

guidelines,⁶⁰ most transfer agents already are marking their cancelled certificates with the word "cancelled" to designate their cancelled status.⁶¹ We believe the new requirement to use the word "cancelled" to a large extent codifies existing business practices with little additional cost to the industry.

As noted, the requirements to supervise, witness, and record the destruction of certificates and to keep easily retrievable records of the cancelled certificates will mean additional costs to some transfer agents. However, the additional costs are justified. As the Commission discussed above, its experience has been that securities certificates records that are not easily retrievable are not appropriate for investor protection, securities processing, or law enforcement purposes. In addition, the existing rules of the Exchange Act have since 1983 required registered transfer agents to maintain "appropriate certificate detail"⁶² for purposes of their master securityholder files concerning "every security transferred, purchased, redeemed, or issued,"⁶³ which includes records of cancelled certificates.⁶⁴ These new requirements also will apply only on a going forward basis, *i.e.*, no transfer agent will have to provide easily retrievable records for certificates cancelled prior to the Rule's effective date. Moreover, the newly-adopted recordkeeping requirements are consistent with good business practices, such as the STA guidelines.

VI. Consideration of the Burden on Competition, and Promotion of Efficiency, Competition, and Capital Formation

Section 3(f) of the Exchange Act requires the Commission, when engaged in rulemaking and required to consider whether an action is necessary or appropriate in the public interest, to consider whether the action would promote efficiency, competition, and capital formation.⁶⁵ In adopting rules under the Exchange Act, Section 23(a)(2) requires the Commission to

consider the impact any rule would have on competition.⁶⁶ Further, the law requires that the Commission not adopt any rule that would impose a burden on competition not necessary or appropriate in furtherance of the Exchange Act. We believe the new rule and amendments should improve market efficiency by reducing a source of fraud and its associated costs (*i.e.*, the fraudulent introduction of cancelled and worthless securities into the marketplace). In addition, the new rule and amendments should have no material anticompetitive effects because they would apply equally to all transfer agents and should have no material effect on capital formation.

VII. Summary of Final Regulatory Flexibility Analysis

A Final Regulatory Flexibility Analysis ("FRFA") has been prepared in accordance with the Regulatory Flexibility Act ("RFA").⁶⁷ This analysis relates to a rule and two rule amendments adopted under the Exchange Act that primarily address the processing of cancelled securities certificates by transfer agents. New Rule 17Ad-19 under the Exchange Act requires every transfer agent to establish and implement written procedures for the cancellation, storage, transportation, destruction, or other disposition of securities certificates. The rule requires transfer agents to mark each cancelled securities certificate with the word "cancelled;" maintain a secure storage area for cancelled certificates; maintain an easily retrievable database of all of its cancelled certificates, including cancelled, destroyed, or otherwise disposed of certificates; and have specific procedures for the destruction of cancelled certificates. Additionally, the Commission has amended Rules 17f-1 (the lost and stolen securities rule) and 17Ad-12 (the transfer agent safekeeping rule) to make it clear that these rules apply to unissued and cancelled certificates.

A. Need for Rule and Rule Amendments

The rule and rule amendments address problems involving cancelled securities certificates. In particular, they address the problem that, until properly destroyed, or properly disposed of, cancelled securities certificates can resurface in the marketplace where they can and have been used to defraud public investors and financial institutions. The rule and rule amendments provide better procedures for processing and destroying cancelled

certificates that will reduce this potential for harm.

The case history of fraud involving cancelled certificates includes several major cases. In one case, approximately \$111 billion of cancelled bond certificates were stolen after being delivered from a transfer agent's warehouse to a certificate destruction vendor. Many of these stolen certificates resurfaced worldwide where they were reintroduced into the marketplace or were used as loan collateral at financial institutions. In many cases, even security professionals were misled because the certificates appeared to be in pristine condition with little or no evidence of having been cancelled. While a number of trade practices have since been formulated by transfer agents to help address these problems, Commission rulemaking will require universal compliance among all transfer agents concerning the proper processing of cancelled certificates.

B. Significant Issues Raised by Public Comment

One commenter, CTA, a trade association, suggested that Rule 17Ad-19 should apply only to transfer agents that maintain securityholder records and suggested an exemption from the rule for transfer agents that act only for their own issuers (*i.e.*, issuer-only transfer agents) and have average monthly volumes of 100 transfer items or less. Another commenter, Otter Tail Power Co., a transfer agent, noted that it processes less than 30 certificates per month and that maintaining retrievable records and witnessing the destruction of certificates would be unduly expensive.

We note that Rule 17Ad-19 does, in fact, exempt certain registered transfer agents (about 100 out of a total transfer agent population of about 900) that do not maintain securityholder records. These are "named transfer agents" that outsource their transfer agent functions to other transfer agents known as "service company" transfer agents.⁶⁸ But we do not believe that the requirements of Rule 17Ad-19, which deal with recordkeeping and the cancellation, storage, transportation, destruction, or other disposition of retired certificates, are inappropriately burdensome simply because the number of certificates that a transfer agent is processing or destroying is small. Even a small transfer agent can designate a person to destroy certificates under specific procedures. Moreover, we also believe that these limited burdens are justified by the rule's value as an

⁶⁰ *Supra*, note 17.

⁶¹ We believe that most transfer agents are properly marking their retired certificates with the word "cancelled," as STA has recommended. However, because doing so is not a Commission requirement, it currently is not a part of the Commission's examination module for transfer agents. Thus, we have no systematic data on the subject.

⁶² 17 CFR 240.17Ad-9(a). The existing requirements for "certificate detail" include the certificate number, number of units, owner's name and address, the issue date, the cancellation date, *etc.*

⁶³ 17 CFR 240.17Ad-10(a).

⁶⁴ See 17 CFR 240.17Ad-6(c) and 240.17Ad-9(a).

⁶⁵ 15 U.S.C. 78c(f).

⁶⁶ 15 U.S.C. 78w.

⁶⁷ 15 U.S.C. 601 *et seq.*

⁶⁸ 17 CFR 240.17Ad-9 (j)-(k).