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TOWARD THE UNCERTIFICATED SECURITY: A CONGRESSIONAL LEAD FOR STATES TO FOLLOW*

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The development of the concept of the uncertificated security and of the policy leading to the immobilization of the certificated security was accelerated by the "paperwork crunch" of the late 1960's.¹ An explosion in the volume of trading had occurred. A system designed to handle an average three million share trading day was incapable of dealing with the thirteen million share trading day common in the late 1960's.² The resultant breakdown in the securities processing mechanism caused chaos as the number of errors in recording transactions multiplied.³ The securities

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¹ The paperwork crunch created a crisis in that the sudden increase in trading volume resulted in an expansion of trading facilities, without a concomitant expansion in the supporting areas, the backrooms. This resulted in financial over-extension to produce customer convenience and an attempt to use computer programming when neither the staff nor the machinery was capable of effecting accurate trade recordation. The subsequent market decline added to these woes. SENATE COMM. ON BANKING, HOUSING & URBAN AFFAIRS, 92D CONG., 2D SESS., SECURITIES INDUSTRY STUDY (Comm. Print 1972); SENATE SUBCOMM. ON BANKING, HOUSING & URBAN AFFAIRS, 93D CONG., 1ST SESS., SECURITIES INDUSTRY STUDY (1973); SUBCOMM. ON COMMERCE & FINANCE OF THE HOUSE COMM. ON INTERSTATE & FOREIGN COMMERCE, 92D CONG., 2D SESS., SECURITIES INDUSTRY STUDY (Subcomm. Print 1972); ROBINS, WERNER, JOHNSON & GREENWALD, PAPER CRISIS IN THE SECURITIES INDUSTRY: CAUSES AND CURES (1969).

² Harold M. Williams, Chairman Securities and Exchange Commission, recently advised brokers to start planning for 150 million share days. The record so far is 81.6 million shares traded on the New York Stock Exchange on October 10, 1979. On an average day 32 million shares were traded in 1979, up from 28 million in 1978. See *The Washington Post*, Nov. 30, 1979, at E-1, col. 3. The average daily volume for January 1980 was 52.5 million shares.

³ SECURITIES AND EXCHANGE COMMISSION STUDY OF UNSAFE AND UNSOUND PRACTICES OF

industry's operational problems created by the "paper crunch" are measurable by the number of "fails to deliver" and "fails to receive" reported by market participants.⁴ In December 1968, member firms of the New York Stock Exchange had \$4.4 billion in "fails to deliver" and \$4.7 billion in "fails to receive."⁵ Brokers and dealers were finding it difficult, if not impossible, to ascertain their own financial condition.⁶ In late 1969, as the prices of stocks began to decline reducing both volume and brokers' commissions, broker and dealer liquidations became common. This operational and financial crisis forced more than one hundred brokerage firms into liquidation causing thousands of customers to be seriously disadvantaged.⁷

The causes of such failures of broker-dealers have been analyzed as being primarily due to inadequacies of management, deplorable book-keeping methods and recording of trades, excessive trading and a concentration on sales rather than service to the customer, and most importantly, a weakness in the capital structure of the broker-dealer.⁸ In its

BROKERS AND DEALERS, H.R. DOC. NO. 92-231, 92d Cong., 2d Sess. 13 (1971) [hereinafter cited as *STUDY OF UNSAFE AND UNSOUND PRACTICES*].

⁴ A "fail to deliver" represents the obligation of a broker or dealer to deliver securities to another broker or dealer against the receipt of money beyond the conventional five business day settlement period. A "fail to receive," the converse of a "fail to deliver," represents the obligation of a broker or dealer to pay money to another broker or dealer against receipt of a security after the settlement period has passed.

⁵ *Clearance and Settlement of Securities Transactions: Hearings on S.3412, S.3297 and S.2551 Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs*, 92d Cong., 2d Sess. 95-96 (1972) (statement of William J. Carey, chmn.).

⁶ *Id.*

⁷ SENATE COMM. ON BANKING, HOUSING & URBAN AFFAIRS, IMPROVED NATIONAL SECURITIES TRANSFER SYSTEM, S. REP. NO. 92-1009, 92d Cong., 2d Sess. 1 (report to accompany S.3876).

⁸ See STAFF OF SPECIAL SUBCOMM. ON INVESTIGATIONS OF THE COMM. ON INTERSTATE & FOREIGN COMMERCE, 92D CONG., 1ST SESS., REVIEW OF THE SEC RECORDS OF THE DEMISE OF SELECTED BROKER-DEALERS (Subcomm. Print 1971); *STUDY OF UNSAFE AND UNSOUND PRACTICES*, *supra* note 3; BARUCH, WALL STREET: SECURITY RISK (1971). Of the sixty-four securities firms liquidated under the Securities Investor Protection Act of 1970, 15 U.S.C. §§ 78aaa-78iii (1976 & Supp. II 1978) (SIPA), through Dec. 31, 1972, the causes of failure are indicated to have been:

Poor Books and Records	44
Misconduct	26
High Operating Costs -	
Poor Control	21
Mismanagement	28
Lack of Knowledge of	
Securities Business	18
Adverse Market Conditions	10
Dealing in Highly	
Speculative Issues	29

To this table must be added lack of adequate capital ranging from too small a capital basis; 50 firms (approximately 80%) had an initial capital of less than \$50,000; thirty of these, less than \$25,000; and eleven of these, less than \$10,000; one even as little as \$4,000; to temporary illiquidity, overcommitment in a particular security or venture, etc. Also of note is that

Study of Unsafe and Unsound Practices of Brokers and Dealers,⁹ the Securities and Exchange Commission (the Commission) indicated that the greatest opportunity to prevent recurrence of a paperwork crisis and the resultant danger of financial loss to the investing public existed in creating a modernized nation-wide system for clearance, settlement, delivery and transfer of securities.¹⁰ Because of the necessity of participating in various markets having different processing systems for clearing, settlement and delivery, brokers' and dealers' costs and accounting control problems were multiplied. Congress, therefore, concluded that it was essential to create a national system for clearance and settlement of securities transactions which will integrate the national market system for securities ordained by it.¹¹ This required putting into place a coordinating mechanism to ensure cooperation among the various entities engaged in securities processing: the clearing corporations, the securities depositories, the transfer agents and the issuers.¹² In addition, Congress called upon the Commission to bring about an end to the physical movement of securities certificates in connection with the settlement of transactions among brokers and dealers.¹³ This legislation provides a legal basis for rulemaking aimed at preventing another intra-industry paperwork crisis and establishing a safe, efficient and modern national clearing and settlement system.¹⁴

The Congress further directed the Commission to "facilitate the establishment of a national system for the prompt and accurate clearance and settlement of transactions in securities;"¹⁵ a directive to which the Commission responded by formulating the characteristics of a national clearing and settlement system which involves the interaction of clearing corporations, securities depositories, transfer agents, brokers and dealers, and securities markets.¹⁶ The system which is evolving is one applicable to the securities industry as such and does not affect the individual investor, unless the investor insists on becoming a registered owner of his shares or desires to hold the certificate himself, *i.e.*, the system applies to

forty-nine firms (approximately 77%) had been in business less than five years. See SECURITIES INVESTOR PROTECTION CORPORATION, 2D ANNUAL REP. 25 (1972). The SIPA has been amended by the Securities Investor Protection Act Amendments of 1978, 15 U.S.C. §§ 78aaa *et seq.* (1976 & Supp. II 1978) and the Bankruptcy Reform Act of 1978, 11 U.S.C. §§ 101 *et seq.* (Supp. II 1978).

⁹ See note 3 *supra*.

¹⁰ STUDY OF UNSAFE AND UNSOUND PRACTICES, *supra* note 3, at 35-36.

¹¹ See Securities Exchange Act §§ 11A(a)(1), 17A(a)(1), 15 U.S.C. §§ 78k-1(a)(1), 78q-1(a)(1) (1976).

¹² See *In re National Securities Clearing Corporation For Registration as a Clearing Agency*, SEC Securities Exchange Act Release No. 34-13,163 (Jan. 13, 1977), 42 Fed. Reg. 3916, 3918 [hereinafter cited as Order].

¹³ See Securities Exchange Act of 1934, as amended by Securities Acts Amendments Act of 1975 § 17A(e), 15 U.S.C. § 78q-1(e) (1976).

¹⁴ See Order, *supra* note 12, at 3919.

¹⁵ Securities Exchange Act § 17A(a)(2), 15 U.S.C. § 78q-1(a)(2) (1976).

¹⁶ See Order, *supra* note 12, at 3920.

securities held in "street name."¹⁷

State laws provide that the issuer only needs to recognize as registered owner of its securities those whose names appear on the stockholders' list. Thus, rights to membership can be made effective only by notation on this list.¹⁸ So long as securities ownership was confined to a miniscule investor class the concept was adequate. As ownership became more widespread, however, complications inevitably ensued. These complications were due primarily to the commercial necessity of recognizing "transfers" by sale, pledge or gift, effective as between transferor and transferee without regard to changes on the stockholders' list.¹⁹ At the same time the issuer could not be bound to recognize the transferee for any purpose, *e.g.*, voting or the distribution of dividends, until the stockholders' list had been appropriately changed, or at least until the issuer had notice of a transfer and a change was properly requested.²⁰ It thus became important to discover whether the system, as it existed, was effective in soliciting the views of the beneficial owner²¹ and in bringing such views to the attention of the issuer.²²

¹⁷ Recordation of securities in the name of a registered broker/dealer or in that of a national bank or their respective nominees is called registration in "street name." Securities registered in the names of members of certain national securities exchanges, *e.g.*, N.Y.S.E. and AMEX and of certain national banks, or their respective nominees are easily transferable among members of the securities industry. Though requiring endorsement, there is no need for a "signature guaranty" and a delivery does not need to be accompanied by a corporate resolution authorizing a transfer. Basically, where the signature guaranty of a broker/dealer or of a bank would be acceptable to a transfer agent, certificates registered in the name of such broker/dealer or that of a bank properly endorsed would not require a signature guaranty to be accepted for transfer. Note also that in many instances facsimile signatures are acceptable under special agreement among members of the securities industry. *See* U.S. Fidel. & Guar. Co. v. Coca-Cola Co., 10 UCC Rep. 759 (Sup. Ct. N.Y.), *aff'd*, 338 N.Y.S.2d 397 (App. Div. 1972); New York Stock Exchange Rule 200(d); American Stock Exchange Rule 765(c); New York Stock Transfer Ass'n Rule 19.05; C. ISRAELS & E. GUTTMAN, MODERN SECURITIES TRANSFERS 5.02 (1971 & 1980 Supp.) [hereinafter cited as MODERN SECURITIES].

¹⁸ *See* U.C.C. § 8-207. Article 8 of the U.C.C. has been enacted in all jurisdictions in the United States. This provision is carried over into the Revised Article 8 (1977).

¹⁹ *See* note 2 *supra*.

²⁰ *See* U.C.C. § 8-301.

²¹ *See* Securities Exchange Act § 12(m), 15 U.S.C. § 78l(m) (1976); FINAL REPORT OF THE SECURITIES AND EXCHANGE COMMISSION ON THE PRACTICE OF RECORDING THE OWNERSHIP OF SECURITIES IN THE RECORDS OF THE ISSUER IN OTHER THAN THE NAME OF THE BENEFICIAL OWNER OF SUCH SECURITIES (Dec. 3, 1976) (pursuant to § 12(m) of the Securities Exchange Act of 1934 ('34 Act)) [hereinafter cited as FINAL REPORT].

²² *See* Securities Exchange Act §§ 12(m), 13, 14, 15(d), 16 and 17A, 15 U.S.C. §§ 78l(m), 78lm, 78n, 78o(d), 78p and 78q-1 (1976 and Supp. II 1978). With respect to the disclosure of beneficial ownership, SEC Rule 13d-1 and Schedule 13d, 17 C.F.R. §§ 240.13d-1, 101 (1980), require the beneficial owner of five percent of the securities of an issuer whose securities are registered under § 12 of the '34 Act, or which but for the exemption set forth in § 12(g)(2)(G) would have to be registered to report such beneficial ownership. A beneficial owner is defined as including "any person who, directly or indirectly, through any contract, arrangement, understanding, relationship, or otherwise has or shares," voting power and/or investment power. SEC Rule 13d-3, 17 C.F.R. § 240.13d-3 (1980). This would include a

Congress called upon the Commission to study and report on the relationship of the corporate issuer to the beneficial owners of its shares where these are registered in "street name."²³ The study concluded that "the current system for transmitting issuer-shareowner communications through intermediaries functions reasonably well . . . while transmission through intermediaries is more circuitous, materials are received by shareowners [*sic*] in a timely manner whether they are transmitted directly by an issuer or through an intermediary."²⁴ Although the study contains some conclusions which are open to question, such as that the system of communication between issuers and beneficial owners is adequate, a closer control over the intermediaries could eliminate these questions. These difficulties do not affect the ultimate conclusion that the interest of the beneficial owner could be adequately protected even where securities are held by a securities depository²⁵ and registered in its nominee name, *i.e.*, "street name."

The Commission is also able to protect shareholders' proprietary interests in securities by requiring broker-dealers to segregate customers' fully paid²⁶ and excess margin securities.²⁷ Brokers use "bulk segregation

pledgee who has foreclosed on his pledge, or who, under the pledge agreement, has voting rights or power to dispose of the pledged security, *id.*, but would not include a clearing agency or its nominee. Depository Trust Co.; Cede & Co., [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,192 (SEC Div. of Corp. Fin. — Interpretative Letter March 23, 1979).

²³ See note 21 *supra*.

²⁴ See FINAL REPORT, note 21 *supra*, at 42.

²⁵ See Securities Exchange Act § 3(a)(23)(A), 15 U.S.C. § 78c(a)(23)(A) (1976) (person who (i) acts as custodian of securities in connection with system for central handling of securities whereby all securities of particular class or series of any issue deposited within the system are treated as fungible and may be transferred, loaned, or pledged by bookkeeping entry without physical delivery of securities certificates; or (ii) otherwise permits or facilitates settlement of securities transactions or the hypothecation or lending of securities without physical delivery of securities certificates). The largest securities depository, Depository Trust Co. (DTC) is owned by the New York Stock Exchange (N.Y.S.E.), the American Stock Exchange (A.S.E.), National Association of Securities' Dealers (N.A.S.D.), broker/dealers and bank participants. Note that U.C.C. § 8-102(4) defines "A 'custodian bank' is a bank or trust company which is supervised and examined by state or federal authority having supervision over banks and which is acting as a custodian for a clearing corporation."

²⁶ See SEC Rules 15c3-3(a)(3), (4), 17 C.F.R. §§ 240.15c3-3(a)(3), (4) (1980) (defines "fully paid securities" to include all securities carried for a customer in a special cash account (see Regulation T of the Federal Reserve System, 12 C.F.R. § 220 (1980)) as well as all margin account securities which have become fully paid).

²⁷ See SEC Rule 15c3-3(a)(5), 17 C.F.R. § 240.15c3-3(a)(5) (1980). Excess margin securities are those securities in the margin account having a market value in excess of 140% of the total debit balance in the customer's account. *Id.* Where the securities are not held by the broker and where they are not in a securities depository, *e.g.*, they are held by a clearing broker, such clearing broker will have to segregate the securities so as to effectuate delivery on behalf of the broker to his customer under state law. See U.C.C. § 8-313(1)(e); *In re Paragon Securities Co.*, 599 F.2d 551 (3d Cir. 1979). Entries on the books of the broker will not suffice. See also SEC Rule 15c3-3(c)(2), 17 C.F.R. § 240.15c3-3(c)(2) (1980). Where the securities are held in a securities depository, however, entries on the books of the clearing corporation will be effective to make the transferee or pledgee who has an account with the clearing corporation, *i.e.*, a participant, a "holder" under state law, so as to enable him to

of street name securities" which segregates these securities by issuer and issues and not in customers' names. In such case the segregation will be by book entries on the broker's books. Where the securities are held in a clearing corporation,²⁸ they will be kept in a general account. This account will contain all securities credited to the participant. If a broker, the account will contain fully paid for, excess margin and securities subject to liens other than securities which have been hypothecated.²⁹ Securities in such a general account with the clearing corporation are deemed to be in the control of the broker providing the delivery of such securities to

qualify as a bona fide purchaser. See U.C.C. §§ 8-313(1)(e), 8-320(1) & (3), 8-302. As at present promulgated, clearing agents which are not registered broker/dealers would not qualify as control locations, neither under SEC Rule 15c3-3(c)(2) nor under SEC Rule 15c3-3(c)(1). This clearly calls for some reconsideration of SEC Rule 15c3-3(c)(2) to include such clearing agents which seek registration and to require them to segregate customer fully paid and excess margin securities in accordance with instructions received from participants. See note 30 *infra* (delivery to customer where securities are held in clearing corporation). See also MODERN SECURITIES, *supra* note 17, § 4.02.

²⁸ See Securities Exchange Act § 3(a)(23)(A), 15 U.S.C. § 78c(a)(23)(A) (1976) (defines a "clearing agency" as "any person who acts as an intermediary in making payments or deliveries or both in connection with transactions in securities or who provides facilities for comparison of data respecting the terms of settlement of securities transactions, to reduce the number of settlements of securities transactions or for the allocation of securities settlement responsibilities"). This definition includes a securities depository.

The U.C.C., which permits delivery by book entry within a central depository system, see U.C.C. § 8-320, defines a clearing corporation as a corporation

- (a) at least 90 percent 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 provision 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 20 percent of the capital stock of such corporation; and
- (b) any remaining capital stock 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.

U.C.C. § 8-102(3). The 1977 amendments add: a "clearing corporation is a corporation registered as a "clearing agency" under the federal securities laws. . . ."

This provision permits the clearing corporation to be wholly owned by a national securities exchange or association registered under a statute such as the '34 Act. The possible participation of two other groups is recognized (1) brokers, dealers, or investment companies registered under the Securities Exchange Act of 1934 or the Investment Company Act of 1940 and (2) banks and insurance companies subject to the provisions of federal or state banking laws or state insurance laws. A broker, dealer, bank, or insurance company may own up to 20 percent of the capital stock of the clearing corporations. Individuals also may own capital stock, provided they purchased such stock in order to qualify as directors before taking office. This permits compliance with the requirements of the Securities and Exchange Commission that there be "fair representation" of participants. See note 50 *infra*.

²⁹ See SEC Rule 15c2-1(g), 17 C.F.R. § 240.15c2-1(g) (1980).

the broker would not require the payment of money or value. They can be segregated by entries on the books of the broker for the purpose for complying with Commission rules calling for the segregation of fully paid and excess margin securities.³⁰

Congress also added to customers³¹ protection against loss due to broker-dealers' insolvency by enacting the Securities Investor Protection Act.³² Once the determination had been made that the beneficial owner could be given adequate protection, consumer obstacles to the immobilization of the share certificate no longer existed. In fact, the need for an efficient trading market demanded that such immobilization apply to securities held in a trading account.³³

Upon making a sale, the selling broker assumes a legal duty, generally defined under the rules and customs of the organized securities markets in terms of a responsibility of the broker to deliver: (a) by placing the security received from his customer or a like security, in the possession of the buying broker, or (b) by effecting clearance of the sale under the rules and customs of the relevant market.³⁴ These obligations arise irrespective of the performance by customers of their legal duties.³⁵ Resolution of the broker's obligations incurred on an exchange or in the over-the-counter market (OTC) generally requires (1) comparison, (2) clear-

³⁰ See SEC Rules 8c-1 and 15c3-3(c)(1), 17 C.F.R. §§ 240.8c-1, 240.15c3-3(c)(1) (1980). Entries in the books of the broker indicating the customer's name should suffice to constitute "delivery" of securities held for the broker by the clearing corporation. We are here assimilating the U.C.C. term "possession" to the securities law term "control." See SEC Rule 15c3-3(b)(c), 17 C.F.R. § 240.15c3-3(b)(c) (1980); *In re Paragon Securities Co.*, 599 F.2d 551 (3d Cir. 1979).

³¹ Persons who have entrusted securities or cash to the broker-dealer, debtor for a purpose connected with participation in the securities market are examples of a "customer" that Congress is seeking to protect. See Securities Investor Protection Act, §§ 16(2), (4), 15 U.S.C. §§ 78lll(2), (4) (Supp. II 1978); *SEC v. F. O. Baroff Co.*, 497 F.2d 280 (2d Cir. 1974) (securities lent to debtor and subsequently hypothecated to relieve its "cash bind" will not afford "customer" status to lender); *In re Weis Securities, Inc.*, 425 F. Supp. 212 (S.D.N.Y. 1977) (investor in subordinated debt or broker-dealer is not a customer).

³² 15 U.S.C. § 78lll (Supp. II 1978). The Act's protection is up to \$100,000, of which \$40,000 can be applied to cash held by the broker. See *id.* § 78fff. There is legislation pending to increase these sums to \$500,000 and \$100,000 respectively. See H.R. REP. No. 6831 which has been reported out of the Interstate and Foreign Commerce Subcommittee on Consumer Protection and Finance.

³³ A trading account is an active account in which the customer may transact numerous purchases and sales requiring delivery into and out of such account. The delay in having the securities registered into and out of the customer's name would prevent the broker complying with the time restraints governing delivery of securities imposed by the market in which the trades occur. The Commission's turnaround rules for transfer agents and registrars cannot alleviate against this delay. See SEC Rules 17Ad-1 to 7, 17 C.F.R. §§ 240.17Ad-1 to 7 (1980); *MODERN SECURITIES*, *supra* note 17, §§ 2.07-2.11.

³⁴ See U.C.C. §§ 8-107(1), 8-314(1)(b), 8-320.

³⁵ Brokers act as agents for unnamed principals. Thus, both under common law principles and under market rules the broker is personally liable to his counter-part on the transactions. See *RESTATEMENT (SECOND) OF AGENCY* § 321 (1958); N.Y.S.E. Rules 175-180; A.S.E. (Div. of Securities) Rules SR 1-6; N.A.S.D. Uniform Practice Code § 12.

ance, and (3) settlement.

(1) *Comparison* — Upon reaching an agreement to sell or to buy, whether on the exchange auction market or on the telephone in an OTC transaction, or through access to the computer on the Cincinnati Exchange,³⁶ information regarding the buy and sell side is sent to a clearing agency by the brokers involved for comparison, *i.e.*, each buy will have to be matched with the corresponding sell slip on the basis of the information submitted (the parties, the amount and identity of the securities and the price).

(2) *Clearance* — Once the trade has been verified, the "compared trade" is "cleared" by the clearing agency.³⁷ This involves sorting the various trades according to brokers and advising the brokers of their delivery or payment obligations arising from the "compared trade." Of the three major systems of clearance, the simplest form is known as "the trade by trade" system (TBT). Brokers under this system deal directly with each other to settle each trade as it arises, once comparison has established their respective obligations.³⁸

The process of clearance by book entry movement is one of the most important features of a national clearance system. Book entry movement occurs when one participant's³⁹ account is debited and another's is credited to reflect a transfer of securities when the securities are registered in the name of the clearing agency and held by the clearing agency for its participants.⁴⁰ The use of book entries facilitates a second and more so-

³⁶ Note, some regional exchanges facilitate computerized trades and automatic execution in some infrequently traded securities, *e.g.*, Pacific Stock Exchange (COMEX), Philadelphia Stock Exchange (PACE) and even the N.Y.S.E. has adopted a Designated Order Turn-around System (DOT) through which N.Y.S.E. member firms transmit small-size orders direct from computers in their own offices to the proper trading post on the exchange floor.

³⁷ See Securities Exchange Act § 3(a)(23)(A), 15 U.S.C. § 78c(23)(A) (1976); U.C.C. § 8-102(3).

³⁸ The organized market limits the concept of "good" delivery as between members of the market to cases where the form of the registration and the corresponding indorsement has no feature which could conceivably give notice of an adverse claim to the security. See U.C.C. § 8-301(1). Thus these rules exclude from "good" delivery all securities indorsed by:

- (a) any person "since deceased";
- (b) a trustee or any other fiduciary;
- (c) an infant;
- (d) an agent;
- (e) an attorney other than an attorney in fact acting for a member organization of the exchange;
- (f) two or more individuals described as joint tenants or otherwise with any "qualification, restriction or special designation"; and
- (g) a corporation or other institution or organization unless there has been filed with the transfer agent a certified copy of a resolution authorizing the actual signer to indorse.

N.Y.S.E. Rules 195-225; A.S.E. (Div. of Securities) Rules SR 34-44; N.A.S.D. Uniform Practice Code §§ 29-38.

³⁹ See Securities Exchange Act § 3(a)(24), 15 U.S.C. § 78c(a)(24) (1976).

⁴⁰ See Order, *supra* note 12, at n.51.

phisticated system to be used in an active market and where equipment such as computers, etc., are available, "the daily balance order system" (DBO).⁴¹ Here, the clearing agency will generate a daily net "buy" or "sell" position for each issue in which a participant in the clearing agency has a "compared trade" due that day. It will then allocate or issue to such participants balance orders to deliver or to receive a net buy or sell position. This may result in payment or delivery being made to or received from someone with whom there had been no "compared trade."⁴² Linked to a depository, physical delivery is also obviated.

Finally, the most sophisticated system is the "continuous net settlement" system (CNS). The clearing agency will net the daily "buy" and "sell" position for each issue in which the participant has a compared trade due to be settled that day and, if not resolved, will carry such net settlement obligations over to the next day to be settled against the obligations resolved by the end of that day.⁴³ Under this system, the clearing agency is interposed between the market participants. Thus, the obligations to pay for or to deliver securities is to the clearing agency, which in turn is obligated to make payment to or to deliver securities to the other side of the "compared trade."

(3) *Settlement* — Comparison and clearance must be completed by the day when the market rules call for the settlement, *i.e.*, delivery and payment. Essentially, there are two types of settlement procedures. One type of settlement procedure occurs where deliveries are effected periodically (*e.g.*, daily) by the physical exchange at the clearing house or on its instructions of "balancing certificates." Thus Broker A obligated to deliver 5,000 shares of XYZ common and entitled to receive 4,500 such shares from Brokers B, C, and D, would at the end of the day deliver to the clearing house in "street name" (his own or that of another broker or bank nominee) one or more certificates aggregating 500 shares. Similarly if the transactions result in a balance in his favor he would receive certificates in "street name" for such balance through the clearing house, *i.e.*, "envelope delivery."⁴⁴

The second type of settlement procedure is "delivery by book entry." Where brokers' or banks' holdings of fungible securities in "street name" are physically held by a securities depository⁴⁵ acting for a "clearing cor-

⁴¹ The "daily balance order system" (DBO) will also be possible without book entry, but will be less efficient if so used.

⁴² See *In re Weis Securities, Inc.*, 542 F.2d 840, 841 (2d Cir. 1976).

⁴³ Since many securities are traded in more than one market, and brokers participate in more than one market, interfaces between clearing agencies are required to enable broker/dealers to settle in one account at one clearing agency with regard to all trades wherever entered into.

⁴⁴ See *In re Weis Securities, Inc.*, 542 F.2d 840 (2d Cir. 1976). Payment through the clearing agency generally requires tender of a certified check or banker's draft against tender of securities.

⁴⁵ See Securities Exchange Act § 3(a)(23)(A), 15 U.S.C. § 78c(a)(23)(A) (1976); U.C.C. § 8-102(4).

poration"⁴⁶ delivery is accomplished by the making of appropriate entries "on the books of the clearing corporation."⁴⁷ Such entries will be made on instructions of the transferor "to decrease the shares of the stock in his account and to increase the account of the receiver by the same number of shares. Appropriate bookkeeping entries would be made in the account of both parties but no physical handling of certificates will occur."⁴⁸ In the CNS system, settlement of a compared trade is guaranteed by the clearing agency. Thus, the CNS system provides a link with the depository so that automatic book entry delivery will be possible to satisfy a short value position.⁴⁹ In all other systems, this obligation generally is on the participants themselves. Participants, of course, must settle directly with the clearing agency in the CNS system.⁵⁰

The U.C.C. provides a legal framework for this methodology of making delivery among market participants.⁵¹ Thus U.C.C. section 8-313(1)(e)

⁴⁶ Securities Exchange Act § 3(a)(23)(A), 15 U.S.C. § 78c(a)(23)(A) (1976); U.C.C. § 8-102(3).

⁴⁷ U.C.C. § 8-320(1)(c). The clearing corporation will give instructions to the securities depository to increase the account of the participant entitled to delivery and will expect delivery to its account from the selling participant.

⁴⁸ Memorandum to Members and Member Organizations of the N.Y.S.E. on "Method for Central Handling of Securities," (July 30, 1964). See also U.C.C. §§ 8-313(1)(e), 8-320(2) & (3). The development of "clearing corporations" and their control by the Commission is set forth in the Securities Exchange Act §§ 3(a)(23), 17A and 19, 15 U.S.C. §§ 78c(a)(23), 78q-1, 78s (1976), and SEC Rule 17Ab2-1, 17 C.F.R. § 240.17Ab2-1 (1980). See further *Bradford Nat'l Clearing Corp. v. SEC*, 590 F.2d 1085 (D.C. Cir. 1978).

⁴⁹ A "short value position" is a net obligation of a participant to deliver securities to the system against payment. A "long value position" obligates a participant to make payment to receive securities from the system.

⁵⁰ Where delivery of a physical certificate is called for, there must be "good delivery." See note 37 *supra*. A failure to make "good" delivery gives rise to rights of rejection under the applicable market rules. These "reclamation" rights arise not only by reason of irregularities which would entitle the issuer to refuse registration of transfer, but also where minor irregularities would cause a delay in obtaining registration. See N.Y.S.E. Rules 268, 270, 272, 275; A.S.E. (Div. of Securities) Rules SR 112, 113, 115, 117, 120; N.A.S.D. Uniform Practice Code §§ 53, 54, 55, 57; MODERN SECURITIES, *supra* note 17, § 6.07.

⁵¹ See notes 25 and 28 *supra*. Securities Exchange Act § 17A(b)(3)(C), 15 U.S.C. § 78q-1(b)(3)(C) (1976), requires assurance of fair representation to participants in a "clearing agency," a concern reflected also in U.C.C. § 8-102(3) which encourages use of depository facilities by non-brokers. The U.C.C. effectively permits distribution of the capital stock of depositories among their users creating a corporate form of ownership and control, which comports with the efforts of the Congress to ensure "fair representation to participants." Although Securities Exchange Act § 17A(b)(3)(C) indicates that "fair representation" might mean "ownership of voting stock" this has not yet been made a requirement. See S. REP. No. 94-75, 94th Cong., 1st Sess. 123-24, *reprinted in* [1975] U.S. CODE CONGRESSIONAL AND ADMINISTRATIVE NEWS 179, 301. The Commission recognizes that owners of an organization usually have voting and administrative powers over their holdings. Compliance with the statutory requirement of "fair representation of participants," however, will be determined by the Commission on a case by case basis and has not been predicated on the existence of voting rights in participants. See Regulations of Clearing Agencies, SEC Securities Exchange Act Release No. 34-14,531 (March 16, 1978) [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,525; Standards For the Registration of Clearing Agencies, Securities

provides that "delivery to a purchaser occurs when appropriate entries on the books of a clearing corporation are made under section 8-320."⁵² This method of delivery to a broker/participant will not effectuate a registration of transfer so as to make a customer of the broker/participant a registered owner,⁵³ nor will it result in delivery to the broker/participant's customer who is not itself a participant.⁵⁴ The securities will remain registered in street name, *i.e.*, that of the depository or its nominee. The broker will be able to direct the depository to have securities presented to the transfer agent for registration of transfer into the customer's name, however, and will thereby be able to make delivery to the customer should the customer so desire. If securities that are fully paid for or excess margin (are held in a segregated "customers' account" with a clearing-broker), book entry on the broker/dealer's books should suffice.⁵⁵ Federal securities regulations do not call for a segregated "customers' account" in a depository which is a subsidiary of "either [a] national securities exchange or of a registered national securities association or of a custodian bank."⁵⁶ Securities in such location are deemed to be in the control of the broker or dealer and can be segregated on his books. By assimilating the terms "possession" in U.C.C. section 8-313(1)(c) to the term "control," we submit that securities in a general account with such registered depository can be delivered to a customer by "book entries" on the broker/dealer's book. The present book entry system has streamlined the transfer of securities, but is still based on the possibility of an eventual deliv-

Exchange Act Release No. 34-16,900 (June 17, 1980), 3 FED. SEC. L. REP. (CCH) ¶ 26,2036. See also Aronstein, *A Certificateless Article 8? We Can Have it Both Ways*, 31 BUS. LAW. 727, 734 (1976).

⁵² The Commission's standards for the Registration of Clearing Agencies, *supra* note 50, requires that the agency have rules which provide that the agency is liable to the participants for a failure to deliver securities where such failure is due to (1) the negligence or misconduct of the clearing agency or its custodian; (2) a claim by the clearing agency against any fully-paid-for participant's securities; (3) larceny; (4) mysterious disappearance or (5) any other cause for which the clearing agency has assumed responsibility. The standard is higher than that of an ordinary bailee for hire. U.C.C. § 8-320(5) indicates that a failure to make appropriate entries "does not affect the validity or effect of the entries," but will give rise to "liabilities or obligations of the clearing corporation to any person adversely affected thereby." Thus, conceivably one whose rights were adversely affected by such entries could sue the clearing corporation to require that they be corrected or, in an appropriate case, for conversion of his securities. The Commission by setting a high standard predicated liability to participants, will not make it possible for clearing agencies to contract out from such liability without risking deregistration as a clearing agency and thus being unable to function as such.

⁵³ U.C.C. § 8-320(4).

⁵⁴ Normally, a broker's customer, other than an institutional customer such as a bank or an insurance company, will not be a participant. Thus the broker cannot make delivery to his customer by means of book entries in the clearing agency under U.C.C. § 8-313(1)(d).

⁵⁵ See SEC rule 15c3-3(c)(2), 17 C.F.R. § 240.15c3-3(c)(2) (1980); *Mattysse v. Securities Processing Servs., Inc.*, 444 F. Supp. 1009, 1018 (S.D.N.Y. 1977). The broker not being in possession of the certificate cannot make delivery by entry on his books, however. See U.C.C. § 8-313(1)(c); *In re Paragon Securities Co.*, 599 F.2d 551, 556-57 (3d Cir. 1979).

⁵⁶ See SEC Rule 15c3-3(c)(1), 17 C.F.R. § 240.15c3-3(c)(1) (1980).

ery of the stock certificate not only to a non-participant, but also to a participant in the system.

A national system for clearance and settlement must be structured so as to enable participants to compare, clear and settle all their transactions through one entity regardless of the market in which the trade is executed or the location of the other party to the transaction provided he qualifies as a participant. This function is called "one account processing." Although a participant should be able to obtain one account processing through one clearing agency, it should also be possible to divide these functions as the participants see fit. Comparison should be performed through the clearing agency affiliated with the marketplace in which the trade occurred.⁵⁷ The comparison instructions can then be directed to another clearing agency to perform the clearing function which would generate settlement instructions.⁵⁸ A number of clearing agencies have been granted interim registration by the Commission; so far none have been granted permanent registration (a) because the Commission's standards for the registration of clearing agencies have only now been promulgated,⁵⁹ and (b) so far, none have demonstrated an ability fully to comply with requirements imposed by the Commission.⁶⁰ In its order granting interim registration to National Securities Clearing Corporation (NSCC) the Commission explained that the registration of NSCC was "an essential step toward the establishment, at an early date, of a comprehensive network of linked clearance and settlement systems and branch facilities with the national scope, efficiencies and safeguards envisioned by Congress in enacting the 1975 Amendments."⁶¹ The Commission therefore imposed a "free interface condition" which requires NSCC to offer

⁵⁷ Prior to the merger into National Securities Clearing Corporation (NSCC), clearance on the N.Y.S.E. was through the N.Y. Stock Clearance Corporation (SCC), on the American Stock Exchange through American Stock Exchange Clearing Corporation (ASECC), and in the over-the-counter market, members of the N.A.S.D. cleared through the National Clearing Corporation (NCC), a subsidiary of the N.A.S.D. of which Bradford National Clearing Corporation (BNCC) was the facilities manager. BNCC was the facilities manager for at least one other regional stock exchange clearing corporation, *i.e.*, The Pacific Stock Exchange's Pacific Service Corporation. The creation of NSCC did not result in clearing agencies outside New York becoming a part of NSCC. It is interesting to note that NSCC was structured so as to comply with U.C.C. § 8-102(3). This required imposing restrictions on transfer of NSCC stock. *See Order, supra* note 12, at 3924.

⁵⁸ The possibility of using a depository not linked to the clearing agency which generated the settlement instructions should not be precluded; the Commission recognized that innovation at the depository level should be encouraged. *See Order, supra* note 12, at 3921.

⁵⁹ *See* SEC Securities Exchange Act Release No. 34-16900 (June 17, 1980), 3 Fed. Sec. L. REP. (CCH) ¶ 26,2036.

⁶⁰ Interim or temporary registration can only be effective for a period of eighteen months, unless the Commission by order provides for a longer period. Within nine months of such interim registration the Commission must determine whether to institute proceedings to grant or deny registration. *See* SEC Rule 17Ab2-1(c), 17 C.F.R. § 240.17Ab2-1(c) (1980).

⁶¹ *Order, supra* note 12, at 3917. The reference here is to the Securities Acts Amendment Act of 1975, Pub. L. No. 94-29, 89 Stat. 146 (June 4, 1975).

and establish full interfaces with other CNS systems without interface charges.⁶² The Commission indicated that by providing such interface without charge, NSCC would facilitate a national clearing and settlement system of interfaced entities where brokers and dealers will execute trades in the marketplace which offers the best price⁶³ and will then be able to use the clearing corporation of their choice. A second requirement is the "remote comparison condition" imposed by the Commission. This requires NSCC to provide at cost the same comparison facilities to NSCC participants located outside of New York City and to participants in other clearing corporations as are presently provided to these participants in New York City, *i.e.*, the Commission required that there be "geographic price mutualization."⁶⁴ At the present stage of technological development, comparison capabilities present the greatest obstacle to a national system for clearance.⁶⁵

A system applicable to the securities industry which permits the im-

⁶² A "full interface" enables a participant in one clearing corporation to compare, clear and settle all its transactions eligible for clearance at both interfacing clearing corporations at either of the interfacing clearing corporations. *See* Order, *supra* note 12, at 3929 n. 121.

⁶³ Note the Intermarket Trading System (ITS) is an electronic communications network that links the American, Boston, Midwest, New York, Pacific and Philadelphia Stock Exchanges so as to enable execution of orders on the exchange showing the best price. The system does not cover all securities listed on these exchanges.

⁶⁴ *See* Order, *supra* note 12, at 3929-30. The objective of geographic price mutualization (GPM) is to expand the securities market into a geographically nationwide operation by enabling brokers outside New York to "compete" more effectively with those inside New York. Whether it allocates resources more efficiently is doubtful. It may prove to be anti-competitive since it subsidizes regional brokers at the expense of those located in New York. Bradford National Clearing Corporation (BNCC) challenged this condition claiming that it would result in greater use of the New York market. The D.C. Circuit Court remanded this issue to the Commission "for a better explanation, if one exists, of how GPM may be utilized without thwarting regional competition. Failing that, the Commission must either condition registration on NSCC's abandonment of GPM, or at least convincingly conclude that the loss of regional competition engendered by GPM will not upset the favorable balance of benefits and anti-competitive effects that [the Commission] originally calculated on the assumption that such competition would exist." *Bradford National Clearing Corporation v. SEC*, 510 F.2d 1085, 1112-13 (D.C. Cir. 1978). BNCC also objected to NCC terminating its facilities management contract with them and the Commission approving NSCC's appointment of Securities Industry Automation Corporation, a subsidiary of the N.Y.S.E. and the AMEX, as "facilities manager and processor" for five years without giving BNCC an opportunity to bid for this contract. This matter also was remanded to determine "whether any exercise of 'business judgment' by a clearing agency may affect the realization of the national clearing system envisioned by Congress - *i.e.*, one that is safe, efficient, and competitive." *Id.* at 1114 (emphasis in original).

⁶⁵ *See* *Bradford National Clearing Corporation v. SEC*, 590 F.2d at 1098 n. 21. Thus at first only participants in New York City were able to take advantage of NSCC's comparison services regarding transactions on the N.Y.S.E., the AMEX and OTC. Participants outside of New York City were able to submit only OTC transactions through the regional network previously operated by NCC. The Commission now permits both listed and OTC securities to be cleared through NSCC branches outside New York City. *See* SEC Securities Exchange Act Releases Nos. 34-15640 (March 14, 1979), 34-16085 (Aug. 3, 1979), 34-16213 (Sept. 21, 1979).

mobilization of the stock certificate seems to be in place. Its extension to the individual shareholder is possible through regulations of broker-dealers and clearing agencies which must assure effective participation of beneficial owners in corporate governance⁶⁶ as well as of disclosure of such beneficial ownership to enable information to be made available to market participants.⁶⁷ The next logical step, therefore, would be to provide for the abolition of the share certificate altogether and its replacement by a computerized record of stock ownership kept by the issuer or his transfer agent. Federal legislation regulating transfer agents⁶⁸ is in place and has granted supervisory and rule-making powers to the Commission and other "appropriate regulatory agenc[ies]."⁶⁹ So far such regulations have called for the registration of transfer agents⁷⁰ and have introduced "turn-around" and "record keeping"⁷¹ requirements applicable to the registration of transfer of certificated securities. Congress, recognizing that the abolition of the securities certificate is but a matter of time, has instructed the Commission to include in its

annual report to Congress for each fiscal year . . . the steps the Commission has taken and the progress it has made toward ending the physical movement of the securities certificate in connection with the settlement of securities transactions, *and its recommendations, if any, for legislation to eliminate the securities*

⁶⁶ *E.g.*, Securities Exchange Act § 14, 15 U.S.C. § 78n (1976); SEC Rules 14a-1 *et seq.*, 17 C.F.R. § 240.14a-1, *et seq.* (1980) (proxy solicitation rules).

⁶⁷ *E.g.*, Securities Exchange Act § 13(d), 15 U.S.C. § 78m(d) (1976). SEC Rules 13d-1 *et seq.*, 17 C.F.R. §§ 240.13d-1 *et seq.* (1980).

⁶⁸ Securities Exchange Act §§ 3(a)(25) and 17A(c)(d), 15 U.S.C. §§ 78c(a)(25) and 78q-1(c)(d) (1976); SEC Rules 17Ad-1 *et seq.*, 17 C.F.R. §§ 240.17Ad-1 *et seq.* (1980). Expressly included in the definition of transfer agent are transfer agent depositories (TAD) which transfer record ownership by bookkeeping entries without the physical issuance of certificates. *See* Securities Exchange Act § 3(a)(25)(E), 15 U.S.C. § 78c(a)(25)(E) (1976).

⁶⁹ The "appropriate regulatory agencies" are:

(1) The Board of Governors of the Federal Reserve System for a state chartered bank which is a member of the Federal Reserve System or for a bank holding company, or for a subsidiary of such holding company or of such state chartered bank which is a bank that is not required to register with the Comptroller of the Currency or the Federal Deposit Insurance Corporation (FDIC);

(2) The Comptroller of the Currency for national banks, or a bank operating under the Code of Law for the District of Columbia, or their subsidiaries;

(3) The FDIC for a bank (or its subsidiary) which is insured by the FDIC other than a bank that is a member of the Federal Reserve System;

(4) The Commission for all other transfer agents including a state chartered bank which is not a member of the Federal Reserve System, is not insured by the FDIC, and is not a subsidiary of a bank holding company (*See* (1) above). *See* Securities Exchange Act § 3(a)(34)(B), 15 U.S.C. § 78c(a)(34)(B) (1976).

⁷⁰ *See* Securities Exchange Act § 17A(c)(2), 15 U.S.C. § 78q-1(c) (1976); SEC Rule 17Ac2-1, 17 C.F.R. § 240.17Ac2-1 (1980). *See also* SEC Rule 17Ac3-1, 17 C.F.R. § 240.17Ac3-1 (1980) (withdrawal of registration); MODERN SECURITIES, *supra* note 17, § 2.08.

⁷¹ *See* SEC Rules 17Ad-1 *et seq.*, 17 C.F.R. §§ 240.17Ad-1 *et seq.* (1980); MODERN SECURITIES, *supra* note 17, §§ 2.09-2.11.

*certificate.*⁷²

The Commission has not yet gone as far as to recommend a certificateless system. But by facilitating the immobilization of the certificate the Commission has gone as far as it can without interfering with state law.⁷³ To achieve the end result, the elimination of the stock certificate, state laws will have to be amended so as not to require the issuance of a stock certificate.⁷⁴ It is the desire of Congress, however, to preserve the right of

⁷² Securities Exchange Act § 23(b)(4)(E), 15 U.S.C. § 78w(b)(4)(E) (1976) (emphasis added).

⁷³ The Commission has power to make such regulations as to the form or format of registered securities as may be "necessary or appropriate for the prompt and accurate clearance and settlement of transactions in securities." Securities Exchange Act § 12(l), 15 U.S.C. 78l (l) (1976).

⁷⁴ State corporation laws pertaining to share certificates:

a. States requiring that certificates be issued:

- ALABAMA, ALA. CODE § 10-2-97 (1975)
- ALASKA, ALASKA STAT. § 10.05.114 (1968)
- ARIZONA, ARIZ. REV. STAT. ANN. § 10-023 (1977)
- ARKANSAS, ARK. STAT. ANN. § 64-208 (1966)
- COLORADO, COLO. REV. STAT. § 7-4-108 (1973)
- DISTRICT OF COLUMBIA, D.C. CODE ANN. § 29-908(g) (1973)
- IDAHO, IDAHO CODE § 30-1-23 (1979)
- ILLINOIS, ILL. ANN. STAT. ch.32 § 157.21 (Smith-Hurd) (1979)
- IOWA, IOWA CODE ANN. § 496A.22 (West) (1962)
- KENTUCKY, KY. REV. STAT. ANN. § 271A.115 (1972)
- MISSISSIPPI, MISS. CODE. ANN. § 79-3-43 (1972)
- MONTANA, MONT. REV. CODE ANN. § 15-2221 (1967)
- NEBRASKA, NEB. REV. STAT. § 21-2022 (1977)
- NEW JERSEY, N.J. STAT. ANN. § 14A:7-11 (Supp. 1979)
- NEW MEXICO, N.M. STAT. ANN. § 53-11-23 (1975)
- NEW YORK, N.Y. BUS. CORP. LAW § 508 (McKinney) (1963)
- NORTH DAKOTA, N.D. CENT. CODE § 10-19-20 (1976)
- OKLAHOMA, OKLA. STAT. ANN. tit. 18 § 1-112 (1947)
- OREGON, OR. REV. STAT. § 57.121 (1975)
- PENNSYLVANIA, PA. STAT. ANN. tit. 15 § 1607 (Purdon) (1965)
- RHODE ISLAND, R.I. GEN. LAWS § 7-1.1-21 (1969)
- SOUTH DAKOTA, S.D. COMP. LAWS ANN. § 47-3-12 (1967)
- TEXAS, TEX. BUS. CORP. ACT. ANN. art. 2.19 (Vernon) (1956)
- TENNESSEE, TENN. CODE ANN. § 48-509 (1979)
- UTAH, UTAH CODE ANN. § 16-10-21 (1972)
- VERMONT, VT. STAT. ANN. tit. 11 § 1869 (1973)
- VIRGINIA, VA. CODE § 13.1-20 (1950)
- WASHINGTON, WASH. REV. CODE ANN. § 23A.08.190 (1969)
- WEST VIRGINIA, W. VA. CODE § 31-1-87 (1975)
- WISCONSIN, WIS. STAT. ANN. § 180.18 (West) (1957)
- WYOMING, WYO. STAT. § 17-1-120 (1977)

b. States requiring the issuance of certificates upon the demand of any stockholder (each stockholder entitled to a certificate):

- CONNECTICUT, CONN. GEN. STAT. § 33-345 (1958)
- DELAWARE, DEL. CODE ANN. tit. 8 § 158 (1974)
- FLORIDA, FLA. STAT. ANN. § 607.067 (West) (1977)
- INDIANA, IND. CODE ANN. § 23-1-2-6(f) (Burns) (1972)

the shareholder to demand delivery of a stock certificate.⁷⁵ Whether or not a certificate is issued is, of course, irrelevant to establishing share ownership in a corporation.⁷⁶ The sole requirement is entry on the stock-list. Thus, even those states which still require the issuance of a share certificate, permit such certificates to be kept in a Transfer Agent Depository (TAD). The TAD would keep computerized stockholder lists which would serve both as issuer's stock records and stockholder's ownership records. Through instructions, the TAD would effectuate book entry transfers between participants by credit and debit book entries, and also would issue and deliver physical certificates if so directed.⁷⁷ It is thus clear that a transaction in an uncertificated security will not be a "paperless" transaction; written instruction to transfer will still be necessary.⁷⁸

KANSAS, KAN. STAT. ANN. § 17-6408 (1974)

LOUISIANA, LA. REV. STAT. ANN. § 12:57 (West) (1969)

MAINE, ME. REV. STAT. ANN. tit. 13-A § 511 (1974)

MARYLAND, MD. ANN. CODE art. 23 § 27 (1973)

MASSACHUSETTS, MASS. ANN. LAWS. ch. 156 § 33 (Michie/Law. Co-op) (1970)

MICHIGAN, MICH. STAT. ANN. § 420.25 (West) (1973)

MINNESOTA, MINN. STAT. ANN. § 301.18 (West) (1969)

NEVADA, NEV. REV. STAT. § 78.235 (1975)

NEW HAMPSHIRE, N.H. GEN. STAT. § 294:51 (1977)

NORTH CAROLINA, N.C. GEN. STAT. § 55-57 (1979)

OHIO, OHIO REV. CODE ANN. § 1701.24(b) (Page) (1978)

SOUTH CAROLINA, S.C. CODE § 33-9-110(a) (1976)

c. States requiring a certificate unless otherwise provided in the articles of incorporation or bylaws of the corporation:

GEORGIA, GA. CODE ANN. § 22-508 (1977)

MISSOURI, MO. ANN. STAT. § 351-295 (Vernon) (1975)

d. States not requiring certificates for shares registered under the '34 Act or the Federal Investment Company Act of 1940:

CALIFORNIA, CAL. CORP. CODE § 416 (West) (1977).

Hawaii has no specific requirements concerning share certificates.

⁷⁵ See S. REP. NO. 94-75, 94th Cong., 1st Sess. 58-59, *reprinted in* [1975] U.S. CODE CONG. & ADM. NEWS 179, 236-37, 301.

⁷⁶ See FLETCHER, CYCLOPEDIA CORPORATIONS § 4655 (1976).

⁷⁷ See Order, *supra* note 12, at n.68. Note also the Transfer Agent Custodian Program (TAC) which permits a securities depository to maintain a Jumbo certificate with the transfer agent to cover any delivery which may have to be made to a non-participant, thereby reducing the movement of certificates between the depository and the transfer agent. The transfer agent can break down the Jumbo certificate and issue shares in accordance with instructions received. As the need for shares changes, the depository will increase or decrease the shares in TAC. *Id.* at 3921 n.72. An issue arises whether such deposit with the transfer agent, *i.e.*, TAC would be in compliance with SEC Rules 8c-1(g) and 15c2-1(g), 17 C.F.R. §§ 240.8c-1(g) and 240.15c2-1(g)(1980). In holding that there would be compliance, the Commission upheld the Fast Automated Securities Transfer (FAST) program instituted by the Depository Trust Company. See SEC Securities Exchange Act Release Nos. 34-13342 (March 8, 1977) and 34-12353 (April 20, 1976).

⁷⁸ SUBCOMM. ON SECURITIES OF THE SENATE COMM. ON BANKING, HOUSING AND URBAN AFFAIRS, 92D CONG., 2D SESS., SECURITIES INDUSTRY STUDY CH. I (1972); SUBCOMM. ON COMMERCE AND FINANCE OF THE HOUSE COMM. ON FOREIGN COMMERCE, 92D CONG., 2D SESS.; SECURITIES INDUSTRY STUDY CH. VII (1972). The use of a non-negotiable "initial transaction statement" is contemplated by the proposed revision of U.C.C. Article 8. See U.C.C. § 8-

The uncertificated security is not a new concept. In recent years short-term debt incurred by the federal government, or by some of the independent federal agencies, such as The Federal Home Loan Bank, the Federal Farm Credit Bank, etc., have not been embodied in an instrument but have been recorded on books specially kept by a Federal Reserve Bank as fiscal agent of the United States.⁷⁹ In addition mutual fund shares, particularly open-ended no load funds, have only rarely issued certificated shares.⁸⁰

Under the existing provisions of the U.C.C. a security not represented by an instrument would not be governed by Article 8 - Investment Securities.⁸¹ Transfer of such contract right could not be by negotiation,⁸² but would be by assignment. Such assignment would require notice to the obligor to be effective.⁸³ Unless there be a provision in the agreement creating the contract right that the obligor will not assert any defenses against an assignee,⁸⁴ the assignment would be subject to the rights of and defenses to the obligor.⁸⁵ Third parties claiming rights in such *chase in action* would have to perfect their rights by complying with the requirements of U.C.C. Article 9 - Secured Transactions, relating to "general intangibles."⁸⁶ In addition, notice of an "adverse claim,"⁸⁷ given to the issuer of such security "at his chief executive office,"⁸⁸ should suffice to protect the "secured party."⁸⁹

408(4) (1977).

⁷⁹ A Federal Book Entry Deposit System governing Treasury Bills exists in New York's Federal Reserve Bank since 1970 and in St. Louis since 1971. See 12 U.S.C. §§ 391-395 (1976).

⁸⁰ Note also dividend reinvestment plans do not issue fractional shares. See Coogan, *Security Interests in Investment Securities Under Revised Article 8 of the Uniform Commercial Code*, 92 HARV. L. REV. 1013, 1019 (1979) [hereinafter cited as Coogan].

⁸¹ The U.C.C., however, does recognize the immobilization of the certificate by providing for transfer by book entry. See, e.g., U.C.C. §§ 8-313, 8-320. In all these cases there is presumably a certificate held somewhere in a depository or a TAC.

⁸² See MODERN SECURITIES, *supra* note 17. Reclamation rules may protect market participants.

⁸³ See U.C.C. §§ 9-318(3), 9-502(1); RESTATEMENT (SECOND) OF CONTRACTS § 170(1) (Tent. Draft Nos. 1-7 Rev., 1973).

⁸⁴ See U.C.C. §§ 9-318(1), 9-206(1), 9-102(3).

⁸⁵ Cf. U.C.C. § 9-318(1); RESTATEMENT (SECOND) OF CONTRACTS § 168(1) (Tent. Draft Nos. 1-7 Rev., 1973).

⁸⁶ See U.C.C. §§ 9-106, 9-103(3). This will require the existence of a security agreement granting the security interest, see *id.* §§ 9-105(1)(1), 9-201, signed by the debtor, *id.* § 9-203(1)(a), and the filing of a financing statement, *id.* §§ 9-302, 9-401, containing the information required to give third parties notice of the existence of a perfected security interest in the creditor. *Id.* § 9-402.

⁸⁷ U.C.C. § 8-301(1).

⁸⁸ U.C.C. § 9-103(3)(d). See DEL. CODE. tit. 5A, § 8-313(1) tit. 8, §§ 169, 324 (1967 & 1974); U.C.C. § 8-320(3) (between participants in a clearing corporation, book entry will perfect pledge of security held by clearing corporation). See also Aronstein, *Security Interests in Securities: How Code Revision Reflects Modern Security Holding Practices*, 10 U.C.C. L.J. 289 (1978) [hereinafter cited as Aronstein].

⁸⁹ U.C.C. § 9-105(1)(m).

But not every "adverse claim" can be handled in this manner. Only an adverse claim qualifying as a "security interest created by contract including pledge, assignment . . . , other lien or title retention contract . . ." ⁹⁰ is covered by U.C.C. Article 9. "A claim that a transfer was or would be wrongful or that a particular adverse person is the owner of or has an interest in the security" ⁹¹ does not necessarily arise out of a contract qualifying as a "security agreement." ⁹² This deficiency in the U.C.C. requires revision of existing provisions of U.C.C. Article 8 and Article 9. It is not clear what would be the effect of notice of such an "adverse claim" against an uncertificated security given only to an issuer where such claim cannot be perfected under the U.C.C. ⁹³ What can be stated, however, is that the status of bona fide purchaser ⁹⁴ cannot arise in connection with a transfer of such intangible neither under the provisions of the U.C.C. at present in force in most jurisdictions ⁹⁵ nor under general equitable principles.

The congressional policy expressed in the 1975 Amendments to the Securities Exchange Act ⁹⁶ calling for the immobilization of securities certificates ⁹⁷ rang a responsive chord in the securities industry to completely abolish such certificates. ⁹⁸ Thus, a revision of U.C.C. Article 8 was undertaken jointly by the ABA-ALI and the Permanent Editorial Board for the U.C.C. ⁹⁹ When the revision received the approval of these bodies they were adopted by the Uniform Laws Commissioners and have now been enacted in three jurisdictions. ¹⁰⁰ A critique by Peter F. Coogan ¹⁰¹ concentrated on the basic philosophy of the revision:

The draftsmen created rules for uncertificated securities which generally parallel the rules presently in use for certificated securi-

⁹⁰ *Id.* § 9-102(2).

⁹¹ *Id.* § 8-301(1).

⁹² *Id.* § 9-105(1)(1).

⁹³ It may be possible to apply U.C.C. § 8-403 by analogy, *i.e.*, the issuer may be given notice of an adverse claim in writing or he may receive such notice as a result of requiring controlling instruments when effectuating a transfer. U.C.C. § 8-402(4). There being no "reification" of the obligation there can be no attachment by physical seizure. *Cf. id.* § 8-317(1). Such rights can only be attached following recourse to legal process. *See DEL. CODE. tit. 8, §§ 169, 324 (1974); U.C.C. § 9-501(1).*

⁹⁴ U.C.C. § 8-302.

⁹⁵ The status of "bona fide purchaser" has been confined historically to a purchaser of goods and has not been applied to one who has acquired a chose in action.

⁹⁶ Pub. L. No. 94-29, 89 Stat. 97 (1975).

⁹⁷ Securities Exchange Act § 17A(e), 15 U.S.C. § 78q-1(e) (1976).

⁹⁸ *See Smith, A Piece of Paper Revisited*, 26 *BUS. LAW.* 1769 (1971).

⁹⁹ The revision does not require that states permit uncertificated equity securities, nor does the revised article require an issuer to issue uncertificated securities even should state corporation law permit it. U.C.C. § 8-102 (1977), *Official Comment*.

¹⁰⁰ The three jurisdictions which have adopted the revisions of Article 8 of the U.C.C. are Minnesota (Ch. 695, L. 1978, effective Jan. 1, 1979), West Virginia (S.B. 110, L. 1979, effective May 20, 1979), and Connecticut (P.A. 79-435, effective Oct. 1, 1979).

¹⁰¹ *See Coogan, supra* note 79, at 1019.

ties. This approach appears to reflect a basic philosophical premise that the rules developed under a half-century of experience with certificated securities (which in turn were based on several centuries of development in negotiable instruments law), being tested and familiar, should generally be applied with a minimum of modification in the new situations — even though that situation involves securities for which there is no certificate and for which there will be no certificates unless the parties agree that the uncertificated securities be converted into conventional securities represented by a certificate.¹⁰²

An “uncertificated security” can exist only in registered form¹⁰³ and qualifies for inclusion in revised Article 8 only if it is “of a type commonly dealt in on securities exchanges or markets.”¹⁰⁴ This functional requirement adequately excludes from the definition “other media for investment”¹⁰⁵ which are represented by book entry, such as savings accounts and which are not dealt in on any securities markets.

Since there is no “reification” of the obligation, a transfer by “delivery”¹⁰⁶ is not possible. Any attachment of the rights represented by an “uncertificated security” will require “legal process at the issuer’s chief executive office in the United States,”¹⁰⁷ or, where such security is registered in the name of a secured party or of a “financial intermediary,”¹⁰⁸ by legal process upon the secured party¹⁰⁹ or “upon the financial intermediary on whose books the interest of the debtor appears.”¹¹⁰

Although the concept of negotiability is thus inapplicable to an “uncertificated security,” the revised provisions of U.C.C. Article 8 attempt

¹⁰² *Id.* at 1014.

¹⁰³ An “uncertificated security” is a share, participation, or other interest in property or an enterprise of the issuer or an obligation of the issuer which is

- (i) not represented by an instrument and *the transfer of which is registered upon books maintained for that purpose by or on behalf of the issuer;*
- (ii) of a type commonly dealt in on securities exchanges or markets; and
- (iii) either one of a class or series or by its terms divisible into a class or series or shares, participations, interests, or obligations.

U.C.C. § 8-102(1)(b) (1977) (emphasis added).

¹⁰⁴ U.C.C. § 8-102(1)(b)(ii) (1977).

¹⁰⁵ *Id.* § 8-102(1)(a)(ii) (1977).

¹⁰⁶ See MODERN SECURITIES, *supra* note 17, chs. IV-VI.

¹⁰⁷ U.C.C. § 8-317(2) (1977).

¹⁰⁸ A financial intermediary is “a bank, broker, clearing corporation, or other person (or the nominee of any of them) which in the ordinary course of its business maintains security accounts for its customers and is acting in that capacity.” U.C.C. § 8-313(4) (1977). The “financial intermediary” must “hold” securities in an account for the customer. Though the securities may actually be deposited elsewhere, they must be at the disposition of the financial intermediary subject to his customer’s orders. Thus a bank pledgee would hold for its own account, while a broker holding securities in margin account would be a financial intermediary. Compare SEC Rule 15c3-3(c)(1), (2), 17 C.F.R. §§ 240.15c3-3(c)(1), (2) (1980).

¹⁰⁹ See U.C.C. § 8-317(3) (1977).

¹¹⁰ *Id.* § 8-317(4) (1977).

to create a "bona fide purchaser" of such "uncertificated security" by providing that "a purchaser for value in good faith and without notice of an adverse claim . . . (b) to whom the transfer, pledge, or release of an uncertificated security is registered on the books of the issuer,"¹¹¹ acquires all the rights which the transferor had or could convey,¹¹² "free of any adverse claims."¹¹³ Notice of "adverse claims" would require either "actual knowledge" of such claims or from the facts and circumstances such knowledge is imputed to the purchaser.¹¹⁴ In the case of an uncertificated security such notice of an adverse claim cannot arise from any notation on a certificate, it will have to be communicated through the "initial transaction statement,"¹¹⁵ or through some other periodic statement submitted by the issuer to the registered owner.¹¹⁶ If such notice is not given to the issuer¹¹⁷ in time for him to enter such adverse claim on an "initial transaction statement,"¹¹⁸ *i.e.*, at the time of (1) a transfer to a new registered owner,¹¹⁹ or (2) a pledge to a registered pledgee,¹²⁰ or prior to the issuer submitting to the registered owner a periodic statement of account,¹²¹ a transferee or a pledgee would not be aware of an adverse claim unless he requires the transferor or the pledgor to submit to him a current-dated written statement by the issuer setting forth whether or not there are any liens, restrictions, or adverse claims to the "uncertificated security."¹²² A failure to make such request for an "issuer statement," however, does not automatically indicate an absence of "good faith" so as to deprive a purchaser of the status of "bona fide purchaser."¹²³ Thus such a purchaser could insist that he receive an initial transaction statement free from all adverse claims and that he be registered as a registered owner.¹²⁴ As we have indicated, this conclusion creates some difficulties.

The policy of following the existing provisions of U.C.C. Article 8 as closely as possible is extended even to the creation of a pledgee, albeit a

¹¹¹ *Id.* § 8-302(1) (1977).

¹¹² *Id.* § 8-301 (1977).

¹¹³ *Id.* § 8-302(2) (1977) (emphasis added).

¹¹⁴ *Id.* §§ 1-201(25)(26)(27) (1977).

¹¹⁵ *Id.* §§ 8-204(b), 8-408(4) (1977).

¹¹⁶ *Id.* §§ 8-408(6), (7) (1977).

¹¹⁷ *Id.* § 8-403(4) (1977).

¹¹⁸ *Id.* § 8-408(4) (1977). Neither the "initial transaction statement" nor any subsequent periodic statement or "dated written statement" is a security or a negotiable instrument. *Id.* § 8-408(9) (1977).

¹¹⁹ *Id.* § 8-408(1) (1977).

¹²⁰ *Id.* § 8-408(2) (1977).

¹²¹ *Id.* §§ 8-408(6), (7) (1977).

¹²² *Id.*

¹²³ See MODERN SECURITIES, *supra* note 17, § 4.11. The issuer may not have received a notice of an adverse claim. On the other hand, a failure to make such inquiry, when there are suspicious circumstances, may be due to a deliberate attempt "not to see what is there to be seen."

¹²⁴ In a market transaction, the requirements of "good delivery" and the existence of "reclamation rights" would protect a purchaser. See note 49 *supra*.

registered pledgee, of an incorporeal right.¹²⁵ The irrationality of this approach is further illustrated by the provision that "there can be more than one registered pledge of an uncertificated security at any time."¹²⁶ There is a conceptual inconsistency here where we are dealing with an incorporeal right.¹²⁷ Was it necessary to continue the idea of a "pledge?"¹²⁸ To justify not adopting a pure secured interest approach with priority determined by notice to the issuer on the ground that,

it was a judgment based on practical rather than theoretical considerations. . . . Thus, the first hurdle to be crossed in any movement from certificated to uncertificated securities is to persuade the issuer to make uncertificated securities available. No issuer is likely to take that path if it feels that, by doing so, it will expose itself to unacceptable risks and burdens. The drafters concluded that a requirement that multiple pledges be registered would impose sufficient additional risks and burdens on issuers to deter significantly the issuance of an uncertificated securities,¹²⁹

is clearly illogical, unproven and unacceptable. The existing Article 8 provides for notice of "adverse claims."¹³⁰ There have been no reported cases of issuers refusing to accept such notice or considering it impossible, a risk, or a burden to comply with the requirements of Article 8, once such notice has been received. Sloppy language and sloppy legal conceptualizing has been the cause of too much litigation. Nor do we need to continue creating new Alice in Wonderland language.¹³¹ The effect of this approach is to create complications and difficulties that a fresh approach to the problems created by an uncertificated security could have obviated.¹³²

It is not our purpose to decry the philosophy underlying the revision of Article 8, nor to fight against the recognition of the "uncertificated security." We support the development of legal rules which will assist in the creation of uncertificated securities should this further the needs of

¹²⁵ See U.C.C. § 8-108 (1977).

¹²⁶ *Id.* § 8-108 (1977).

¹²⁷ See Coogan, *supra* note 79, at 1028-48.

¹²⁸ *Id.* The change in commercial transactions from the use of negotiable promissory notes and drafts to assignments of open accounts has been noted by the draftsmen of Article 9, by not patterning that Article on the rules governing the negotiability of commercial paper. Similarly, any revision of Article 8 or of Article 9 to take account of a security not represented by a certificate should not attempt to continue concepts inapplicable to such different commercial transactions.

¹²⁹ Aronstein, Haydock and Scott, *Article 8 Is Ready*, 93 HARV. L. REV. 889, 900 (1980); Aronstein, *supra* note 87, at 300.

¹³⁰ See U.C.C. § 8-304.

¹³¹ See Conrad, *New Deal For Fiduciaries Stock Transfers*, 56 MICH. L. REV. 843, 883 n. 162 (1958).

¹³² We will reserve to a future time a complete analysis of the effect of revised Article 8 and how it can be improved upon. Not having been involved in the work of the 348 Committee, this criticism levied at Professor Coogan by Aronstein, Haydock and Scott would not be applicable then.

the marketplace, as it obviously will. We merely wish to point out that accepted concepts should not be distorted, that legal rules can be formulated to achieve desired results without creating confused thinking. A revision of the proposed new U.C.C. Article 8 is called for, not to change its philosophy but to change some of its specifics so as to allow state law to follow the lead of federal securities law and regulations.