

II. Background

A. History

When a security certificate is retired, such as when a bond is redeemed or ownership of stock is transferred, the certificate is cancelled by the transfer agent. Cancellation normally involves both an accounting entry on the books of the transfer agent and an alteration of the certificate itself, though either by itself is an act of cancellation. After cancellation of a registered certificate,⁵ the Exchange Act's record retention rules for transfer agents require that the certificate or appropriate record of the certificate be retained for not less than six years.⁶ In recent years, many corporate bond issues have been called for redemption and cancelled decades before their maturities.⁷ These bond redemptions and an active stock market have generated vast amounts of cancelled securities certificates that must be processed, stored, and safeguarded. Certificate processing of retired certificates can involve significant costs and risks. The following examples illustrate some of these risks.

In a 1992 case, cancelled bond certificates with a face amount of approximately \$111 billion disappeared after being delivered from a transfer agent's warehouse to a certificate destruction vendor. The certificates, issued by many well-known public companies, later began to resurface

worldwide. A number of banks and brokers as well as individuals were defrauded through sales of the cancelled certificates for cash or through use of the cancelled certificates as loan collateral. The bulk of these cancelled certificates still remain unaccounted for and continue to resurface in the marketplace.⁸

In a similar case in 1994, cancelled bonds with a face amount of approximately \$6 billion disappeared after being delivered from a transfer agent's record center to two certificate destruction vendors. The cancelled certificates, issued by well-known companies, later began to resurface worldwide. Again, the bulk of these cancelled certificates remain unaccounted for and continue to resurface in the marketplace.⁹

In another instance, a transfer agent's shipping bags filled with cancelled certificates were stolen while in commercial air transit. The transfer agent regularly shipped cancelled certificates from the West Coast to a New York bank for processing. The transfer agent, however, did not record the contents of its shipments and, in effect, relied on its New York bank processing agent to do its bookkeeping. When the shipping bags were stolen, neither the transfer agent nor its bank processing agent realized that the certificates were missing. A number of the certificates later resurfaced in off-market transactions.¹⁰

Other instances have involved bulk thefts of cancelled certificates from warehouses. In some cases, the records of the certificate numbers of the stored certificates also were stolen because they were stored with the certificates. Even in cases where certificate records for stolen securities were available, they generally were of limited value in identifying the stolen securities because the records were organized chronologically by cancellation dates rather than by certificate numbers. As a result, the necessary information was not easily retrievable from the records.

A common transfer agent practice contributed to this widespread problem. In physically cancelling certificates, many transfer agents marked the certificates only with pinhole-sized perforations. These tiny perforations were intended to indicate cancelled status without defacing the certificates and impairing their usefulness as records. The pinholes, which usually show the cancellation date and the initials of the transfer agent within a space about the size of a quarter, often have been barely noticeable. In some cases, they have been mistaken for notary or authentication markings. Even more problematic has been the practice by some transfer agents of not marking certificates at all to indicate that the certificates have been cancelled.

In many cases, the stolen certificates have reentered the marketplace either through sales or as collateral for loans, resulting in substantial fraud on public investors, public companies, creditors, broker-dealers, and transfer agents. Not only do situations such as these present potential liability for the transfer agents responsible, but they consume the resources of regulatory and criminal law enforcement agencies.

As discussed below, the Commission hopes that these unfortunate practices have been or are being eliminated by the transfer agents themselves through improved trade practices. But without standards and verification, there is no way to be certain. The new rule and rule amendments address these practices and will permit the Commission's examiners to verify compliance as a routine part of their examination schedules.

B. The Commission's Authority

Sections 17(f) and 17A of the Exchange Act provide the Commission with authority and responsibility to protect investors and securities industry participants from the dangers associated with the fraudulent use of cancelled

⁵ The term "registered" as used in 17 CFR 240.17Ad-6(c) with reference to cancelled certificates means certificates registered in the name of an owner, as distinct from bearer certificates that were in wide circulation when this rule was promulgated in 1977.

⁶ 17 CFR 240.17Ad-6(c) and 240.17Ad-7(d). See also 17 CFR 240.17Ad-7(f). It has been suggested that transfer agents should have the option to destroy cancelled certificates shortly after cancellation. See comment letter from Steven Turowski, Chief Regulatory Counsel, PFPC, Inc., (December 4, 2000). While current practices are changing and some transfer agents may want to select alternative means, such as electronic imaging, to satisfy the recordkeeping requirements for cancelled certificates, many transfer agents may prefer to satisfy these recordkeeping requirements by maintaining the physical certificates themselves. Nevertheless, in the Proposing Release, we invited commenters to address this issue, and their comments are summarized below.

We note that we have also proposed amendments to Securities Exchange Act Rule 17Ad-7, 17 CFR 240.17Ad-7, which if adopted would make clear that transfer agents may use certain alternative means to store cancelled securities certificates provided that the certificates are electronically stored in conformity with the terms of Rule 17Ad-7. Because these electronic records satisfy the recordkeeping obligations, the paper certificates would not be required to be kept by Rule 17Ad-7. Securities Exchange Act Release No. 48036 (June 16, 2003), 68 FR 36951.

⁷ Among the reasons for these bond redemptions has been the decline in long-term interest rates since the early 1980s.

⁸ The Commission brought an action against this transfer agent for its failure to report stolen certificates pursuant to Rule 17f-1, 17 CFR 240.17f-1, and for its failure to safeguard securities in its possession pursuant to Rule 17Ad-12, 17 CFR 240.17Ad-12. The transfer agent agreed to pay a civil penalty of \$750,000 and to cease and desist from future violations of Sections 17(f)(1) and 17A of the Exchange Act and Rules 17f-1 and 17Ad-12 thereunder. *SEC v. Citibank, N.A.*, Civil Action No. 92-2833 (USDC, DC, 1992). See also Securities Exchange Act Release No. 31612 (December 17, 1992).

⁹ The Commission and the Comptroller of the Currency brought a joint action against this transfer agent for its failure to report as stolen the cancelled certificates pursuant to Rule 17f-1 and its failure to safeguard securities in its possession pursuant to Rule 17Ad-12. The transfer agent agreed to pay a civil penalty of \$100,000 and to cease and desist from future violations of Sections 17(f)(1) and 17A of the Exchange Act and Rules 17f-1 and 17Ad-12 thereunder. As remedial measures, the transfer agent also agreed to mark cancelled certificates with the word "cancelled" and to adopt other safeguards. *The Chase Manhattan Bank*, Securities Exchange Act Release No. 34784 (October 4, 1994).

¹⁰ The Commission and the Office of the Comptroller of the Currency brought a joint action against this transfer agent for violation of Section 17(f)(1) of the Exchange Act and Rule 17f-1 thereunder for failure to report the missing securities to the Commission's Lost and Stolen Securities Program. The transfer agent agreed to pay a \$75,000 civil penalty and to cease and desist from any further violations of Section 17(f)(1) and Rule 17f-1 thereunder. *Seattle-First National Bank*,

Securities Exchange Act Release No. 34293 (July 1, 1994).