

## The Problem of Securities Thefts\*

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We at the Federal Reserve welcome the study by the Permanent Subcommittee on Investigations of the problem of securities thefts. We share its concern about the gravity of the problem, and we're most hopeful that the present study will focus attention on the problem and result in constructive measures toward its resolution.

The Federal Reserve Bank of New York has an interest in this problem in three respects. In the first place, as a Federal Reserve Bank we have a direct interest in the safety and security of banks and the banking system, and in sound banking practices. Second, as the Federal Reserve Bank responsible for implementing monetary policy by means of open market operations in the Government securities market, we have a direct interest in the effective functioning of that market. Finally, as fiscal agent of the United States, we have an overall interest in all Government securities transactions, particularly with respect to Government financing and the management of the public debt.

As a reflection of our particular interests in these matters, our principal concern—and our experience—relates primarily to United States Government securities and the Government securities market—which means, in effect, marketable Treasury and Federal agency instruments—and my statement today focuses mainly on such securities. However, the Federal Reserve is also con-

cerned with the problem of securities thefts as it relates to other types of securities and securities markets—corporate and municipal securities—and references will also be made to those securities to the extent that we have become involved.

It may also be useful to note at this point that the main problem in the area of Government securities is the theft of bearer instruments, reflecting the fact that practically all of the marketable public debt is in bearer form. This is not the case, of course, with respect to corporate securities; nor does it apply to United States savings bonds, which are not considered marketable instruments and which do not constitute part of the Government securities market.

As a general indication of the kind of volume and velocity of transactions that we are concerned with in the Government securities market, attached is a table setting forth some statistics that should serve to illustrate the overall dimensions of our operations in Government securities.

### GOVERNMENT SECURITIES

The problem of thefts of bearer Government securities did not become acute until the latter half of 1969, when there was a dramatic increase in the incidence and magnitude of such thefts. Within a couple of weeks of each other, one New York City bank reported a loss of \$2.1 million in Government securities, and another reported a loss of \$1.6 million. Shortly thereafter, a third bank reported a loss of \$13.2 million. That made a grand total of about \$17 million reported missing in a period of little over a month, and in New York City alone. By the end of 1969 the total value of Government securities reported to us as missing in New York City—including reports from brokerage houses as well as banks—was about \$20

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ANALYSIS OF UNITED STATES GOVERNMENT  
SECURITIES ACTIVITY AT THE  
FEDERAL RESERVE BANK OF NEW YORK IN 1970

Marketable debt obligations	Pieces (in thousands)	Amount (in millions of dollars)
Original issues .....	1,917	209,558
Servicing* .....	6,195	782,727
Redemptions .....	2,883	169,781
Total transactions handled .....	10,995	1,162,066
Average daily activity .....	44	4,648
Telegraphic transfers .....	312	269,000
Coupons paid .....	3,155	1,633
Safekeeping accounts† Deposits and withdrawals .....	763	182,366

\* Includes such transactions as denominational exchanges, wire transfers, exchanges of coupons for registered securities, etc.

† Includes various corporate and municipal securities.

million, and the total for the country as a whole, as reported to the Treasury, exceeded \$30 million.

It was obvious that we all had a serious new problem on our hands. As we saw it, there were two basic ways to approach the problem. The first—which required immediate action—was how to recover the securities already stolen. The second—of longer term application and importance—was how to prevent securities being stolen in the first place.

#### MEASURES FOR RECOVERY

In reviewing the first question—measures for the recovery of stolen securities—it appeared to us that there was then no centrally coordinated system for distributing current information on missing Government securities within the financial community. Lists of stolen securities were distributed from time to time, depending on the efforts of the institutions suffering the loss, but for the most part the lists were not distributed widely throughout the country and, since they could not be kept up to date, they soon became obsolete.

As for the Reserve Banks, traditionally their role with respect to Government securities had been limited to their responsibilities as fiscal agents of the United States, carrying out the instructions of the Treasury Department. Prior to 1958, the Treasury had maintained various lists of certain Government securities reported as missing or stolen by individuals throughout the country, and it distributed such lists to the Reserve Banks. Over the years, however, the maintenance of the lists presented difficult operating problems—particularly as the volume of Treas-

ury securities increased—and it also involved complicated legal questions for the Treasury as the issuer of the securities. In view of these problems, in 1958 the Treasury discontinued the distribution of the list and instructed the Reserve Banks to terminate the maintenance of the list.

When we reviewed the situation with the Treasury in the fall of 1969, it appeared that it would be impracticable for the Treasury to try to reinstitute the former procedures to meet the acute problem that had developed as of that time. In view of the magnitude of that problem, however, it was clear that the Reserve Banks had a direct and immediate interest in the matter, apart from their responsibilities as fiscal agents of the United States; they had a concern in the problem as it affected the banking system, and also as it affected the Government securities market, through which monetary policy is implemented. Accordingly, with those interests in mind, we began to develop a new kind of procedure—we call it a “checklist procedure”—for maintaining a surveillance for Government and agency securities reported as stolen or missing from the financial community.

The procedure was first initiated at the Federal Reserve Bank of New York in December 1969, and was gradually coordinated with similar procedures established at other Reserve Banks. By the summer of 1970, a uniform system had been developed for use by all thirty-six Federal Reserve Banks and Branches throughout the country. The operation of the national system is described in detail in a circular letter issued by the Federal Reserve Bank of New York dated October 23, 1970. Similar letters were issued by the other eleven Reserve Banks.

The object of the checklist procedure is to maintain a current list of stolen securities at all Reserve Bank offices, based on reports received from banks and other financial institutions throughout the country. Up-to-date information is promptly circulated to all Federal Reserve offices, by wire, through the Federal Reserve Bank of New York, which acts as the coordinating bank for the System. With the list, each Reserve Bank office is able to check securities received at the office. Each office also serves as a clearing house for information on stolen securities within its own territory. It is prepared to answer legitimate inquiries regarding stolen securities, and is also prepared to facilitate prompt contact with the appropriate law-enforcement authorities, including the local police as well as the Federal Bureau of Investigation (FBI).

The basic aim of the checklist procedure is to discover securities on the checklist; in the words of our circular letter, “whenever a listed security is discovered, the Federal Reserve office will inform the appropriate law-enforcement agency, as well as the Treasury and other

interested parties, of the discovery so that they may act promptly in taking whatever steps they may deem necessary. The Federal Reserve's primary function is to inform the appropriate parties of the discovery of a listed security as promptly as possible".

In general, the checklist is intended to supplement existing procedures. It is no substitute for the normal reporting of crimes to the appropriate law-enforcement agencies. The procedure was established within the framework of existing Treasury regulations and is based on full cooperation with the FBI and the local police.

Experience with the checklist to date indicates that it has been fairly successful in achieving its limited objectives. At the New York Reserve Bank alone, we have had hundreds of inquiries involving stolen securities, and we have been involved in about thirty cases in which the checklist procedure was instrumental in the discovery of stolen securities. At least seven other Federal Reserve offices have been involved in similar cases.

Apart from the fact that the checklist procedure has led to the recovery of securities, we believe that one of its principal benefits is simply the fact that it exists. The fact that the community is aware that the Federal Reserve Banks are now checking for missing securities, and that they serve as a central clearing house for information, insuring the prompt relay of such information to the authorities, should serve as a deterrent to the criminal elements dealing in such securities.

I might note at this point that there have been other developments during the last year or so that should also serve to discourage Government securities thefts, and hopefully help to continue the recent decrease in the incidence of such thefts. Such developments—most of which have already been referred to in these hearings—include (1) cooperative efforts among the various sectors of the financial community to cope with the problem—reflecting in general an increased awareness and concern within the community—including for example, the work done by the Banking and Securities Industry Committee (BASIC) and related groups, such as the Joint Industry Control Group and the Joint Bank-Securities Industry Committee on Securities Protection; (2) as a result of such cooperative efforts, the development of the Securities Validation System, the data bank on stolen securities recently put into operation as a commercial venture by Sci-Tek, Inc.; (3) better utilization of the FBI's National Crime Information Center (NCIC); (4) changes in Treasury administrative procedures designed to speed up the processing of Government securities; and (5) the good record of recovery of stolen Government securities, in large part as a result of the efforts of the banks suffering the losses, in co-

operation with the insurance companies and the law-enforcement agencies; an outstanding example is the record of recovery in the Morgan Guaranty case.

#### LONGER TERM SOLUTIONS

The checklist procedure, and similar measures for reporting stolen securities, are designed to recover missing securities. Much more important, of course, are measures designed to prevent or minimize the loss of securities in the first place. At the Federal Reserve Bank of New York, we have been working on such measures in two areas. The first is the Bank's Government Securities Clearing Arrangement; the second is the book-entry procedure for Government securities, in use at all Reserve Banks.

*Securities Clearing Arrangement.* The Government Securities Clearing Arrangement was developed by the New York Reserve Bank several years ago as a means of reducing to a minimum the need for the physical handling of securities in transactions involving the major New York City banks active in the Government securities market. In brief, the Clearing Arrangement permits each of the participants to send and receive Government securities to and from any other participant, and to and from any other Federal Reserve District throughout the country, by means of transfer messages entered into terminals in its premises, with only a single net settlement of the physical securities involved at the end of the day. Instead of requiring the banks to make deliveries of the physical securities underlying each transaction—to or from the New York Reserve Bank or to or from any other participating bank—the Clearing Arrangement's net settlement procedure requires only one delivery, and only of the net amount of securities due to or from a bank at the end of the day. Obviously, such a procedure greatly reduces the need to handle physical securities, and thus the exposure to loss. As an indication of the volume involved, during the last twelve months, there was a total of 300,000 transfers, representing about \$390 billion, processed through the Clearing Arrangement; as a result of the offsetting of transactions through the clearing process, about 75 percent of this amount, or \$290 billion, did not involve any physical securities.

Until recently, the Clearing Arrangement was based on low-speed teletype equipment. At the present time, we are completing a process of conversion to new high-speed equipment, based on a new computer switch at the New York Reserve Bank, which is integrated with the Federal Reserve System's new national communications network. With the new equipment, we expect to increase greatly the volume and velocity of securities transfers processed through the Clearing Arrangement, and that in itself

should reduce further the need to handle physical securities. More important, however, is the capability we will have for integrating the Clearing Arrangement with the book-entry procedure, thereby achieving almost complete automation in Government securities operations and reducing to a minimum the need for any handling of physical securities.

*Book-entry procedure.* Several references have been made to the book-entry procedure during the course of these hearings. In brief, the book-entry procedure is a system under which a definitive Government security—the piece of paper representing a Government obligation—is eliminated, and the obligation is recorded on the computerized books of a Federal Reserve Bank. In this respect, the book-entry procedure is the optimal solution to the problem of thefts of Government securities—as well as the problem of counterfeiting such securities—for it eliminates the security. Beyond that, however, it provides the key to the ultimate automation of all Government securities operations.

The creation of the book-entry system has not been easy. Nor is the system completed. It has been a gradual process of conversion, with much more to do. Without going into detail, it is enough to say that the conversion of each class of security account has presented new and different legal problems, tax questions, and operational complications. These are a reflection of the fact that for centuries the law, commercial practices, and traditions governing transactions in securities—including, for example, sale, purchase, assignment, negotiation, endorsement, hypothecation, delivery, taxation, and creditors' rights—have all been based on the existence of a piece of paper having intrinsic value. Under the book-entry procedure, that piece of paper no longer exists. In this respect, the book-entry procedure is indeed a revolutionary concept, and it should be no wonder that its continuing development must be a gradual process.

The first phase of the process began on January 1, 1968, after several years of study by the Federal Reserve and the Treasury. At that time, the procedure was applied to the securities owned by member banks and held in custody at their Federal Reserve Banks. The procedure was then gradually extended to cover other types of accounts held at the Reserve Banks. By 1970, most of these accounts had been converted; the next step in the program was to go beyond the securities already held at the Reserve Banks, and to convert the securities held in custody by the member banks themselves for account of third parties. It was recognized that this step in the program marked an entirely new direction in the further expansion of the book-entry procedure, and it was expected that it would

take the banks a considerable amount of time to complete the process of conversion.

#### INSURANCE CRISIS

That was the situation that existed as of December 1, 1970, when the so-called "insurance crisis" emerged in the Government securities market. The Subcommittee has already heard testimony on that problem, but I would like to review it for a moment from the point of view of the Federal Reserve and as an example of the serious consequences that can result from the underlying problem of securities thefts.

Beginning in 1969, particularly with the sharp increase in Government securities thefts in the latter half of that year, the insurance companies active in this field became more reluctant to continue their coverage of such securities. Unfortunately, despite some of the measures developed during 1970, the dollar amounts of the thefts continued at a relatively high level during most of the year. For 1970 as a whole, losses of marketable Government securities reported to the Treasury amounted to over \$30 million.

The insurance companies were obviously concerned about the amount of those thefts. They were just as concerned, however, by the fact that they could not recover on claims filed with the Treasury until after the maturity date of the missing securities, even in cases where it appeared that the securities would never be presented for redemption and even where the company was willing to sign a bond of indemnity. The reason for this was that the Treasury did not have the legal authority to provide relief on such claims before the maturity of the missing security.

As the Subcommittee has heard, as a result of this situation, a major insurance company announced plans in December 1970 to exclude all bearer Government securities from its blanket bond coverage for dealers and brokers and to limit severely its coverage on such securities held by money center banks in New York City. Since the company was a predominant carrier in this field, it became immediately obvious that, if it were to proceed with its plans, which were to become effective early in January—and even if no other insurance companies followed suit, which at that time was doubtful—there would be most severe consequences for the Government securities market. Many of the major institutions which constitute the market—including the nonbank primary dealers, the bank dealers, and the clearing banks—carried coverage by that company. Without adequate coverage, it was entirely possible that the banks and dealers affected would terminate their handling of Government securities. If they

were to do so, the market would cease to function effectively.

These developments served to dramatize a very fundamental fact that is usually taken for granted—the fact that an effective and efficient Government securities market is essential to the national economy. From the point of view of Government, it is essential for Government financing and the general management of the public debt. From the point of view of the Federal Reserve, it is essential as the means through which monetary policy is implemented, the tool that is used to affect the level of money and credit in the economy. To perform effectively, the Government securities market must have depth and breadth; it was obvious that the market could not perform effectively without the participation of many of the major institutions that comprise the market.

It was in the light of these considerations that the New York Reserve Bank undertook a program in December 1970 designed (1) to provide for contingency planning to ensure the continued functioning of the Government securities market in the event that major participants terminated their securities operations because of inadequate insurance coverage and (2) to reduce the risk of thefts of Government securities by accelerating the further expansion of the book-entry program, thereby encouraging the insurance companies to continue their coverage. At the same time, the Treasury undertook a complementary program (1) to facilitate the further expansion of the book-entry procedure, including the resolution of certain tax questions by the Internal Revenue Service and (2) to accelerate the time within which relief on stolen securities could be granted.

In the light of such a program, a decision was made by the insurance company to continue coverage for the banks affected, on a curtailed basis, for a period of ninety days, at the conclusion of which the situation would again be reviewed. Coverage was not extended, however, for bearer Government securities held by dealers and brokerage firms.

During the ninety-day period, the Treasury proposed legislation in the Congress to permit it to accelerate the granting of relief on stolen securities—such legislation was subsequently enacted as Public Law 92-19, approved May 27, 1971—and substantial progress was made in implementing the program for further extending the book-entry procedure. It was against the background of these developments that the insurance company, as the Subcommittee knows, decided to negotiate with the banks concerned to continue coverage beyond the ninety-day period.

As for the brokerage firms, it appears that there has been a general trend, by most of the insurance companies

active in the field, to exclude coverage on bearer Government securities while they are in the premises of the firm. The net effect of such a development has been that the brokerage firms affected either enter into arrangements with banks for the custody and handling of their Government securities or else they decide to terminate their business in such securities. Hopefully, as the problem of Government securities thefts is brought under control, insurance coverage on bearer Government securities will again be generally available to those brokerage firms that wish to handle such securities for their customers.

As the Subcommittee knows, there are indications that the measures thus far taken may have had an effect of containing the problem of Government securities thefts. Treasury records indicate that the level of such thefts has been relatively low so far this year—about \$3 million in the first five months, with less than \$500,000 from financial institutions in New York City. While it is too early to draw any optimistic conclusions from these figures, we are all hopeful that the trend will continue.

Over the long run, of course, the best solution is the book-entry procedure. At this point, we are in the process of extending the procedure to securities owned by customers of banks. The current status of the program is described in our circular letter of April 26, 1971. As indicated in that letter, we have started with the large New York City banks—those that have been most exposed to the problem of insurance coverage—and we expect the program to be available for all member banks throughout the country within a matter of months. At the present time, over \$125 billion in Treasury securities is in book-entry form, with \$110 billion of that amount at the Federal Reserve Bank of New York. Thus, well over one half of the \$230 billion of Treasury securities outstanding in bearer form—those most vulnerable to theft—is in book-entry accounts. Gradually, as the banks bring in their customer securities, we expect that a major portion of the remainder of the \$230 billion will be converted to book-entry form and that ultimately there will be relatively few pieces of paper in existence evidencing a Government debt obligation.

In New York City, we can foresee the day—not too long distant—when virtually all transactions in the central Government securities market will be effected through the Government Securities Clearing Arrangement by means of entries on computer terminals in the premises of the participating banks, with little need ever to handle—or even issue—a piece of paper representing a Government security. The transmission and accounting will be done by computer, and billions of dollars in Government securities will flow to and from all sectors of the market through our

computer switches. Obviously, this will greatly assist in eliminating the present problem of thefts in the Government securities market.

#### OTHER SECURITIES

##### BOOK-ENTRY SYSTEMS

It is just as obvious that some kind of book-entry computer system or systems for corporate and municipal securities would also help solve the problem of thefts of those securities as well. However, the obstacles to be overcome in the corporate and municipal area are quite complex and require considerably more study. In the case of Government securities, we have been working on the problem for many years and have been fortunate in having to deal with only one issuer—the United States Government—and only one body of applicable law—Federal law. In the case of corporate and municipal securities, there are thousands of issuers, and the laws of fifty states to contend with. Nevertheless, despite the obstacles, it would appear that this is the direction in which the financial community must go, and indeed there has been significant progress in moving forward in this direction. The establishment of the Central Certificate Service is clearly a step in this direction and, as the Subcommittee knows, there have been many studies of proposals for the further immobilization or ultimate elimination of stock certificates.

While we are not in a position to judge the relative merits of the various proposals under consideration, it seems to us that the ultimate objective should be the reduction to a minimum of transactions requiring the processing and exchange of pieces of paper having intrinsic value. Based on our experience with the book-entry procedure, we do not expect that the financial community can achieve this objective overnight; much more work and time is required. As a Federal Reserve Bank, we of course have an interest in the effective functioning of all financial markets, and we are prepared to offer whatever assistance we can in moving forward in this direction.

##### MEMBER BANK PRACTICES

In addition to our general interest in the long-term possibilities of developing some kind of book-entry systems for the corporate and municipal securities markets, we also have a specific interest in the problem of stolen corporate and municipal securities—and that is the extent to which banks subject to our supervision may become involved with such securities.

In general, a bank may become involved in a stolen security case where (1) the security is stolen from its custody or (2) the bank receives a stolen security in the

course of its business, such as collateral for a loan. The Federal Reserve has developed rules and standards applicable in such cases to state member banks, and the Federal Reserve Bank examiners review compliance with such rules and standards during the course of their examinations.

One of the basic rules requires that every bank subject to Federal Reserve supervision should report any apparent violation of the Federal banking laws to its Federal Reserve Bank. Such reports are then forwarded to the local United States Attorney and to the Department of Justice. An example of the standards applicable to cases in which securities are offered to a bank as collateral is set forth in a Federal Reserve System letter on the subject dated March 3, 1971. During their examinations, the Federal Reserve Bank examiners determine whether such standards are being applied by the member banks.

We are continuing to study this question, particularly in the light of the valuable information produced as a result of these hearings, with a view to determining how our standards may be improved to ensure that banks maintain adequate safeguards against the risk of loss of securities as well as the risk of accepting stolen securities in the course of their business.

In this connection, the Federal Reserve has for some time been of the view that it would be desirable to have some kind of coordinated, centralized, and current checklist and information system on corporate and municipal securities available for direct and immediate access by the financial community. As one possibility for such a system, we have worked with the Joint Bank-Securities Industry Committee on Securities Protection in its project for a data bank on stolen securities. As the Subcommittee knows, this is the project that has been developed by Sci-Tek, Inc., as the Securities Validation System. Following a pilot program, the system began on-line operations last month. We are continuing to watch its progress, and are hopeful that the basic concept can be developed into a useful tool for the financial community.

##### LEGISLATIVE RECOMMENDATIONS

In response to the Subcommittee's offer, we have reviewed, in the light of our experience and responsibilities, the possible need for legislation to assist in dealing with the problem of securities thefts. On the basis of our review, we do not believe that legislation is necessary in more than one or two areas at this point in time.

With respect to the Reserve Bank checklist procedure for Government securities, no legislation appears necessary for its continued operation or future development.

However, our experience with the procedure has indicated that it might be helpful, primarily to clarify the jurisdiction of the FBI, to enact Federal legislation to make the theft of a Government security a crime in itself, rather than limit Federal jurisdiction to cases involving thefts from banks or cases in which stolen securities having a value of \$5,000 or more are transported in interstate or foreign commerce. Such a proposal has already been discussed in the course of these hearings, and we would support its further consideration.

With respect to a data bank or centralized information system on stolen corporate or municipal securities available to the financial community, we would favor the development of such a system. It does not appear, however, that Federal legislation is necessary to facilitate such development. If it should appear that at some future date such legislation would be helpful, we would trust that it would be given favorable consideration.

With respect to commercial bank practices in connection with stolen securities, we believe that the present banking laws are adequate and permit the Federal bank supervisory agencies sufficient authority and flexibility to deal with the problem of securities thefts. The Federal Reserve will continue to study the matter with a view to determining the extent to which further administrative action may be desirable.

With respect to the corporate and municipal securities markets, we would favor in principle any proposal that would reduce to a minimum—whether by immobilization or elimination of the securities—the need to process and exchange pieces of paper having intrinsic value. At this point, it does not appear that Federal legislation is necessary to move forward in the development of such a program. In any case, much more study of this question is essential before legislative action—whether on a Federal level or a state level—can be taken. Depending on the ultimate outcome of the Subcommittee's present investigation, perhaps the Subcommittee may wish to consider means of facilitating such a study, whether by legislation or otherwise.

With respect to the book-entry procedure, it does not appear that legislation is necessary at this point to proceed further with our program. Nor do we see the need for legislation to extend the program to Federal agency securities, a step which is planned for the near future by means of administrative action. However, in view of the rather revolutionary nature of the book-entry concept, it may well be that at some point in time legal questions may arise that might best be resolved by Federal legislation. In such event, we hope we would be able to seek the assistance of this Subcommittee in support of such legislation and in support of the book-entry concept in general.