

About These "Street Certificates"

© Supreme Court in a recent decision upholds ruling of the SEC, strictly limiting their use.

By James M. Robb

Almost unnoticed, a decision has recently been rendered by the Supreme Court, of considerable interest to brokers and traders, as well as to the general public. The decision, upholding the interpretation which the Securities and Exchange Commission placed upon one of its own Rules governing trading on the Stock Exchange, is far-reaching in effect since it hits at an almost universal practise among brokers—that of converting all certificates placed with them into "street certificates."

A street certificate is a certificate on which "the name of a person other than the owner—is inserted for convenience of rapid trading." In practice local brokers have been following the Wall Street custom of sending all stock certificates deposited with them by their customers, whether margined or not, to the Clearing House for cancellation and substitution by new certificates, usually in the name of another brokerage house. This custom has been general because through it stock certificates become very nearly as negotiable as "bearer" promissory notes or bills of exchange. Thus, transfer of the stock on the books of the corporation need not occur at once, and often does not until it becomes desirable to change the entry on the register in order to avoid complications with dividend checks. This increased negotiability is due to the fact that, once a certificate is changed into a street certificate in the name of a brokerage firm, nearly all impediments to negotiation—such as the possibility of fraud or forgery, or bankruptcy of a client—are removed.

In March of last year, the Securities and Exchange Commission promulgated its Provisional Rules and Regulations, Rule A-6 of which read as follows:

"Securities to which a broker has not extended any credit to a customer shall be kept separate for the particular customer who owns them and, except with the written consent of the latter, shall not be loaned, pledged, or commingled with other securities owned by the broker himself or by other customers, or otherwise disposed of as his own. In case they should be loaned, pledged, or otherwise disposed of as his own by the broker, by virtue of the customer's written consent, the broker shall report it to the latter, stating the name of the person or persons to whom they were loaned or pledged or disposed of, and the amount for which they were disposed of, and the maturity of the loan."

Soon after this rule was promulgated—and it has not been amended—one Vicente Galian deposited with Swan, Culbertson and Fritz an order, good until cancelled, to sell 10,000 shares of Gumaus Goldfields, Inc., at P0.185 per share, and deposited with the brokers a certificate for 20,000 shares of the corporation's stock, issued in his name, and properly endorsed in blank. At the same time, he signed the usual form, which provided that,

"All securities, or commodities, contracts for commodities or other contracts now held or hereafter purchased by the Brokers for, or now or

hereafter deposited with the said Brokers by the Customer, are to be held by the Brokers as security for the payment of all liabilities of the Customer to the Brokers however and whenever arising, and the Brokers are hereby authorized, without further notice to the Customer, and without regard to whether the Brokers have in their possession or subject to their control at the time thereof other securities, commodities, or contracts for commodities of the same kind, and amount in the usual course of business, to repledge, rehypothecate—and loan the same from time to time, separately or together with other securities; and the Brokers shall not be required to deliver to the Customer the same certificate or securities deposited or received, but only certificates or securities of the same kind and amount."

On April 13, 1937, the broker sent the original certificate to the clearing house of the Manila Stock Exchange for transfer to "street certificates," and two new certificates were sent to it for 10,000 shares, in the names of Mackay and McCormick and Leo Schnurmacher, respectively. On that same day, the customer cancelled his selling order, and requested return of his stock, and the two street certificates were delivered to him. He accepted them without protest, and signed the corresponding receipt. On April 19th, he filed a written complaint with the Commission, alleging violation of the Rule A-6 above-quoted.

The Commission, after taking evidence, held that the brokers had indeed violated the second part of the Rule, in that they did not give notice of the conversion of the original certificate into street certificates, although they did not violate the first part of the Rule since they had the customer's written authority to deliver to him substitute certificates of any kind, so long as they totalled the number of shares originally deposited with them. The Brokers were censured by the Commission in rather strong language, and they appealed to the Supreme Court.

Counsel for the brokers argued before the Court, among other things, that the simple transfer of certificates endorsed in blank, to street certificates is not a "disposal" of them within the meaning of Rule A-6. The brokers had not, of course, "loaned or pledged" the securities, and, it was contended, neither had they "disposed" of them. When the brokers received two street certificates from the Clearing House, in the names of two other brokerage firms, they had then on hand 20,000 shares of Gumaus Goldfields stock, as they had before, and immediately delivered these two certificates to the customer, who accepted them without protest, and received therefor. The advantages of the practise were pointed out, and the prevalence of the custom brought to the attention of the Court. Furthermore, it was argued, since there was no "disposal", or other forbidden dealing with the certificates, there could be no necessity to report to the customer, as required by the last part of the Rule. It was contended that the Rule contemplated a report to a customer only where certificates

were loaned, or pledged, or hypothecated, and not in a case of mere conversion into street certificates. Besides, said the lawyers, since the customer accepted the new certificates without protest, he of course knew that the original certificate had been substituted by the two which he received, and there was no necessity for reporting to him something which he already knew.

The Attorney General, for the Commission, retorted that the brokers had "disposed" of the original certificate, and called upon Webster as their authority, that "to dispose of" means "determine the fate of; fix the condition, employment, etc., of; to direct or assign for a use; to get rid of, or put out of the way; to finish with—to transfer to the control of someone else, as by selling; to alienate; part with; relinquish; bargain away".

The Attorney General also expressed grave concern over the plight of customers whose original certificates are dealt with in this fashion, stating "if brokers could at will convert the customer's certificates into street certificates, they could use and trade on such street certificates as their own even without retaining equivalent certificates in their possession. They could sell or pledge—or trade on their own account." Furthermore, "if a stockholder's meeting is called, a stockholder will not be notified, and will not, therefore, be able to vote and otherwise take part in the deliberations. If he wants to retransfer the street certificate to his own name, he must send that certificate to the transfer office of the corporation, and pay the corresponding transfer fee. If a dividend is declared, he will not receive any portion thereof because his name does not appear among the corporation's stockholders." The fact that the practise is well-nigh universal in New York and other securities centers does not mean that it should go unrestricted here, the Attorney General argued, for local investors are not as yet

educated in the intricacies of market trading, and need more "protection" than traders with more experience.

Strangely enough, neither side succeeded, apparently, in locating much authority in support of their respective positions. The attorneys for the brokers relied mainly on a case decided by the New York Supreme Court, Appellate Division, and the Attorney General cited a decision of the Court of Appeals of the State of California. Neither court is the highest court of the State, and decisions of these two courts are not, naturally, controlling. The Attorney General also dug up a very old Massachusetts case, and both sides quoted freely from Meyer, "The Law of Stockbrokers and Stock Exchanges".

The Supreme Court, in a unanimous opinion, sustained the Commission, holding that the brokers had "disposed of" the original certificate of stock, without notifying the customer, as required by the Rule A-6 of the Commission. The Court also criticised the practise of changing "free" certificates on which the broker has not loaned money, into street certificates. (Swan, Culbertson & Fritz, Petitioner, vs. Securities and Exchange Commission and Vicente Galian, Respondents, R. G. 45792).

The immediate effect of the decision will probably be that brokers will have their forms amended, so as to include a waiver of notice of the changing of certificates into street certificates, and that brokers will be careful to see that every customer signs these forms. The practise itself has not been outlawed, but only the obtaining of street certificates without (1) previous authority from the customer, and (2) notifying the customer when the street certificates have been obtained in lieu of the originals.

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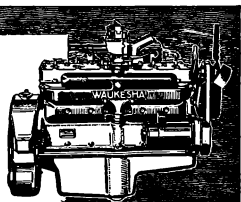
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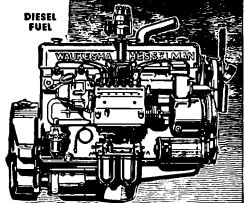
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