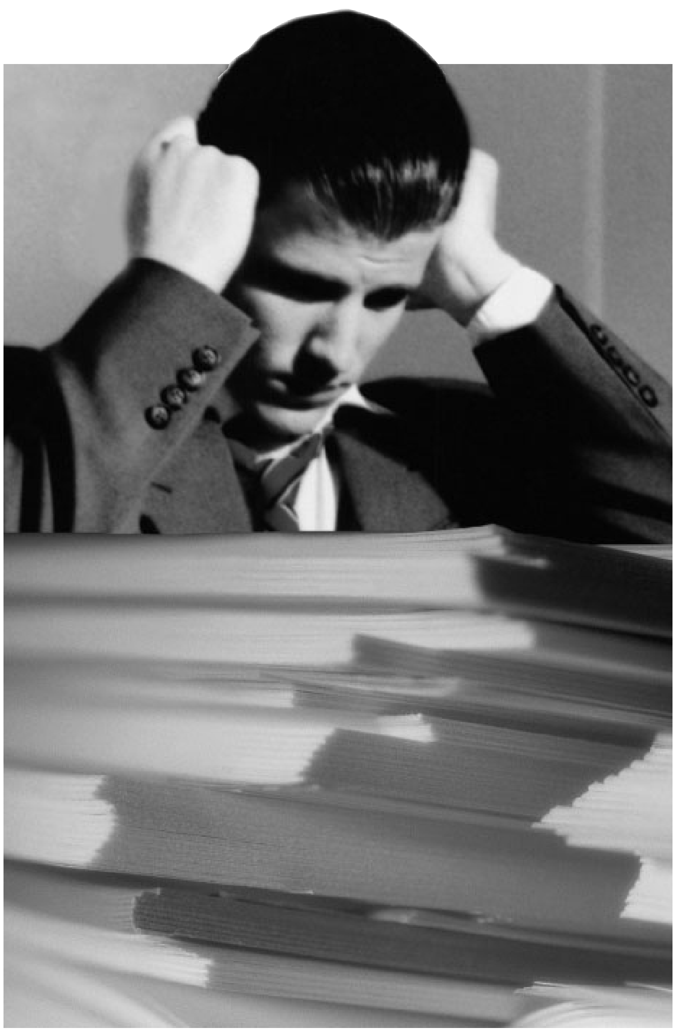
PAPER TORTURE

Nearly all corporate, muni and federal government securities issued are "paperless." So why are brokers still using stock certificates? By Janet Wynn of The Depository Trust & Clearing Corporation



Paper stock certificates are colorful and can give investors a sense of ownership in a company. But avoiding paper certificates-a bastion of 19th century technology-is a serious issue to the industry, because paper stock certificates have a tendency to disappear. On average, something like 1.7 million certificates are reported lost, stolen or counterfeit every year, costing investors or their financial intermediaries about $50 million each year to replace. On 9/11, billions of dollars worth of paper certificates stored in vaults at the World Trade Center simply vaporized. It took months of work with computer backup facilities and millions of dollars to reconcile ownership records. The safety of securities held electronically, however, wasn't threatened at all.

So why does today's securities industry, which uses some of the most sophisticated technology available, still issue and distribute equities the same way it did two centuries-as pieces of paper?

It's a difficult question, and the blame gets spread around-from registered reps' love of the certificate to, well, tradition. Sure, the number of paper certificates still held in the vaults at DTCC has declined from 25 million 12 years ago to about 3.9 million last year. Still, paper securities continue to be issued, and there's no dispute that managing the industry's antiquated paper technology is expensive.

According to an estimate last year by the Securities Industry Association, the cost to issuers, broker/dealers and investors for handling paper securities is at least $250 million a year, probably more. Cost include custody, audits, file maintenance, medallion guarantees, surety bonds, shipping, microfilming, loss replacements, clerical processing and more. Issuers bear part of that expense. Most of the rest, however-$140 to $150 million-comes right off the bottom line of brokers, financial intermediaries and transfer agents. It's clear that, in dollar terms, no one in the securities industry benefits from paper equity certificates (although some insurance companies, messenger services and printing firms undoubtedly make money from the printing, shipping and storing of certificates).

Huge Paper Costs for Equities

These ongoing costs, which are likely to climb this year following the rash of mergers and acquisitions now under way, stem almost entirely from the need to cope with equities. They're the only broadly distributed securities still issued as paper certificates. Everything else issued and traded on U.S. markets is paperless. More than 98 percent of all corporate and municipal debt securities are floated electronically in book-entry-only format. In other words, in the eyes of investors, they're paperless. Futures and options are paperless as well. So are Government securities. This year, even the venerable savings bond is going paperless.

According to the Treasury Department, it costs too much to administer all that paper-about $154 million per year. In fact, the Treasury Department is so determined to get rid of paper certificates that it's going one step further. It's actively encouraging current holders to convert their existing paper bonds into a book-entry or Internet account form.

If the Treasury's program is seen as innovative in this country, it's viewed as old hat in many other countries where they did away with paper certificates long ago. They have no need to store securities in vaults, deliver paper securities for trades or convince shareholders to swap their paper certificates for electronic registration. In France, Denmark and China, for example, markets have done away entirely with paper certificates. Japan is now well on its way to dematerializing all its securities and, earlier this year, people started taking serious the idea of doing away with all paper certificates on the biggest equities market in Europe, the London Stock Exchange.

Registered Reps as Paper Junkies

In the U.S., meanwhile, the paper equity culture lives on. Although the industry has long had book-entry registration systems in place to cope with the rising volume of equity issues, many investors-far too many, from the industry's point of view-continue to end up with paper certificates.

Some of my colleagues within the industry pin the blame for this and the resulting costs directly on brokers and registered independent reps. "They're paper junkies," says one industry observer. "They should know better. They don't bother to tell their clients how to avoid paper certificates, and that ends up costing us over and over."

Others take a different view. According to the head of one stock transfer firm, brokers are the neglected front-line soldiers in the industry's anti-paper war. "If the industry spent more time educating its brokers about this problem, and encouraging them to educate their clients about the various non-paper certificate options, we'd see real progress," he said.

which a pending rule would finally do away with. This is obviously a relic from the days when almost all equities were in certificate form.

A New Order of Battle

Buoyed by the growing use of DRS and the response to a Securities and Exchange Commission "concept" release last summer-that asked "What if we do away with paper certificates?" -the industry is now preparing to fight its paper battle on several different fronts:

It is charging ahead to stem the issuance of new paper certificates as much as possible through the use of DRS and book-entry-only programs.

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Spreading the Blame

The fact is, blame for the industry's paper predicament can be spread far beyond the broker community. Some of it can be blamed on, well, tradition. And a stubborn tradition it is. On the one hand, the industry has long seen the need to eliminate or streamline paper handling, so it created the electronic Direct Registration Service (DRS) seven years ago. DRS lets investors register as owners directly on the books of the company issuing the securities, or on the books of its transfer agent. This obviously eliminates the need for paper certificates, and DRS now extends to more than 1,000 separate issues and handled some 38 million book-entry accounts by 2003. But it took the service a number of years to really take off because the New York Stock Exchange didn't drop its rule requiring all its listed companies to issue paper equity certificates until three years ago.

Meanwhile, other anachronisms live on. There is still the requirement that firms maintain physical certificate "drop sites" near Wall Street in New York City,

Meanwhile, it's fighting a rearguard action to ensure that paperless securities remain paperless, and that shareholders don't convert them into paper.

On still another front it's continuing to do-with more and more tools-what the Treasury Department has now started to do: convert paper certificates into paperless electronic accounts.

Arching over all of these is the industry's campaign to change regulations in the five states that still require companies to issue equities on paper. One of these, Delaware, is pivotal, because it's where the bulk of U.S. corporations are registered.

Brokerage houses and registered reps are critical combatants in all these efforts. Although one major wirehouse was an early participant in DRS, until several years ago 95% of its customers continued to receive paper certificates. The reason, it turned out, was not necessarily that customers wanted paper. Instead, the company's internal systems were set to default to paper, so that's what customers received.. When the

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company switched the default to DRS, the number of investors seeking paper certificates dropped sharply. As the company discovered, however, it was also important to have its reps explain to their customers the three ways investors can hold securities: in street name through the brokerage firm, in direct registration with the issuer or its agent through DRS, or as physical pieces of paper.

Easy Lessons, Big Saves

The push now is to get other brokerage houses to pick up on the lessons learned so far. It's sometimes astounding to individual registered reps how much money can be saved in paper-handling costs by something as simple as setting a default to DRS rather than paper, or by asking reps to explain carefully the different ways investors can hold securities. And there's evidence the industry has made genuine progress toward electronic equity ownership. Seven years ago, when investors received DRS statements instead of paper certificates, almost a third sent the statements right back and demanded certificates. Today, the number of investors seeking to exchange DRS statements for paper certificates is about one in 20.

To provide a "disincentive" for these conversions, and to help educate brokers on the costs involved, the industry has authorized a hike in DRS withdrawal fees to minimum of $12 per transfer, plus a $15 disincentive fee. Add on to that the agent's fee, averaging around $11 per transaction, and the total cost could easily reach $38. For DRS transfers where the broker asks for a statement instead of a certificate, the cost is only $5 per transaction plus a maximum agent fee of only 92 cents-a difference of more than $32 from a certificate transfer.

Lost Certificates Add Up

The industry, in short, wants to end torture by paper. It wants to drag equities out of their expensive 19th century paper technology and handle them efficiently and cheaply with today's electronic technology. But that's unlikely to happen without the cooperation of brokers and registered reps. For investors, the payback will be better, far more hassle-free service. It will be more efficient, more streamlined and less costly. For the industry, including brokers and reps, the payback in eliminating paper equities will be at least $250 million a year in reduced costs. In terms of the paper-torture headache factor, however, it would be, as the MasterCard ads say, "Priceless!"

Janet Wynn is a Managing Director of The Depository Trust & Clearing Corporation. She is also the General Manager of Asset Services, DTCC Deriv/SERV and the company's international business.

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For more information on dematerialization efforts, please contact Joe Trezza at 212-855-4400 or jtrezza@dtcc.com.