

Scrapping Share Certificates

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Following proposals from the European Securities Forum (ESF), the UK Shareholders Association (UKSA) issued a press release supporting the idea of scrapping paper share certificates. We stated in the press release that UKSA agreed that they should be replaced by an electronic record, and hence be “dematerialised”, subject to some changes in the details of the proposals. The immediate reaction from some of our members was severe criticism, but this note is an attempt to explain why the UKSA board adopted the stance that it did. Note that the press release was simply a brief summary of some of the salient points in our response to the ESF and to the Government which was quite extended and is available in full on the UKSA web site. The press release should not be taken to be a definitive policy statement by UKSA. The ESF proposals also covered the problem of nominee accounts where we welcomed the proposals as a step in the right direction, but again criticised the details.

Why Share Certificates Have Lasted So Long

There have been three available ways to hold and trade shares in public companies in the UK in recent years:

1. By paper share certificates.
2. By nominee accounts (eg. as required by law for ISA accounts).
3. By Personal Crest membership.

Nominee accounts, as operated in the UK, have certainly been opposed by all sensible people, and UKSA has consistently campaigned against the way that they undermine shareholders rights. You typically don't receive company reports and accounts, generally become ill-informed and lose your voting rights. The basic problem is that your name is no longer on the company share register.

In Personal Crest membership your shares are “dematerialised” and your stockbroker submits all transactions electronically to the Crest system. But your stockbroker sends you contract notes in the normal way and you do get a paper summary statement once per year from which you can check your holdings. From my personal experience, I find this works exceedingly well, with prompt settlement, reliable payment of dividends and accurate handling of complex transactions (eg. takeovers, share splits, buy backs, rights issues). You always receive all company notices and can attend and vote at all meetings without question, as your name is on the share register.

But there are two minor downsides to Personal Crest membership. Firstly there is often a small charge for setting up such an account, and secondly trading through multiple brokers can be difficult. With brokers preferring to encourage the use of nominee accounts, Crest membership has tended to be taken up only by active share traders or those with larger portfolios, although there are estimated to be 40,000 members so it's popularity is growing. Also where shares were issued in privatisations, or sometimes at new IPOs such as those for Venture Capital Trusts, paper share certificates were issued so even Crest members tend to still hold a few share certificates.

So paper share certificates have hung on in the UK, particularly for the small private shareholder, or those who are inactive traders. There is also no doubt a preference for the “traditional” proof of ownership of a paper share certificate among older shareholders, although as we will see later, this is a mirage.

The Objections to Paper Share Certificates

The ESF rightly spelled out some of the problems with paper share certificates, which are numerous. These are in summary:

- Difficulty of achieving quick settlement times because of the need to post share certificates backwards and forwards.
- The risk of fraud and theft of certificates.
- The risk of accidental loss of certificates (e.g. lost in the post, mislaid in a house move).
- Confusion from out-of-date or invalid certificates following such transactions as stock splits and corporate take-overs.
- Difficulty in trading if you are away from home, e.g. on holiday overseas.
- Excessive costs.

On the last point, the ESF estimated that replacing lost paper share certificates costs up the £2million per annum (mainly paid by shareholders in indemnities), and up to £3.75 million is wasted on the extra costs of paper processing and such items as postage versus that achievable from electronic processing.

A Share Certificate is Not Necessarily Proof of Share Ownership

There is a presumption by many people that holding a share certificate is prima facie evidence that you own the shares. But this is legally not the crucial point. Your name on the company share register is what really matters. UK share certificates are not “bearer bonds” - if you lose the certificate you can get it replaced as the registrar has no qualms about doing so if you provide reasonable evidence that you are the person on the share register.

However, because stockbrokers do not know who are the holders of shares, and do not have access to share registers, they can be misled into selling shares represented by a share certificate which is why an indemnity for loss is required. Also it is worth pointing out that share certificates are easily forgeable with modern technology, and paper of course goes up in smoke if you ever suffer a house fire (few shareholders actually bother to deposit them in their local bank).

Everyone has “Dematerialised” Holdings Already

But there is resistance to destroying paper share certificates and replacing them by an electronic record. People fear an increase in fraud or difficulty in getting access to their holdings.

Oddly enough, everyone accepts that their cash holdings should be recorded by an electronic record in their bank. Indeed “cash” (ie. gold or silver coin) was first dematerialised into promissory paper (bank notes), and then dematerialised further into simple ledger entries which became electronic records in due course. There is of course a lot more “cash” in the banking system than is represented by bank notes. There are also not many people in the UK who can walk into their bank and demand to see their cash holdings represented by their latest bank statements - there is simply nothing in the vaults any more!

Everyone lives with this state of affairs without any qualms at all, because they have grown up with it. And of course, share registers have been “dematerialised” and replaced by computer records many years ago. So if you don’t trust computer systems to record your ownership of shares, you really have no alternatives in the modern age.

The New Proposals

The new proposals from the ESF simply suggest that paper share certificates be abandoned and that a new “electronic” form of holding is introduced. But the key point is that your name will be on the share register. You would be given a Shareholder Reference Number (SRN) which would uniquely identify you, much like your current bank account number does at present. You would simply quote the SRN when buying or selling shares. Clearly there would have to be security provisions to provide proof of identity, in the same way as there are to stop people accessing your bank account, but that seems to be no great problem.

For example, as a Personal Crest member I can phone my stockbroker and deal immediately because he recognizes my voice, and his system identifies the phone number I am calling from as additional confirmation. And of course he knows what my holdings are, and I could only withdraw cash by requesting it be sent to my registered address or to my registered bank account. For less frequent traders, or those working on-line (ie. internet trading), a system of PINs or Passwords would clearly be required.

The full details of the new system have yet to be worked out, but it certainly does not seem to involve impossible difficulties, and is likely to be more rather than less secure than the use of paper share certificates.

Incidentally some people have raised the issue of identity fraud, which is a growing problem, but this is a risk whether you have paper share certificates or not. In fact the interception of paper documents is one of the biggest causes of loss, whereas you very rarely hear of the interception or corruption of electronic transmissions because it is much more difficult.

Paper Copies of Records Will Still Exist

Note that you will still receive contract notes, and a regular statement of your holdings and these will still be on paper if that is how you want them. You will continue therefore to have independent paper evidence of your share holdings. But as at present, these will be copies of the underlying electronic records. The new proposals are not necessarily intended to reduce the volume of paper that shareholders receive, which is often a concern, although there may be some slight reduction in due course, subject to personal preferences.

Will Dividends and Shareholder Communications be Affected?

The dematerialisation of share certificates does not mean that dividend payments will be affected in any way. You will still have the option of receiving dividend cheques or having dividends sent by direct payment to your bank. This is a separate issue and no change is likely to be forced on shareholders in that regard.

Neither will it affect how you receive shareholder communications such as Annual Reports. Although there is a suggestion that some shareholders may wish to receive such items electronically, or not at all, you will still be able to insist on paper copies.

Conditions for UKSA Support

The board of UKSA has decided that we would only be likely to support the ESF proposals when they are fully delineated if the following conditions are satisfied:

- That all the existing facilities supported by share certificates continue to be provided in the new system. For example, that there is some way for a bank to secure a loan against the holding.
- That shareholders incur no additional costs as a result.
- That the details of the new system are satisfactory.
- That security is not compromised by the new system.
- That the majority of our members do not oppose the change.

Note that we would hope and expect that UKSA and its members will be consulted in full when the complete details of the proposals are available (the ESF document did not reveal the details and it would be wrong to jump to conclusions, positive or negative, about how the new system may operate in practice). You should also bear in mind that as with any arrangement the quality of the new system in terms of reliability, security and speed may depend to some extent on the quality of the back office systems and staff employed by the stockbroker you use. As at present, the satisfaction of shareholders will depend on the capabilities of the stockbroker to execute trades efficiently and reliably.

In Conclusion

To conclude, our argument is simply that any opposition to “dematerialisation” may not have taken full account of all the benefits, which we feel are likely to outweigh any possible negative aspects. An electronic system for recording share transactions is likely to be more secure not less, and will reduce the cost of trading both for you and your stockbroker.

The UK Shareholders Association will be reviewing and commenting on the details of the new system when they are defined, but the principle of dematerialisation in due course is surely right.

If you have any comments or questions on this document, or require more information, please contact Roger Lawson on telephone: 020-8467-2686, email: roger.lawson@btclick.com, or write to him at the main UKSA address. Your views will be passed on to the UKSA board members.

Note that the UKSA Press Release, our full submission to the government on this issue and on the associated issue of nominee shareholdings, with past articles on this subject, can be seen on our web site at: http://www.uksa.org.uk/Share_Certificates_Nominees.htm .