SECURITIES DEPOSITORIES AND REVISION OF THE UNIFORM COMMERCIAL CODE

I. INTRODUCTION

During the late sixties the securities industry suffered a series of spasms popularly referred to as the "paper crunch." Processors of securities transactions found themselves literally drowning in a flood of paperwork generated by an ever-expanding volume of trading. Brokerages floundered and stock exchanges were forced to cut back on trading hours.[1] The immediate public outcry resulted in Congressional investigation, partially remedial legislation,[2] and a direction to the Securities and Exchange Commission to discover the source of the problem.[3] Discovery of the villain was immediately forthcoming.[4] The securities certificate was identified as the source of the evil, its continued existence condemned, and its elimination suggested as sound public policy.[5]

Discerning observers, however, pointed out that the need for certificates was more easily eliminated in theory than in the real world of the financial community.[6] An alternative interim proposal soon emerged. This plan called for the physical immobilization of certificates with transactions to be completed by bookkeeping entry rather than through actual delivery of certificates. This was to be accomplished by means of a system of interconnected securities depositories. These depositories would accept certificates for deposit much as a bank accepts monetary deposits. Transactions between depositors could then be expeditiously consummated by a simple series of bookkeeping entries.[7]

As a practical matter, the feasibility of the private development of such a system would be dependent upon the willingness of financial institutions to participate as depositors.[8] At least arguably, such participation would not be

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1 *See generally* S. Robbins, W. Werner, C. Johnson, A. Greenwald, *Paper Crisis in the Securities Industry: Causes & Cures*, 4 *Study of the Securities Industry, Hearings before the Subcomm. on Commerce & Finance of the House Comm. on Interstate & Foreign Commerce*, 92d Cong., 1st Sess. 2159 (1971) [hereinafter cited as *House Hearings*]; REPORT OF THE SUBCOMM. ON COMMERCE & FINANCE OF THE HOUSE COMM. ON INTERSTATE & FOREIGN COMMERCE, SECURITIES INDUSTRY STUDY, H.R. REP. No. 92-1519, 92d Cong., 2nd Sess. 3 (1972).

2 Securities Investor Protection Act of 1970, P.L. 91-598 (1970).

3 *Id.* § 11(h).

4 *See* S.E.C., STUDY OF UNSAFE & UNSOUND PRACTICES OF BROKERS & DEALERS (1971).

5 *Id.*; Werner, *The Certificateless Society: Why and When?*, 26 BUS. LAW. 605 (1971).

6 Steadman, *The Lender in the Certificateless Society*, 26 BUS. LAW. 623 (1971); Clark, *The Fate of the Negotiable Stock Certificate—UCC Immobilization or SEC Elimination*, 5 U.C.C.L.J. 83 (1972).

7 Potter & McLean, *Introduction to Book Entry Transfer of Securities*, 28 BUS. LAW. 209 (1972).

8 With total institutional participation, estimates of the total percentage decline of certificate movements vary from 25% to 74%. *See* 2 *Securities Industry Study, Hearings before the Subcomm. on Securities of the Senate Comm. on Banking, Housing & Urban Affairs*, 92d Cong., 1st Sess. 288 (1972) [hereinafter cited as *Senate Hearings*], *but see*, *House Hearings* at 1838.

forthcoming unless they were granted a "piece of the action" and a voice in the administration of the depositories (ostensibly to insure the security of their deposits).[9] However, institutional participation in the ownership and control of securities depositories was blocked by Section 8-102(3) of the Uniform Commercial Code which limited the ownership of capital stock in "clearing corporations"[10] to national securities exchanges or associations registered under the Securities Exchange Act of 1934.[11]

An amendment to the Uniform Commercial Code altering this situation has been passed in several states[12] and is being actively pursued in all others.[13] The text of the proposed uniform amendment is as follows (bracketed materials have been deleted; italized material has been added):[14]

> (3)-A "clearing corporation" is a corporation [all]
> (a) *at least ninety per cent* of the capital stock of which is held by or for *one or more persons (other than individuals), each of whom*
> *(i) is subject to supervision or regulation pursuant to the provisions of federal or state banking laws or state insurance laws, or*
> *(ii) is a broker or dealer or investment company registered under the Securities Exchange Act of 1934 or the Investment Company Act of 1940, or*
> (iii) *is* a national securities exchange or association registered under a statute of the United States such as the Securities Exchange Act of 1934, *and none of whom, other than a national securities exchange or association, holds in excess of twenty per cent of the capital stock of such corporation; and*
> *(b) any remaining capital stock of which is held by individuals who have purchased such capital stock at or prior to the time of their taking office as directors of such corporation and who have purchased only so much of such capital stock as may be necessary to permit them to qualify as such directors.*

It is the purpose of this Note to examine the circumstances surrounding this proposed uniform amendment in the hope of aiding in the evaluation of the advisability of its passage.

II. Securities Depositories

At the present time depositories are in operation in New York and San Francisco with another in the planning stage for Chicago.[15] The proposed amendment is most significantly related, however, to the history and future of the New York depository. The Central Certificate Service (CCS) is a

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[9] *See Senate Hearings* at 380.
[10] The term "clearing corporation" includes securities depositories.
[11] 15 U.S.C. § 78 (1971).
[12] Connecticut, Delaware, Hawaii, Kentucky, Maryland, New York and Virginia have passed this amendment. Potter & McLean, *Introduction to Book Entry Transfer of Securities*, 28 Bus. Law. 209 (1972).
[13] *See, e.g., Senate Hearings* at 378, which contains the text of a letter which was sent to all state securities commissioners advocating the introduction and passage of this amendment.
[14] *Senate Hearings* at 389.
[15] *Id.* at 379.

wholly-owned subsidiary of the New York Stock Exchange (NYSE). Its systems were originally designed in the early sixties but were not implemented until 1968.[16] Presently CCS accepts deposits of NYSE, AMEX[17] and selected OTC[18] issues. It is a "depository" in name only, however. "Deposited" securities, registered in the name of a common nominee, Cede & Co.,[19] are actually physically kept in the vaults of certain New York banks.[20]

Undoubtedly spurred on by a fear of federal intervention into security transfer operations,[21] the New York financial community has proposed a plan for the creation of a private national securities depository system. The proposed Comprehensive Securities Depository System (CSDS) would utilize CCS as its foundation. A tentative plan to accomplish this goal has been widely promulgated by the Banking and Securities Industry Committee (BASIC) in the form of a "Memorandum of Understanding"[22] which commits its signatories to the task of establishing the CSDS.

The membership of BASIC seems to reflect almost solely the interests of the New York financial community[23] and opposition to its plans seems to be largely arising out of a lack of consultation with other regional interests.[24] However, regional opposition has not taken the form of a competing proposal, and CCS has already begun to expand its operations beyond the New York area.[25]

The proposed amendment was suggested by BASIC and is being actively pursued by them.[26] It is alleged to be vital to their proposals. Their interim plan would indeed be impossible without it. This plan calls on the NYSE to "spin off" ownership of CCS as a first step toward the formation of CSDS.[27] This plan has recently taken concrete form with submission to the SEC by the NYSE of a complete plan for the divestiture and reorganization of CCS.[28] It is to become a trust company organized under New York banking law, with

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16 *Id.* at 110.

17 American Stock Exchange.

18 Over the Counter; *see* REPORT OF THE SUBCOMM. ON SECURITIES OF THE SENATE COMM. ON BANKING, HOUSING & URBAN AFFAIRS, SECURITIES INDUSTRY STUDY 92d Cong., 2d Sess. 14 (Comm. Print 1972).

19 *Id.*

20 *Topic: When Securities Paper Gets Fed Into a National Network, Who Will Control The Switches?*, Sec. Reg. & L. Rep., No.142, B-6 (1972).

21 *See, e.g.*, National Securities Act, S. 2551, 92d Cong., 1st Sess. (1971).

22 *Senate Hearings* at 364.

23 The members of BASIC are: John M. Myer, Jr., Chairman (former Chairman of Morgan Guaranty Trust Company); Herman W. Bevis, Executive Director (former Senior Partner of Price Waterhouse & Co.); Richard B. Howland (Executive Vice President, New York Stock Exchange); Paul Kotton (President, American Stock Exchange); Gordon S. Macklin, Jr. (President, National Association of Securities Dealers, Inc.); William H. Moore (Chairman, Bankers Trust Co.); Walter B. Wriston (Chairman, First National City Bank).

24 *See Senate Hearings* at 269.

25 The CCS has recently established "branch" depositories in Richmond, Va., Hartford, Conn., and Dallas, Texas. Wall St. J., Jan. 29, 1973, at 24, col. 6.

26 *See Senate Hearings* at 378.

27 *Id.* at 364.

28 S.E.C., Exchange Act Release No. 9849 (Nov. 8, 1972), CCH Fed. Sec. L. Rep., ¶ 79,078 (1972).

membership in the Federal Reserve System an eventual goal. In addition, pending passage of the amendment here under discussion, the ownership of CCS is to be taken over by "qualified" depositor institutions.[29] Broker-dealers, though "qualified," are specifically excluded from holding an ownership interest in the "new" depository. It is also interesting to note that the proposed corporate charter would prohibit the depository from performing the functions of transfer agents.

III. Regulation of Securities Depositories

Congressional concern, generated by the "paper crunch," has yet to subside, and potential federal legislation will inevitably have a broad impact in this area. Congress adjourned last session without having reconciled the disparities between House and Senate versions of "back office" bills which would have dealt with the regulation of securities depositories. Legislation similar to these bills may yet become law. Thus, their contents must be examined for their relevance to the UCC amendment.

The furor of the late sixties resulted in the Securities Investor Protection Act of 1970.[30] Among its provisions was a direction to the SEC to study the problem and find some answers.[31] The results were a study report and a proposal for legislation. This legislation, essentially a request for additional SEC regulatory authority, was submitted to Congress.[32] Eventually, following numerous hearings and substantial revisions, a House version[33] and a Senate version[34] were passed by their respective houses. These bills, though they varied greatly in many respects, would have substantially the same effect on securities depositories.

Depositories would be regulated by the "appropriate regulatory agency." This term was carefully defined as:[35]

> (A) the Comptroller of the Currency, in the case of a national bank or a bank operating under the Code of Law for the District of Columbia, or a subsidiary thereof other than a nonbank subsidiary of a bank holding company;
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> (B) the Board of Governors of the Federal Reserve System, in the case of a State member bank of the Federal Reserve System, a subsidiary thereof, a bank holding company, or a nonbank subsidiary of a bank holding company;

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[29] "Qualified" institutions under the proposed amendments would include banks, insurance companies, broker-dealers, stock exchanges and the NASD.

[30] P.L. 91-598 (1970).

[31] *Id.* § 11(h).

[32] S.E.C., Proposed Securities Transaction Processing Act of 1972 (March 22, 1972).

[33] Securities Processing Act, H.R. 16946, 92d Cong., 2d Sess. (1972); *see also* H.R. Rep. No. 92-1537, 92d Cong., 2d Sess. (1972). This bill has been replaced this session by H.R. 5050, 93d Cong., 1st Sess. (1973).

[34] National Securities Transfer System Act, S. 3876, 92d Cong., 2d Sess. (1972); *see also* S. Rep. No. 92-1009, 92d Cong., 2d Sess. (1972).

[35] National Securities Transaction Processing Act, S. 3876, 92d Cong., 2d Sess. 925 (1972).

(C) the Federal Deposit Insurance Corporation, in the case of a bank insured by the Federal Deposit Insurance Corporation (other than a member of the Federal Reserve System) or a subsidiary thereof other than a nonbank subsidiary of a bank holding company; and

(D) the Commission, in the case of all other transfer agents and all other clearing agencies.

All securities depositories would, however, without regard to the identity of the "appropriate regulatory agency," be required to register with the SEC, which would have the power to review and amend their rules of operation. Enforcement of such rules, however, would be left to the "appropriate regulatory agency." It is also interesting to note that the Senate version also called for the eventual elimination of the stock certificate and for the creation of a unified national system for the handling of securities transactions.

IV. Regulatory Problems Created By the Proposed Amendment

The federal "back office" bills discussed above represent, however, at best an uncertain factor. The regulation of securities depositories in their absence must also be considered in evaluating the proposed amendment. SEC authority over existing depositories presently exists because they are subsidiaries of stock exchanges. Under the BASIC proposal, the CSDS would, as a member of the Federal Reserve, presumably come under the authority of its Board of Governors. The Board of Governors would also be the "appropriate regulatory authority" under the federal "back office" bills. However, absent such legislation, SEC oversight and authority over depository rules would apparently be lacking.

The proposed amendment and BASIC plan exacerbate this situation. Of the proposed "owners" of the CSDS only the National Association of Securities Dealers (NASD) is subject to SEC regulation.[36] SEC regulation of the CSDS, if it existed at all, would be extremely tenuous.

This result could perhaps cause some difficulty. Bank regulators may be ill-prepared to combat problems which do not parallel those encountered with respect to money or federal securities deposits.[37] In addition, the bank regulators' conception of the public interest may tend to begin and end with a guarantee of the financial stability and integrity of the banks themselves. Would they fully consider *all* of the interests of the investing public? In this respect, continued SEC regulation would appear desirable.

On the other hand, the day-to-day operations of securities depositories, to the extent that they closely resemble those of banks, might best be left in the hands of bank regulators. Particularly in the field of guaranteeing depositor se-

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[36] Under 15 U.S.C. § 78o-3 (1970).

[37] The Federal Reserve System has, however, been for some time in the business of book entry transfer of treasury securities. *See*, Rassnick, *Certificateless Deposits and Transfers of Securities in the Federal Reserve System*, 26 Bus. Law. 611 (1971).

curity, bank regulators probably have the most extensive expertise. Depositors (particularly banks), insecure in the hands of the SEC exploring a new regulatory area, could be reassured by the solid presence of reliable bank regulators.

The federal bills, by combining the best of both regulatory schemes, would appear to have great merit. However, the proposed amendment, without passage of these bills, would seem to allow complete divestment of SEC authority. This should represent a strong reservation to its passage.[38]

The possibility that federal regulation of securities depositories could be completely divested by the proposed amendment has been suggested to its proponents. The problem was specifically raised by a member of the Stock Certificate Subcommittee of the Corporation Law Committee of the Delaware Bar Association, Mr. Bruce M. Stargett, while the amendment was being considered for passage in that state.[39] Mr. Stargett even perceived the possibility of a securities depository which could avoid effective regulation completely when he stated: "The idea of somebody being able to set up a UCC-blessed clearing corporation by creating five insurance companies incorporated and under the jurisdiction of a friendly insurance commissioner appeals to me not at all."[40] Support for the Delaware amendment was well-organized,[41] however, and its passage was accomplished despite Mr. Stargett's objection.[42]

The advocates of the amendment dismissed the problem of non-regulation with the somewhat disingenuous argument that the problem was more illusory than real. They argued that the substantial organizations likely to be involved in securities depositories would be unlikely to be involved in fraud, and that, in any case, the SEC could shut down any depository by not allowing those under its authority to deal with the villain.[43] This answer merely evades the real issue, however. Effective regulation requires more than the mere prevention of fraud and gross malfeasance. The best possible total regulatory system must be insured if securities depositories are to have their greatest possible beneficial effect on the securities industry.

V. Conclusion

The objection of a failure of federal regulation remains at the present time unanswered, and the effects of the proposed amendment would therefore seem to be variable as a function of the nature of the eventual federal legislation.

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[38] The S.E.C. as a practical matter would still retain a tremendous leverage in this matter even if the amendment became effective. It could maintain its hegemony simply by refusing permission for the NYSE to "spin off" the CCS.

[39] *See Clearance and Settlement of Securities Transactions, Hearings before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs*, 92d Cong., 2d Sess. 819-22 (1972).

[40] *Id.* at 821.

[41] *Id.* at 812-23. Among those endorsing the passage of the amendment were: the Securities Exchange Commission, the Permanent Editorial Board for the Uniform Commercial Code, the American Bankers Association, the Securities Investor Protection Corporation, and the Securities Industry Association.

[42] See Del. H.R. 652, 1972 Reg. Sess. (approved June 30, 1972).

[43] *Supra* note 39, at 823.

Therefore, until Congress has made its final pronouncement, it is impossible to rationally evaluate the potential effects of the amendment on the securities industry. The ramifications of this issue go far beyond the question of who is to own the securities depositories. It is clear that the securities transaction process will eventually be controlled nationally by a single integrated organization.[44] Such a monolith could be extremely profitable to the interests which controlled it,[45] and its effective regulation would be essential to a healthy securities industry. The securities depositories, and especially the proposed CSDS, are critical in this area. The CSDS represents a crucial first step and its formation may soon become a *fait accompli.*

The immediacy of the need for a rational evaluation of the issues surrounding securities depositories is clear. The determination of their ownership and control, once made, must inevitably create a tenacious vested interest which would strongly color all future decisions. This determination should be made only upon the rational weighing of all alternatives.

Immediate revision of the UCC may make such a rational weighing impossible. Possible federal action represents a critical and unpredictable element at this time. Also, an immediate amendment clears the way for immediate action. This action, however, has perhaps not been fully considered,[46] and may have certain detrimental and irreversible effects. At the very least, until a "back office" bill is made public law, the proposed amendment should be held in abeyance.

The magnitude of the "paper" problems in the securities industry and the pressing need for reform are apparent. These very facts, however, militate most clearly for only the most well-considered action. Precipitate, unilateral and unreasoned action, rather than leading to timely improvements, can only serve to exacerbate the problem.

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[44] Such as was proposed in the National Securities Act, S. 2551, 92d Cong., 1st Sess. (1971).

[45] *See, e.g.*, the discussion of investment and return in a letter from the President of NASD to the President of NYSE. *House Hearings* at 1428.

[46] There has, for example, been no affirmative counter proposal as of yet representing the interests other than BASIC.

CONSTITUTIONAL LAW—EQUAL PROTECTION—A PRIMARY ELECTION FILING FEE SYSTEM UNDER WHICH CANDIDATES BEAR THE COST OF CONDUCTING THE PRIMARY ELECTIONS AND WHICH PROVIDES FOR NO REASONABLE ALTERNATIVE MEANS OF ACCESS TO THE BALLOT, VIOLATES THE EQUAL PROTECTION CLAUSE OF THE FOURTEENTH AMENDMENT.—*Bullock v. Carter* (U.S. Sup. Ct. 1972).

Texas law required candidates in the state's primary election to pay a filing fee as an absolute prerequisite to the candidate's particiaption in the election.[1] Candidates were assessed a portion of the cost of the primary election at fees ranging as high as $8,900. No alternative procedure was provided for potential candidates unable to pay the required fee to appear on the primary ballot by petition or otherwise. Write-in votes were not permitted in primary elections for public office.[2] In a consolidated action by several excluded candidates unable to pay the required fees, several parties intervened as voters desiring to vote for the excluded candidates. A three-judge federal district court declared the filing fee system unconstitutional.[3] On direct appeal, the United States Supreme Court *Held*, affirmed. A filing fee system which requires candidates to finance the cost of conducting primary elections and provides no reasonable alternative means of access to the ballot contravenes the equal protection clause of the fourteenth amendment by establishing a system which utilizes the ability to pay as a criterion for appearing on the ballot. Such a system thereby excludes otherwise qualified candidates who cannot meet the required pecuniary standard and deprives a portion of the voters of the opportunity to vote for candidates of their choice. *Bullock v. Carter*, 405 U.S. 134 (1972).

The constitutionality of state primary election filing fees[4] has in the past been challenged and upheld in state courts as a reasonable exercise of the states' power to regulate elections.[5] The cases turned on the reasonableness of the fees imposed. More recent election cases[6] in federal courts have more

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[1] *See* TEX. REV. CIV. STAT. art. 13.07(a), 13.08, 13.08(a), 1315 (Vernon Election Code 1967).

[2] TEX. REV. CIV. STAT. § 13.09(b) (Vernon Election Code Supp. 1972-73).

[3] Carter v. Dies, 321 F. Supp. 1358 (N.D. Tex. 1971).

[4] For a short historical account of the development of filing fees as a part of the Progressive Movement see Note, *The Constitutionality of Candidate Filing Fees*, 70 MICH. L. REV. 558, 558-59 (1972). It is suggested that filing fees have come under increasing attack because of a change in prevailing national values. Whereas the Progressives were concerned with restriction of the ballot to achieve voting rationality—the filing fees being a means to that end—the thrust of recent electoral reforms has been to increase access to the ballot. This conflict has been translated into constitutional litigation.

[5] *See, e.g.*, Socialist Party v. Uhl, 155 Cal. 776, 103 P. 181 (1909); Keane v. Lawrence, 30 Pa. D. & C. 235 (C.P. Dauphin County 1937); *accord*, Bodner v. Gray, 129 So. 2d 419 (Fla. 1961). *Contra*, Adair v. Drexel, 74 Neb. 776, 105 N.W. 174 (1905); Johnson v. Grand Forks County, 16 N.D. 363, 113 N.W. 1071 (1907).

[6] *See, e.g.*, Evans v. Cornman, 398 U.S. 419 (1970); Williams v. Rhodes, 393 U.S.