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Ian F. G. Baxter

David L. Johnston

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TRANSFER OF INVESTMENT SECURITIES — SOME CURRENT PROPOSALS

By IAN F. G. BAXTER* and DAVID L. JOHNSTON**

The Present Situation:

Methods of transfer of investment securities — stocks and bonds — have remained unchanged in North America for a considerable period of time until the last few years. Strains on the traditional system have created pressure for more efficient, safe and economical methods of transfer. In the United States several important innovations have taken place within the last few years with further new developments in the active planning stages. In Canada some assessment of various new alternatives has been made. However there has been no positive commitment to any particular plan at this time. Before discussing various alternatives it will be helpful to focus on the past and future economic dimensions of securities transfer.

Turning first to share transactions, thirty years ago the daily volume of shares traded on the New York Stock Exchange (the largest by far of the North American exchanges) was somewhat under a million shares. By contrast in one day in 1971 over 28 million shares were traded. During 1968 an average of 13 million shares per day were traded on the New York Stock Exchange.¹ In Canada, the general volume trend has been upward as in the U.S.A. although not quite at the same pace. On the Canadian exchanges in 1945, 532 million shares were traded with a value of just under \$1 billion, and in 1967, 1,488 million shares were traded with a value of over \$5 billion.² In 1969 the value of shares traded was \$8.6 billion.³ In 1965 there were New York Stock Exchange forecasts of a possible daily volume of ten million shares by 1975. However in 1968 the estimates were revised and there were predictions of a possible 60 million shares daily in 1980.⁴ The Toronto Stock Exchange 1969 Annual Review concluded that "it is highly likely that the next decade will see an even greater rate of growth in the size of the Canadian equity market than was achieved in the 1960's."⁵

* Professor of Law, University of Toronto.

** Associate Professor of Law, University of Toronto.

¹ S.M. Robbins, C.G. Johnson, W. Werner, and A. Greenwold, *Paper Crisis in the Securities Industry: Causes and Cures: Is the Stock Certificate Necessary?* (New York: Lybrand Ross Bros. and Montgomery, 1970) at 15 (hereinafter the Lybrand Study); *Time Magazine* 22 February, 1971; as cited in I.F.G. Baxter and D.L. Johnston, *New Mechanics for Securities Transactions* (1971), 21 U of T. L.J. 336.

² G.R. Conway, *The Supply of and Demand for, Canadian Equities: A Conspectus* (1968 Toronto Stock Exchange) and the complete study, G.R. Conway, *The Supply of and Demand for, Canadian Equities* (1970 Toronto Stock Exchange).

³ Toronto Stock Exchange, 1969 Annual Review at 9.

⁴ Lybrand Study at 15 and at 74.

⁵ *Supra*, note 3 at 9.

Statistics on trading in bonds or debt obligations — technically bonds, debentures, notes and treasury bills — are not so readily available. However past growth and predictions of increases in share trading provide a reasonably reliable index for trading in debt obligations.

In the face of such increases some searching questions have been asked about the traditional securities settlement and transfer methods. The total amount of checking and paper work involved is huge. It is regarded in the securities industry as something of an unproductive nuisance (an attitude reflected in the salaries paid to the clerical staff doing this kind of work). A Commissioner of the U.S. Securities and Exchange Commission has said that:

The movement of a certificate from customer through the broker to the transfer agent and back requires a number of people doing little more than just logging it in, reviewing it, logging it out and sending it on to the next person.⁶

The present system has contributed to serious problems and insolvencies in New York, and similar problems of less magnitude elsewhere. Some of the problems have been:

- (a) Great strain on brokers' "back offices".
- (b) Large quantities of "street certificates" stolen.
- (c) Great difficulties experienced by brokers in obtaining the necessary certificates from wherever they are kept, in order to exchange them in time with a broker who is their opposite number in the deal.

U.S. Depository — Central Certificate Service:

The major development in response to volume problems, and the "paper work crisis" in New York, has been the establishment of the Central Certificate Service (C.C.S.) which began operations in May, 1968.⁷ It is a division of the Stock Clearing Corporation which in turn is a fully owned subsidiary of the New York Stock Exchange (N.Y.S.E.). Its essential purpose is to immobilize the share certificate and replace some of the ancillary documentation by computerized records.

Initially securities eligible for deposit in C.C.S. were only those listed on the N.Y.S.E. The basic concept of operation is quite simple:

Brokerage firms maintain shares of eligible securities on deposit in their C.C.S. accounts. These accounts are credited with the number of shares deposited, and stock certificates representing the shares are registered in the name of a common nominee, Cede and Co., to standardize the administrative and bookkeeping procedures in which they may subsequently become involved. C.C.S. does not acquire any beneficial interest in the shares.

To make delivery, the selling brokerage firm instructs C.C.S. to debit its account by, say, 500 shares of XYZ corporation and credit the buying broker's C.C.S. account by the same number of shares. Title to the shares is thus transferred by a computerized bookkeeping entry while the certificates themselves remain immobi-

⁶ R.B. Smith, *A Piece of Paper* (1969-70), 25 *Bus. Lawyer*, 923 and 925.

⁷ *Central Certificate Service Profile of Services*, September 1969, A.P. Reres, *Stock Clearing Corporation Central Certificate Service New York, N.Y.* 2.

lized in the C.C.S. level. At the same time, the off-setting changes in the buying and selling members' daily cash balances are made by electronic bookkeeping entry.⁸

Dividend payments are controlled through C.C.S. for eligible securities on deposit. The dividends are forwarded to the brokerage firms on whose behalf the particular securities are deposited. The brokerage firms in turn credit the appropriate customers' accounts. Also, proxy materials relating to the securities on deposit with C.C.S. are sent to the appropriate brokerage firm and then redistributed by that firm to the owner of a security. In addition the depository will permit brokers to borrow money against the collateral of stock without the stock certificate ever leaving C.C.S.

C.C.S. commenced in January, 1969, and as of June, 1971 had 1,250 of the 1,800 issues listed on the New York Stock Exchange and 960 of the 1,300 issues listed on the American Stock Exchange in the depository with imminent plans for bringing in the first of the over-the-counter stocks (securities publicly traded but not listed on a recognized stock exchange).⁹ The value of the 834 million shares in the depository at that time was \$35 billion. C.C.S. was averaging over 500,000 transactions per month. In each of these 500,000 transactions a bookkeeping entry settled the trade. The need to move the stock certificate and transfer the stock itself was eliminated. The 500,000 trades represented about 265 million shares with a value of just under \$9 billion.¹⁰

U.S. Federal Government Securities:

One of the more recent U.S. innovations which not only immobilizes the certificate, but will shortly destroy it, arises from the Government Securities Clearance Agreement which became effective in 1967. This establishes clearing house arrangements for the transfer of U.S. Treasury securities through high-speed teletype machines. Each of the participating banks has such a machine connected by leased line to other participants. The core of the system is the New York Federal Reserve Bank which has the central ownership records for these securities. Legislation now permits New York banks to put all the U.S. Government securities they hold into this system. These include securities they hold in trust, in custody for customers and in dealer clearance operations as well as for their own investment account. With new equipment installed in April 1971 it is intended that new certificates will not be created and existing ones will be destroyed. In their place will be only an electronic record.¹¹

⁸ *Central Certificate Service, How the Automated Depository Concept of Handling Stock Certificates Speeds Operational Procedures*, Stock Clearing Corporation, New York Stock Exchange, July 1970, New York, N.Y.

⁹ Richard B. Howland, President of the Stock Clearing Corporation and Executive Vice-President of the New York Stock Exchange, Address to the American Society of Corporate Secretaries' Annual Meeting, June 15, 1971.

¹⁰ *Id.*

¹¹ John F. Lee, Executive Vice-President, New York Clearing House, Address to the American Society of Corporate Secretaries' Annual Meeting, June 15, 1971.

European Depositories:

Collective securities depositories and transfer by "book entries" have been long established in Continental Europe perhaps in part because of the greater concentration of trading institutions there and the common usage of bearer securities. The idea was first introduced in Berlin in 1882 by the Bank des Berliner Kassenvereins. Central depositories for certificates (Wertpapier-sammelbanken) were given statutory recognition by a law of 1937. In 1949 these became the present day Kassenverein.¹² In France a central depository under the name of Sicovam (for Société Interprofessionnelle pour la Compensation des Valeurs Mobilières) was established by a law of 1949.¹³

About 90% of the transactions that go through Sicovam and the Kassenverein are effected by book-entry; the remaining 10% are represented by a combination of physical deposits and withdrawals. Sicovam is a country-wide operation. There are seven Kassenvereins in Germany each independent of the other in terms of ownership and operation, but interrelated by being depositors in one another. Thus anyone can deposit securities in one of the Kassenverein and have them delivered by book-entry in a different city.¹⁴

Canadian Depository:

The influence of the U.S. Central Certificate Service has been felt in Canada. The Canadian Depository for Securities Ltd. was incorporated under the Canada Corporations Act in 1970¹⁵ with an implementation date of late 1972. It was recommended by an industry report in January, 1969¹⁶ which identified 9 chartered banks, 16 insurance companies, 16 trust companies, 17 investment companies, 43 mutual funds, and 215 stock exchange and investment dealers' association members as potential participants. In concept it was intended to include in its membership at the very outset a variety of financial institutions and not simply member brokers of one stock exchange. In this respect it is dissimilar to the U.S. depository which originally included only brokers, although now it includes some banks as members. Eligible securities for the Canadian depository would include securities of a number of stock exchanges, unlisted securities and also bonds and debentures. In this latter respect it would be more comprehensive than the present U.S. depository. Most of the shares of a given company are to be consolidated into a large denomination certificate, called a "jumbo" certificate, held in the depository's name. In addition the depository would contain several smaller denomination certificates of the same company for transfers out of the system.

¹² Delorme, *Automation of the Securities System* (1969 Frankfurt Exchange); Dresdner Bank Pamphlet, *The German GIRO — Transferable Collective Safe Custody for Securities* (1969).

¹³ Perquel and Levantal, *Opérations de Bourse* (1963), 29; Hamel and Lagarde, *1 Traité de Droit Commercial* (1954) at 642-8.

¹⁴ Mr. H.W. Bevis, Executive Director of the Banking and Securities Industry Committee (B.A.S.I.C.), Address to the American Society of Corporate Secretaries' Annual Meeting, June 15, 1971.

¹⁵ H.C. Debates, 23 June, 1970, at 8486.

¹⁶ Study Group Central Securities Depository, Report No. 2, January, 1969, Woods Gordon & Co., Management Consultants.

Like the U.S. depository, transfers between members would be made entirely within the system with no need for movement of the certificates.

As of February, 1972 close to \$1 million had been spent on planning for the Canadian depository. However implementation was postponed partly, it is understood, because cost estimates had risen from an initial target of \$2 to \$3 million to as high as \$7 to \$10 million and partly because questions were raised as to whether the depository concept was the appropriate one for the Canadian investment community. At the present time the planning group is considering a number of different alternatives, not limited to the depository approach, with a view to making some preliminary recommendations in mid-1972.

The present authors have described long-range models for a locked-in computerized investment securities trade and transfer system.¹⁷ The following short-term appraisal and proposals are made with regard to the process of settlement of investment transactions.

Short Term Proposals for the Transfer of Investment Securities in Canada:

The main question appears to be what are the objectives and advantages of a central depository for certificates as presently envisaged in Canada, and whether such depository is the most desirable of the viable alternatives. The concept of a depository, and also the more advanced idea of eliminating the certificate *qua* negotiable instrument, both represent a preference for the transfer of stock ownership by book entries as compared with transferring negotiable paper by endorsement (signing over) and delivery (handing over physical possession). Transfer by book entries implies a registration system for stock ownership in which title to stock will be officially recorded. Such a registration system exists at present in respect of the registered shares of a company and is maintained by the company or by a transfer agent on its behalf. At present the great bulk of share registration in Canada is handled by six or seven trust companies located principally in Toronto or Montreal. It takes on the average about 48 hours for a trust company acting as transfer agent to process a change in registered ownership. In addition to maintaining a register of ownership of shares, the transfer agent handles the distribution of dividends and notices.

The Canadian depository would be a computerized facility operating by book entries. Firms of brokers, banks, and certain other financial institutions would be able to open accounts in the depository and to deposit against these accounts share certificates endorsed in blank. A book transfer from one such account to another would be legal and equal to a physical delivery of certificates according to the present practice. Shares lodged in the depository would be registered by the transfer agent in the name of the depository. As the Canadian depository appears to be conceived at present, it would not distribute dividends (which is done by the U.S. depository) but would submit a list of account holders and stock balances to the transfer agents so that they could pay dividends and issue notices. A particular depositor in the

¹⁷ See Baxter-Johnston, *supra* at note 1.

central depository would be able to withdraw actual certificates against his account, so that there will be an option to settle a deal either by book entries in the depository (by transfer from one account to another) or by physical delivery of actual certificates as at present.

Assuming that a central depository came into existence in the form indicated in the previous paragraph, consider the settlement of a deal between broker A and broker B by book transfer in their accounts in the depository. On the making of the deal, an authorization will be given to the depository to transfer the required number of shares from the one account to the other. Dividends and notices consistent with the change will come from the transfer agent and not from the depository. No paper certificate is used in the settlement of this deal. (Indeed this is suggestive of what the Ontario Select Committee on Company Law described as "an old fashioned 'book stock' or registration of title concept which seems, historically, to have evolved in the 19th century as a result of the refusal of the law to recognize a company share as a chose in action and a share certificate as a negotiable instrument.")¹⁸

The introduction of a central depository would seem to create a hybrid system of stock records involving the participation of both the transfer agents and also the depository. A second limitation is that transfer by book entries and non-issue of a certificate only applies to shares which can and have been deposited in the central depository.

A more compact, and one would say significantly less expensive, approach than the creation of a central depository might be suggested as a viable alternative, and would be along the following lines. The law, regulations, and industry practices would be altered to make possible settlement through the records of the transfer agents. Consider how this would operate. Broker A (selling broker) makes a deal with broker B (buying broker) for the sale of a certain quantity and type of shares. On the deal being made, broker A will then deliver to broker B in duplicate a standard "Authority to Transfer" completed for the shares sold and executed by broker A. The Authority to Transfer at this stage will leave the name of the transferee blank. Broker B now wishes to register the shares in his own or his customer's name as the case may be. Broker B completes the two copies of the Authority to Transfer and executes them. He then delivers them to the appropriate transfer agent who records the required change of ownership in the records. The transfer agent keeps one copy of the Authority to Transfer and returns the other copy to broker B endorsed as certifying that on the date in question broker B (or his customer) has been registered as the new owner of the shares. The transfer agent will not issue a share certificate unless specially requested to do so. In carrying out the settlement of a deal by this procedure, it is not necessary for broker A to obtain a *particular* piece of paper, which in many circumstances may be troublesome to find, but he will simply complete and execute a standard printed document which (for want of a better name) we call in this article an "Authority to Transfer". It would also be

¹⁸ 1967 Interim Report of the Select Committee on Company Law, Ontario Legislative Assembly at 40.

provided that a buyer of stock could make a request for a (negotiable instrument) share certificate according to the present form and practice (on the same principle as that permitting a depositor in the central depository to withdraw an actual certificate). When an actual share certificate has been issued by the transfer agent, then a deal would have to be settled by physical delivery of that certificate according to the present practice.

If the book entry settlement system herein suggested were in use the Authority to Transfer could be used in credit transactions. Authorities to Transfer with the name of the transferee left blank could be delivered to a bank under a hypothecation agreement. If the borrower defaulted the bank could register the collateral in its own name by executing the Authorities to Transfer and presenting them to the transfer agents. It would also be possible as an alternative to withdraw (negotiable instrument) certificates and pledge them with a bank according to the present practice.

It has not been suggested that the system of transfer agents which we have in Canada works inefficiently (and an average of 48 hours for a registration compares well with the three days or more which may be required for physical delivery of certificates). However some of the trust companies at present perform their stock transfer work manually. Thus there are possibilities for modernization of their record-keeping systems. The trust companies involved in Toronto and Montreal might be induced to consider a computer department for each city serving the transfer agents there, if they do not feel equal to computerizing themselves completely on an individual basis.

The changes in the law required by the foregoing alternatives to a central depository would not be at all extensive. They should only involve minor amendments to the established legal system. Furthermore a new institution (the depository) would not have to be interposed into the existing setup and at the same time the use of certificates should be substantially reduced by action at the source — the transfer agent. In practical terms this proposal could provide an immediate cheap answer to reducing the movement of paper and set the stage for a more comprehensive technical and legal reform of the transfer system for investment securities.

