



Securities Transfer Association of Canada

William J. Speirs
President

THE CASE TO MAKE DRS A CANADIAN LISTING REQUIREMENT

INTRODUCTION

The Securities Transfer Association of Canada (“STAC”) strongly supports the incorporation of the Direct Registration System (“DRS”) into Exchange listing requirements in sync with U.S. Listing requirements as it will provide direct benefits for all stakeholders (the Issuers, Financial Intermediaries, Security Holders, Depositories (CDS & DTC) and the Exchanges). The Dematerialization of shares is a global trend in which global markets and the securities industry participants are seeking to eliminate the reliance on physical securities, wherever possible, and the associated risks and costs inherent in handling paper certificates.

Paper stock certificates are:

- Costly¹, in terms of the costs of production and of replacing lost and stolen certificates, as well as in terms of time and expense of transporting and storing paper;
- Vulnerable to physical calamities such as terrorist attacks, acts of nature, etc; and
- A barrier to shorter equity trade settlement times.

Most securities industry participants understand that participation in an electronic recordkeeping system offers several advantages:

- Provides greater flexibility/timeliness of share administration and transfer than paper certificates.
- Eliminates administrative costs and risks with storing and moving paper certificates for all parties.
- Eliminates the risk of lost or stolen certificates and the insurance costs associated with replacement.
- Allows fast and secure electronic transactions between the investor and their agent, whether a transfer agent or a bank or broker.
- Paves the way for full dematerialization of the Canadian securities environment.

¹ Canadian Capital Markets Association (CCMA) collaborated with the US Securities Industry Association White Paper which documented the industry costs associated with certificated holdings. Of the \$185 million savings anticipated by Financial Intermediaries associated with certificated handling, \$15 million in savings was attributed to Canadian FI's. Surety bond premiums to replace lost, stolen or destroyed share certificates provided by the Surety bond companies were \$50 million annually, of which \$3 to \$4 million was attributed to Canadian savings.

- An industry-mandated DRS will position Canada to participate in growing international trends including dematerialization, reduced settlement periods and straight through processing.

The introduction of DRS in the U.S. and Canada established a book-entry environment in North America linking both the Direct (share register) and Indirect (via an intermediary) holding systems with an electronic Straight Through Processing (“STP”) process from the security holder’s intermediary through CDS and DTC to the Issuer’s Transfer Agent. It is timely to now more firmly establish DRS in the Canadian market by mandating DRS participation by issuers as a stock exchange listing requirement. This will allow investors to retain their right under Canadian law to request a certificate at any time, but will ensure consistency in availability of DRS.

The incremental costs of participating in DRS are only nominal for Issuers. There is a nominal one-time charge to create a customized DRS Advice/Statement format. These costs are quickly offset through the elimination of insured/registered mail charges for the delivery of certificates, maintenance of certificated inventories and charges associated with lost certificate replacement. Securityholders are provided with a cost-effective, accessible and secure DRS (book-entry) system to hold their registered securities.

The benefits to the industry as a whole are broad and substantial, including cost and time savings in corporate actions processing, and the elimination of surety bond costs required by securityholders to replace lost, stolen or destroyed share certificates. The relatively small size of the Canadian market and the availability of book-entry holding mechanisms in both the direct and indirect systems make Canada one of the most modern and efficient securities markets.

Requiring all Canadian listed Issuers to participate in DRS is an important step in enhancing the efficiency of the Canadian market for the benefit of all stakeholders and provides uniformity of availability for both investors and their financial intermediaries. Reducing reliance on paper certificates through a broader adoption of DRS will provide securityholders with the option to take advantage of today’s modern, secure and cost efficient shareholding methods and will ultimately enable shorter settlement times in the future to drive capital market efficiency.

THE PROBLEM WITH SECURITY CERTIFICATES:

Paper certificate processing is slow and expensive in the modern securities industry, where trades can now be executed in fractions of a second.

Holding and processing share certificates poses a number of concerns for issuers, banks and brokers, and investors. These include:

- *Timely trading and settlement*

Many brokers require the delivery of a share certificate to them prior to placing a sale order for the securities. In times of high market activity, this requirement can disadvantage certificated shareholders, with potential price movements in the time it takes for their certificate to be delivered to the broker. In DRS, the broker can obtain rapid delivery of the securities to their CDS account.

With the growing international trend towards reduced settlement periods to Trade Date plus 2 days or even Trade Date plus one day, including in the U.S., the pressure on certificated shareholders to deliver prior to trading is likely to grow significantly. In the U.S., dematerialization is seen as a 'core enabler' for achieving trade date plus one day settlement, and as a closely related requirement for successful implementation of Trade Date plus two days settlement. With the close integration of the U.S. and Canadian markets, changes to the U.S. settlement period are highly likely to exert pressure on the Canadian position.

- *Risk of widespread loss or damage to certificates*

Paper share certificates are vulnerable to loss and damage, resulting in loss of ability to trade securities prior to replacement of the certificates as well as the costs of replacement. This is, of course, an issue for individual investors. However, it becomes a more significant concern in the event of particular events such as natural disasters which result in widespread destruction of property.

The U.S. experienced this most recently in the wake of Hurricane Sandy, which resulted in the flooding of DTC's vaults in New York and substantial damage to share certificates stored therein, as well as loss or damage to certificates held by investors. There were 1.3m certificates at risk in the DTC vault. Similarly, the terrorist attacks of 9/11 caused the destruction of \$16bn worth of certificates held in bank and broker vaults in the World Trade Center towers.

This risk is wholly negated where securities are held in DRS rather than as share certificates.

- *Transaction-related costs of certificates*

A further concern with certificates is the higher costs imposed on transactions involving certificates, which reflect the increased time and risk involved in processing certificates. For example, DTC charges a fee to its participants of \$500 for certificated withdrawals. The participants generally pass such fees onto the investor. In Canada, individual FI firms also usually apply a disincentive fee on clients wishing withdrawals in certificated form. These fees serve as an effective incentive to withdraw into DRS rather than certificated form. However, where DRS is not available for a particular issue, the investor is unable to avoid these higher fees.

It should be noted that in the near to medium term, there will still be occasions when paper certificates will be required, such as individual choice or for securities issued by non-Canadian companies where the issuer's local laws require the issuance of a share certificate. However, such exceptions are expected to diminish over time, with more international markets moving to greater dematerialization and with investor experience of DRS growing.

PROGRESS TOWARDS DEMATERIALIZATION

Since the introduction of DRS in Canada, STAC members, working with their clients on a voluntary basis, have reached the U.S. pre-mandated DRS levels of 40% penetration. The

voluntary use of book entry technology has plateaued and further progress is a slow process that requires additional stimulus for the Canadian securities industry to achieve its processing efficiencies in which all participants benefit including the Issuer. In 2012, CDS introduced the process of defaulting CDS withdrawals to DRS (where the Issuer is offering DRS) and TA's have worked with CDS and their participants over the past 20 years to convert the vast majority of CDS registered holdings from certificates to book-entry. We suggest that CDS would be able to provide the Exchange with statistics showing the tangible efficiencies obtained to date through the reductions of certificated processing.

There is the opportunity to improve DRS usage to current U.S. levels as documented in the following paragraphs, by making DRS a listing requirement, as the U.S. did. As stated earlier, the one-time costs to the Canadian Issuer (to have a customized DRS Statement) are nominal and quickly recovered through reduction in the Issuers' costs associated with the delivery of physical share certificates. Making DRS a Canadian listing requirement could be phased in (e.g. mandating DRS participation for new Issues in year 1 and subsequently requiring DRS participation for all issues the following year).

In addition, the North American securities market is very integrated with approximately 40%² of investors in Canadian companies that are U.S. residents where DRS is a mandated listing requirement. U.S. investors holding securities in their own name have come to expect the efficiencies of DRS. Indeed, this shift to acceptance by many investors of book-entry registered holdings is seen across many international markets that have already eliminated the requirement for certificates.

In the U.S., where eligibility for DRS is mandated by the stock exchanges, a high-level analysis of the majority of the Dow 30 representing more than \$143 billion in registered securities revealed that approximately half the market value of directly held shares are in DRS with the remainder in certificated form. When "street name" book-entry shares held in Cede & Co. for these companies are included in the analysis, the value of shares held in non-certificated form increases to 95% of the total value.³

DTC has reported (DRS White Paper 2012) a substantial reduction in certificated processing and reduced issuance of physical certificates. Issuers, investors and market participants will finally have less costly and more secure alternatives to certificates as a way of recording ownership. DTC reported that these efficiencies have contributed to a significant reduction in overall cost and risk to the financial services community. DTC and the U.S. Exchanges are currently working with U.S. market stakeholders to take the next step in moving from a certificated environment to a book-entry statement only environment, by developing proposed new Listing Rules to require that all new listings be fully dematerialized in DRS, with exceptions for restricted securities and foreign issuers. These new rules are expected to take effect in late 2014. DTC has also announced its intention to explore mechanisms with the industry to further dematerialize existing listed securities, with a suggested deadline of 2016.

The U.S. moves are consistent with a forthcoming European Union regulatory requirement to fully dematerialize all traded securities by no later than 2025, while noting that some European markets have been fully dematerialized for over 20 years. Several other global markets that are

² Source Broadridge 2013 analysis of Beneficial Ownership records

³ June 2013. Internal analysis of large US Transfer Agent

not as yet fully dematerialized are also pursuing initiatives to achieve this, including Hong Kong and South Africa. The electronic DRS adopted and implemented by the securities industry in cooperation with DTC in 1996 and with CDS in 2007, uses the issuer's transfer agent's system to enable investors to hold their shares in DRS participating companies. Shares are maintained electronically in the investor's own name on the records of the Issuer or Issuer's transfer agent. Shares are held with the same ownership privileges as shares held in certificated form, and, as with certificated direct shareholding, the investor's identity is directly visible to the Issuer. DRS allow investors to easily transfer and sell shares directly through their chosen bank or broker.

It is also common for investors to hold shares indirectly via an intermediary, such as a bank or broker (often called holding in "street name"). In these cases, the investor has beneficial ownership of the shares and the Issuer does not recognize the investor as a directly registered shareholder. Most commonly, indirectly held shares are registered in CDS' nominee name, CDS & Co. Today, almost all Canadian securities trade in the U.S. market (dual listings or trade Over-the-Counter). Canadian shares may also be held indirectly through DTC's nominee, CEDE & Co.

However, it is critical to understand that even when beneficial owners' shares are held indirectly through CDS and DTC, they may not be recorded in book-entry form on the Issuer's register. For example, a number of Canadian Issuers are still certificated within CDS and DTC. Most U.S. OTC securities are not eligible for DTC's book-entry FAST system thus cannot participate in DRS and remain certificated. Those physical certificates are still held in the depository vaults for the broker or bank. In addition, some 60% of Canadian issuers do not participate in DRS, in which case the Canadian and U.S. brokers must process certificates in and out of their depository positions. This increases the time and cost to process transactions.

In the U.S., DRS eligibility is a Listing requirement, and recent initiatives taken by DTC and U.S. Exchanges are designed to build on the gains and benefits already achieved through book-entry processing by taking that next step in moving the U.S. securities market towards a full dematerialized securities market. Harmonizing the listing and securities processing requirements of markets so closely integrated, we suggest, is a highly desirable objective for all parties, particularly, for Canadian Issuers seeking to raise capital in both markets.

ADVANTAGES OF DRS FOR ISSUERS

The prime rationale for DRS is that the securities industry is moving away from certificates because of the handling cost which indirectly benefits the issuer. Investors benefit because they can hold shares in their own name, as millions of them do, without the inconvenience of a certificate.

By having all Issuers participate in DRS, each Issuer can realize cost savings by issuing DRS statements rather than share certificates. DRS statements, printed on stock paper, provide even greater cost savings than generic share certificates, which require security paper. As CDS defaults all withdrawals to DRS, the costs of certificate production will reduce. And with the use of generic share certificates as the 'fallback' for any investors that do request a certificate, Issuers are not required to maintain expensive inventory of banknote certificates, reinforcing the cost advantage for Issuers.

Further, when Issuers engage in various corporate events that require bulk issuance of new securities to shareholders, a default to DRS unless the investor expressly requests a certificate will produce material cost savings. Under existing arrangements, the Issuer calls in old share certificates and issues new certificates in exchange. The cost savings of using DRS will continue over time. For example, as participation in DRS by investors increases, Issuers will not need to call in share certificates for exchange for those investors in DRS, further reducing time and cost in the exchange process.

A further example of the production cost benefit can be seen in a corporate event such as a stock split, where additional shares are being issued in the form of a Stock Dividend. For large Issuers still using banknote certificates, the lead time to get pre-printed certificates in the quantities required were frequently impractical based on the timeframes involved. In addition, the quantities involved were expensive to purchase and required bonded companies to move the inventory. With DRS, the extra shares are credited to the client's account and a single statement issued to reflect the additional shares being issued. The dollar savings for the Issuer in both cases are substantial.

ADVANTAGES OF DRS FOR INVESTORS

DRS as a holding choice is very relevant for many investors. While active investors who trade frequently may prefer to hold their securities indirectly at banks or brokerage firms, infrequent traders often benefit from having a more cost-effective option to manage their registered holdings in DRS, including:

- The ability to deliver their securities quickly to their broker of choice to sell them.
- No risk of loss of the security certificate.
- Retaining direct legal title to their shares, which also allows them to directly receive any dividend payments, vote directly with the Issuer and participate in the other benefits of registered share ownership.
- Certainty of availability for both investors and their intermediaries if all listed issuers provide DRS, who otherwise need to check the DRS eligibility status of securities prior to each depository deposit or withdrawal.
- No securityholder holding fees, which may be particularly relevant to longer term investors.
- Under Canadian law, investors in the significant majority of Canadian issuers will also retain the right to request a share certificate at any time, should they so desire.

In addition to many Canadian transfer agents being federally or provincially regulated trust companies, many are also registered with and regulated by the SEC as they have clients whose shares trade in the U.S. either on an exchange or over-the-counter. Investors do need a third party — a bank, broker or a transfer agent — to perform transactions with their shares, but they should choose such party on the basis of service and costs best suited to their needs. Investors holding shares in DRS in their own name on the books of the Issuer, can generally transfer their shares to a bank or broker for sale, or transfer the shares into a bank or brokerage account, faster and easier without the need to send certificates.

CONCLUSIONS:

Harmonizing the listing and securities processing requirements (in making DRS a listing requirement) of U.S. and Canadian markets so closely integrated, we suggest, is a highly desirable objective for all parties, in particular for Canadian Issuers seeking to raise capital in both markets.

- 40% of Canadian Issuers currently offer their Canadian and foreign registered holders the benefits of book-entry DRS holdings.
- The voluntary use of book-entry technology, as was shown in the U.S. prior to making it a listing requirement⁴, is a slow process for a securities industry to achieve its processing efficiencies in which all participants benefit, including Issuers.
- The benefits of DRS for all participants in the Canadian securities market can be accelerated through adopting DRS as a listing requirement.
- An industry mandated DRS reduces broker and investor confusion regarding which issues they can hold in DRS and standardizes book processing for all transactions rather than a dual processes to accommodate the less efficient certificated positions.
- As we have stated earlier, the costs to Issuers of making DRS a listing requirement are not onerous - a nominal charge for formatting a customized DRS Statement - and are easily recovered by the efficiencies and benefits of moving away from certificates.
- The benefits to Canadian investors who experience lost or destroyed securities and need to replace physical certificates are direct and immediate.
- Mandated DRS will position Canada to participate in growing international trends including dematerialization, reduced settlement periods and straight through processing.

STAC supports the incorporation of the Direct Registration System (“DRS”) into Exchange listing requirements as it will provided direct benefits to all stakeholders (the Issuers, Financial Intermediaries, Security Holders, Depositories (CDS & DTC) and the Exchanges).

⁴ DRS in the US market were voluntary for 10 years prior to being made a listing requirement in 1996.

President: William Speirs, CST Trust Company, 320 Bay Street, 3rd Floor, Toronto, Ontario M5H 4A6

Phone: (416) 682-3885 Fax: (514) 985-8837

Secretary/Treasurer: Richard Barnowski, Olympia Trust Company, 100 University Avenue, 8th Floor, Toronto, Ont. M5J 2Y1

Phone: (416) 364-5043