CMI In Focus: Immobilisation / Dematerialisation of Listed Equities

It is widely recognised that a Central Securities Depository (CSD) is integral to the efficient operation of the capital market. One of its primary roles is the custody and protection of assets lodged by holders or its participants. As such, it is paramount that a CSD puts in place rules, procedures and controls to protect the securities lodged by holders.

In the past, the norm was that securities were issued in paper form and beneficial owners could either hold these directly or pay a custodian to safekeep the scrips. The handling of physical certificates entails a high level of Operational Risk. Vaults are required to store the vast amounts of paper and controls on access to the vaults are usually as tight as those on bank vaults. Still, there remains the potential for misplaced, stolen or lost securities, or for the certificates to be damaged by environmental factors. This can be of particular significance for bearer securities where possession of certificate confers legal ownership.

To overcome this, securities are immobilised in one location (a depository or CSD) and a limited number of global or jumbo certificates are printed to represent the whole issue. Although immobilisation greatly reduces the amount of paper being used, there still exists a need to keep the global certificates secure which in turn entails physical safekeeping costs and controls, albeit significantly reduced.

A step further is to totally eliminate paper by dematerialisation, whereby no certificates are issued at all; securities only exist as electronic records. This allows the depository to dispense with the vault and the associated risks, and allows for clearing and settlement processes to be made more efficient, faster and cheaper. Notwithstanding, the CSD still has to provide for adequate internal controls to protect assets under its custody from losses due to neglect, misuse, fraud or inadequate recordkeeping.

In Thomas Murray’s ratings of CSDs, the rate of dematerialised/immobilised securities held by the CSD as a percentage of total market issue is factored into the analysis of both Operational Risk and Liquidity Risk. The Operational Risk of holding physical certificates is as described above and those CSDs with high levels (defined as over 90%) of dematerialisation rate highest, followed by those with high rates of immobilisation, and so on down to those mainly holding individual physical certificates.

The impact on Liquidity Risk lies in the availability of securities within the system to be able to fulfill delivery obligations at the appropriate time. The holding of physical certificates (rather than dematerialised/immobilised securities) can impact this in two ways, either slowing down processing due to the increased requirement for manual intervention (i.e. the so-called ‘paper crunch’ that impacted settlement rates in high volume markets in the 1970’s), or in the event physical securities need to be deposited/dematerialised into the CSD in order for them to settle within the system. The time for deposit in some markets may take several days and any delay in the process may impact upon timely settlement of the trade and also (depending on local law) may affect the onward trading of that security.
**Rates of High Dematerialisation**

![Chart showing regional breakdown of markets reaching >90% dematerialisation]

*Figure 1. Regional breakdown of markets reaching >90% dematerialisation.*

**Rates of High Dematerialisation/Immobilisation**

![Chart showing regional breakdown of markets reaching >90% immobilisation / dematerialisation]

*Figure 2. Regional breakdown of markets reaching >90% immobilisation / dematerialisation.*
On a regional basis, the markets in the EU and the Middle East have achieved very high degrees of dematerialisation, with at least 75% of the markets in the regions reaching high dematerialisation rates. Including immobilised securities, this is achieved by more than 90% of the markets. This is due to the initiatives that the respective markets have undertaken to encourage the use of a scripless environment. In markets that have been set-up more recently such as in the Middle East, securities have been issued in electronic form from the outset, as they have factored in the benefits of the dematerialised model when designing their market infrastructure.

In contrast, only 38% of the markets covered in the Americas have achieved similar levels of dematerialisation, rising to 56% of markets when immobilisation is included. In markets where a majority of domestic retail investors dominate, dematerialisation has been generally slow as traditional shareholders still prefer to hold physical certificates directly.

On a global scale, 61% of equities markets are ‘highly dematerialised’, rising to 76% including immobilised scrips. It is quite clear that there is still work to be done in this area.

In the UK for instance, to encourage private investors to dematerialise their securities, Euroclear UK & Ireland allows individuals and small investors to open accounts under their own names (sponsored by regulated participants) in the CSD. Physically settled transactions can also attract higher fees.

In the US, DTC has outlined a proposal to fully dematerialise the US financial services industry. The multi-year programme is designed to further drive the elimination of all remaining physical certificates in the US market. Depending on the industry’s response, DTC could begin implementing recommendations for its dematerialisation campaign this year, with the goal of reducing and ultimately eliminating physical processing over the following three-to-five years.

Belgium is near the end of its physical-dematerialised conversion period (31 December 2013). Thereafter, unconverted securities will be automatically converted into book-entry registered form, depending on the arrangement by the issuer. The rights to bearer securities for which conversion has not been requested, will be suspended until the holder converts them into registered or dematerialised form. From 1 January 2015, securities with unknown holders will be sold by the issuer, with prior announcement in the Official Bulletin and the press. The revenue will be deposited at the Caisse des Depots et Consignations. Holders who claim the cash will be fined 10% of the value of the securities per year of dematerialisation delay as calculated from 31 December 2015.

Canada CDS is also gearing up to make Canada’s system as electronic as possible. Their dematerialisation strategy will eliminate all physical scrips and reduce the flow of new physical issues. CDS Canada has prohibited the withdrawal of certificates for market participants if there is an active direct registration programme with their transfer agent in Canada. Shareholders can hold their securities registered electronically under their own names. They only receive an account statement from the transfer agent after a transactions is completed.

In Sri Lanka, a mandate from the Securities and Exchange Commission requires all new listings to be in dematerialised form. Existing listed equities are also being dematerialised, and as at end of 2012, a 93% dematerialisation rate has been achieved.

Conclusion

Dematerialisation has been and continues to be pursued aggressively as a risk reduction measure worldwide. Markets that have historically been dealing with certificates have been on a drive to move towards a paper-free environment. Investor education, particularly aimed at traditional or private shareholders plays a key role in the success of such campaigns. In some countries, restrictions and even penalties are already in place to encourage the lodging of securities prior to trading, and only allowing paper-free trading on the exchange. Others have
started to require issuers to only issue electronic shares from a certain date onwards. Prohibitions on the withdrawal of securities once they have been deposited in the CSDs also help prevent the re-issuance of certificates.

As it stands, this push for dematerialisation is at the forefront of international best market practices around safekeeping. In the Principles for Financial Market Intermediaries, CPSS-IOSCO recommends that a CSD should maintain securities in immobilised or dematerialised form for their transfer by book-entry. With appropriate controls, this helps ensure the integrity of the securities and greatly diminishes risks attached to physical securities. A paperless environment offers considerable savings on processing and safekeeping costs, clearly making for a cheaper, safer and more efficient market.

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