laws even specify how certificates must be filed, and most require that fiduciary securities be segregated from the bank's own securities.

In view of the importance of depositing bank-held securities in a CSD, it early became obvious that many fiduciary laws must be changed for this to be done.

The fiduciary laws of the states are not uniform. It was, therefore, not possible to devise a model fiduciary law amendment which could be used in all states. In these circumstances, BASIC and its legal counsel decided that the first step should be to secure the desired amendment to the New York State fiduciary law. The New York amendment could serve bankers and interested parties in other states as a starting point in developing tailor-made amendments to their respective laws.

During 1971, an amendment to the New York Estates, Powers and Trust law was developed, exposed, revised, explained, and cleared with much the same organizations in New York as mentioned above in connection with the UCC amendment. It was introduced in the New York State legislature early in 1972. With the powerful support of those organizations which endorsed the UCC change, the amendment was passed and became law on May 22, 1972.

A copy of the proposed New York EPTL amendment was part of the package of materials furnished those in other states in connection with the UCC matter. The transmittal letter made clear that the New York EPTL change was illustrative only, and was for such assistance as it might give to fiduciaries and custodians in any state who wished to free up securities they held for immobilization in a CSD.

[6.1] Minn., Miss., and Ohio were added in the first quarter of 1974.

While BASIC did not attempt to mount a campaign to amend fiduciary laws in any state other than New York, bankers and brokers in several of the states did so. The result was that at year-end 1973 the necessary amendments to fiduciary laws had been secured in 16 states (Ariz., Calif., Colo., Conn., Ga., Ill., Me., Md., N.H., N.J., N. Mex., N.Y., N.C., Ore., Va., and Wash.)[6.2]

Appreciation of the advantages of immobilization and book-entry is spreading rapidly. It seems highly probable that even bankers in states beyond those with major financial centers will soon realize the advantages to them of having their fiduciary law amended so that they can make full use of the CSDS.

Eliminating the New York State transfer tax problem

At the time BASIC was organized, all depositors in CCS were doing business in New York State. An amendment to the New York State Transfer Tax Law in 1966 had made clear that book-entry deliveries of securities in CCS would *per se* not be subject to the tax, nor would be taxed the transfer of deposited securities by CCS into its nominee, CEDE & Co.

As BASIC developed the concept of a national CSDS, it became evident that securities presently held and transferred in many states would have to be immobilized and transferred by book-entry in CSDs in only a few states. One of these CSDs certainly would be in New York.

Yet, at that time, the New York tax law might be construed as subjecting to transfer tax a book-entry transfer in a New York CSD by an out-of-state depositor, even when all other elements of the transaction occurred outside the state and made it not now taxable. Further, the deposit of securities by an out-of-state depositor in a New York CSD, and the transfer thereof into the CEDE name, might be construed by some as a taxable transaction.

Therefore, New York's transfer tax law had to be clarified so that use of a New York CSD by an out-of-state depositor would not, by itself, give rise to transfer taxes not now payable. While the clarification might have been accomplished by an official interpretation of existing law, it was concluded that the most definitive disposition of these questions would be through amendment of the law.

BASIC used the firm of Milbank, Tweed, Hadley & McCloy as counsel on this legislation. That firm and its tax partner, Howard O. Colgan, Jr., as counsel to the NYSE, had had many years' intimate experience with New York's transfer tax law.

After several drafts of the tax law amendment and the explanatory memorandum, conferences were held on the amendment with New York State's Commissioner of Taxation and Finance and his staff (the first on November 17, 1971). Lending important support to the amendment at this point and later was the New York State Superintendent of Banks. Boston's State Street Bank also participated in discussions with the Department

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[6.2] Minnesota passed such a law in the first quarter of 1974.

of Taxation and Finance in Albany, which brought realism to the problems and opportunities of an out-of-state bank depositing in a New York CSD.

The New York State Commissioner of Taxation and Finance reacted sympathetically to the proposed amendment, but recommended that the subject be cleared with the Fiscal Administrator of New York City, the beneficiary of the tax. This was done in a conference on January 6, 1972.

Legal counsel in Albany was retained, and the amendment to the transfer tax law was introduced on February 28, 1972. After many conferences with, and answering many questions from, legislators, their staffs, the Department of Taxation and Finance, and others (and some changes in the bill as a result), the needed change in the transfer tax law was approved on May 9, 1972.

Are depositories a further obstacle to corporation-stockholder communications?

As shares deposited in CCS-CCS, Inc.-DTC increased, the number of shares appearing on corporation stockholder lists registered in "CEDE & Co." (the depositories' nominee) of course grew commensurately. Corporation managements had already expressed concern about the extent to which the identity of beneficial owners was hidden behind stock registered in the names of brokers and of bank nominees. Wasn't the former corporation communication chain of corporation-broker or bank-beneficial owner now further complicated by adding "CEDE" as the second link in the chain?

The American Society of Corporate Secretaries raised this question with BASIC soon after the latter's formation. Similar concerns were expressed at the SEC, on Capitol Hill, and by those writing on the stock certificate.

The first question to be considered on this subject was the extent to which the New York depository was further impeding corporate communications. For one category of deposited shares — those which formerly circulated as "street name" certificates — the depository provided a distinct improvement.

Under the former common practice, a brokerage firm endorsed in blank a certificate in its name and delivered it to another party, who redelivered it to another, and so on until, perhaps, it was reregistered in the then holder's name near a dividend record date. The circulation of a "street-name" certificate could go on almost endlessly if dividends were not being paid. On any given date — say, a record date for voting — Broker & Co. had *absolutely no idea* of who was holding or owning "street name" stock registered to it which it had endorsed and circulated.

Much of brokers' stock that formerly circulated in "street name" was placed in the depository. At least, on any given date the depository could list, by broker, the shares each actually had on deposit. This established a corporation-broker chain of communication that circulating "street name" certificates had broken.

The New York depository early established a practice of furnishing corporations with a list of the holders and their holdings of issues on deposit with it, on record dates and at other times as requested. The depository also worked out a procedure whereunder CEDE shares would be voted as instructed by its participants. That the procedure has been effective is indicated by the high percentage of CEDE shares that have been voted.

Thus, the New York depository has provided corporations with better identification of broker holders of their shares than when "street name" certificates circulate. It can identify bank participants' holdings in total (but not by separate categories of holdings formerly identified by the several nominees of a given bank). DTC recently announced revised proxy procedures for the voting of CEDE shares. BASIC has not studied these new procedures, so it is not known how they will affect the corporation-stockholder link, if at all.

Voting proxies for CEDE shares must still be signed by CEDE under the corporation laws of most states. The Committee on Stock Certificates of the Committee on Corporate Laws, American Bar Association, has studied this matter. It has considered an amendment to the Model Business Corporation Act (adopted by about 80% of the states) which would permit corporations to substitute on the stockholder list the names and deposited shares of depository participants as of a record date, as certified by the depository. Such participants could then vote these shareholdings directly.

The forgoing amendment, if adopted, would put the corporation in direct touch with participants for voting. It would restore the *status quo ante* depository development in this respect (except improve communications to the extent that CEDE certificates replaced the former floating "street name" certificates). However, such a procedure would not attack the matter of getting behind banks' and brokerage firms' names to the identities of the ultimate beneficial owners. This problem for corporations existed long before depositories came on the scene.

For beneficial owners (who did not wish to remain anonymous) to vote in their names shares they owned, but which are held in the name of a financial institution, would require a change in laws, similar to the one described above involving depository participants. The systems change in the financial community to substitute beneficial owners' names on stockholder lists for those of banks and brokers would, however, be much more complex than the depository-participant substitution.

BASIC did not go deeply into possible procedures for getting the names of beneficial owners of immobilized shares on stockholder lists. However, the Task Force noted, in studying the application of modern communications technology to the completion of securities transactions (see Chapter VIII), that an automated system would enhance the feasibility of so substituting names. Where a stock is widely held, one of the first requirements for a consolidated list of beneficial owners would be the universal adoption of a precise standard for computer name and address files. Such a standard has been developed. Its adoption and use would no doubt have to be mandated. The authority or authorities who did this would no doubt first need to be satisfied that the foreseen benefits outweighed the cost in effort, money, and disruption to make the change.