Introduction

The advent of paper certificates dates back hundreds of years and is often credited to the East India Trading Company as the first to use. Historically, certificated shares were relied on as a simple and material means of documenting ownership in a company – not unlike a passbook or check register was used to document personal finances. However, as technology evolved and the need for transparency and immediacy of financial information changed, the use of paper-based products like checks and stock certificates steadily began to decrease. Today, passbooks no longer exist, most retailers no longer accept checks, and many publicly held companies no longer issue paper certificates - times have changed!

Dematerialization

In simple terms, dematerialization is the complete elimination of physical stock certificates – in reality there's nothing simple about it. As the universe of paperless issuers continues to expand; the flow and deposit of new certificates is declining – a positive step! Unfortunately, many issuers are still reluctant to go completely certificateless. Partially because some shareholders have an affinity for certificates and issuers feel obligated to provide them or are fearful of upsetting shareholders by completely eliminating the option of obtaining a physical certificate.

Therefore, Dematerialization remains a challenge, despite evidence that both physically and financially supports its need and viability:

- September 11, 2001: approximately $16 billion worth of certificates were destroyed when the World Trade Center Towers collapsed.
- Superstorm Sandy: DTC vaults flooded and put 1.3M certificates at risk.
- Annually: thousands of certificates are reported lost, requiring shareholders to pay significant fees to regain possession of the lost assets.

The SSA believes issuers, brokers, and transfer agents should continue to provide shareholder education on the value, availability, and security that book entry offers vs. holding certificates.

Methods of Holding Stock

Depending on the issuer and a shareholder's preference, stock is held in one of three ways:

- **Direct Registration System (DRS)** – Shares eligible for movement through the Depository Trust Company and Clearing Corporation's (DTCC) DRS Profile System. Shareholders hold stock electronically in their name on the issuer's books. A statement is received rather than physical certificates.
- **Book-entry** – Shares in electronic form but not eligible to move through DTCC's Profile System. Examples include restricted stock, private placements, and non DTCC FAST issues. Shareholders hold stock electronically in their name on the issuer's books. A statement is received rather than physical certificates.
- **Plan Book-entry** – Shares in a dividend reinvestment plan, employee stock purchase plan, or direct purchase plan. Shareholders hold stock electronically directly on the issuer's books. A statement is received rather than physical certificates. If the issuer is eligible for DTCC's DRS Profile System, plan shares may move electronically through the system.
- **Street Name** – Shares are held in electronic form registered either to 1) DTCC's CEDE and CO registration for deposit in the broker/dealer/bank participant account or 2) in the nominee name of the broker/dealer/bank. Shareholders hold an "entitlement" to the shares but not the actual shares.
- **Physical Certificates** – Stock is registered in the shareholder's name on the issuer's books and a physical certificate representing ownership in the company is issued.

The SSA recommends that all eligible issuers immediately eliminate offering certificates and strongly urge its shareholders to hold shares in DRS or book-entry. Unfortunately, moving shares from certificates into street name doesn't guarantee the certificate's destruction.

<u>Impacts of Paper Certificates</u>

There are several impacts to shareholders, issuers, transfer agents and the exchanges that are directly driven by certificated shares being present in the marketplace.

Shareholders: Shareholders carry the risk and cost associated with storing a certificate in a secure place. They also are responsible for the risk and cost associated with replacing a lost certificate as well as market risk during the time the lost certificated shares are being replaced. Finally, shareholders might incur additional fees from their brokers for the handling of physical stock certificates.

Issuers: There are two main impacts to issuers; first is the additional expense that's incurred as a result of infrastructural support that transfer agents and brokers incur and directly pass-thru to issuers and shareholders. The second impact occurs during corporate action activity. When shareholders hold certificates, the corporate action exchange process is both slower and more expensive because certificates need to be submitted before the new shares can be issued. In the absence of certificates, corporate actions are more fluid thus allowing the action to complete faster and give shareholders quicker access to the markets. Unfortunately, certificates in addition to being a corporate action challenge are also a driver of issuer escheatment expense and work - which ultimately leads to shareholder confusion and dissatisfaction.

Transfer Agents: One of the core duties of a transfer agent is to issue shares of stock, including certificated shares. For transfer agents to service issuers that offer certificates, it requires increased infrastructure including personnel, vaults, security, and increased regulatory scrutiny and review – all which leads to increased issuer expense. Managing the cost of certificate production and replacement, along with transportation and storage is a costly transfer agent service. And, until certificates are 100% eliminated, transfer agents will have to maintain the fixed-cost infrastructure it takes to support certificates.

Exchanges: Trade settlement is the primary challenge driven by certificated share ownership. Today's North America trade date + 3 trails other modern markets and creates inherent risk in our marketplace. The near-term goal of instituting trade date + 2 will create settlement challenges for shareholders with certificates; however, the end goal by 2020 is trade date + 1 and will require mandatory dematerialization to achieve.

<u>Steps to Dematerialization</u>

The first efforts around dematerialization began in the late 1960s and early 1970s with the creation of DTCC's depository as the central location for certificates. In the early 1980's, book-entry only (BEO) securities were introduced. BEO securities do not allow for registered shareholders. Investors wanting registered positions have continued to generate millions of new certificates annually. In 1996, the next big step occurred with the launch of DRS allowing for book-entry registered ownership. DRS was later reinforced by the Securities Industry Immobilization & Dematerialization Implementation (SIFMA) Guide in 2004. Finally, in 2008 the Securities Exchange Commission (SEC) approved the stock exchanges rule filings to make DRS eligibility a listing requirement. This is required for all NYSE and NASDAQ traded equities. Today, more than 7,000 issues are traded on the major exchanges; however, there are approximately 400 outliers that are DRS eligible, but do not participate and offer this as an option to investors.

The SSA feels that DRS should be mandatory and is a necessary step to achieve full dematerialization. For those continuing outliers, a dematerialization levy should be developed and applied as a disincentive fee to not offer DRS.

<u>Dematerialization Today</u>

The last few years have seen positive directional changes in making dematerialization a reality. Heightened focus has been generated thru several industry whitepapers directly leading to fewer issuers offering certificates, a decline in the volume of certificates being moved in and out of DTC's depository, and more shareholder education on the benefits of book-entry. In addition to education and transparency around the need for dematerialization, disincentive fees to dissuade certificates have also arisen from both DTC and the transfer agent community; however, these fees have been focused on new certificate issuance vs. how to dissuade shareholders from keeping their existing shares in certificates.

The SSA strongly supports the need for decisive action through the implementation of new and stronger disincentive fees, including certificate management and redemption fees applied to shareholders that will not voluntarily convert into a book entry position.

Conclusion

Dematerialization is a top priority, not only for the SSA, but also for issuers, transfer agents, the securities exchanges, and DTCC. Industry and regulatory collaboration is still needed with outlier issuers not offering DRS and with banks and brokers not yet supporting the industry's goals and efforts. On-going shareholder education on the benefits of book entry vs. certificates is critical to the success of dematerialization and will help shareholders migrate away from paper much like retail banking has done with online and mobile banking. New and aggressive disincentive fees are needed to deter issuers from offering and shareholders from requesting new and holding existing certificates in lieu of book entry. And, more aggressive steps need to be taken on the part of DTC to make its FAST program accessible and affordable for all issues, including OTCs. Finally, the various security industry participants must resolve how to accommodate restricted stock so it too can be held in DRS, thus moving the North American markets to a point where all securities are certificateless so full dematerialization can be achieved.