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Inter-Regional Clearance of Securities – 1980 Horse and Buggy or Jet Age?

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THE BACK OFFICES of West Coast investment houses have gradually emerged from the welter of paper work that devastated the industry during 1968 and 1969. To a great degree, progress in controlling the paper work has been made because the volume of trading has receded from the days when twenty million shares a day were traded on the New York Stock Exchange. Forward-looking operations managers should now raise the question. How are we to avoid another paper-work snarl if volume returns to its former levels again? As we enter the new decade of the '70s, it may now be appropriate to consider where the back-office half of the industry may be when we finish this decade and enter the decade of the '80s.

CRITICAL OPERATIONAL PROBLEMS

To look for the possibilities for significant improvement in the next ten years in the operational aspects of the brokerage industry, perhaps we should examine briefly the more critical problems facing operations managers on the West Coast today. Some of these problems are geographic, others are a result of custom, past and present, rules and regulations of various regulatory bodies, and the relationships of West Coast firms to other members of the industry. As I see them, the essential problems today are:

- Time/value differences arising from geographic distance from New York. The value of securities in transit must be financed, usually by the delivering broker.
- Many securities actively traded on the West Coast do not transfer locally. Securities not in good form for delivery must be financed while in transfer. Delay in delivery is compounded by time required for distant transfers.
- Cost of moving securities east/west and west/east places West

Coast brokers at an economic disadvantage. Such cost should be deemed to include the actual or imputed cost of interest while securities are in transit. Brokers operating through a New York correspondent find that they are charged on the shipment date for the value of securities shipped west and do not receive credit for securities shipped east until receipt in New York, etc.

- An inadequate degree of control exists over third parties in other cities (banks, correspondents) acting for the account of West Coast brokers. Deliveries for institutional customers may be refused by the receiving bank for a variety of reasons, causing delay in collections. The situation has been mitigated recently by rule changes that now require acceptance of partial deliveries in quantities as confirmed to the customer.
- If securities are shipped from east to west, "fails to deliver" and "fails to receive" are inflated because of delivery lags, and then must be reshipped east, etc. Such circumstances are most notable in over-the-counter transactions. With the current capital charges for old "fails to deliver," any delay in delivery that results in a capital charge requires appropriately greater net capital to operate the business.
- Long-range training programs for back-office clerical personnel must be instituted. Hiring employees from other brokers does not add to the total available brokerage work force; it may adversely affect many houses, particularly in markets of rising volume when pirating of employees, in one form or another, tends to occur.

In the solution of these problems it is essential to know the *real* as opposed to the *apparent* problem. It is sometimes all too easy to attempt to treat the symptoms without identifying the root cause.

PAPER-WORK SNARL—ITS CAUSES

The ostensible cause of the late lamented paper-work snarl was simply more volume of trading than the industry was geared to clear. A closer analysis of the underlying causes of the paper-work snarl indicates some of those areas that operations managers should be viewing critically in their long-range planning:

- The customs of the industry, originating in times of lesser volume, are by present-day standards, burdensome and inefficient.

- Transfer agents, not always being located in each financial center, tend to bog down as volume increases, becoming in many cases the key bottleneck in the chain of events in the clearance of securities.
- As volume of transactions increases, additional clerical personnel are employed. The tendency is to hire fewer qualified persons as the tempo increases. In the absence of adequate training programs, untrained personnel commit errors that only add fuel to the fire.
- Cost accounting has not been sufficiently emphasized in brokerage accounting and, as a consequence, most brokers are unable to determine, even in a general way, what the costs are to render a particular service. One result is that business decisions are made in a vacuum, without the benefit of any worth-while cost accounting information.

CONTINGENCY PLANNING

Another thing that must be done is to institute contingency planning—developing new ideas on how to do it, if . . . . One topic we hear about from time to time is the suggestion, in one form or another, to eliminate the stock certificate. What we haven't learned much about yet is how security transactions would be cleared in a certificateless society.

Machine-Readable Stock Certificate

There are several possibilities. A few decades ago, when many business transactions were settled by the payment of legal tender, contracts in some cases even specified payment in gold! Today we seem to survive in a business atmosphere in which a substantial payment in currency would evoke great surprise. Substantial payments in currency today must be reported. The check is the thing today; banks clear their checks through a clearinghouse or the Federal Reserve System. Magnetic ink seems to have made the non-par bank and its checks a relic of yesteryear. Perhaps a machine-readable stock certificate could be cleared like a check, through local clearinghouses in each financial center. But mechanical difficulties may make such certificates impracticable to use.

If the fifty state jurisdictions could ever agree on legislation to eliminate the present form of stock certificate, perhaps each shareholder could have an "account" with the transfer agent for the shares and such shares could be transferred by writing a "check" to the buyer.

Bearer Shares

Another alternative that should not be overlooked is the return to the use of bearer shares. Think of the dividend-claim problems that could be eliminated by the use of bearer shares! Consider the increased work load that the issuance of debt securities in registered form only has caused brokers' transfer departments. Perhaps bearer securities weren't so bad after all!

Movement of Securities

Clearing securities could be improved in the years to come if all security clearinghouses acted in a manner similar to the Federal Reserve System in the clearance of checks. The physical movement of many securities could be reduced between cities to the extent that transactions could be netted out among the members of a particular clearinghouse, just as the Pacific Coast Stock Clearing Corporation effects a netting of money and securities among its clearinghouse members. Can you visualize a daily shipment from Los Angeles to New York of only the net quantity of shares sold to brokers clearing through the New York Clearinghouse? Some rules of the several stock exchanges might have to be bent to fit such an arrangement, but for the future, we need the most efficient method of clearing, at the least cost, that can be obtained.

Many of you are familiar with the technique of "moving" U.S. Treasury securities between Federal Reserve Banks by wire transfer. Consider whether certain actively traded stocks could similarly be "moved by wire" if appropriate floating supplies of stock could be held in each of the clearinghouses in the country. Aside from possible reduction in transit costs, the reduction of risk of loss has additional appeal, and those brokers who experienced delay in delivery because of storm conditions at John F. Kennedy Airport during the winter of 1969-1970 will also appreciate the time/value problem that wire transfers might solve.

Modification of Transfer Facilities

Reflecting on the problem created by transfer agents during the recent back-office paper-work crunch, when transfers took two or three weeks to accomplish, some modification of the existing transfer facilities seems required within the next ten years if:

a) stock certificates are not eliminated, and
b) the industry is to "gear up" appropriately for substantially greater volume in the next decade.

More transfer agents for all securities are going to be needed—perhaps transfer agents accomplishing security transfers in each city that has a clearinghouse. Mechanization, machine-readable certificates, and increased ability to handle widely fluctuating volume may provide a solution to the transfer bottleneck.

CUSTOMARY FREE SERVICES

In the next decade some of the concepts of handling a customer's account may change drastically. From time to time there has been some comment concerning unbundling of the fees earned by brokers. Many services that brokers perform for their customers are provided as a "customary" service, such as research, safekeeping, dividend and interest collection. Services such as these are not the essential services of a broker, but over many years have become ingrained in the customs of the business. Many brokers would dearly like either to get out of the safekeeping business or to make a charge for the service, but competition prevents a change of custom. If a broker had an adequate cost accounting system, he could determine what safekeeping service costs were. To increase the probability of getting a later sale and reinvestment of the proceeds, there is always pressure from the registered representatives to retain custody of the customer's stock. As the economic pressure through rising costs comes to bear on each broker, the ability to continue to render "free" services to customers must be continually re-evaluated.

SPECIALIZED SERVICE BUREAUS

Many functions now performed by the broker could be provided by specialized types of organizations. For example, brokers now handle certificates twice on a "transfer and mail" type of purchase. Perhaps, in years to come when transfer into the customer's name has been completed, transfer agents customarily will mail securities direct to the customer. Many years ago brokers would have been aghast at the suggestion that several brokers pool their bookkeeping. Today, service bureaus of many types provide bookkeeping service for brokers on a fee basis. When cost and efficiency can be improved we can expect other functional services now performed by brokers to be "farmed out."

RULES, REGULATIONS, CUSTOMS

Many problems now besetting the brokerage industry result from rules, regulations, and customs that are outmoded. There have been several in-depth system studies of the industry, its operational problems, and proposed solutions. In my opinion, some of these studies treat the symptoms and not the causes; some may be economically unworkable; and others take as premises some assumptions that realistically there can be no hope of achieving in our lifetime.

INTER-REGIONAL CLEARANCE

One aspect of inter-regional clearance of securities merits special comment. A common type of security transaction is illustrated in a purchase by an institutional customer with delivery against payment, characteristically at a New York City bank, which acts as custodian for safekeeping for the buyer. One segment of the institutional market—insurance companies—presents some particularly thorny problems. Much missionary work must be done by the brokerage industry in this regard, since the hidebound rules that structure the clearance of security transactions for insurance companies are the rules of the state insurance commissioners and the states they oversee. Any long-range simplification of clearance of transactions with insurance companies must come to grips with the changes in statutes that may be required to accommodate any automated, depository-oriented securities clearance systems.

LONG-RANGE AND CONTINGENCY PLANNING

To solve many of the underlying problems that continue to beset the industry, long-range planning is essential. Each firm and each operations manager must consider long-range planning. If undue effort continues to be directed to putting out small fires, they will probably still be with us in 1980.

In seeking solutions to current vexing operational problems, contingency planning should consider the alternatives that have been suggested by the various operational studies. Possible alternatives to the present form of securities are machine-readable certificates, the certificateless society, bearer shares, and depository systems. Eventually, movement of securities may be simplified by clearance between clearinghouses, including perhaps a system of automated securities movement by "wire."

The industry now needs in each financial center more flexibility in the use of transfer agents. The transfer bottleneck is one that can be resolved within the framework of existing rules; the industry, however, can probably afford some nominal increase in cost for the relative increase in efficiency.

The rules for handling customers' orders and accounts may require extensive revision. Perhaps the size of a round lot may go as high as 1000 shares and any lesser order treated as an odd lot; trades may be fully automated, and the accounting and reporting "locked-in"; peripheral customer services may be farmed out to specialized organizations.

CONCLUSION

In summary, the clearance of securities by West Coast brokers must be simplified by eliminating present inefficient methods for security clearance that place the West Coast brokers at a relative economic disadvantage as compared with brokers in other parts of the country. Inter-regional clearance of securities should be reduced, so far as practicable, to minimum physical movement of securities among regional clearinghouses. The ultimate acceptance of a substantially certificateless society (in this country, at least) hinges on the degree of success that the brokerage industry may achieve in gaining the acceptance of the concept by bankers, insurance commissioners, other regulatory bodies, and ultimately, by the investor.