The Certificateless Society and the Constitution

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SEC Commissioner Richard B. Smith has called for federal legislation to abolish the stock certificate, thereby overriding contrary state laws. The author discusses the constitutional and policy implications of the proposal.

"A national problem calling for a national solution." In a provocative address, SEC Commissioner Richard B. Smith has thus characterized the present legal requirement of physical delivery and transfer of stock certificates in securities transactions. His proposed solution is adoption of federal legislation which would eliminate the stock certificate and provide for a securities processing system capable of handling securities transactions in modern markets.

The purpose of this article is to present reflections on the constitutional and policy implications of the Smith proposal. In the analysis, two postulates are made.

First, the requirement of delivery and transfer of a stock certificate has resulted in, and threatens further to result in, significant impediments to the smooth operation and functioning of the national securities market.

Second, any federal legislation adopted would be reasonably circumscribed so as to focus on the elimination of this particular problem alone. No sweeping steps to eliminate all stock certificates of all state corporations would necessarily be contemplated. For instance, federal legislation might be limited in its application to those corporations listed on national exchanges, or involved in extensive over-the-counter trading, such as those subject to section 12(g) of the Securities Exchange Act.

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2 See generally Uniform Commercial Code art. 8, pt. 3. "Delivery" is necessary for transfer (§ 8-301), although "delivery" is defined (§ 8-315) to make actual change of possession unnecessary in certain cases; e.g., where a central depository system is established under § 8-320 (such as the New York Stock Exchange's Central Certificate Service). Although the expanded use of CCS appears to have been accepted as at least an interim ameliorative (see Wall Street Journal, Apr. 20, 1971, at 2, col. 3), it may be forecast that a permanent solution could well require more—the CCS system is both limited in its availability and dependant upon voluntary adherence.

3 For documentation in addition to Commissioner Smith's recent address, see, e.g.,
Such a process would be wholly in line with the "interstitial character of federal law." In the typically lucid language of Hart and Wechsler:

Federal legislation, on the whole, has been conceived and drafted on an \textit{ad hoc} basis to accomplish limited objectives. It builds upon legal relationships established by the states, altering or supplanting them only so far as necessary for the special purpose. Congress acts, in short, against the background of the total \textit{corpus juris} of the states in much the way that a state legislature acts against the background of the common law, assumed to govern unless changed by legislation.\footnote{H. Hart, Jr. & H. Wechsler, \textit{The Federal Courts and the Federal System} 435 (1953).}

**Sources of Federal Power**

Federal legislation to abolish the stock certificate would most logically be based upon the constitutional power of Congress to regulate interstate commerce. While the issue may once have been in doubt, it is clear today that the commerce power applies to intangibles in interstate commerce, as well as to goods and merchandise.\footnote{United States v. South-Eastern Underwriter's Ass'n, 322 U.S. 533 (1944).} "[T]hat transactions on national securities exchanges have taken on an interstate character, justifying regulation under the commerce clause, is now beyond doubt."\footnote{United States v. South-Eastern Underwriter's Ass'n, 322 U.S. 533 (1944).}

In thus attempting to regulate, control, and further the operation of national markets, the Congress would act on a constitutional premise extending back at least to \textit{Stafford v. Wallace} \footnote{258 U.S. 495 (1922).} (involving stockyards), and \textit{Chicago Board of Trade v. Olsen} \footnote{262 U.S. 1 (1923); see also, United States v. Wrightwood Dairy Co., 315 U.S. 110 (1942) (milk); Sunshine Anthracite Coal Co. v. Adkins, 310 U.S. 381 (1940) (bituminous coal); Currino v. Wallace, 300 U.S. 1 (1939) (tobacco).} (which concerned the grain futures exchange).

It is, of course, true that the adoption of the proposed federal

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legislation in a sense would involve more than the direct regulation of the market itself. As Commissioner Smith pointed out in his speech, while present laws basically regulate the conduct of trading in the national securities markets, the new legislation would regulate the conduct of processing and completing securities transactions effected in those markets.

Such regulation might, in one light, be viewed as an impermissible federal intrusion into an essentially intrastate process. However, it is long since settled that activities that are in themselves intrastate may be regulated by Congress if they "affect" interstate commerce. Strikingly put in United States v. Women's Sportswear Mfrs. Ass'n, "If it is interstate commerce that feels the pinch, it does not matter how local the operation which applies the squeeze."10

The doctrine received renewed affirmation in the Supreme Court very recently in Perez v. United States.11 There the Court upheld the constitutionality of a criminal statute outlawing "loansharking" (extortionate credit transactions), even though the loan was entirely intrastate and no showing was made that the defendant's activity had any connection whatsoever with, or impact on, interstate commerce. It was enough that the "class of activities" regulated had such ties.12

The series of Supreme Court cases rejecting various attacks on the Public Utility Holding Company Act reflects the virtually absolute control that the Congress can exercise over even the very structure of a corporation where interstate commerce is affected. In North American Co. v. SEC,13 the SEC had ordered a holding company to divest itself of subsidiaries. The Supreme Court postulated that the right to own or retain property is typically a state law issue, but said:

The fact that an evil may involve a corporation's financial practices, its business structure or its security portfolio does not detract from the power of Congress under the commerce clause to promul-

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12 A relatively recent listing of a number of other Supreme Court cases to this effect may be found in Justice Black's concurring opinion in Heart of Atlanta Motel, Inc. v. United States, 379 U.S. 241, 270-72 (1964). In perhaps the most famous of these cases, Wickard v. Filburn, 317 U.S. 111 (1942), it was held that the federal government could control a farmer's growing of wheat on his own land for his own consumption since "even if appellee's activity be local and though it may not be regarded as commerce, it may still, whatever its nature, be reached by Congress if it exerts a substantial economic effect on interstate commerce ... " Id. at 125. See also the other leading case of United States v. Darby, 312 U.S. 100 (1941). Of course, under the commerce clause, Congress is not limited simply to preventing abuses, but also may affirmatively promote interstate commerce. See, e.g., The New England Divisions Case, 261 U.S. 184, 189 (1923).
13 327 U.S. 686 (1946). Earlier in Electric Bond & Share Co. v. SEC, 303 U.S. 419 (1938), the registration requirement of the Act had been upheld.
gate rules in order to destroy that evil. Once it is established that
the evil concerns or affects commerce in more states than one,
Congress may act.\(^{14}\)

A few months later, in American Power & Light Co. v. SEC,\(^ {15}\) the
Court sustained an SEC order requiring the actual dissolution of two
subsidiaries of a holding company, again affirming in sweeping terms
Congressional power over corporate structure and activities under the
commerce clause.

A particularly illustrative lower court case involving federal con-
trol of the details of the stock structure of a corporation is Common-
wealth & Southern Corp. v. SEC,\(^ {16}\) where the company challenged the
constitutionality of SEC action under 11(b) of the Public Utility
Holding Company Act. The SEC had ordered the elimination of all
preferred stock of the company and the consolidation of the company's
corporate structure into a single class of common stock. In sustaining
the action, the court noted:

> It may be conceded, as Commonwealth urges, that the right
to exist as a corporation, the power to own and vote stock in sub-

sidary companies, the right to issue stock having designated pref-
erences, priorities, voting power and other rights, and the right
to retire or redeem securities are all local matters, normally regu-
lated by the laws of the state. It does not follow that Congress is
restricted in the exercise of the commerce power because any or
all of these rights are affected thereby. That is the fundamental
weakness of Commonwealth's contention that if section 11(b) (2) is
construed so as to permit an order which deals solely with the

porate structure of the holding company and the rights of the
stockholders among themselves it is unconstitutional because out-
side the power conferred by the commerce clause. Such a contention
takes entirely too narrow a view of the extent of the power con-
ferred upon Congress by the commerce clause. . . . It is immaterial
whether the effect upon interstate commerce is direct or indirect
if the activities exert a substantial economic effect on that com-

merce.\(^ {17}\)

Indeed, if the power of the federal government exists under the
Constitution, it is no obstacle that sovereign powers and interests of
the state itself are thereby interfered with. In Maryland v. Wirtz, the
Supreme Court was faced with the issue of whether the extension of the
Fair Labor Standards Act to state-owned and operated hospitals

\(^{14}\) 327 U.S. at 406.
\(^{15}\) 329 U.S. 90 (1946).
\(^{16}\) 134 F.2d 747 (3d Cir. 1943).
\(^{17}\) Id. at 752-53.
and schools was permissible. The argument was made that such an extension was an unconstitutional interference by Congress with state sovereign powers. In holding the Act applicable, the Court noted that "It is clear that the Federal Government, when acting within a delegated power, may override countervailing state interests, whether these be described as 'governmental' or 'proprietary' in character."

The basic doctrine is hardly novel. A recent case on the general point in the securities field is SEC v. National Securities, Inc., where the Court upheld the power of the SEC under Section 10(b) of the Securities Exchange Act and rule 10b-5 to seek, as an appropriate remedy, to unwind a corporate merger specifically approved by the Arizona Director of Insurance under state law.

It is equally clear that it is for Congress, not the courts, to determine whether regulation is advisable, and what form it should take. The deference that the Supreme Court will show to such determinations by Congress is illustrated in Katzenbach v. McClung. The Court there pointed out that where the Congress, in light of the facts and testimony before it, has "a rational basis for finding a chosen regulatory scheme necessary to the protection of commerce," the investigation of the Court is at an end.

It should be added that the commerce clause does not stand alone as a possible source of federal power to enact legislation on a certificateless society. In adopting, for example, the Securities Exchange Act, the Congress invoked a panoply of constitutional considerations: to

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19 Id. at 195.
20 See, e.g., McCulloch v. Maryland, 17 U.S. (4 Wheat.) 316, 405 (1819). Second Employers' Liability Cases, 223 U.S. 1, 53-54 (1912). In Sanitary Dist. of Chicago v. United States, 266 U.S. 405 (1925), the Court sustained an injunction prohibiting the District from taking more water from Lake Michigan than allowed by the Secretary of War. "There is no question that this power [to remove obstructions to interstate and foreign commerce] is superior to that of the States to provide for the welfare or necessities of its inhabitants." Id. at 426.
23 Id. at 304. Other examples abound. Thus, in Oklahoma v. Guy F. Atkinson Co., 313 U.S. 508 (1941), the state challenged the construction of a dam on a non-navigable river on the ground that the project exceeded the power of Congress and was contrary to the sovereign and proprietary rights of the state. The Court said:

It is for Congress alone to decide whether a particular project, by itself or as part of a more comprehensive scheme, will have such a beneficial effect on the arteries of interstate commerce as to warrant it . . . nor is it for us to determine whether the resulting benefits to commerce as a result of this particular exercise by Congress of the commerce power outweigh the costs of the undertaking . . . nor may we inquire into the motives of members of Congress . . . it is sufficient for us that Congress has exercised its commerce power, though other purposes will also be served.

Id. at 527-28.
protect interstate commerce, the national credit, the federal taxing power, the national banking system, and the postal power.

**STATE INTERESTS AND FEDERAL POWER**

It is not unusual for Congress to deliberately stop short of extending a regulatory scheme under the commerce clause to the full limits of constitutional permissiveness. Indeed, where a new exertion of federal power will touch upon what are traditionally state areas of concern, one might anticipate that legislation would be drafted with a particular aim of confining its application.

In this regard, it may be useful to examine briefly the principal areas of state concern that might be affected by enactment of federal legislation relating to the certificateless society, and to see the extent to which such state interests might in fact be infringed upon. Such an analysis can also be useful in testing further the constitutional foundation for such legislation.

A convenient way to approach this problem is to examine the provisions of state law that would have to be amended if a state were to adopt legislation making it a certificateless society. While the details would vary, depending on the exact nature of the statutory scheme decided upon, it seems generally agreed that the three chief areas affected are the regulation of corporate structure and procedures (i.e., state corporation laws), the regulation of the transfer of and perfection of security interests in stock ownership of corporations (Articles 8 and 9 of the Uniform Commercial Code), and the regulation of fiduciaries.

**Corporation Laws**

It is interesting that the proposal for federal legislation to create a certificateless society may resurrect a debate almost a hundred years old. Louis Loss reports that around the turn of the century, the question of whether federal incorporation should be required of all corporations engaged in interstate commerce was a popular topic among high school debaters. Argument over the pros and cons of the proposi-
tion rumbled on for several decades, until essentially quieted by the enactment of the series of federal securities acts after 1933.\footnote{29}

Talk of "federal corporation law" has, of course, again come to the fore, particularly in connection with the judicial interpretations of rule 10b-5.\footnote{30} But the distinction between the older discussions of a federal corporation law and the recent ones is significant. The former contemplated a general federal regulatory scheme comparable to that now exercised by each state—\textit{i.e.}, the creation of federally chartered corporations. The more recent discussions have focused on the fact that by the securities acts and other legislation and judicial interpretations, a substantial body of federal law is supplementing or superseding state corporation laws in selected areas.\footnote{31}

The important point for present purposes is the fact that in enacting legislation for a certificateless society, the aim would dearly not be to "pre-empt the whole field of corporate affairs."\footnote{32} Rather, it would be designed to eliminate a specific evil impeding the smooth operation of interstate commerce and threatening the soundness of the market for the investor.\footnote{33}

While such legislation would not regulate the market directly, its rationale would be in line with existing provisions of federal securities laws to control conditions with indirect but adverse market effects.\footnote{34} For example, in speaking of a much-discussed provision of the federal securities laws, the Fifth Circuit noted: "Section 10(b) [of the Securities Exchange Act] is not concerned so much with fraud per se as it is with the effect of fraud upon investors and upon the public interest in the maintenance of free and open securities markets nurtured in a climate of fair dealing."\footnote{35}

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\item \footnote{29} L. Loss, \textit{Securities Regulation} 107-11 (2d ed. 1961) [hereinafter Loss]; but see Kaplan, \textit{Foreign Corporations and Local Corporate Policy}, 21 \textit{VAND. L. REV.} 433, 480-81 (1968) (proposes a comprehensive federal corporation law).
\item \footnote{30} A recent discussion may be found in Note, "Federal Corporation Law" and lOb-5: \textit{The Case for Codification}, 45 \textit{ST. JOHN'S L. REV.} 274 (1970). See also note 31 infra, and the Ruder article cited therein.
\item \footnote{33} Compare the Investment Company Act, which in many regards is in truth a charter of sweeping federal control over the capital structure and corporate action of investment companies. See Brown v. Bullock, 194 F. Supp. 207, 217-19 (S.D.N.Y.), aff'd, 294 F.2d 415 (2d Cir. 1961); Fleischer, supra note 31, at 1153.
\item \footnote{34} For a short general exposition, see Shade, \textit{Duties of Publicly Held Corporations under the Federal Securities Laws}, 26 \textit{BUS. LAW.} 497 (1970).
\item \footnote{35} Herpick v. Wallace, 430 F.2d 792, 808 (5th Cir. 1970).
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Generally, it can be said that already, "the Federal securities laws and rules have created standards of conduct that directly affect management behavior and corporate activity." The most graphic example, perhaps, for present purposes is the structure of federal control over proxies. Thus, in *J. I. Case Co. v. Borak*, the Supreme Court held that the federal law on false proxy solicitation authorized broad relief, despite the provisions of state corporation law. "The protection of investors," a stated purpose of the statute, was seen to require such a holding. The insider trading and Section 10(b) provisions discussed hereafter are further examples of such federal controls. The legislation under discussion would fall within this pattern of selected control of specific problem areas.

**Uniform Commercial Code**

Here, again, the specter of a debate of years past may arise. At one time in the drafting and development of the Uniform Commercial Code, the possibility of its adoption by Congress, with nationwide applicability, thereby avoiding the laborious task of attempting to persuade fifty state legislatures, was considered. An early draft of the Code did, in fact, make available adoption of a code at the federal level. However, the drafters ultimately returned to the conservative basic philosophy underlying the Uniform State Laws, as described by Professor Allison Dunham, viz., "uniformity of law by voluntary state action," as a means of "removing any excuse for the federal government to absorb power thought to belong rightfully to the states."

However, here again, it will be seen that the proposal to enact at the federal level provisions dealing with the transfer of, and perfection of security interests in, the shares of traded corporations would not attempt to be a general regulation of the commercial field, but rather a specific cure of a limited problem. Provisions of the Ship Mortgage

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36 Fleischer, *supra* note 31, at 1151.
37 Loss, *supra* note 29, at 887 et seq.
38 377 U.S. 426 (1964).
Act of 1920⁴¹ and of the Federal Aviation Act,⁴² illustrate previous efforts to deal at a federal level with sales and hypothecation of certain types of property.

In the same vein, but more recently, several consumer protection bills have been enacted by the Congress.⁴³ While more comprehensive in scope than the two acts referred to, this form of legislation, nevertheless, focuses on a limited number of specific abuses: concealment of credit costs, improper collection practices, credit rating injustices, and so forth.⁴⁴

The question of the scope of the provisions of these acts, as applied to seemingly purely local intrastate transactions, may be noted. As far as policy is concerned, although the sections generally apply to all transactions,⁴⁵ Congress took pains to preserve the applicability of consistent state laws.⁴⁶ In addition, the federal law governing certain aspects of credit transactions is explicitly suspended in favor of state laws which provide substantially the same consumer protection as the federal law.⁴⁷ This provision was designed to prompt state action such “that after a period of years the need for any Federal legislation will have been reduced to a minimum.”⁴⁸ The provisions establishing criminal penalties for extortionate credit transactions also apply to all transactions without any showing of connection with interstate commerce.⁴⁹

As already discussed, the constitutionality of these provisions has been attacked, but sustained, as a valid exercise of power under the commerce clause.⁵⁰

⁴⁵ That is not to say such sweeping coverage went unopposed. See, e.g., Hearings on Truth in Lending, Senate Comm. on Banking and Currency, 90th Cong., 1st Sess. 288 et seq. (1967). The Fair Credit Reporting Act is related to interstate commerce. The definition of “consumer reporting agency” covered by that act requires that the agency “use any means or facility of interstate commerce for the purpose of preparing or furnishing consumer reports.” 15 U.S.C. § 1681a(f) (1964).
Fiduciary Interests

State law has generally predominated in regulating fiduciary relationships. The elimination of the stock certificate would perforce require fiduciaries to modify their operational procedures to some extent.

This effect, however, would be at best indirect. Certainly it is far short of provisions of the various securities acts which, in some areas, are already directly controlling fiduciary relationships; e.g., insider trading and fraud provisions, the Trust Indenture Act, the Investment Adviser Act, and the Investment Company Act. Referring back to the discussion as to the appropriate and permissible extent of federal control, it is interesting to contrast the limitation of section 16 of the Securities Exchange Act (insider trading) to section 10 corporations only, with the broad scope of section 10 of that Act (the general anti-fraud provision) and rule 10b-5, which apparently is applicable to all securities transactions where the mails or other interstate facilities are used. Thus, section 10 has been held to apply to sales of securities of a foreign corporation between foreign buyers and sellers, and to sales of stock of a close corporation made by intrastate telephone calls. Indeed the scope of section 10 and rule 10b-5, as judicially interpreted, has led one prominent commentator to label this development — with more precision than most — as the "Federal Law of Corporate Fiduciary Relations."  

One particular operational problem specially mentioned in the fiduciary area is the common state law requirement that fiduciaries segregate physically and separately the property they so hold with


See Loss at 1456-57.


Myzel v. Fields, 386 F.2d 718 (8th Cir. 1967), cert. denied, 390 U.S. 951 (1968) (interstate checks also involved); but see Burke v. Triple A Machine Shop, CCH Fed. Sec. L. Rep. ¶ 92,949 (9th Cir. Feb. 9, 1971) (two local telephone calls to officer of corporation are not enough).

respect to each fiduciary relationship. In New York, for example, this requirement has presented an obstacle to the full functioning of the Central Certificate Service of the New York Stock Exchange.

A partial New York reaction was the enactment of the so-called FOSBI amendment, permitting some commingling. The adoption of some comparable provision in this regard at the federal level might prove necessary, but this would seem to constitute only a modest inroad into the functioning of the normal fiduciary laws of each state.

Other Provisions

There are, of course, numerous other state laws of a lesser nature which would be affected by the creation of a certificateless society. An informal compilation of such state laws has been made by the legal study group of BASIC, and no insurmountable problem is known to have yet been found.

CONCLUSION

In short, no constitutional impediment appears to exist to the enactment of federal legislation to deal with the problem created by the continuing requirement of stock certificate transfers. Indeed, it is not to be expected that difficulty in that regard will be found by a Supreme Court which has upheld federal power under the commerce clause to control the activities of a snack bar on an Arkansas country lake, the growing of wheat by a farmer to feed his own livestock, or the sale of milk produced by Illinois cows grazing on Illinois farms and sold to Illinois drinkers. While it may be conceded that the "power to regulate commerce, though broad indeed, has limits," the enactment of reasonable legislation designed to deal with the stock certificate would seem neither to test those limits nor to unacceptably interfere with the state interests discussed above.

"We reaffirm once more the constitutional authority resident in

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58 N.Y.E.P.T.L. §§ 11-1.1b(9) & 11-1.6(c) (McKinney 1970).
59 Other federal laws may also be affected. See, e.g., Note, Stock-Brokerage Bankruptcy: Implementing CCS, 54 CORNELL L.Q. 750 (1969).
60 BASIC is the Banking and Securities Industry Committee, located at 84 William Street in New York City. It started operations on June 1, 1970. The executive director is Herman W. Bevis, a retired senior partner of Price, Waterhouse & Co. See BASIC YEAR-END REP. 7 (Feb. 1971).
Congress by virtue of the commerce clause to undertake to solve national problems directly and realistically, giving due recognition to the scope of state power." This end the Smith proposal might well serve.

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