

Our ref: 366

14 January 1992

SECURITIES TRANSFER ACT 1991 - NZSE FASTER PROPOSAL

Pursuant to section 7 of the Securities Transfer Act 1991 ("the Act"), the Governor-General may, from time to time, on the advice of the Minister of Justice given in accordance with a recommendation of the Securities Commission, approve a system or systems that are wholly or partly electronic for the transfer of securities.

The Commission has received a request from the New Zealand Stock Exchange to make a recommendation in respect of a system for the transfer of listed securities to be known as FASTER. A copy of the system description is attached.

It will be seen that the system provides for the establishment on company share registers of Broker Transfer Accounts ("BTAs") and for the electronic transfer of securities into, between and out of those BTAs. There will be three types of transactions affecting BTAs:

- (a) Client Inward Transfer - a transfer of shares from the seller into the selling broker's BTA. This will be supported by scrip and a signed transfer. No approval under the Act is therefore necessary. The selling broker will enter the Client Inward Transfer onto the system and will be responsible for this purpose for checking the documents. In this respect the broker would appear to be acting on behalf of the company. No scrip will be issued in respect of the shareholding of the BTA.
- (b) Broker to Broker Transfer - an electronic transfer of securities from the selling broker's BTA to the buying broker's BTA, that is, a transfer effected electronically without written transfer form or scrip.
- (c) Client Outward Transfer - an electronic transfer of securities from the buying broker's BTA to the buyer. This would be a transfer without written transfer form or scrip. Upon completion of the Client Outward Transfer the registry will issue new scrip direct to the buyer.

Thus, it can be noted that:

- (a) the system will not be fully paperless - a transfer still has to be executed by a seller of shares in the usual way.
- (b) the system will not be fully scripless as the existing rules apply:
 - (i) in relation to the production of the certificate by the initial seller of shares, and
 - (ii) the issue of a new certificate to the ultimate buyer of shares;

However as there will be no physical transfer documents for either the Broker to Broker Transfer or the Client Outward Transfer the proposed system needs approval under the Act.

It is proposed that all shares held in BTAs will be held upon trust for the clients concerned although the detail of the trust arrangements is not stated in the system description (see para 11.3 of the system description).

By virtue of to sub-section 7(6) of the Act, the Commission may not make a recommendation to the Minister of Justice unless it has done everything reasonably possible to consult with such persons and organisations as the Commission considers will be substantially affected by the recommendation.

The Commission accordingly seeks comments on the FASTER proposal. The Commission suggests that those wishing to comment might consider the particular points listed in the Schedule attached, although the Commission would be pleased to receive comments on any other aspect of the proposal.

Comments are required by 27 January 1992.

Yours faithfully,


J. Farrell
Chief Executive

SCHEDULE

1. Policy Considerations

The need for automation in the securities markets is well documented and widely accepted both here and overseas. The New Zealand market needs to be able to provide internationally competitive systems for the transfer and registration of securities, systems that are fast, cost effective, and appropriately safe for investors.

The point has been made that:

"... each time a new system is produced, our more or less conscious attachment to tradition leads us to expect guarantees which were previously not only never fulfilled but were not even asked for".¹

The Commission must endeavour to strike a judicious balance between the somewhat conflicting aims of efficiency and investor protection.

2. Fraud

An important question is whether or not securities trading under the proposed system would be more open to fraudulent abuse than under the existing procedures. In advising that it would not, the NZSE argue that:

(a) Client Inward Transfer

Whilst a broker could conceivably make a fraudulent Client Inward Transfer, under the present system he or she could just as easily forge a declaration of loss and a transfer so the possibility of fraud is no greater under FASTER; and

(b) Broker to Broker Transfer or Client Outward Transfer

Once the securities are in the broker's BTA, the broker could fraudulently transfer them to whomever he wishes. However this situation is no different from that obtaining under the present system in relation to the completion by brokers of brokers transfers (see Second Schedule Securities Transfer Act 1991 - which reproduces the provisions of the Securities Transfer Act 1977).

However even if FASTER does not lend itself to the prospect of fraud to any greater extent than the present system, that of course does not mean that the possibility of fraud is eliminated altogether. Accordingly it is also necessary to consider whether, in the event of a fraud, the disenfranchised shareholder would be in any worse position under FASTER than he would be under the present procedures.

1. Walden & Savage "The Legal Problems of Paperless Transactions" Business Law Journal, March 1989 p.102

The Commission is advised by the NZSE (which has consulted its legal advisors) that the legal position in this regard may be summarised as follows:

- (a) A forged share transfer is of no effect. Upon the true owner discovering the fraud he or she can require the company to rectify the share register to confirm that he or she remains the owner of the shares;
- (b) Because the original owner remains the owner of the shares the buyer is, under the present system, left only with a claim against his/her broker for the loss suffered.
- (c) Under FASTER, the seller's rights will be exactly the same - and as such a seller would be no worse off under FASTER.
- (d) Under FASTER the buyer of the shares from the fraudulent "seller" may be in a better position. The shares which the buyer receives have passed through two BTAs (which are fungible pools of securities). It will not routinely be possible to trace and identify the shares for the purposes of "restoring" the register. Thus under FASTER a buyer is likely to continue to own the shares notwithstanding that his/her purchase may have been preceded by a fraudulent sale.

3. Mistake

In the absence of fraud, is it possible that a broker could make a Client Inward Transfer by mistake? The NZSE advise that it would not, for the reason that in entering a Client Inward Transfer a broker would have to key in some reasonably detailed and quite specific information.

Perhaps a more likely possibility would be a situation where a broker, in breach of the rules of the system, enters a Client Inward Transfer in anticipation of receiving the scrip and transfer from his client and the client then refuses to produce the documents claiming that he had not agreed to sell or transfer his shares. In entering a Client Inward Transfer, a broker, we think, would be acting as a registry agent of the company and so the company would have an obligation to reinstate the shareholder on the register. The status of the broker in this respect needs to be clarified.

4. Contractual Nexus

It is likely that shares transferred into BTAs would lose their identity and become part of a fungible pool. In a stock exchange transaction this would seem to remove any contractual nexus which might currently exist between a broker's selling client and the ultimate buyer. This will have implications in relation to any attempt by a selling client to trace scrip which has passed through a broker's hands.

5. Partly Paid Shares

The Act permits not only the transfer of fully paid securities by broker's transfer (section 4) or on an approved system (section 7) but also the transfer of partly paid securities by those two methods. The Securities Transfer Act 1977 excluded partly paid securities from those which could be transferred using the simplified procedures set out in the 1977 Act. It seems that the rationale was that because the transferee of a partly paid security was assuming a contingent liability, there should be an acknowledgement in writing from the transferee that that liability was accepted.

The Commission is advised by the NZSE that both the NZSE and the Listed Companies Association wish that partly paid securities be transferred on FASTER and thus without the signature of the transferee. Their view is that:

- (1) liability for a call is a matter of contract between the company and the shareholder for the time being;
- (2) this contract need not be in writing in all respects;
- (3) the enforceability of an oral contract depends on there being sufficient evidence of the contract;
- (4) in the case of a stock exchange transaction there is sufficient evidence of the transferee's willingness to assume the obligation because -
 - (a) partly paid securities are well identified to the market,
 - (b) before the securities are transferred to the buyer a contract note will be sent to the buyer by the broker identifying the securities and requesting payment,
 - (c) the act of payment by the buyer against the contract note confirms the buyer's willingness to acquire the securities and the liability attaching thereto.
- (5) In any event, given that partly paid securities may now (pursuant to the 1991 Act) be transferred by broker's transfer, they should also be transferrable under FASTER.

6. Control of Automation Risks

It is important to consider what risks the introduction of the technology would create and what should be done to minimise those risks. The U.S. General Accounting Office in a paper on International Financial Markets and Automation Risks² identifies four areas that must be addressed:

2 Report of the US General Accounting Office 'Global Financial Markets: International Co-ordination Can Help Address Automation Risks' September 1991.

- (a) security to prevent unauthorised access and misuse of data;
- (b) capacity planning to deal with sudden increases in demand;
- (c) contingency systems to ensure continuous service in the event of system failure, natural disaster or intentional malicious act;
- (d) independent technical reviews to confirm that the system performs and continues to perform as intended.

The steps the NZSE propose taking to address these concerns are summarised in the system description in sections 15 and 16. Any comment on the adequacy or otherwise of the NZSE proposals in this regard would be welcomed. The Commission has not undertaken any analysis in this respect and is not qualified to do so.

7. Share Certificate/BTA

No share certificates will be issued for shares held in BTAs. Section 90 of the Companies Act 1955 requires a share certificate to be issued by a company in respect of all transfers entered on its register. Thus it seems that there may be a technical breach of section 90. However shares are routinely held for very short periods in any BTA. It would be impractical to issue a share certificate in respect of all transfers entered on BTAs. It would simply reduce the efficiency of the system to do so. This matter will need to be addressed in the new Companies Bill at present before Parliament.

8. BTAs As Trust Accounts

The Commission considers that further detail of the trust arrangements for shares held in a BTA should be recorded in the system description or elsewhere.

9. Approval Function

If the Commission makes a recommendation to the Minister of Justice to approve the system, then it will do so on the basis of the system as outlined in the system description annexed hereto or any modification that might be made prior to a recommendation by the Commission. The responsibility for ensuring that the system operates within the parameters set out in the system description will be that of the NZSE.