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SEC Proposes Transfer Agent Rules

The following is written by Laura Anthony, Esq., a going public attorney focused on OTC listing requirements, direct public offerings, going public transactions, reverse mergers, Form 10 and Form S-1 registration statements, SEC compliance and OTC Market reporting requirements.

On December 22, 2015, the SEC issued an advance notice of proposed rulemaking and concept release on proposed new requirements for transfer agents and requesting public comment. The transfer agent rules were adopted in 1977 and have remained essentially unchanged since that time. An advance notice of proposed rulemaking (ANPR) describes intended new and amended rules and seeks comments on same, but is not in fact that actual proposed rule release. The SEC indicates that following the comment process associated with this ANPR, it intends to propose actual new rules as soon as practicable.

To invoke thoughtful comment and response, the SEC summarized the history of the role of transfer agents within the securities clearing system as well as the current rules and proposed new rules. In addition, the SEC discusses and seeks comments on broader topics that may affect transfer agents and the securities system as a whole. This blog gives a high level review of the whole APNR and concept release with a more detailed focus on the proposed rules and discussions that will directly impact the transfer and deposit of restricted securities in the small-cap industry.

Introduction

As set out by the SEC, among other functions, transfer agents (i) track, record and maintain the official shareholders registrar and ownership records; (ii) cancel, issue and transfer securities, both in certificate and book entry form; (iii) communicate with shareholders on behalf of issuers; and (iv) process dividends and corporate actions such as reverse splits. In addition, from my own experience, transfer agents will act as mailing agent for proxy and other communications from the issuer, sometimes offer EDGAR agent services, and facilitate DTC eligibility applications with DTC member firms, obtain DWAC/FAST DTC eligibility for issuers and act as a front line where shareholders are attempting to remove a restrictive legend and deposit securities with brokerage firms.

Transfer agents are also seen as a gatekeeper in the prevention of fraud, and compliance with the registration and exemption provisions of the federal securities laws. In that regard, the SEC intends to impose obligations on a transfer agent in the processing and transfer of restricted securities. A major focus of the rulemaking is related to combatting microcap fraud. This is consistent with the recent SEC approach of increasing obligations and pressure on the gatekeepers, including brokerage firms related to the deposit of securities (see my blog HERE), attorneys and auditors, and transfer agents.

For the discussion of the proposed new rules related to the transfers of restricted securities, see the discussion below under the subheading “Restricted Securities and Compliance with Federal Securities Laws.”

History and Background

The SEC ANPR is lengthy and provides an in-depth discussion of the history of the clearing and settlement process and role of transfer agents in the process. Briefly, the ownership of securities represents certain property rights and the securities themselves are a negotiable instrument under state law allowing the owner to transfer such property to a third party. Where federal securities laws govern the registration and exemption provisions, the individual state’s Uniform Commercial Code (UCC) governs the transfer of certificates and securities as property. Accordingly, in addition to compliance with federal law, the daily activities of a transfer agent require knowledge of and compliance with the UCC.

Under the UCC, in order to obtain valid title to a security, the seller must voluntarily transfer possession of the security and the buyer must give value, not have notice of any adverse claim to the security and actually obtain control over the security. It is compliance with the UCC that requires that a certificate be endorsed, the signature guaranteed, instructions and authority from the seller, proof of payment/consideration from the buyer, proper cancellation of certificates and the proper registration and recording on the shareholder list. Moreover, it is the UCC that governs the process for replacing lost or stolen certificates and for an issuer or security holder to impose stop transfer restrictions.

Technology has helped streamline some of this process and for traded securities in DTC eliminated paper certificates altogether, but as all in the industry know, the paperwork is still extensive. Article 8 of the UCC governs the transfer of electronic or uncertificated securities. The SEC gives an interesting background discussion of the Paperwork Crisis beginning in the 1960s resulting from the massive volumes of paper needed to transfer securities associated with the growing and active trading markets. As a result of the Paperwork Crisis, the Depository Trust Company (DTC) and its securities holding arm, CEDE, were formed.

Moreover, for those interested, the APNR and concept release provides a thorough history of the creation and amendments to the national market system, national clearing and settlement system, SIPC, DTC the FAST program, and development of laws allowing for the holding and trading of book entry and electronic securities. Although this history is well beyond the scope of this blog, what I found particularly interesting is how recent many of these developments have been. For instance, it was only in 1996 that the Direct Registration System (DRS) was implemented that allowed investors to hold uncertificated securities in registered form on the books of the transfer agent and to utilize the FAST system to transfer shares to and from and brokerage account. It was during the late 1990s that DTC really flourished to become the largest depository and clearing house in the US. Today DTC provides the depository and book entry services for virtually all securities available for trading in the US.

Transfer Agent Role in Clearance and Settlement Processes

A transfer agent is an integral part of the National C&S System. The clearance and settlement process depends on the type of security being traded (stock, bond, etc.), how the security is owned (registered or beneficial), the market or exchange traded on (OTC Markets, NASDAQ…) and the entities and institutions involved. I will detail the clearing and settlement process in a future blog.

Security ownership can be either registered or beneficial. State corporate law conveys certain rights to registered owners that beneficial owners may not receive. For example, the right to examine a stockholder list at a meeting is limited to registered and not beneficial owners. Registered owners are listed on the stockholder list by name and are sometimes referred to as "holders of record." In addition to state law rights, the holders of record is an important concept throughout the securities laws. For example, Section 12(g) of the Securities Exchange Act requires a company to register when it has 2,000 or more holders of record. Likewise, deregistration eligibility is determined in part by the number of holders of record.

A transfer agent often deals directly with a holder of record, including in the provision of transfer services, dividend payments and communications, such as the delivery of proxy forms. Record holders may hold their securities in either certificate or book entry form.

The majority of shareholders of a public company are beneficial owners rather than record holders. Beneficial ownership refers to securities held in street name which have been deposited with a brokerage firm and are in the DTC system. These securities usually show up on the shareholder list in the Cede account and sometimes in the name of the particular brokerage firm. Each brokerage and clearing firm maintains records and facilitates transfers for its beneficial owner account holders. Transfer agents process the restrictive legend removal for the initial deposit of securities into the brokerage firm but do not process transfers once in the system.

Current Transfer Agent Regulations

Transfer agents have been regulated by federal securities laws since 1975. A "transfer agent" is defined as any person who engages in the following activities on behalf of an issuer: (i) countersigning securities upon issuance; (ii) monitoring issuances and preventing unauthorized issuances; (iii) registering the transfer of securities; (iv) exchanging or converting securities; or (v) processing transfer and maintaining book entry ownership records. Public company transfer agents are required to be registered with the SEC.

The SEC currently regulates (i) registration and annual reporting requirements; (ii) timing and certain notice and reporting requirements (the "turnaround rules"); and (iii) recordkeeping and record retention rules and safeguarding requirements for securities and funds. The current transfer agent rules are extensive, and below is just a very high-level brief overview.

Current Registration and Annual Reporting Requirements

The current registration and annual reporting requirements are found in Exchange Act Rules 17Ac2-1 through 17Ac3-1. All transfer agents must register with the SEC on Form TA-1. The rules include eligibility prohibitions against certain "bad actors" similar to other bad actor rules within the securities laws. All transfer agents must file an annual report on Form TA-2, including information on compliance with turnaround rules, number of accounts, items received, funds distributed and lost securities. Both the application and the annual report can be viewed by the public on EDGAR. In addition to reviewing these forms, the SEC performs site visits and examinations of transfer agents.

Current Processing, Reporting, Recordkeeping and Exemptions

Exchange Act Rules 17Ad-1 through 17Ad-7 set forth performance standards for transfer agents. In relation to these rules, transfer agents must have written internal controls and procedures. The rules focus on establishing minimum performance and recordkeeping standards for routine transfers, cancellations and issuances. Routine items must be processed within 3 business days of receipt and non-routine items must receive "diligent and continuous attention" and be "turned around as soon as possible." Routine items are defined in the negative such that all items are routine except items (i) requiring the issuance of a new certificate that the transfer agent does not have; (ii) subject to stop order, adverse claim or other restriction; (iii) requiring additional documentation to review and complete; (iv) are part of a corporate action (such as split or dividend); (v) are part of a public or private offering; or (vi) certain warrants, options or other convertible securities. The performance rules contain certain exemptions, such as for the processing of limited partnerships and redemptions for registered investment companies and for certain very small transfer agents.

The performance rules also require a transfer agent to respond to certain written inquiries within prescribed time periods and, in particular, within 5, 10 or 20 days depending on the person making the inquiry and the subject of the inquiry.

Transfer agents are required to keep detailed, defined records including minimum delineated information that allows for the prompt delivery of information related to shareholders, ownership positions and historical records related to same. Records, funds and securities in a transfer agent's custody must be safeguarded to prevent theft, loss, destruction or misuse.

Transfer agents are required to notify DTC when terminating or assuming transfer agent services for an issuer.

SRO Rules and Requirements

In addition to federal securities laws, transfer agents are regulated by SRO's including, for example, the NYSE and DTC. The NYSE requirements include further regulation on turnaround times and recordkeeping as well as capitalization and insurance requirements.

All transfer agents that include electronic or book entry services (which is really all of them) must comply with DTC rules including (i) being "Limited Participants" in DTC; (ii) participate in the FAST program and agree to DTC's Operational Arrangements; (iii) link with DTC's electronic communication system; and (iv) participate in DTC's Profile Surety Program.

State Law

As briefly discussed above, transfer agents must comply with state corporate statutes related to recordkeeping and notice requirements as well as each state's Uniform Commercial Code.

Proposed New Rules

The SEC has issued an advance notice of proposed rulemaking (ANPR) which describes intended new and amended rules and seeks comments on same, but is not in fact that actual proposed rule release. Following the receipt of public comment on the ANPR, the SEC will publish proposed rules. The ANPR reveals a thorough revamping of the transfer agent rules.

The ANPR proposes rules to (i) increase the scope of information on the registration application (Form TA-1) and annual report (Form TA-2) for transfer agents; (ii) require all contracts between a transfer agent and issuer to be in writing, which includes a fee schedule and termination provisions, including provisions for handing over information to a new transfer agent; (iii) enhance transfer agent requirements for the safeguarding of funds and securities; (iv) apply anti-fraud provisions to specific transfer agent activities; (v) require transfer agents to establish business continuity and disaster recovery plans; (vi) require transfer agents to establish basic procedures regarding the use of information, including safeguarding personal information; (vii) revise recordkeeping requirements; and (viii) conform and update various terms and definitions and eliminate those that are obsolete.

Restricted Securities and Compliance with Federal Securities Laws

All sales of securities, including the re-sale of restricted securities held by a current shareholder, must either be registered under the Securities Act or there must be an available exemption. The most common exemption for the resale of restricted securities is Section 4(a)(1) of the Securities Act and Rule 144, which is a safe harbor under Section 4(a)(1). Since transfer agents are responsible for affixing a restrictive legend on stock certificates or making a restrictive notation on book entry securities and for processing the transfer and legend removal from such securities, they are an important gatekeeper in the prevention of fraud and unregistered distributions.

Transfer agents are subject to aiding and abetting liability for violations of the registration requirements under Section 5 of the Securities Act. In addition, like any market participant, a transfer agent could be charged with fraud violations under Section 10(b) and Rule 10b-5 under the Exchange Act and Section 17(a) of the Securities Act.

Currently a transfer agent must determine whether any particular request is routine and thus requires a 3-day turnaround, and whether the state UCC requires the processing of a request. Neither federal nor state UCC regulations require the processing of a request that does not comply with the federal securities laws. Accordingly, the transfer agent must determine whether a particular request complies with federal (or state) securities laws and thus what their particular processing requirements are. It is this determination that has made it an industry practice to require an opinion letter from counsel with each request to transfer or remove a legend from restricted securities. The SEC is concerned that reliance on opinion letters from a shareholder's or issuer's counsel does not offer enough protection against improper transfers or fraud.

Accordingly, the SEC proposes new rules prohibiting any registered transfer agent or its officers, directors or employees from directly or indirectly taking any action to facilitate a transfer of securities if such person knows or has reason to know that an illegal distribution of securities would occur in connection with the transfer. Such knowledge qualifier carries a duty to make reasonable inquiry.

Moreover, the SEC proposes new rules prohibiting any registered transfer agent or its officers, directors or employees from making any materially false statements or omissions or engaging in any other fraudulent activity in connection with the performance of their duties.

In addition, the SEC proposes new rules requiring each transfer agent to adopt internal controls, policies and procedures reasonably designed to ensure compliance with securities laws and requiring that each transfer agent designate a chief compliance officer.

There is no proposal to adopt rules that would provide specificity to a transfer agent related to the removal of a restrictive legend or transfer of restricted securities. However, the SEC does seek comment on same and, in particular, whether there should be requirements related to (i) obtaining an attorney opinion letter; (ii) obtaining issuer approval; (iii) requiring evidence of a registration statement or available exemption; (iv) requiring evidence of beneficial ownership; (v) requiring representations related to affiliation; and/or (vi) conducting some level of due diligence. I would advocate for such guidelines.

As the SEC notes, there is a potential conflict between a transfer agent's duties to process a transfer and to ensure compliance with federal securities laws. However, in my opinion, from a transfer agent's perspective, there are certain rules (turnaround rules and the UCC) requiring processing and only a vague fear of being charged with aiding and abetting related to ensuring compliance with federal securities laws. The proposed new rule generally increasing the potential liability on the transfer agent is likewise vague in the APNR. Without specific guidelines and standards, transfer agents will have a hard time navigating the new regulatory environment and all market participants will pay the price.

In fact, fear of regulatory retribution has already created a very challenging environment in the small-and mid-cap marketplace. The deposit of penny stock securities has become extremely difficult and expensive, but the flow of information to the market participants as to what is and is not acceptable has been slow and disjointed. At the same time that the OTC Markets has created self-imposed quantitative and qualitative standards to improve the marketplace and has been attempting to support small and emerging growth business capital formation, the secondary trading becomes increasingly difficult.

Moreover, there is a contrarian reality among the legislature, the SEC's public position, and again, the actual small-cap secondary trading market, including the ability to deposit securities. The JOBS Act, including Regulation Crowdfunding, and the FAST Act are designed to improve capital formation in the small and emerging growth sectors, including a specific focus on allowing companies easier access to public markets and facilitating going public transactions. The advent of Regulation A+ and 506(c), the creation of the emerging growth company category, the various provisions of the FAST Act including improvements to the Form S-1 filing process and the SEC initiatives to modernize and update disclosure obligations are all meant to ease capital formation and public filings for micro- and small-cap companies.

Further, the active SEC Advisory Committee on Small and Emerging Companies was organized by the SEC to provide advice on SEC rules, regulations and policies regarding "its mission of protecting investors, maintaining fair, orderly and efficient markets and facilitating capital formation" as related to "(i) capital raising by emerging privately held small businesses and publicly traded companies with less than $250 million in public market capitalization; (ii) trading in the securities of such businesses and companies; and (iii) public reporting and corporate governance requirements to which such businesses and companies are subject."

The contrary side to all of this is the extreme difficulty in depositing securities for small- and micro-cap public companies and in creating a vibrant trading market. Although not comprehensive on the issues, see my blogs HERE regarding broker duties in depositing stocks and HERE regarding the need for a venture exchange.

The small- and micro-cap marketplace needs more definitive standards that companies and practitioners can rely upon. The fact is, it is relatively easy for a company to pass a footnote 32 type vehicle through the SEC and obtain a ticker symbol from FINRA and then extremely difficult to do anything with it. See my blog HERE. The fact that it is easy to create the vehicles in the first place creates a sort of confusion and disconnect in the marketplace. I'd rather see the SEC and FINRA be more stringent in their review process on these obvious vehicles and require that they label themselves a shell such that brokers and transfer agents have some comfort that when a company has cleared the SEC and FINRA, it is as labeled, subject of course to post effectiveness changes.

Of course, brokers and transfer agents still need to be gatekeepers, but the standards they are relying upon and the issues they are facing in their own SEC investigations and reviews need to be articulated and communicated to the marketplace. New proposed transfer agent rules is a step in the right direction and a very good start, but if those rules include a vague requirement that the transfer agent follow the law, we will not have made the type of headway that is badly needed to support real and viable small businesses and their capital formation.

I note that as part of the SEC request for comment there are some extreme thoughts. For instance, the SEC requests comment on whether a transfer agent should be required to (i) confirm the existence and legitimacy of an issuer's business by reviewing contracts and corporate records; (ii) conduct credit and criminal background checks for issuers and their officers and directors; (iii) obtain information on shareholders before processing requests for legend removal; and (iv) review public news and information on issuers and principals. My view is that this level of review by a transfer agent is too extreme. I strongly oppose giving a transfer agent that level of independent power over an issuer and its shareholders. In addition to the shutdown in the small and micro-cap markets that would entail, the re-tooling of current transfer agents to adequately be able to satisfy this level of responsibility would be cost-prohibitive both to the transfer agents and their clientele.

Some of the other comment requests of interest (and my view in parentheses) include: (i) should the SEC enumerate red flags that would trigger a duty of further inquiry by a transfer agent (yes); (ii) should there be a heightened review for securities of non-reporting issuers (yes, if no current information); (iii) should a transfer agent be required to deliver securities only to the registered shareholder and not third parties (yes, unless the third party is an attorney or other proper representative of the shareholder); and (iv) should transfer agents be prohibited from accepting stock as compensation (no).

Registration and Annual Reporting

The purpose of the registration and annual reporting requirements is to assist the regulators, issuers and investors in determining whether a transfer agent is performing its functions properly, determining the nature of a particular transfer agent's business, assisting the SEC in making examination and investigation decisions, including areas of concern, monitoring the transfer agents activities and ensuring compliance with rules and regulations.

The SEC proposes to add information to the registration and annual reporting requirements, including financial information, potential conflicts of interest and details about the types of services being provided and the transfer agent's clientele. For example, it is proposed that a transfer agent disclose any past or present affiliations with or ownership of issuers or broker-dealers serviced by or affiliated with a transfer agent. I note that several small-cap broker-dealers have sister transfer agencies and do not believe such vertical business investment is problematic nor should it be construed as nefarious. However, I do see benefit in the disclosure of same.

The SEC also proposed to require a transfer agent to designate a chief compliance officer with responsibilities to ensure compliance with written internal controls and procedures.

Written Agreements Between Transfer Agents and Issuers

The APNR proposed to require written agreements between transfer agents and issuers. Although it is not now a legal requirement, I think most transfer agents do have such agreements. I am hard-pressed to think of any issuer clients that do not have a written contract with their transfer agent, and most are quick to require the signing of an addendum or updated contract where there is a change of management or control of the issuer.

However, the SEC rightfully points out that where there is either no written agreement or the agreement does not cover certain questions, there is an increase of disputes with respect to (i) the duration of the arrangement; (ii) termination rights; (iii) the disposition of records and transfer of records to a new transfer agent; and (iv) fees. These issues are most prevalent in the small-cap world, especially where a transfer agent "holds records hostage" in exchange for a large termination fee. The APNR does not suggest that the transfer agent be limited in allowable termination fees, nor that a transfer agent be required to turn over records regardless of sums owed or the payment of a termination fee, though it does seek comment on such issues.

Safeguarding Funds and Securities

Transfer agents often provide administrative and processing services in relation to dividends, payouts associated with splits (paying agent services) and other transactional escrow services. The APNR proposes a more robust set of standards for transfer agents acting as a paying agent or providing escrow services. The APNR indicates the SEC will provide new rules such as (i) maintaining secure vaults; (ii) installing theft and fire alarms; (iii) having written procedures related to access and control over accounts and information; (iv) greater bookkeeping requirements; (v) and specific unclaimed property procedures. In addition, the SEC intends to impose rules similar to those for broker-dealers, requiring internal controls, annual reporting and independent audits related to these services.

Cybersecurity, Information Technology and Related Issues

Cybersecurity is a big concern for the SEC. In 2014 the SEC adopted Regulation Systems, Compliance and Integrity requiring covered entities to test their automated systems for vulnerabilities, test their business continuity and disaster recovery plans and notify the SEC of intrusions. In particular, the SEC intends to propose new or amended rules requiring registered transfer agents to, among other things: (i) create and maintain a written business continuity plan; (ii) create and maintain basic procedures and guidelines governing the transfer agent's use of information technology, including methods of safeguarding data and personally identifiable information; and (iii) create and maintain appropriate procedures and guidelines related to a transfer agent's operational capacity, such as IT governance and management.

Concept Release and Request for Additional Comment

The SEC concept release contains discussion and seeks comment from the public on issues outside of and in addition to the APNR. The SEC highlights different questions and issues such as whether brokerage firms should also be required to be registered as transfer agents when they hold securities in nominee accounts; specific issues affecting transfer agents for mutual funds and transfer agents that serve as administrators for employee stock option and similar plans. The concept release also seeks comment on a transfer agent's role in a Regulation Crowdfunding offering (Title III Crowdfunding).

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Securities Law Blog is written by Laura Anthony, Esq., a going public lawyer focused on OTC Listing Requirements, Direct Public Offerings, Going Public Transactions, Reverse Mergers, Form 10 Registration Statements, and Form S-1 Registration Statements. Securities Law Blog covers topics ranging from SEC Compliance, FINRA Compliance, DTC Chills, Going Public on the OTC, and OTCQX and OTCQB Reporting Requirements. Ms. Anthony is also the host of LawCast.com, the securities law network.

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