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**CAN WE DO WITHOUT STOCK CERTIFICATES?
A LOOK AT THE FUTURE**

By

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I. The Problem

Everyone who reads the financial pages has been made aware of the log-jam in processing securities transactions, growing out of the tremendous stock trading volume of the past three years. The number of times that some act of human intervention is required during the interval between A's decision to sell his 100 shares of X stock on an exchange, and the coming to rest of the transaction by the delivery of a certificate of stock to the purchaser, B, is truly a source of dismay. Sufficient employees with aptitudes and attitudes requisite to carrying out the multitude of tasks involved in these operations simply do not exist.

Recent articles have singled out the necessity of dealing with the stock certificate itself as the worst factor in this situation.¹ It is the purpose here to examine into the feasibility of doing away with the certificate altogether, at least as to those corporations whose stock enjoys a substantial volume of trade on the exchanges or in the national over-the-counter market.

II. Are There Other Alternatives?

Elimination of certificates is a drastic way of resolving the paperwork problem, and before turning to it one should first question whether other solutions or palliatives have been tried. Some of these implemented or proposed in recent years are:

- (1) Stock exchange service corporations which provide computerized bookkeeping for member firms.
- (2) Stock exchange and other clearing corporations which centralize payments and deliveries between brokers.
- (3) Central Certificate Service of the New York Stock Exchange, whereby stock held in the names of brokers for customers will be transferred into large denomination certificates, in nominee name, and left with a depositary. This will permit inter-broker transfers to be effected by book entries without transfer of the underlying stock.

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1. Frost, *Action Proposed to Help Solve "Fails" Problem*, Investment Dealers' Digest, November 27, 1967, p. 42; *Back Office Blues*, Wall St. J. (Midwest Ed.) Feb. 6, 1968, p. 1, col. 6 & p. 23, col. 1-2; *Streamlining Proposal for Stock Certificates*, *ibid.*, p. 23, col. 3.

- (4) CUSIP, developed by an American Bankers Association committee to provide, in effect, a numeric name for each issue of publicly held securities. For example, all XYZ Corporation 5% Cumulative Preferred Stock certificates would have imprinted on the back a unique eight-digit number, assigned by a central authority. The Transfer Agent in issuing the certificate could also show the number of shares on the back. These numbers will provide a quick reference for manual handling and permit the use of optical scanning techniques for preparing input for the record-keeping of banks and brokers.
- (5) A recent proposal by the Association of Stock Exchange firms recommending consideration of punched card stock certificates in substitution for present forms.

Procedures (1) and (2) above are apparently working satisfactorily, but it is generally agreed they cannot in themselves solve the problem. CCS (referred to at (3) above) has been in experimentation and study for 12 years; its period of gestation is not yet over, with expectations for late 1968 or early 1969. If successful, this system will eliminate some paperwork; however, as indicated above, it applies only to stock which would otherwise be registered, more or less permanently, in brokers' names (perhaps 10% of all outstanding N.Y.S.E. listed shares). This 10%, of course, is the stock which tends to be in motion; thus the elimination of its transfers and reissues should cut the work load for brokers and transfer agents.

Items (4) and (5) must be considered as palliatives at best. Assuming their acceptance by the securities fraternity, they will simplify to a degree such things as counting and identifying issued certificates, but there will still be just as many millions of pieces of paper, first to be created, and then to be handed back and forth between brokers, clearing corporations, transfer agents, registrars, pledgees and (finally) stockholders.

III. Why Are Certificates Necessary?

One automatically associates stock certificates as being an essential part of the relationship between a business corporation and its shareholders. However, it is generally considered that shares can be created where no certificates are issued.² Some early corporation statutes apparently did not provide for the surrender and issuance of certificates as having any significance in the transfer process.³ There would seem to be no reason why the legislature could not authorize noncertificated shares to be issued and remain outstanding.

Stock certificates have not always been considered as having the

2. CHRISTY, *THE TRANSFER OF STOCK*, 3rd Ed. (1964) §11, *et seq.*; *U. S. Radiator Co. v State of New York*, 208 N. Y. 144, 101 N. E. 783 (1913).

3. *Agricultural Bank v. Burr*, 24 Me (11 Shep.) 256 (1844).

attributes of negotiable instruments or as constituting property apart from the shares as recorded on the corporate books. It was not until the turn of the century that the concept of negotiability, and of the certificate as in itself property, took firm hold in the law.⁴ It is ironic that this quality of negotiability growing out of the commercial necessity of sixty years ago should be the very quality which causes us so much trouble today. The answer is simply, changing times. We are today by reason of our electronic equipment better able to cope with record keeping and creation of products from that record keeping; we are less able to cope with the individual handling of millions of units of negotiable paper. So, in order to negate the negotiability built by law into these pieces of paper we are driven to the following expedients:

- (a) The Central Certificate Service of the New York Stock Exchange will assemble large denomination negotiable stock certificates, lock them up, and keep a set of books as to their beneficial ownership.
- (b) "Treasury securities that pass between commercial banks and Federal Reserve banks next year will be represented by small slips of paper rather than the engraved, negotiable documents currently used."⁵
- (c) Many of the mutual funds in declaring capital gains dividends payable in shares send the shareholder only an annual advice stating that he is entitled to a certain number of additional shares but that certificates will be issued only if demanded.

It clearly is time to consider whether, in the light of the advantages and limitations of existing operating methods we are dealing with rituals rather than realities in retaining the idea that the certificate serves a commercial necessity by continuing to be negotiable and by representing, in itself, a property interest.

IV. How Manage Records and Transfers?

Passing for the moment the question of statutory changes that will be required, let us look at a hypothetical X corporation, which has

4. The Uniform Stock Transfer Act was first enacted in 1910. The following excerpts from the notes of the Commissioners on Uniform State Laws appearing in *Uniform Laws Annotated*, vol. 6, *Stock Transfer*, (1922) provide a capsule history:

Section 1: "... the transfer of the certificate is here made to operate as a transfer of the shares, whereas at common law it is the registry on the books of the company which makes the complete transfer. The reason for the change is in order that the certificate may, to the fullest extent possible, be the representative of the shares."

Section 5: "This section gives full negotiability to certificates of stock. In so doing it goes beyond the existing law but is in accordance with mercantile custom."

5. *Banks, Reserve to Switch to Slips from Certificates*, *Wall St. J.* (Midwest Ed.) Nov 21, 1967, p. 23, col. 3.

just gone public for the first time, in a secondary offering, and there are 10,000 shareholders and a New York Stock Exchange listing. The names, addresses, shares and taxpayer I.D. numbers are all recorded on the Transfer Agent's computer. Each of these shareholders has received an advice from the Transfer Agent reading something like this:

ISSUANCE ADVICE

Date: *July 2, 1968*

To *John J. Owner*
762 East Madison Street
Chicago, Illinois 60603

Taxpayer
 Identification No. *319-09-1642*

This will advise you that on this date there has been registered in your name on the books of the corporation named below: 100 Shares

X CORPORATION COMMON STOCK, \$5 PAR

Your previous balance was 0 Shares

Your new balance is 100 Shares

THIS IS NOT A SECURITY AND IS NOT NEGOTIABLE.
 Your shares may be assigned and transferred only upon proper execution and delivery of an approved Transfer Order.

For further information see reverse side.

(Reverse side)

Your bank or broker can supply you with Transfer Order forms upon request. You may find it desirable, for income tax and other purposes, to preserve advice forms as received. However, if you are maintaining separate book records of your transactions, you may wish to discard all but the most recent advice form.

NOTICE

(Here insert legend, if necessary, regarding a statement of designations, preferences, etc., pertaining to different classes of stock.)

This advice is printed on a check or bank-note grade of paper, and perhaps has a vignette or an engraved border to give it a solid appearance, though it will not be an imitation stock certificate. It will be card size.

Necessarily, the general routine in relation to the shareholder—payment of dividends, mailing of proxies, etc.—will be handled exactly as under a certificate system. Happily, there are no certificate numbers; the record of the shareholder's account now and for the future will show only share debits and credits, and the respective dates—just as his personal bank account shows only dollars in and dollars

out. If Shareholder A wants to sell his 100 shares, he calls his broker B, who immediately executes the order by sale to Broker C. Next day A goes to B's office and signs an instrument (hereinafter called a "Transfer Order") which constitutes an assignment of the shares and an order on the Transfer Agent in favor of B for 100 shares of X Corporation. B on the same day deposits the order in his firm's shareholder account with the Transfer Agent—he has also authorized a debit to the B account for 100 shares, to be credited to Broker C. C in turn debits his account and credits his customer D. By this time (not more than 3 days if all parties are in the same city) A has his money and D has an advice from the Transfer Agent confirming his new ownership.

As a matter of fact, Broker C may well have to hold up the transfer to D for a day or two, in order to permit the confirmation of the purchase to reach D and give him an opportunity to pay what he owes. Contrast the foregoing with the over-all time span of at least 10 days under ideal conditions for the requisite certificates to complete their travels under today's system—and under conditions prevailing at this writing a span of a month or more is not unusual.

It should be made clear that the transfer by A *must* be made by a written "Transfer Order" on which his signature is guaranteed by a bank or broker as at present. The property interests involved are too vast to permit dispensing with this formality by means of a credit card or other device. X Corporation will expect its Transfer Agent to see that all technical requirements on A's assignment are met. The transfers from Broker B to Broker C, and from Broker C to purchaser D, could be handled instantaneously by "on line" computer directions from the respective brokers to the Transfer Agent, or from a brokers' clearing house to the Transfer Agent.

Another instance where a substantial saving takes place is the issuance of a stock dividend or stock split. Instead of issuing 10,000 stock certificates and sending 10,000 people to their safe deposit boxes, there will simply be mailed 10,000 advices—as easy to prepare as a check—which will show the old and new balance and will, of course, be non-negotiable. If fractional interests are involved they will be rounded up or down on orders before the advices are mailed. And for the 30 people who would have claimed under the old system, that they did not receive their dividend stock certificates, there is no problem of surety bonds and affidavits—they can have a duplicate advice whenever they want it.

Suppose A wants to pledge his 100 shares as collateral for a bank loan. Presumably the bank would insist on transferring the shares into its own name as pledgee, or, more likely, outright into the name of its nominee. The burden thereby assumed by the bank in handling and passing on to the borrower such things as dividends and proxies may well be offset by the fact that the bank no longer will need to count in

and out, and provide custody and audit for, actual securities. The bank will also be assured of being credited with any stock dividends or splits, without depending on the borrower.

Finally, suppose that A dies. The record of his stock ownership will be with the Transfer Agent, just as the record of his cash account will be with his bank. Advices as above referred to in the decedent's possession, dividend records, income tax records, 1099 reports by disbursing agents, all will provide clues to ownership, just as in the case of other types of property not made the subject of certificated ownership. Transfer by the executor, or by a trustee or other fiduciary will require a signed transfer order plus supporting papers appropriate under present practices.

While inquiring into the sufficiency of the shareholder's own records it might be pointed out that basically he is in no different situation from that of hundreds of thousands of shareholders who leave their stocks permanently in the hands of their banks or brokers permitting the custodian to register the stock in its name or that of a nominee. Only the statements and remittances received provide a clue to ownership.

V. Statutory Changes Required

Clearly the following sections of the Model Business Corporation Act would need to be amended:

§21. *Certificates representing shares.* This section states that shares shall be represented by certificates, and enumerates the formal requirements involved. There would, of course, have to be an amendment to this section permitting the alternative of a notice or advice to the shareholder and possibly specifying the mechanics of transition from the certificate procedure to advice procedure.

§22. *Issuance of fractional shares or scrip,* and §74. *Rights of Dissenting Shareholders,* would need minor amendments by reason of existing references to certificates.

Changes required in Article 8 of the Uniform Commercial Code would be substantial; perhaps "monumental" would be a better word. The title of Article 8 is "Investment Securities"; it deals with securities as instruments constituting property; 40 of its 41 sections use the words "security" or "securities."

Thus, it would seem to be necessary to add a new definition ("Investment Interests," for example) and work it into the context of most of the Sections, with a good many variations. Innumerable questions must be answered such as "When does one become a bona fide purchaser?"; "How define an appropriate person?"; "Is certification of a transfer order by the Transfer Agent an assurance that there are no adverse claims or transfer restrictions on file?"; "What happens if an adverse claim is filed after certification?"; "As there will be no certificate subject to attachment, do we have to adopt the Delaware rule in this area?"

A possible alternative would be an expansion of, or a separate section along the lines of, Section 8-302 which provides for a Central Depository System. The purpose of this section was to provide sanction for the Central Certificate Service of the New York Stock Exchange referred to earlier. This system was designed to deal with the deposit of a portion of the outstanding stock of a great many corporations, under the supervision of a clearing corporation and held only for the accounts of brokers and their bank pledgees.

Essentially the Central Certificate Service will be a service organization operated by and paid for by brokers for their own benefit—issuing corporations have no direct concern in it. While the successful operation of the service will be very helpful and of great interest to those studying the larger plan of eliminating stock certificates altogether, it seems most unlikely that it could be developed operationally and economically into a successful vehicle for transfers generally. Most corporations will want to retain control over their Transfer Agents.

Apart from the corporation acts and the Code, there will be other statutes requiring amendment because of references to stock certificates.

VI. General Observations

Debt Securities

Bonds and debentures have been omitted from this discussion, as inappropriate for certificateless treatment for the following reasons: (1) Most are in bearer form; the volume of registered obligations, while rising rapidly, is tiny in relation to stock, (2) holders are creditors rather than proprietors and by reason of adverse interests should have the advantage of full documentation of their claims (see U.C.C. Section 8-202).

The Registrar

What will happen to the Registrar's function? Traditionally, its duties have related only to avoidance of overissue of shares through control over *certificates*—it has not warranted anything as to the state of the Transfer Agent's records. Under a no-certificate system, the stock exchanges will have to decide (1) whether they will permit a corporation whose shares are listed to keep its own records; (2) whether an approved independent bank or trust company transfer agent will be permitted to do the job alone; and (3) whether a separate Registrar can effectively perform a control function to provide additional assurance of the integrity of the Transfer Agent's records.

What corporate action is required?

By-laws must be amended, consistent with changes adopted in the corporation acts, to permit share interests with or without certificates to co-exist. It would seem desirable to provide that turning in of certifi-

ates should not be mandatory until such time as the holder wishes transfer or reissue, in which case he or his transferee should be entitled only to the "Advice of Transfer" form. If corporations where only Board of Directors approval is necessary for By-Law changes will lead the way, there should be no great difficulty in obtaining shareholder approval in companies where such approval is necessary. Some shareholders will be reluctant to go along, but it is doubtful that there will be a sufficiently aroused minority to block the action.

Federal tax regulations

Inasmuch as certificate identification will no longer exist, the Treasury Department should be asked to rule as to evidence acceptable on the question of identifying the cost of shares sold, for capital gains purposes.

A law or regulation making refusal to transfer mandatory when no Taxpayer Identification Number of the transferee is furnished would also be helpful. This number could be part of the system of identifying shareholders and becomes more important because of the lack of a certificate.

Co-Transfer Agents

Most of the large companies employ two or more transfer agents—some as many as five or six. Central records, as now, will have to be maintained by a principal agent, with appropriate means for intercommunication with co-agents. So that a sub-agent may honor or certify a Transfer Order, it can instantaneously (1) check the initial ownership record (just as airline space is checked instantly with a national center); (2) complete the transfer on its own records if satisfied that technical transfer requirements have been complied with; and (3) notify the principal agent of the transfer details. Establishment of systems such as this must take into account the impact of existing stock transfer taxes and the prospects of increased or new transfer taxes in commercial states.

Special statements

With certificate number detail a thing of the past, transfer agents should at moderate cost be able to furnish monthly statements to brokers and nominees (similar to a statement on a checking account) to assist them in reconciling. Another possibility would be an annual statement to each shareholder showing his beginning and ending balance and all transactions in the interim.

VII. Conclusions

The foregoing is submitted only as a tentative outline of a system. No one will know, until considerable research has been done, whether a non-certificate system for actively traded stocks can be put together

without creating more problems than it solves—legally or operationally. Moreover, it could pass both tests but fail economically. Computer conceptions, plausible in the telling, sometimes turn out to involve costs which cannot be endured. Nevertheless the general subject should be explored, using the best efforts of the different segments of the securities industry. With the continued increase in stock ownership by the public, and the near-failure of present methods to cope with it, some approach going beyond minor operational short-cuts must be envisioned for the future.

The A.B.A. Section of Corporation, Banking and Business Law, through its Corporate Laws Committee is already studying the problem; so is a committee of the Association of Stock Exchange Firms. Other organizations which are or may be expected to become interested include:

American Bankers Association; American Society of Corporate Secretaries; Association of Stock Exchange Firms; Major stock exchanges; National Association of Securities Dealers; Securities and Exchange Commission; and The Stock Transfer Association.

The economic and social aspects of this change will be sufficiently broad that if an over-all study by a disinterested and highly qualified research organization could be financed, it might be highly desirable to have it. The public interest is certainly present in anything that touches 25,000,000 shareowners. There are bound to be contending forces in connection with the design and operation of the system, between corporations, brokers and transfer agents; between exchange members and over-the-counter dealers; and between regional interests. Any differences might have the best chance of being resolved by resort to an independent study, making use of information and facilities furnished by the groups above-named.

