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Escaping the Parallel Universe of Paper Certificates

By Jill M. Considine

You may think that parallel universes are nothing but science fiction. But we know better in the securities industry. We work in parallel universes all the time.

In one universe, we're in a world of high technology with paperless trading and straight-through processing. In this universe, securities are dematerialized. They can be issued, traded, registered, cataloged and stored quickly and electronically. Because they consist of bits and bytes in book-entry form, they're nearly impossible to steal or destroy. And they can be delivered halfway round the world in seconds.

In the other universe, we're somewhere back in the 19th century. In this time warp, securities consist of engraved paper certificates that have to be manually issued, registered, shipped, insured and filed. Although many of these certificates are stored in vaults for safekeeping, some 1.7 million of them are still lost, counterfeit or stolen every year. And it can take as long as a week to transport them safely overseas.

Sustaining this science fiction is an expensive luxury laced with irony. The irony is that most high-tech public companies whose business is to help people do away with paper are still issuing paper stock certificates. Google, for example, may have an innovative public offering totally online, but it still has to issue paper securities. This irony is also costly. The Securities Industry Association (SIA) puts the price tag on paper securities at $265 million every year. Costs include vault security, medallion guarantees, shipping, microfilming, clerical processing and more. Issuers eat 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.

In much of the rest of the world, paper is no longer a problem. Markets in dozens of countries–France, Denmark and China, to name just a few–have already done away with paper certificates. They're totally electronic. Last year, the Group of Thirty recommended that all markets do the same.

In response, the Securities and Exchange Commission has floated this idea for the U.S. market. "What if we do away with paper certificates?" the agency asked in a "concept release" this year. We all know the answer. We'll be far more efficient, and we'll save ourselves and our customers $265 million a year. The real question is not what. It's how…how can the industry eliminate paper certificates?

The good news is that U.S. markets now handle far less paper than they used to. As a result of electronic book-entry registration and automated transfer systems, the inventory we hold in the vaults of DTCC's depository has declined from more than 30 million certificates in 1990 to about 4.8 million last year. Meanwhile, all market-traded U.S. government securities are now issued in paperless form, as are futures and options. And while bearer bonds still show up in movies, better than 98 percent of both corporate and municipal debt securities are floated in book-entry only (BEO) format.

The sole throwback to the 19th century is equities. Somehow, in the minds of many investors–and brokers too–the word "stock" is always married to the word "certificate". How to unhitch the two is the challenge.

We don't lack for technology to do so. In addition to the book-entry registration systems long in place, the industry's Direct Registration System (DRS), which we administer at DTCC's depository, lets investors register as owners on the books of the companies issuing the securities–or their transfer agents–without the need for physical securities. Stock and certificate are thus unhitched. And these book-entry positions can be transferred electronically between agents and broker/dealers.

In addition, we've designed systems to cope with restricted securities such as private equity placements or other securities not registered in a public offering, and typically issued in paper form. In fact, our Networking for Equities service converts all types of securities traditionally kept in certificate form into electronic form, yet it does so in a way that lets our customers, such as brokers, retain their relationship with their clients while still gaining the increased efficiency of DRS. We expect to see more restricted issues coming into this service if companies choose to reward employees with restricted stock instead of stock options. Employees who want to cash in or trade their restricted stock will find it much easier to do so if it has been converted to electronic format.

So if technology's not the problem, what is the problem? The problem has to do with people's habits and expectations, as well as some longstanding industry practices and legal conventions that are still rooted in the 19th century.

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Some investors, for example, simply expect paper certificates. Others, who don't realize they can register their shares directly and hold them electronically, and are concerned about proving their ownership of the shares, will typically request paper stock certificates. Until late last year, 95 percent of Merrill Lynch customers who wanted their equity shares registered in their own name asked for paper certificates. Then Merrill changed the default setting on its internal securities transfer system. For all securities eligible for direct electronic registration, Merrill switched the default from "certificate" to "DRS statement." Now that its customers clearly understand they have an alternative, many prefer a statement reflecting electronic registration to the actual paper certificates. This is progress, and it can be repeated at other firms. As an industry, however, we need to make it very clear to retail investors that they have a choice. We have some educating to do.

Even when people think paper is necessary, such as when grandma and grandpa want to give equity shares in the Disney Corporation or some other company as a birthday gift to their grandchildren, there are ways around the problem. Instead of negotiable paper certificates, which we know are easily misplaced or stolen, issuers could offer "gift" certificates, presumably designed by Disney itself, representing a set number of electronic shares. If the gift certificate is lost, the electronic shares are still registered in the grandchildren's names. And the gift certificates may become collectors' items in their own right.

On the regulatory front, only five states still require companies to issue paper securities if shareholders request paper. As an industry, however, we should be helping issuers get out from under the paper burden. Not only does it cost them millions of dollars to issue paper shares, it costs even more to handle paper shares in a corporate action. According to the SIA, for instance, in a corporate action such as a merger, the cost for an issuer with 100,000 certificated accounts would be $1 million more than for book-entry accounts.

This helps explain why two years ago, when the New York Stock Exchange relaxed its Rule 501 requiring listed companies to issue paper equities, AT&T promptly issued electronic shares only to its 18 million shareholders. It was the first large company to do so. Since then, some 16 other companies have followed suit. Meanwhile, we now have some 845 securities issues enrolled in the Direct Registration System and the number of book-entry accounts at transfer agents tops 37.5 million, more than double the number in 2000.

So we're making progress. We've come light years from the paper crisis days of the late '60s and early '70s when the exchanges had to shut down one day a week and curtail trading hours on other days simply to keep up with the flood of paperwork. Now it's time for more progress. Having to time travel back to a 19th century paper world is expensive.

By working together as an industry, we can end the parallel universes and prepare ourselves for hyper drive growth here in the 21st century. Together, we can educate investors, issuers and legislators alike that doing away with paper securities will save us countless headaches and red tape, not to mention millions of dollars each a year. To borrow the now famous advice from *Star Wars*: "The force is within you. Use the force."

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