REMARKS OF RICHARD B. SMITH, COMMISSIONER
UNITED STATES SECURITIES AND EXCHANGE COMMISSION,
BEFORE THE AMERICAN BANKERS ASSOCIATION,
NATIONAL BANK DIVISION,
HONOLULU, HAWAII, SEPTEMBER 29, 1969

"A Piece of Paper"

I first want to thank you for your invitation to attend this session and, even more, for your willingness to listen to an SEC Commissioner. It is a rare event when any of us have a chance to speak to you, and so it is a privilege for me to be here with you today.

I admire your fortitude. With due apologies to Comptroller Camp and to Chairman Randall and Governor Sherrill, I guess you almost have to listen to three federal agency representatives while you are here. But you did not have to listen to a fourth, particularly one from whose jurisdiction you are largely saved. Well, you may have the comfort at least to know that our regular custom is for an SEC member to point out in a speech he speaks only for himself.

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What I want to discuss with you today is a piece of paper. It is nothing more than that, and yet it represents a great deal more. It is a piece of paper that vitally affects you and us and the entire financial community. It is also a piece of paper that despite being old and encrusted with a century or more of hoary legalisms has the most amazing, the most appalling reproductive capacity--it procreates not merely subdivisions of itself but during the course of its life and travels generates an incredible number of relative pieces of paper, that cling to it, describe it, give it directions, authenticate it, transfer it, transform it, cancel it, encumber it. Like all relatives, these attachments are each very different and together very expensive.

The progenitor piece of paper to which I am referring, of course, is the stock certificate.

In a way the stock certificate is a symbol of our private enterprise economy. It has been the most seeable device in the successful separation of ownership from management that has occurred in American industry over the last century. Historically, it has been what the public has relied upon to evidence their share in an industrial growth physically remote from the individual investor. The reverse side of the same coin is, that to the extent the public has relied upon it, the stock certificate has been a device enabling private enterprise to obtain the huge amounts of capital that equity investment in this country has provided.

The marvelous liquidity that the nation's securities trading markets have furnished to equity investors had some basis in the existence and negotiability of the stock certificate. It is easy to take that liquidity for granted, but we should remember how unique it is in the world. Without the liquidity of our securities markets, it is difficult to imagine how new offerings of securities would be accepted or why shareholders would permit management to retain earnings in the volume it does. Retaining earnings is certainly more efficient than paying them out in dividends and trying to recollect the funds in new offerings. That is a valuable, not-to-be-overlooked byproduct of strong, liquid securities markets.

Banks have a large stake in the securities markets. They administer an aggregate of about $132 billion in equity investments, in the form of pension funds, personal trusts and common trust funds. That's more than half of all institutional stock holdings, and institutions account for more than a third of the holdings of all outstanding corporate stocks in the United States. In addition to the administered $132 billion, banks are estimated to have in house about $35 billion of stock on some sort of agency basis. And banks act as custodians and as delivering and receiving agents for the roughly $60 billion of stock held by the investment companies. Finally, banks are the principal source of credit in the securities markets as the providers of margin loans and broker-dealer loans. Thus, enlightened bank interest in market liquidity goes far beyond the performance of the banks' transfer agent and registrar roles. Market liquidity, of course, requires the timely consummation of securities transactions.

That brings us back to the stock certificate. What is the difficulty about this particular piece of paper? After all, state law, federal rules, stock exchange requirements, all have elevated the stock certificate because of its apparently prime status in our highly successful form of economy.

The difficulty is that in today's world the movement of the stock certificate, if not the stock certificate itself, and the wildly varied documents that accompany it over various portions of its movement, have seriously clogged a vital pipeline. Clogged it so badly, in fact, that rather than being an aid and symbol of a successful system of private capital formation and transference, the prevailing ways of handling the stock certificate have literally become an impediment and threat to that system. Brokers, exchanges, corporate issuers, investors, banks--all of us who share our national commitment to the broad private ownership of American business have a large stake in properly solving the problems of this piece of paper and its relatives.

Of course, financial paper work is not entirely a new phenomenon. Following lunch I presented to your President (I hasten to add, with a sense of Puck) a copy of a "Portrait of a Banker" painted somewhere around the beginning of the 16th century.* The Flemish artist captured the dignity, solidity and courteous-but-skeptical bearing of the successful banker. But the interesting thing to me was that the artist, at that early date, thought it necessary to fill the background of the banker's portrait with piles and folios of paper. The banker sits there looking out proudly from his surroundings of paper. That apparently was the 16th century attitude.

Well, since the days of the Flemish League and its successors, capitalism and technology have developed into a structure in America, still evolving, that would confound that 16th century banker. Especially would the sheer volume of paper work today confound him. The trouble is that the system for processing paper in securities transactions confounds many of us today in the 20th century, too.

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*Gossant (Mabuse) (c.1478-1533/36), National Gallery of Art (Ailsa Mellon Bruce Fund)

Why has the securities transfer and delivery system suddenly come into question, after having worked adequately for so long?

The short answer is that the massive increase in securities market activity has simply out-paced it over the last two or three years. The trading increase was largely unanticipated, by anyone. It led to broker settlement "fails", to long delays in transfer, then to drastically shortened trading hours, to restrictions on activities of a number of securities firms, and other steps that decreased market liquidities.

The trading increase accentuated the disjuncture between, on the one hand, the highly automated and integrated way in which a securities order is processed, and on the other hand, the predominately manual and segmented way in which a securities certificate is processed. Both must be accomplished to complete the transaction.

Let's take a brief look at the way securities transactions are handled.

Recently on the New York and American stock exchanges there has been an average of around 45,000 transactions a day. That number is substantially below the peaks of 1968, and it does not include any regional or over-the-counter transactions. The clearing corporations through their comparing, netting and allocating process eliminate settlement hangups on something over half of these trades. That leaves something less than half of the trades which under present conditions must be settled daily by the physical movement of securities between brokers, and between brokers and banks.

The contrast between the way these trades are executed in the first place and the way in which they are then settled is a significant factor in explaining the existence of the paper crunch. In large part the difference is merely that between an order that can be transmitted verbally or electronically and a piece of paper that must physically be moved from place to place.

A typical order is transmitted from the registered representative to the firm's message-switching center and from there routed by computer to the broker's booth on the floor of the exchange closest to the post for that security.

Contrast this execution of the trade with its settlement. Instead of just a few people using the most modern of equipment to route the order quickly to the proper place, there are scores of people manually handling a specific document, and attaching to it or detaching from it a plethora of varied forms. The movement of the certificate from customer through the broker to the transfer agent and back requires numbers of people doing little more than just logging it in, reviewing it, logging it out and sending it on to the next person.

Involved in this paper pushing process at the securities firm are the branch office, the receiving department, the transfer analyst, the transfer department and the delivery department. This is for a routine transfer that involves no legal questions or the need for additional documents or signatures. Added to this are the numerous documents that each of these movements must generate so that the firm's general ledger and related ledgers correctly reflect the location and movement of the certificates and the status of the firm's and the customer's accounts.

Then the certificate has to be packaged and carried to the transfer agent. At the transfer agent, the certificate is logged in, examined and logged out a total of almost seven more times, and the certificate still has to go to the registrar. Handling the certificate at the transfer agent are the window clerk, the transfer analyst, the examiner who looks for lost, stolen or stop ordered certificates, and the cage clerk where the new certificates are held. Then it goes to the typing department, then to proofing and balancing, and then to cancelling and sorting for routing to the registrar.

Once carried to the registrar, he engages in another logging in, reviewing for lost, stolen or stop ordered certificates, proofing and balancing. At that point the registrar must manually sign the certificate, and then the certificate must be carried back to the transfer agent for preparation of the transfer journal and matching up the new certificate with the old window ticket. From here it is back to the brokerage house for at least another two logging ins, and logging outs--by the receiving department of the cage and then by either the vault if the firm keeps the stock, or the delivery-mailroom if it is to be sent out to a broker, bank or individual.

In total the certificate goes through, I do not know how many separate, distinct processes--one person counted 14. It also goes through four separate street carries not including those at the very beginning, from customer to selling broker, and at the very end, from selling broker to buying broker or institution. Multiply 14 by the number of unnetted trades per day on the two major exchanges and you have one massive pile of paper. Then add to that the volume on the regional exchanges and the very large volume in the over-the-counter market, where there is not even a central clearing house to reduce the initial movement of stock certificates. Then add the picture of messengers scurrying from one delivery window to another. And then add to that some increment, you decide how large, for the multitudinous possibilities of mistake, because most every step has a pronounced manual aspect. Expensive time is absorbed in searches for the corrections of mistakes, and in rejected deliveries and redeliveries. And "fails" result.

A fail occurs when the selling broker is unable to deliver the certificate called for in the contract to the buying broker or institution by settlement day. Settlement is now required on the fifth business day after the trade. Settlement on the fifth day already reflects some softening of delivery requirements. Prior to 1946, settlement was required in two days. In that year it was extended to three days, in 1952 to four days, and last year to five days.

In December of last year, broker fails rose to in excess of $4 billion. This was more than three days trading volume. Fails have decreased to just over $1.4 billion at the end of August as a result of a lot of hard work by everyone. That appeared enough in relation to the fall-off in trading volume over the last several months, together with other improvements, to warrant extending the trading day to within a half-hour of normal. That occurred just today. Fails nevertheless still constitute a significant aggregate liability. And sustained heavy market activity would undoubtedly overtax existing procedures. Clearly the system should be made capable of economically and efficiently handling the increased volume projected for the future, without an excessive amount of fails recurring.

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What is being done to attack the problem?

Two general routes toward a solution have developed. One is to eliminate or severely reduce the handling and movement of the stock certificate. The other, seemingly almost in the opposite direction, is to improve and facilitate its handling and movement. The two approaches need not be mutually exclusive, but emphasis on one has tended to shift attention from the other. Some combination of the two approaches probably is needed, because it does not seem likely that either one can be achieved sufficiently quickly to cancel out totally the value of the other.

Let me first refer to the approach that would eliminate or reduce certificate movement. The "certificateless society" is not necessarily a visionary concept. Yet, given the remarkable variety of American corporate life--big and little, the strong individualism of American shareholders and the deeply embedded provisions of state corporate and commercial law, it hardly seems likely that the certificateless society is around the corner. It is perhaps an ultimate goal to which the best legal and business minds should now be addressing their attention. (At the least, the time for any statutory requirement of a manual signature on the stock certificate is past.) But in the meantime the problem cries for earlier solution.

Short of eliminating the certificate is to reduce its movement. Such an approach is reflected in part in the stock exchange clearing houses. As I described earlier, by netting clearing member balances against each other, certificate movement is substantially reduced. The absence of any national clearing facility for over-the-counter transactions is a major deficiency, and the reason transactions in unlisted securities have contributed disproportionately to the fails problem. The NASD, the AMEX, and the regional exchanges are tackling this glaring need. But clearing facilities alone cannot bite deep enough into the certificate movement problem to solve it.

That has led to the depositary concept. The New York Stock Exchange over the past ten years has been working in the direction of a central certificate service that would be a depositary for securities listed on that exchange. The Central Certificate Service, or CCS, has actually been in limited operation since June of last year.

Exchange member firms on a voluntary basis have deposited securities with this central depositary. The certificates are registered in CCS's nominee name. Certificates not needed as part of CCS's working supply are placed in custodian banks. When this depositary will resolve its implementation problems and become mandatory, and when banks will become part of its operations (a participation that the growing institutional nature of the market would seem to necessitate), remain to be seen. There is the prospect that CCS may be expanded to include American Stock Exchange listed securities and possibly national over-the-counter securities. Recently, North American Rockwell in its report to the American Stock Exchange has suggested a variation of this concept with the creation of transfer agent depositaries combined with an expanded central netting and clearing system. It has also recommended that the audit function of the registrar be performed within the same bank that acts as transfer agent, reducing that movement. Thus, the rigorous systems logic of automation is emphasizing elimination of nonfunctional steps in the total process as well as automation of the functional steps and some better "interface" between the steps.

This brings us to the other approach, streamlining the movement of securities. Whether this is an alternative or complementary approach depends upon your estimate of how quickly and completely movement of certificates can be reduced by implementation of depositary arrangements. Estimates vary on that.

In June of this year, after extensive work, the SIP task force of the CUSIP Committee of the American Bankers Association recommended that the securities industry support the adoption of a man-machine readable stock certificate in the form of a standard size engraved punched card. The SIP task force considered and rejected retention of the present 8" x 12" size certificate. The Association of Stock Exchange Firms has spoken favorably of this proposal. The North American Rockwell report and the exchanges, and I understand some banks, have reservations about the punch card certificate. The SIP task force has developed a very precise recommendation for a standardized form of certificate that would seem to place the burden of substantial explanation on those who would defer decision, or who see the punch card certificate as not cost-justified, or who see it as inconsistent with a total system or a depositary concept.

The SIP group is also presently working on a standard transfer instruction form and a uniform securities transaction record to serve as an inter-bank/broker trade comparison form. Both of these documents would be man and machine readable. The need for standardized instruction forms is critical. Efficient utilization of the CUSIP securities number system, already completed, presupposes the interchange of standardized documents between firms.

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There are now more than a half dozen major, serious and informed studies, completed or in an advanced stage, on aspects of the operations underbelly of the securities markets. Those published have made constructive contributions. I referred earlier at several points to the overview study of securities industry operations by North American Rockwell. In addition, individual securities firms have had studies made of their own "back office" operations. I assume individual banks have had comparable studies made.

The securities paper problem has been with us in aggravated form now for more than two years. My profound belief and prayer is that the problem be solved by the private sector. This must be done soon. Decisions must be made now.

For this to be done, neither banks nor securities firms nor stock exchanges nor industry organizations can afford parochial viewpoints. I appreciate the delicacy and sacrifice that such an endeavor entails. The whole financial community has much to gain from efficient operations that meet the needs of the investing public. It has much to lose from not acting together now to achieve this. Progress is being made. But so far as I can see, in this very interconnected and interrelated area, without the full and organized cooperation of the leadership of both the banking and the securities businesses, what has to be done cannot be done.

Is it not time for the financial community as a whole to decide what that is, and to act on it? And is it not ironic that all this swirls around a piece of paper?

Thank you.