

not believe that bearer certificates can reasonably be excluded from a definition of securities certificates. We note, too, that any burden caused by bearer certificates is diminishing year-by-year due to the Tax Equity and Fiscal Responsibility Act of 1982, which essentially eliminated the issuance of bearer certificates.³²

Moreover, the definition of "securities certificate" of Rule 17f-1(a)(6) does not contemplate bond coupons, which are expressly exempted from the reporting and inquiry provisions of Rule 17f-1 by its subparagraph (f)(2). We note, however, that while, due to the exemption, coupons are not securities certificates or reportable within the meaning of Rule 17f-1, they are not exempted from Rule 17Ad-12 and, accordingly, they do come within the "funds and securities" safeguarding provisions of Rule 17Ad-12(a). In any case, Rule 17Ad-19 does not establish specific cancellation practices for coupons. We believe that it is appropriate for coupon cancellation to be governed by accepted, reasonable industry practices at this time.

b. *"Missing" Securities Certificates.* The term "missing" is used in Section 17(f)(1) of the Exchange Act and in Rule 17f-1 thereunder, but until now it was not defined.³³ The term generally has been used to describe certificates that cannot be located, such as certificates that are not found during a count or audit, but that are thought to be misfiled rather than lost or stolen.

There are other circumstances, however, where a transfer agent does not have possession of a certificate though it believes, but cannot be certain, that it knows what happened to the certificate, *i.e.*, that it was destroyed. Some would claim that such a certificate is not "missing" but is more accurately described as "destroyed," and that accordingly a reporting institution is not required to report the certificate under Rule 17f-1 as being missing, lost, or stolen. For example, if cancelled certificates are stored by a transfer agent in a warehouse that is destroyed by a fire, the transfer agent may reasonably believe but cannot be certain (*i.e.*, to the point of providing a guarantee) that all the stored certificates were destroyed.³⁴ In such a situation,

especially where arson is found, there is a risk that some of the certificates may not have been destroyed and may resurface in the marketplace.

We are amending Rule 17f-1(a)(7), as proposed, to define the term "missing" for purposes of Rule 17f-1 as any certificate that: (1) Cannot be located but which is not believed to be lost or stolen or (2) the transfer agent believes was destroyed but was not destroyed according to the certificate destruction procedures required by Rule 17Ad-19. We received no comments on this proposal.

As a result, it will be clear that reporting institutions are required to report the above-described types of missing certificates to LSSP. Then, if such certificates later resurface, there will be a high degree of likelihood that they will be promptly identified and interdicted through LSSP.

3. LSSP Reports of Cancelled Certificates

The Commission has brought enforcement actions for violations of Rule 17f-1 where cancelled securities certificates that were lost or stolen were not reported to LSSP.³⁵ Nevertheless, there appears to be some uncertainty about whether this rule applies to cancelled certificates.³⁶ We believe clarification would be useful.

We believe that cancelled certificates are within the meaning and purpose of Rule 17f-1. Like counterfeit certificates, cancelled certificates have no investment value, but they can be used to defraud.³⁷ The inclusion of the definition of "securities certificate" in Rule 17f-1(a)(6) as discussed above clarifies that cancelled certificates are reportable to LSSP.

4. LSSP Inquiries

In Rule 17f-1, paragraph (c) governs reports and paragraph (d) governs inquiries about lost, stolen, missing, and counterfeit securities. While the rule specifies time frames for making reports,

it specifies no time frames for making the inquiries.³⁸

When Rule 17f-1 was adopted in 1976, requirements for making inquiries were intended to accommodate business practices and to avoid commercial disruptions.³⁹ The time frames for making inquiries were left to the business judgment of inquiring companies.⁴⁰ Since then, business conditions have changed substantially, in large part due to improvements in automation and communications. Inquiries to LSSP by financial institutions have become quite routine and automated. In addition, the lack of any time limit for making required inquiries has made compliance with the rule difficult to monitor, and it has produced judicial comment.⁴¹ No public comment was received in response to our Proposing Release concerning the time frames for inquiries.

Accordingly, we are adding subparagraph (d)(3), as proposed, to Rule 17f-1 which provides that inquiries must be made by the end of the fifth business day after a certificate comes into the "possession or keeping" of a reporting institution.⁴² The amendment also provides that inquiries shall be made before the certificate is sold, used as collateral, or sent to another reporting institution if

³⁸ See Section III.B.1 above for description of inquiries.

³⁹ When enacting the underlying statute, Congress stated that the Commission should carefully weigh the benefits of mandating inquiries against the costs and effects on efficient business practices. Conference Report on S. 249, Securities Acts Amendments of 1975, 94th Cong., 1st Sess. 104 (1975). In 1976, the Commission observed that the system for inquiries should avoid undue disruptions to commercial transactions and chose not to set time limits for inquiries. Securities Exchange Act Release No. 12030 (January 20, 1976), 41 FR 04834.

⁴⁰ In 1979, when the Commission asked for comments from the industry, reporting institutions said they favored a policy of leaving to their own business judgment the time frames for valuing and inquiring of LSSP about securities that came into their possession. The Commission accepted that position. See "Inquiry Time Frames," Securities Exchange Act Release No. 15683 (March 29, 1979), 44 FR 20614.

⁴¹ The Seventh Circuit Court of Appeals observed that the addition of a precise time frame for making required inquiries would improve the operation of the rule. *First National Bank of Cicero v. Lewco Securities Corp.*, 860 F.2d 1407, 1416, n.14 (7th Cir. 1988). The court also said that whether an institution meets the test of "good faith" required for bona fide purchaser status with respect to securities certificates may depend on whether it has met the inquiry requirements of Rule 17f-1. *Id.* at 1413-1415. See also Yadley and Ilkson, "Bona Fide Purchasers of Lost and Stolen Securities: Meeting the 'Good Faith' and 'Notice' Requirements," 5 George Mason U.L. Rev. 101, 127-133 (1982).

⁴² The term "reporting institution" is defined in 17 CFR 240.17f-1(a)(1).

³² Pub.L. 97-248 (September 9, 1982), 26 U.S.C. 309 *et seq.* While not prohibiting bearer securities, TEFRA imposes financial disadvantages on both their issuers and their holders. See, *e.g.*, 26 U.S.C. 6049.

³³ While parallel terms (lost, stolen, and counterfeit) also are not defined by the statute or the rule, we believe that their meanings are clear from the context.

³⁴ On March 9, 1997, a major warehouse fire, believed to have been caused by arson, apparently

destroyed a large number of cancelled securities certificates held in storage by a transfer agent. See "A Burning Question: How Safe Are Your Records," *Business Week*, June 23, 1997, at page 130E4.

³⁵ *Supra* notes 8, 9 and 10.

³⁶ For example, one court has found that because "cancelled securities" were not expressly included in Rule 17f-1, they were not subject to the reporting requirements of that rule. *A.G. Edwards & Sons, Inc. v. Centocor, Inc.*, Civil Action No. 91-6133 (E.D. PA, 1992).

³⁷ In *United States v. Jackson*, 576 F.2d 749, 757 (8th Cir. 1978), the court recognized that stolen blank stock certificates have no intrinsic value as investments but that they have a "thieves' market value" as demonstrated by an FBI undercover operation, which was part of the case, where the certificates were purchased at 40% of their apparent market value.