

REMARKS OF RICHARD B. SMITH, COMMISSIONER  
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"A Piece of Paper Revisited"

"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."

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"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 journey, 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."

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"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."

. . .

"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."

. . .

"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."

Now before I am accused of not having taken the trouble to prepare a new speech for you, I should tell you that I have just read to you verbatim a few selected lines from a speech I made sixteen months ago to the American Bankers Association (National Bank Division) at its annual meeting in September of 1969. In that talk<sup>1/</sup> I described in some detail the mind-boggling series of paper-pushing steps that banks and brokerage houses follow to complete the purchase and sale of corporate stock in our trading markets. I also described the resulting series of fails to deliver and to receive stock certificates, and the unacceptable level of recordkeeping differences, that securities firms underwent in the high volume trading of 1968 and early 1969. Finally, I described the three general routes being considered as solutions:

One was to eliminate the certificate, which I referred to as "an ultimate goal to which the best legal and business minds should be addressing their attention." I had then put that aside because of the general assessment that the time needed to achieve it would be too long for a problem crying for earlier solution.

The second route, which I considered a modification of the first, was to reduce certificate movement, by improved clearing facilities and central depositories. I referred to the absence of any national clearing arrangement for over-the-counter transactions as "a major deficiency", and commented that whether implementation of the New York Stock Exchange's Central Certificate Service depository would be successful "remains to be seen."

The third route, only seemingly in the opposite direction, was to facilitate certificate movement, principally by making it man-machine readable, by standardizing the accompanying transfer documents, and by continuing to improve back-office and transfer agent capacity, procedures and control.

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<sup>1/</sup>"A Piece of Paper", Published by The Section of Corporation, Banking and Business Law of The American Bar Association at 25 Business Lawyer 923 (April 1970).

What has happened in the intervening sixteen months?

Probably the most obvious thing was the drastic fall-off in trading volume and market prices. I hardly need to recount that to you.

During 1968, the height of the paper work crisis, the turnover rate on the New York Stock Exchange was 24% and average daily volume had risen to 13.0 million shares. In 1969 the turnover rate dropped to 20% and average daily volume declined to 11.4 million shares. By 1970 the turnover rate fell even further to 18% and, excluding December, average daily volume went down to 11.1 million shares. During an eleven week period in the summer of 1970 the average daily volume sank to 9.5 million shares. The fall-off in trading was mirrored in dropping price index -- the Dow Jones Industrial Average fell from the 1968 record high by a third to its low in mid-1970. Gauged by the fall-out in trading volume on the AMEX, the decline in transactions in the over-the-counter market was greater than on the New York.

The volume decline was bittersweet for the securities industry.

On the one hand, a large part of the problem of brokers failing to make securities deliveries on settlement day was abated. From a record \$4.1 billion in December 1968, fails to deliver fell to around \$800 million in the middle months of 1970. This is the lowest fails have been since 1966.

On the other hand, the decline in trading volume, and prices, also meant a loss of revenue to the industry. The reduction in income was so severe that in April of last year the Commission approved a New York Stock Exchange proposal to add a service charge to the brokerage commission. 115 firms left the New York Stock Exchange either by merger, resignation or liquidation mainly because of the losses they were experiencing. A large part of the losses of securities firms were due to the operational problems they experienced in 1967-69. The back office crisis of that period became the financial crisis of 1969-70.

Because of the financial adversities caused by the decline in market volume and securities prices, a number of broker-dealers could not meet the financial responsibility required of a broker-dealer. The New York Stock Exchange had to closely monitor and work with 139 member firms doing business with the public because of their financial problems. The financial pressure became so great that the Exchange had to take an active role in the

liquidation of 12 members and has not only fully committed its \$55 million Special Trust Fund but also had to seek membership approval to increase this fund to \$75 million.

Because the dimensions of the problem exceeded the capability of the self-regulatory mechanisms to cope with it, the Commission, the Treasury Department and the industry worked together to urge Congress to enact legislation to protect customers of broker-dealers that failed. In December, Congress enacted and the President signed the Securities Investor Protection Act. This Act creates the Securities Investor Protection Corporation (SIPC) which insures customer securities and cash up to \$50,000 but with a limit of \$20,000 for cash claims. This non-profit private corporation whose Board is appointed by the President and consists of representatives of the securities industry, government and the public will be funded by assessments on the securities industry and when necessary, a \$1 billion line of credit from the U.S. Treasury. SIPC is now in existence with a functioning Board of Directors.

A promising development in the past sixteen months for the industry's operations problems has been the formation of the Banking and Securities Industries Committee (BASIC). This organization was created in February 1970 and consists of three bank presidents representing the New York Clearing House banks, the presidents of the New York and American Stock Exchanges, the president of the National Association of Securities Dealers and a full time uncompensated executive director. Its purpose is to serve as a centralized inter-industry group to coordinate and oversee the implementation of the many recommendations proposed to deal with the paper work problem. At its formation, BASIC set four major goals for itself: (1) the development and expansion of a securities depository as the ultimate solution to the securities-handling problem; (2) adoption of legislation to allow banks to leave their securities in this depository; (3) development of an integrated system of securities documents, including the stock certificate, which are man-and-machine readable; and, (4) improving the securities settlement process, and particularly resolution of the "DK" or "don't know the trade" problem. Other organizations working on these same problems turned over their work to BASIC and disbanded. BASIC's work on "DK" problems and CUSIP numbering, among other areas, is encouraging.

Let me retrace with you what has happened to the three basic approaches to the certificate problem that I reported before you sixteen months ago.

There has been a good deal of discussion and study on the possibility of facilitating movement of the stock certificate. In June 1969 the SIP task force of the American Bankers Association CUSIP committee recommended that the securities industry support the adoption of a man-machine readable stock certificate in the form of a standard size engraved punch card. The Association of Stock Exchange Firms promptly endorsed this recommendation. However, in their September 1969 report to the American Stock Exchange, North American Rockwell questioned this approach and suggested, in its place, development of a system to handle securities transactions and including in such a system uniform man-machine readable documents that would move the certificate and effect settlement. In November 1969 both the New York and American Stock Exchanges expressed their support for the adoption of a system of man-machine readable documents for the securities industry including early conversion to a machine readable stock certificate. During the first six months of 1970 the only progress in this area was that the SIP task force completed and turned over to BASIC their final recommendation for a standard punchcard size man-machine readable instruction form.

Last September BASIC issued its discussion paper on the man-machine readable certificate comparing the punch card size document and the larger certificate with OCR lines on it. Comments were solicited and received from the banking and securities industries and from other business as well. Feasibility tests were conducted on the various proposals. Recently BASIC's executive director has been quoted as saying that automating the stock certificate is not a practical solution in light of the cost and time it would take compared to immobilizing certificates in a central depository such as the New York Stock Exchange's Central Certificate Service (CCS).

The second approach that I discussed in my prior speech was to reduce the movement of the stock certificate by the expansion of clearing facilities to the over-the-counter area and the increased use of securities depositories to effect deliveries rather than the physical movement of the certificate from seller to buyer. The NASD has formed a wholly-owned corporate subsidiary, the National Clearing Corporation, to establish and operate a nationwide clearing system. National Clearing Corporation envisions several regional clearing centers settling local transactions with inter-connections with other regional centers to settle inter-regional trades. They have already purchased the National Over-The-Counter Clearing Corporation, located here in New York, to be one of their regional centers. Work is now being done on establishing other regional centers. A pilot operation, using the

net-by-net settlement system developed by the Pacific Coast Stock Exchange and sharing their facilities, is planned to go into operation sometime later this year. The National Over-The-Counter Clearing Corporation has expanded its operations in the past sixteen months by including approximately 900 or more securities in its clearance and settlement operations.

The New York Stock Exchange's Central Certificate Service has expanded considerably so that it now includes 1300 of the 1800 issues on the New York Stock Exchange and 243 of the 960 eligible issues on the American Stock Exchange. At present about 1/32 of the total number of shares listed on the New York Stock Exchange have been actually placed in CCS. Member firms are beginning to use CCS more so that recently some 75% of the CCS eligible deliveries were made through the recordkeeping system of the service. Moreover, banks are now beginning to participate more fully in CCS to the extent of its delivery and receipt functions, although not in any full sense in its custody function. In May 1970 the New York state legislature enacted the FOSBI legislation to allow banks and trust companies acting as fiduciaries to hold securities by issue rather than by account thereby permitting to be merged into a few certificates the separate holdings of a number of accounts in the same security. This legislation facilitates bank participation in CCS. The New York clearing house banks are also participating in a CCS pilot lending operation with 50 clearing brokers.

The last of three possible solutions to the stock certificate problem is probably the most obvious--abolish it. What more forthright way to resolve essentially an inventory problem than to do away with the inventory. In my earlier talk I suggested that it was time for the best legal and business minds to consider this. This was not a new or revolutionary suggestion. Quite the opposite; to some extent it is a return to what existed years ago. Many early state corporation laws permitted the issuance of shares without any stock certificates being necessary. And it was not until the early part of the twentieth century, with the enactment by state legislatures of the Uniform Stock Transfer Act (starting in 1910) that the stock certificate became a negotiable document. Because the certificate is negotiable, its delivery by seller to buyer has become necessary for the consummation of a securities transaction.

Negotiability, of course, served important functions in a technologically simpler and (by today's standards) low volume environment. But it is not an eternal law that one must hold a negotiable instrument in order to have an equity interest or to

be a creditor of a corporation. The reification of a corporate interest into a certificate and the numerous controls and procedures that have attached themselves to this now valuable piece of paper led to the contemporary problems I have just recounted. There are a number of people who have spoken or written about the incongruity of tying modern securities markets to a piece of paper. Law professors Jolls, Steadman and Werner, economists Kendall and Robbins, and accountants Weinberg and Greenwald have all at various times advocated elimination of the stock certificate.

So where are we now? What have we accomplished in the four years that the securities processing and transfer problems have been with us?

We still have the same stock certificate that we had in 1967-- only now we have more of them. We handle these certificates in essentially the same way following the same procedures that were in use a decade or more ago. About the only changes have been the relatively limited utilization of CCS and NOTC. But this is only for certain brokers taking in certain securities. There is still no national over-the-counter clearing system. We still lack uniform standardized documents, man-machine readable or otherwise, for use in processing securities transactions. To date the only uniform document the banking and securities industries have been able to reach agreement on is the broker originated window ticket. The transfer process is still as labor intensive as ever. Only recently have major bank transfer agents agreed to reduce their detailed documentation requirements for "legal transfers" as permitted for some years by the Uniform Commercial Code. The registrar step is still required, although no longer necessary where there are independent transfer agents. It is a tribute to the people trying to operate such a system that it has worked to the extent it has for so long.

Progress is being made. But, Lord, how slowly it comes! All of us must be chastened by the complexity of the systems problem. There is no easy, quick panacea. It is not simply a matter of inefficient individual firm management, or inadequate automation, or lack of uniform standards, or scarcity of industry planning, or laxity of self-regulation, or reticence of government regulation, or foolish laws, or conflicting business objectives, or need for organized study, or absence of a cohesive structure and authority, or failure of leadership, or complacency and apathy. It is perhaps something of all these things in this frustrating world but fault is less important a consideration than constructive solution.

The time has come, it seems to me, to move beyond discussing the problems of the stock certificate and beyond seeking to adjust it to a world for which it is no longer suited. We have had sixteen months of grace in terms of lessened market volume. Now that volume appears to have resumed and even increased; yet there hardly exists today the capacity to handle sustained heavy volume. Fails at the end of December 1970 were at about the same absolute level, \$1.4 billion, as in September 1969 when I last spoke on the subject. Volume so far in 1971 is well above December. Over the last four weeks shares traded averaged 19.1 million a day on New York, comparable to the 1968 peaks. This past week the average was over 20 million shares. Combined New York and AMEX daily volume has climbed steadily since the first week of the year, from 18 to 22 to 23 to 25 to 27.5 million shares. And today, February 8, NASDAQ is scheduled to go on stream with a very likely boost to over-the-counter volume, and a far reaching impact on the future structure of all our markets.

While the volume is only beginning to show large individual investor participation and (so far) has not been cluttered with the special tender offer and first offering processing problems that existed in 1968, and while there has undoubtedly been significant improvement in capacities and forewarning systems during the past sixteen months, and while the formation of BASIC has been a marked step forward, and there has been the SIPC legislation to provide an improved ability to deal with individual firms--nevertheless, until the physical act of delivering the certificate can be dispensed with, the system must inevitably strain under sustained volume. The 20th and 19th centuries cannot exist at the same time. We are here talking about the stock certificate, a root cause that almost brought an important industry to its knees, and which continues to seriously compromise the successful functioning of the country's equity markets, perhaps the most important of our capital markets. Because of that it is a national problem calling for a national solution.

I have become convinced of three things over the past sixteen months.

First, that the only final solution to this constant threat, this Damocles sword hanging over the growth of our markets, is the rapid, systematic elimination of the stock certificate for publicly traded securities, or at the least the elimination of its negotiability and the various fiduciary, secured lending, taxation and bankruptcy requirements of physical possession, physical identification or physical segregation that attach to it. It must be replaced or superseded by some other evidence of ownership

compatible with automated processing of massive amounts of securities transactions. The stock certificate is not a thing-in-itself having some independent metaphysical existence, except such as man's laws have cloaked it with. And so law must be brought to conform to the operational needs of the securities and banking industries who are earnestly trying to serve public investors.

I do not underestimate the complexity of the task. The negotiable stock certificate has become embedded in the public consciousness and in various fields of law and regulation--corporate, commercial, securities, fiduciary, creditors rights and even tax. But that was because it initially served an important economic function in facilitating the formation of capital for corporate enterprises and in providing certainty in the transfers of ownership interests in those enterprises. It no longer does that for publicly traded corporations. It does the reverse, by making the achievement of that function far more cumbersome, expensive, error prone and time-consuming than it need be.

That leads me to my second conclusion, that elimination of the stock certificate is a task requiring a level of attention, structure and effort beyond what it is now receiving. I say this with due regard for the tremendous efforts made and being made by BASIC, the stock exchanges, CCS, the clearing house banks, the NASD, the ASEF, the ABA, the IBA and others. Their work has been important and the studies conducted by them invaluable. Those studies indeed have brought all of us to a comprehension of the entire securities processing system and the requirement that any part of it, such as the stock certificate, must fit the needs of the whole system, must further the system's objective. It makes no sense to try to fit a system around an outmoded, nonfunctional instrument simply because it is encased in legal requirements designed for a very different environment.

BASIC, the most integrative of the groups and consequently the most promising, has apparently determined to concentrate its efforts on expanding CCS to include the major financial institutions in addition to brokerage firms so as to reduce certificate movement among them. That is a sensible objective it seems to me. To go on to elimination of the certificate is consistent with expansion of the depository concept. I would submit it is an improvement on immobilizing certificates in the depository because it reaches those unable to participate in it and would simplify the work of the depository organization. Given the desirability of BASIC pursuing its depository objectives vigorously, it would not seem to me to have the additional resources to proceed now on a project to eliminate the negotiable certificate for publicly traded securities.

And that brings me to my third conclusion, that federal legislation amending the Securities Exchange Act of 1934, and perhaps other federal statutes, will be required.

In the early part of this century the nation suffered from the difficulty of money not being able to move in a timely flow from one part of the country to another. That difficulty among others led to the 1914 federal legislation creating the Federal Reserve System. In the 1920s the nation suffered from securities offerings made with inadequate or misleading disclosure by issuers and underwriters and from securities trading in manipulated markets. Those problems among others led to the federal securities legislation presently administered by the Securities and Exchange Commission.

More recently (as I described earlier), the nation suffered from the financial weaknesses of broker-dealers firms. In response, federal legislation was enacted last year to insure customers' securities accounts and to increase regulation of the financial condition of broker-dealers. Those weaknesses in large part were traceable back to the operations problems. Those problems in turn reflected in large part the inadequacy of a system bottomed on physically delivering securities certificates in high volume markets.

The existence of Federal law recently allowed the Federal Reserve System to create and transfer many Government securities nationally by bookkeeping entry without the actual issuance of a certificate. Further, because the pledging mechanism was created under Federal regulations adopted pursuant to this law, the supremacy clause of the Constitution made these rules on pledging superior to the filing provisions in the state adopted Uniform Commercial Code.

I for one have not come quickly to the view that there should be federal legislation. Those who know my views in other areas, know that my first instinct is not to supercede state laws with federal legislation unless absolutely necessary. But just as federal law was necessary to regulate the conduct of trading in the national securities markets, so now federal law is necessary to regulate the conduct of processing and completing securities transactions effected in those markets. This latter function integrally affects the ability of the markets to function and the capacity of intermediaries in those markets to service public investors.

I urge therefore the creation of a nonpolitical national commission, or some other specially created group that is adequately staffed, with the single purpose to consider and draft federal legislation that would provide for a securities processing system capable of handling securities transactions in modern markets. Such a system would, it seems to me, necessarily do away with the negotiable stock certificate as we know it. This "ultimate goal" will not come in time unless systematic work is begun now by a body that can speak authoritatively to the Congress as the legislation is considered. The body should be composed of experts from all aspects of securities processing--legal, tax, accounting, banking, brokerage, regulation, automation, and operations--who are dedicated to solving the problem and who take the most comprehensive view of it.

This is a national problem of major importance and complexity, which will have an impact on numerous state laws. We cannot wait for these questions to be resolved in the legislatures of fifty states, although the legitimate interests of the states must certainly be preserved. But the compelling need for focused attention now, for intimate knowledge of the technology and the markets, and for uniformity require that the solution be national in scope. Unless such work is begun full time, the lack of rapid progress seen these last sixteen months will continue. That cannot be allowed to happen because the markets will not wait.

Thank you.