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STRATEGIC PERSPECTIVES—Securities industry ‘record keepers’ may see 70s era rules updated

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In recent years, there has been an increasing call from the SEC as well as many industry insiders to update the rules that transfer agents must adhere to. Industry insider and Chairman of Industry Initiatives for the [STA](#), Charlie Rossi, was asked to offer his thoughts on the calls for change. His insights and a general background of the role and function that transfer agents perform in the broader markets are discussed more in depth in the following article.

Transfer agents. Transfer agents have become an increasingly integral part of the securities industry as companies have continued to move away from issuing physical stock certificates in favor of maintaining records digitally. Some corporations choose to act as their own transfer agents, but most choose a third-party institution to fill the role, such as a trust company, bank, or similar financial institution. This means that transfer agents stand between issuing companies and the security-holders and, as such, the proficient operations of these record keepers are crucial to the effective completion of secondary trades.

Transfer agent functions. The SEC maintains that transfer agents provide three main [functions](#), including: issuing and canceling certificates to reflect changes in ownership, acting as an intermediary for the company, and handling of lost, destroyed, or stolen certificates. In addition, transfer agents also monitor restrictive legends and “stop transfer” orders that distinguish freely-tradable securities from restricted securities. As if that was not a daunting enough task, considering how many shares are at play, the role of the transfer agent may expand in the near future as some JOBS Act [provisions](#) may result in an increase in the amount of businesses whose shares are traded in the secondary market without the benefit of registration.

Establishment of the rules. As there is no self-regulatory organization (SRO) that governs transfer agents, the SEC has promulgated rules and regulations for all registered transfer agents that are intended to facilitate the prompt and accurate clearance and settlement of securities transactions and that assure the safeguarding of securities and funds.

The [rules](#) regulating transfer agents are encompassed in Section 17 of the Securities Exchange Act of 1934 and, with very few exceptions, those rules have rarely been amended since their inception in 1977. The rules include minimum performance standards regarding the issuance of new certificates and related recordkeeping and reporting rules, the prompt and accurate creation of security holder records, and the safeguarding of securities and funds.

Unlike the rules, however, which have been virtually stagnant since inception, market structure and business practices have grown and transformed exponentially, due in large part to the overwhelming increase in technological advances that have pushed the marketplace into new and uncharted territory.

The rules simply have not kept pace, and the SEC, recognizing there is an issue, has addressed this fact on many occasions as far back as October 2011, when it hosted a public Roundtable on the *Execution, Clearance, and Settlement of Microcap Securities*, which identified a number of concerns related to transfer agents' roles in the issuance and transfer of these microcap securities. Even then, the issues and concerns appeared ripe for serious rulemaking, or, at the very least, amendments to the existing transfer agent rules seemed prudent. To date, however, there has been a lot of talk and very little action.

Roundtable discussion. The SEC [Roundtable](#) focused on the fact that the microcap market is prone to fraud and manipulation, most often through pump-and-dump schemes, and the discussions centered in part on the role of transfer agents.

Some of the issues discussed included questionable client honesty concerning attorney opinion letters on the removal of restrictive legends, a topic that has been addressed in several recent cases, one of which found its way to the [Nevada Supreme Court](#). That case, if anything, however, shows the diligence that some transfer agents adhere to before they submit to removing a restrictive legend.

Now, over four years later, Commissioner Luis A. Aguilar released a Public Statement on December 17, 2014 entitled, "[The Importance to the Capital Markets of Updating the Rules Regarding Transfer Agents](#)," and a speech on "[Addressing Known Risks to Better Protect Investors](#)," on February 21, 2014, at "SEC Speaks," and in both instances he referred to transfer agents as "gatekeepers," saying that "[t]his gatekeeper role takes on particular importance with microcap securities because typically there is little, if any, meaningful disclosure or independent research regarding such companies."

It is apparent from both Commissioner Aguilar's public statement and speech that once again, there appears to be a renewed push for the Commission to draft new or amend old rules to fit the current landscape, and address new concerns such as cybersecurity and licensing requirements for agents. In Commissioner Aguilar's public statement on December 17, 2014, he acknowledged that "[w]e've known for a while that more has been needed to be done." The Commissioner echoed a similar sentiment in his February speech, stating that "while I recognize that the issues go beyond transfer agents, the SEC needs to take a hard look at whether the current regulatory framework governing transfer agents appropriately addresses the risks associated with the anticipated increased trading in unlisted securities."

Why the delay? According to the SEC's FY 2014 Congressional Budget Justification, Annual Performance Plan, and Annual Performance Report, the SEC [oversees](#) approximately 460 transfer agents. It seems difficult to comprehend that there are so many transfer agents and that concern over transfer agent rules has been a topic for so long while little has been done to correct what many across several disciplines see as a very real problem. Of course, the shifting political climate is likely partly to blame, as could be the frequent changing of the guard at the SEC.

Few barriers to entry. In his June 12, 2013, testimony, R. Cromwell Coulson, President and CEO of OTC Markets Group Inc., before the Subcommittee on Capital Markets and Government Sponsored Enterprises Committee on Financial Services Hearing Entitled "[Reducing Barriers to Capital](#)

Formation,” suggested that transfer agents need to be better regulated. He addressed the licensing regime for SEC registered transfer agents and stated quite frankly that “[u]nfortunately, the licensing regime for SEC registered transfer agents, who supervise the share register, is nearly nonexistent.”

Mr. Coulson continued, saying that “[t]he only requirement to become a transfer agent for SEC-reporting companies is to register with the SEC or a bank regulatory agency via a simple online form.” The SEC form itself takes an estimated 1.5 hours to complete and asks only for the registrant’s name, address, names of the control people, and any regulatory actions against them. Once submitted, it is effective automatically after 30 days unless the SEC finds cause for concern.

In comparison, Mr. Coulson noted that with the SEC’s Form S-1 for registration of a class of securities, “which takes an estimated 972.32 hours to complete and possibly months to approve, and you get some indication of the lack of scrutiny paid to the transfer agent role.” Mr. Coulson also reiterated what had been expressed back at the SEC Roundtable in 2011 increased licensing requirements, background checks, and inspections would likely root out those allowing many of the fraudulent stock issuances.

Changes are coming. Charlie Rossi was asked to comment on the current state of affairs for transfer agents and what effect additional compliance regimes may have on the industry and the security-holders. At the outset of the interview, Mr. Rossi said that yes, the rules do in fact need to be updated, and he explained how the STA is very supportive of changes and is actively working with the Commission to establish new rules.

Transfer agents, Mr. Rossi stated, “need to be at the top of their game” and, as such, he explained that the some of the new rules that are currently being discussed include: microcap fraud and how to further restrict it from happening; the fact that there are currently no insurance or capital requirements for transfer agents; and concerns over unscrupulous attorneys issuing opinions on the sale of shares or the removal of restrictive legends that fail to meet compliance requirements.

Mr. Rossi continued, saying that it is in the SEC’s best interest that transfer agents have a robust disaster recovery system because the loss of managed data could be catastrophic and it calls into question the safety and soundness of the entire system. That concern is easily quantifiable when you remember that individuals no longer have physical certificates to demonstrate ownership, he said.

SRO a possibility? When asked if he thought a self-regulatory organization might be an appropriate way to address the regulation of transfer agents, Mr. Rossi explained that SROs are costly to establish and maintain. It doesn’t help, he continued, that transfer agents have very thin margins and that, ultimately, the costs associated with an SRO are prohibitive. The big question being “who would pay” for the SRO? While some of the larger transfer agents may be able to bear the costs associated with establishing and maintaining an SRO, others would be unable to do so.

Depending on the depth and breadth of the new regulations there could be a further consolidation of transfer agents in much the same fashion as seen in the mutual fund industry where the highest concentration is now between two providers. Such a consolidation would ease the burden on the Commission’s oversight of transfer agents and make an SRO unnecessary.

Conclusion. In a very real sense, transfer agents are the “record keepers” or “gatekeepers” of the industry, if you prefer the term espoused by Commissioner Aguilar. As their roles and the amount of information maintained by them continue to expand, it becomes clear that the rules, as established, are simply inadequate for the task at hand. If the Commission continues to work with, and take suggestions from the STA, then a clear set of rules, meant to address the current and future work that transfer agents will be asked to perform, can be established so that companies, transfer agents, and individuals will feel better protected.

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