

MEMORANDUM

TO: Chairman Ruder

FROM: Richard G. Ketchum, Director
Division of Market Regulation

DATE: September 17, 1987

RE: Meeting with the Financial Industry Securities
Council ("FISC"), Monday September 21, 1987

As you may recall, you accepted Ron Readmon's invitation to join FISC representatives for lunch at the American Bankers Association ("ABA") on Monday, September 21, 1987. The meeting is scheduled for noon at 1120 Connecticut Avenue, 5th floor conference room (Room 5B). FISC was formed by the ABA and the Securities Industry Association ("SIA") to foster efficient and uniform securities processing. We expect to discuss a wide range of topics with FISC, including international clearance and settlement; and developments in safekeeping and processing corporate, municipal, U.S. Government and mutual fund securities.

FISC has been involved actively in securities and banking efforts to improve securities transaction processing and, in particular, to prepare for high volume trading in corporate and municipal securities. Over the last few years, FISC supported and monitored the progress of centralized institutional trade settlement at securities depositories; and worked with Division staff in coordinating with 1985 Securities Immobilization Workshops and the 1984 Securities Processing Roundtable. FISC has developed uniform standards for machine-readable securities certificates and assessed whether the banking and securities industries should consider establishing same-day funds as the exclusive payment mechanism (instead of next-day funds [e.g., certified checks]) on securities settlements among broker-dealers, financial intermediaries and institutional investors.

The following summarizes key points on the agenda.

- I. International Clearance and Settlement.
 - A. London market activity.

As a result of "Big Bang" and privatization of several government-owned enterprises, trading volume on the International Stock Exchange of the United Kingdom and Northern Ireland increased dramatically. Before changes in October 1986, equity securities generally did not trade in volume (Government securities ("Gilts") accounted for the bulk of Exchange trading

volume). We have the following preliminary observations concerning the “London Paperwork Blitz.”

1. Many market participants were caught unprepared. The exchange, broker-dealers and banks found themselves using paper-intensive, trade-by-trade processing techniques in a market that demands centralization and automation. For example, trade reporting procedures were not enhanced to lock-in trades at the time of execution, to prevent disagreement between counterparties concerning the basic terms of trades. In addition, trade accounting and securities delivery mechanisms were not automated or centralized sufficient to meet market needs. Furthermore, the exchange did not employ any techniques to reduce the flow of paper in processing transactions -- such as netting broker-dealer delivery obligations in each issue on a daily or “account” basis, or developing a centralized automated facility for recording ownership of securities among broker-dealers and banks.

2. Clearance and settlement activities were not sufficiently coordinated or disciplined. Smooth processing of securities transactions requires coordination among securities exchanges, broker-dealers, investment managers, custodian banks, registrars and transfer agents. Before Big Bang, there was no single entity with responsibility to foster prompt, accurate and safe clearance and settlement of securities transactions. The exchange and market participants relied, for the most part, on informal understandings and “gentlemen’s agreements” to coordinate the activities of, and discipline the laggard among, securities processors. The exchange rarely disciplined members for failing to meet minimum processing standards and rarely required specific action (such as buying-in securities) to cure those problems. The general attitude was reflected in the membership motto -- “my word is my bond.”

3. Key players in processing transactions are not subject to performance standards. For example, U.K. company registrars (*i.e.*, transfer agents) are not subject to any minimum turnaround requirements in processing changes to the list of shareholders. Unlike U.S. commercial law, U.K. law does not recognize stock certificates as “negotiable instruments.” Thus, delay at the registrar can prevent a trade from settling, because the trade cannot be completed until the buyer is listed on the issuer’s books. Registrar delays appear to be particularly costly to dealers in issues with widespread individual investor interest, such as the National gas, telephone, water and airport authority companies. Indeed, we understand that several dealers decided against participating in recent offerings because the cost of servicing small investors likely would exceed the commissions those investors would generate. (The number of small investors in the U.K. has tripled since 1979, from 3 to 9 million.)

B. The International Securities Clearing Corporation (“ISCC”) -- Facilities for International Linkages

ISCC is a wholly-owned subsidiary of the National Securities Clearing Corporation, and was formed to serve as a bridge between U.S. clearing agencies and non-U.S. clearing agencies. (NSCC is the dominant U.S. clearing corporation and processes more than 90% of inter-dealer trades in corporate and municipal securities.)

ISCC has applied for registration as a clearing agency under Section 17A of the Securities Exchange Act of 1934. Section 17A requires the Commission to determine, among other things, that an applicant clearing agency's structure, organization and rules are designed to promote prompt, safe, and efficient securities processing and that the clearing agency has the capacity to safeguard funds and securities in its possession and control. We are reviewing proposed changes to ISCC's rules in response to our comments last February, and we expect to submit our recommendation to the Commission with respect to that application within the next few months.

Pending ISCC's registration, the Division has granted ISCC and NSCC (its facilities manager) no-action letters to operate a pilot link with the London Stock Exchange. Under that link, ISCC members have access to the London Stock Exchange's checking and talisman systems, as if they were members of the Exchange. Several FISC members are members in ISCC and use the London link.

II. Equity Securities

A. Efficient Clearance and Settlement

FISC has been a leader in preparing the banking and securities industry for 100, 200, and 300 million share trading days. In 1982, FISC supported amendments to self-regulatory organization ("SRO") rules that were designed to require routine customer-side settlement of institutional trades at registered securities depositories. By coordinating settlement between broker-dealers and their customers to occur at the same time and place as settlements between broker-dealers, the majority of trades (by dollar value) can be completed on a timely and efficient basis. Indeed, successful coordination of bank and broker-dealer efforts has permitted NYSE trading volume to exceed 150-200 million shares routinely without substantial delays or investor losses.

Nevertheless, we and FISC are concerned that now is the time to prepare for 500 million share days. Because it takes only one weak link in the chain to bring trade processing to a halt, we expect to encourage FISC to review the entire trade clearance and settlement cycle.

The NYSE, Pacific Stock Exchange and National Association of Securities Dealers ("NASD") have filed with the Commission proposed rule changes that may pave the way for efficient processing at higher trading volumes. Those changes would require broker-dealers to deny cash account/delivery-against-payment privileges to customers who did not use securities depository facilities for settling securities transactions. This would eliminate physical delivery of certificates against payment as a mode of settling institutional transactions. We expect to approve those amendments by delegated authority later this month.

B. Shareholder Communications.

We hope to review with FISC representatives recent experience and developments concerning shareholder communications. This is an area that has undergone significant change in the last few years, and many of the bugs are still being worked out.

1. Disclosure of Beneficial Ownership. In response to recommendations from the Advisory Committee on Shareholder Communications, the Commission undertook several initiatives to improve shareholder communications. For example, the Commission facilitated the disclosure to corporations of the identity of investors who hold securities through broker-dealers and banks. Under SRO and Commission rules, broker-dealers are required to provide the identity of non-objecting customers to issuers, under procedures that are designed to minimize duplicate reporting and unnecessary expense. Moreover, effective July 1987, banks holding securities on behalf of investors must comply with the Commission's proxy distribution rules, including similar provisions concerning disclosure of beneficial ownership.

2. Dissemination of Quarterly Reports. The SIA has brought to our attention that two companies refused to reimburse broker-dealers for the cost of disseminating quarterly reports to beneficial owners. Currently, Commission rules do not specifically require issuers to send or pay for distribution of quarterly reports to beneficial owners. We are studying this matter, in consultation with the Division of Corporation Finance.

3. Direct Registration. As a result of discussions at the 1985 Securities Immobilization Workshops, a task force of transfer agent representatives has been exploring alternatives for developing transfer agent (or issuer) book-entry systems for corporate equity securities. The task force explored several alternatives, designed to reduce outstanding certificates on a voluntary basis. The task force met with a special FISC subcommittee, which expressed reservations about those alternatives. We understand FISC was concerned that brokers and banks would need to communicate routinely with multiple transfer agents to complete customer transactions, instead of communicating with one depository of their choosing.

We think a viable transfer agent/issuer book-entry experiment can be developed, consistent with efficiency, safety and corporate governance concerns. One possibility is for transfer agents to offer individual investors, on a voluntary basis, custodial services similar to those provided investors in existing corporate dividend reinvestment programs. We hope to explore this matter with FISC.

III. Municipal Securities

A. Call and Put Processing.

We expect to discuss with FISC representatives the need for greater uniformity in processing municipal securities transactions, redemptions and voluntary offerings (puts). As you may know, transfer agents that handle municipal securities exclusively are exempt from federal regulations that apply to transfer agents handling corporate securities. Accordingly, the Municipal Securities Rulemaking Board and some financial intermediaries, particularly securities depositories, have urged legislation to subject municipal securities transfer agents and bond trustees to Commission oversight.

We also expect to discuss with FISC the lack of uniform standards for whole-issue and partial calls. The decline in interest rates to single digits encouraged issuers to refinance their obligations at record rates, and redemptions reached record levels last year. Inadequate notice of

called securities and non-uniform redemption procedures led to considerable processing stress at depositories, broker-dealers and custodian banks. To address these problems, we developed voluntary guidelines for processing mandatory redemptions, in consultation with representatives from federal bank regulators, depositories, bond counsel, broker-dealers, issuers and banks. The Commission endorsed those guidelines last December. We expect to review with FISC industry experience since those standards were disseminated.

We are drafting legislation to authorize federal regulation of municipal securities transfer agents. We are also drafting legislation to authorize minimum requirements for redemptions and puts. We hope to enlist FISC help in considering what, if any, uniform standards for puts might avoid processing stress should economic conditions dictate record exercises of put option securities.

B. DTC Same-day Funds Settlement System.

We expect to review with FISC broker-dealer and bank experience with centralized processing of transactions in municipal notes. In June 1987, the Commission authorized the Depository Trust Company to provide custodial services with respect to municipal notes and to operate, on a pilot basis, a same-day funds settlement system. (DTC is a registered clearing agency, the dominant securities depository, and holds approximately \$3 trillion for member banks and broker-dealers.) DTC's existing settlement system and custodial services are designed for payments in next-day funds (e.g., certified checks), consistent with industry practice for processing transactions in stocks and long-term corporate and municipal debt securities. DTC developed its same-day funds settlement system in order to provide facilities for investment products like municipal notes (tax-anticipation, bond-anticipation and revenue-anticipation notes), and zero-coupon securities.

IV. Government Securities: Mortgage-backed Securities

We expect to discuss with FISC recent efforts in the development of a central depository for certificated mortgage-backed securities, particularly securities guaranteed by the Government National Mortgage Association. To date, FISC has not been involved actively in those efforts.

Last February, the Commission granted temporary registration to the MBS Clearing Corporation ("MBSCC") to run clearing and depository facilities for mortgage-backed securities. At that time, the banking industry, particularly the New York clearing banks, hoped that GNMA securities would be converted to book-entry form on Fedwire, like Treasury bills, bonds and notes. These banks did not support development of a private, cooperative depository for GNMA securities, notwithstanding GNMA support for MBSCC's depository and statements by the Federal Reserve Bank of New York that Fedwire services would not be available for these securities.

Banks now support the effort to establish a private depository for mortgage-backed securities. That support resulted from, among other things, MBSCC's registration as a clearing agency and the announcement by GNMA and the Public Securities Association of a schedule for converting to the depository settlements in GNMA securities among dealers, institutions and

banks. That schedule contemplated eventual issuance of GNMA securities exclusively through the depository (investors still would be able to get certificates through withdrawals from the depository). Support and interest was so great, that the depository was unable to meet the anticipated transaction volume of both first and second tier banks and dealers (the depository was originally organized to handle transaction volume of the first tier). The conversion schedule was suspended in April, to permit the depository to restructure its operations.

We are working closely with MBSCC staff and hope to encourage FISC's banking representatives to do the same. Senior staff at MBSCC have set up a user committee to guide them on operational matters and are setting up a New York trust company to be owned by its member banks and brokers. Moreover, MBSCC is working with a committee of clearing bank representatives to develop mechanisms for financing dealer positions through the depository.

xc: Linda Fienberg