

**The Dematerialisation of
shares and share transfers**

**Results of the consultation regarding the proposal to
remove the requirement for paper share certificates
and stock transfer forms**

October 2006

Results of the ICSA Consultation on the Dematerialisation of shares and share transfers.

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1. Background to the consultation

The subject of dematerialisation of shares and share transfers has been under consideration for many years. Taurus, and its subsequent failure, is probably the best-remembered attempt to deal with the subject but its successor 'CREST', which effectively dematerialised the process for institutional investors, has proved a notable success. There still remains, however, a significant section of the market outside of CREST still using paper share transfer forms where share certificates remain the prima facie evidence of title to the shares in question. In the main, these 'certificated' shares are held by private shareholders.

The number of certificated shares has been falling over recent years helped along by the increase in the use of both corporate and independent nominees. Many private shareholders have, however, objected to the use of nominees as this can often affect the shareholder's direct relationship with the company in which they have invested and, almost inevitably, ties the shareholder to dealing through one broker. The loss of 'name on register' status will frequently affect the right to receive the Annual Report and Accounts, Notice of General Meetings and other communications direct from the company, the right to attend and vote at General Meetings and access to 'shareholder perks'.

The need to process paper transfers has also meant that efforts to reduce settlement periods have been frustrated. For many years the market has had as a goal T+1 settlement and, whilst CREST transfers are now settled on T+3 and some brokers will settle certificated trades on T+5, most transfers of certificated shares are still settled on T+10, meaning that sellers can wait up to 14 days before receiving the proceeds of the sale. The need to process paper transfers has also resulted in those bits of paper being transported up and down the country on a daily basis and prevented market participants achieving the cost reductions available from the use of modern technology. As a result the cost of processing paper based transfers remains high relative to the rest of the market.

In 2004 a European Securities Forum (ESF) working party, under the chairmanship of CrestCo, began looking at ways to resolve this 'problem' and, after some 15 months of discussion and deliberation, concluded that the time had come to develop an electronic method of transferring certificated shares effectively 'dematerialising' that process. As mentioned above, under current company law¹, the share certificate is prima facie evidence of title thus to facilitate such a mandatory change it would also be necessary to change the legal status of the share certificate.

To take matters any further than this, to explore how such a system might work and to examine in detail all the implications of and intricacies associated with such a change, would be a lengthy and time consuming exercise involving market participants in considerable work. Before asking them to take on such a commitment it was agreed that a preliminary consultation should be carried out to see whether or not there was underlying support for the proposal especially from private shareholders who might be considered to be those most affected.

At this point E.S.F. withdrew and CrestCo, deciding that it was not the right organisation to take this forward, declined to take over the lead. At the request of the Steering Committee the Institute of Chartered Secretaries and Administrators (ICSA) agreed to do so and, with the aid and support of a 'Dematerialisation Reference Group', published the consultation paper '*The Dematerialisation of shares and share transfers*' at the beginning of April 2006

¹ S186 Companies Act 1985

2. The questions asked

As mentioned, the primary aim of the consultation paper was to measure the support or otherwise for dematerialisation of the share transfer process and this was the focus of the principal question. The opportunity was also taken to outline some basic ideas as to how a dematerialised system might work as compared to the current system. Comments were sought on these ideas, thus questions were also asked about the broad scope of the proposals, security, whether they thought that a PIN number might be useful addition, the impact on market costs, and alternative methods of implementation.

Soon after publication of the consultation paper a particularly misleading press article appeared following which responses were submitted, mainly by private shareholders, which were clearly based on entirely false information. E.g. shareholders objected to the idea of dematerialisation purely because they did not want to be pushed into using a nominee, did not want to be forced into using a particular broker, did not want to lose their direct relationship with the companies in which they invest, the right to receive Annual reports and Accounts or notices of meetings, the right to attend shareholder meetings nor did they want to lose any shareholder perks. None of these scenarios would result from the proposal. Steps were taken to correct these misunderstandings, however, at least 11 (5% of respondents) of those written responses recorded as 'opposed' to the proposal fall into this 'misinformed' category.

This issue also highlighted the point that a number of private shareholders were responding to press coverage and not actually reading the consultation document. In addition the reference group were anxious to ensure that it reached as many private shareholders as possible. To address this problem a short questionnaire in the form of a one-page flyer was prepared (see appendix 2) which focused on the principal question – whether respondents agreed that the UK should adopt a dematerialised transfer system. Arrangements were then made for the flyer to be handed out at a small number of Annual General Meetings that were known to draw high private shareholder attendance e.g. Marks and Spencer Plc. Due to the timing of these AGMs the consultation was held open a few weeks longer than originally planned to allow time for the questionnaires to be returned to us.

The full list of questions and a statistical analysis of responses is given in appendix 1.

3. Overview of responses

In all, 206 responses to the consultation were received of which 141 were from private shareholders. The rest of the responses break down as follows:

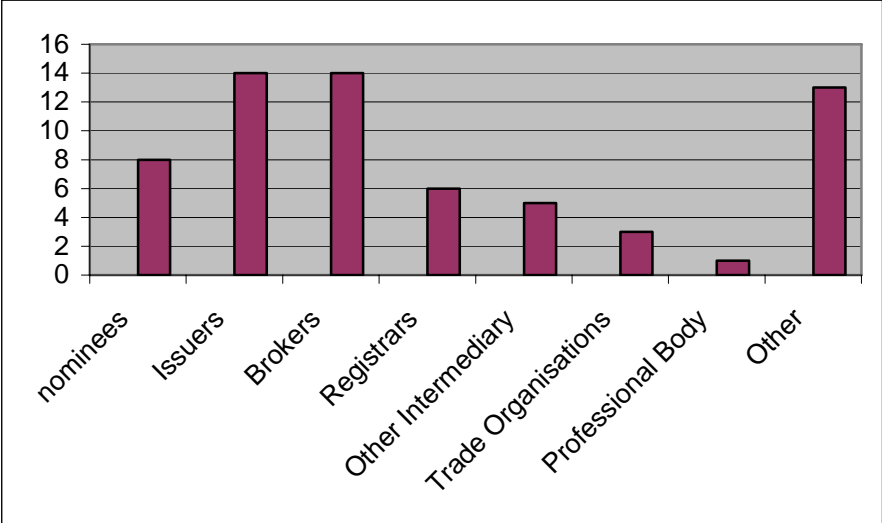


Fig 1

109 Questionnaires were completed on-line and 48 short-form questionnaires were received back from AGMs. The remaining 49 responses were a mixture of paper copies of the full consultation or other submissions that did not follow a particular format.

A few respondents, whilst answering yes or no to a particular question, were clearly providing ‘qualified’ responses. These responses have been recorded as either ‘for’ or ‘against’ as appropriate. Where explained, however, the reason for the qualification will obviously be given careful consideration should the proposal go forward.

In summary 66% of respondents were in favour of the proposal, 31% voted against (including the 5% of ‘misinformed respondents’ referred to above) and 3% declined to offer an opinion. This unequivocal support for dematerialisation justifies further examination of the subject and development of the proposal. As a result approaches have been made to Government to ensure that the Companies Bill currently going through Parliament is drafted in such a way as to facilitate dematerialisation.

Although all ‘on-line’ submissions were required to address all the questions, the short form questionnaire focussed on question 2 although it did ask for any additional comments. Free form responses rarely addressed all the questions thus the figures and percentages given in appendix 1 relate to the number of respondents answering that particular question.

A number of respondents commented that the system proposed hardly amounted to dematerialisation as it appeared that even more paper may be generated by the issue of statements of holding etc. Whilst this may appear to be the case we do not believe it will be so on two counts:

1. the statement of holding will, by and large, be a direct replacement for the share certificate. Periodical statements may well be combined with other documents such as notice of a meeting or a dividend tax voucher. The only really additional piece of paper would be the zero balance statement issued to the seller after a trade; and

2. the fact that statements of holdings will be capable of being sent electronically whereas share certificates have to be in hard copy. Whilst some private shareholders will always prefer to receive a paper statement, at least in the short term, experience in other areas would indicate that, over time, the move to electronic delivery will increase significantly thus reducing the overall burden of paper.

It is also apparent that other markets such as AIM, may pose their own specific problems that will need to be addressed as do off market transactions. From a market efficiency point of view it is clearly desirable that all such transactions should be included.

We greatly appreciate the time and effort taken by all respondents especially those that went into considerable detail about some of the issues that still need to be addressed before dematerialisation can be taken further. For example one point that has not previously been given much attention is that physical possession of share certificates is often taken where these have been posted as security e.g. for a loan.

There were, however, two main topics raised by a number of respondents; security, both of the current and proposed system, and the absence of a cost/benefit analysis. Both of these were, however, highlighted in the consultation paper and were the focus of specific questions. These together with some of the other issues raised are addressed in the following paragraphs.

Security/ SRNs/PINS

Security was probably the most frequently mentioned issue, with several respondents questioning whether an electronic system would in fact be more secure than the current paper based system. Whilst we acknowledge and understand this concern it is, we believe, the opinion of most market participants that a dematerialised system gives greater opportunity to improve security. Security of the current system is a major issue with identity theft increasing and the Registrars in particular are already looking at this and taking steps to improve their systems.

As can be seen from the answers to question 6, there was little consensus over the suggestion that PINs might be used as an added security measure. It is clear from the responses that the 4 digit PIN system, such as that used with Chip and PIN cards, is not generally acceptable. Were it to be introduced there would have to be a facility for shareholders to be able to change their PIN to an easily remembered number. What may be more acceptable would be a longer 'password' that shareholders could choose for themselves and where only selected letters would be called upon to identify the shareholder thus the complete password would never need to be disclosed.

Where shareholders have an on-going relationship with their brokers security checks will be handled by the broker as a normal part of that relationship. The main problems occur where there is no on-going relationship (execution only trades) and here extra security checks will be essential. A possible solution may be the use of physical evidence/ documentation as is usually required to open an account with a bank or building society.

Liability

This follows on from Security as, should something go wrong and a fraud is successfully perpetrated, the question of who bears the liability will arise. The first point to make here is that the shareholder will, providing they are an innocent party, ordinarily be held harmless against any loss.

As was made clear in the consultation document the intentions of all intermediaries is that the overall position as regards liabilities would remain largely as it is under the current system. As the process goes forwards, the preferred method is agreed and the finer details of how dematerialisation might be implemented, detailed discussions will be needed between those intermediaries to ensure that the status quo as regards liabilities is maintained. Should a change in liability be likely then it is important that those affected are fully aware of, and in agreement with, such changes.

Taxation

Taxation is an issue as stamp duty, which is currently levied on the paper stock transfer form, would disappear under dematerialisation to be replaced by SDRT. Brief discussions have already taken place with HMRC who have been reassured that due consideration will be given to taxation issues as we proceed to discuss and develop possible methods of taking dematerialisation forward. Whatever system is adopted it is important to ensure that it does not result in any unwanted side effects.

Implementation methods

It is clear from many of the comments made by respondents that there is no overall agreement as regards the method of implementation. As a consequence, a good deal more work will be needed to agree a method that addresses most, if not all of the concerns raised.

A number of respondents, whilst preferring a 'big bang' approach, recognised the staffing difficulty that this would create with many issuers and intermediaries. One suggestion was to dematerialise the FTSE 100 first with other listed companies to follow once any bugs had been ironed out. The FTSE 100 will obviously cover the bulk of transactions whilst affecting only a small percentage of issuers. It would, however, result in having to run both systems in parallel and private shareholders could be confused during this interim period by having to use paper transfer forms for some trades and not others. Another possibility would be to trial the system with one or two large companies before implementing it across the board.

All of these issues will be closely looked at over the coming months.

One critical point is to ensure that shareholders rights will be unaffected by the process.

Shareholder communications / education

It is clear from some of the misconceptions referred to earlier that the consultation document was not as clear as it might have been and should perhaps have focussed more on the primary objective of dematerialising the share transfer process and less on the subject of share certificates. This does, however, illustrate the need for considerable effort to be placed into communicating with shareholders and informing them as to what dematerialisation will mean in practice.

Cost Benefit analysis

Several respondents commented on the lack of a cost benefit analysis and were of the opinion that this should be undertaken before the proposal is taken much further. We recognised that a detailed analysis of the costs involved would be needed, however, it was impossible to calculate costs of a new system until the details of such a system were known and understood. A costing of the various transactions under the current system is underway and these will be compared with the expected costs of any new system as it is developed to ensure that it remains cost effective.

4. The next steps

As indicated above, individual respondents have raised a number of interesting points and all of these will be examined in detail to ensure that they are adequately addressed. In some cases ICSA may be in touch with the individual respondents to ensure that we have adequately understood concerns.

Corporate actions for example generate their own problems however these have, in the main, already been addressed. The few points that remain will be raised with experts in this area, analysed in detail and appropriately dealt with. In addition technical issues arise with regard to takeovers and procedures will be developed to ensure the integrity of the system and market overall. Rights issues also create specific problems with shareholders who wish to sell their rights having to trade their allotment letter. As indicated in the consultation document the Reference Group will work closely with market participants and the UKLA to adequately address these issues

Members of the reference group are already looking at ways of adapting or improving the proposed model in order to address all the issues that have been raised in response to the consultation. Assuming that Government is supportive and makes the necessary legal changes, and all parties agree on the way forward, a programme of shareholder education will be undertaken to ensure that shareholders are fully informed of what to expect and reassured as to their unchanged position as 'name on register' shareholders and all that entails.

Overseas experience

As mentioned in the consultation paper a number of other countries have already dematerialised some or all of their stock transfer systems. Several respondents suggested we should review the experiences of these countries before 'reinventing the wheel'.

We are in the process of gathering information from some of these countries; particularly Australia where we believe the closest comparison exists. Many of them, however, have significantly different markets than the UK which are not directly comparable as regards volumes, sophistication or complexity. As a consequence their experiences may be of varying degrees of assistance.

Appendix 1. Responses by question

Question 1 asked respondents to identify the capacity in which they were answering the questions i.e. private shareholder, broker, issuer etc. The breakdown of respondents is given above so is not repeated here. Unsurprisingly there were no responses from Institutional Investors who, in the main, already operate in a dematerialised environment through Crest.

Question 2. *Do you agree that the United Kingdom should adopt a dematerialised share transfer system for listed companies? If not please explain why.*

As mentioned above the overall response showed 65% in favour of dematerialisation, 31% against and 3% who declined to offer an opinion. As well as the 11 'misguided' written responses referred to above a number of on-line responses were also basing their answers on a misunderstanding as can be illustrated by the comments e.g.

- Dematerialisation will cost me money, as I shall need some sort of intermediary.
- Want to receive Company Reports
- Want to receive dividends by cheque through the post.
- Because I would prefer to hold the share certificate personally and benefit from any promotions or special offers that the companies are offering.
- This whole idea is to make private shareholders go through nominee accounts...

The following chart shows the breakdown of answers, in percentage terms, by respondent category. It is, however, important to remember the number of respondents in each category e.g. only one professional body responded to this question hence 100% against. (It should be noted here that the ICSA did not submit a response as it felt it inappropriate to do so).

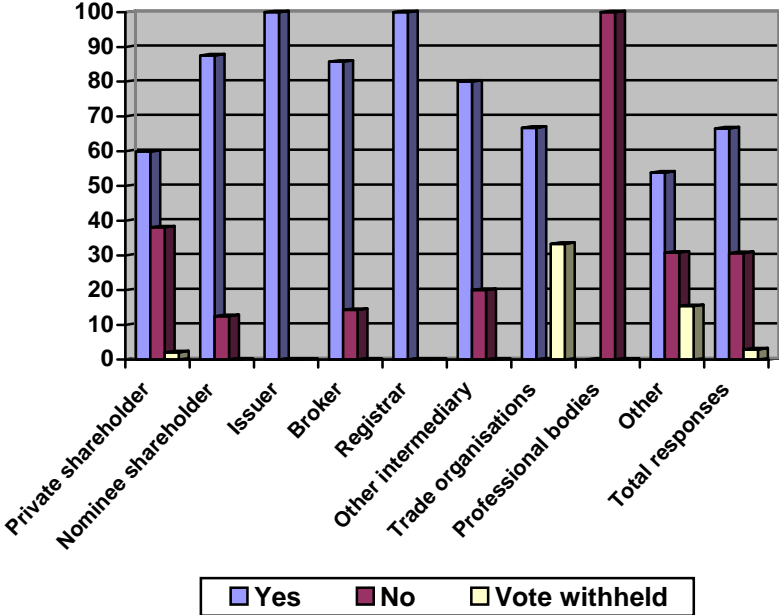


Fig 2

Question 3. *Do you have any views in support of the proposals that are not mentioned here?*

28% of those that responded to this question answered yes and most of the issues raised are covered in the body of this report. A breakdown of responses is shown in the following chart.

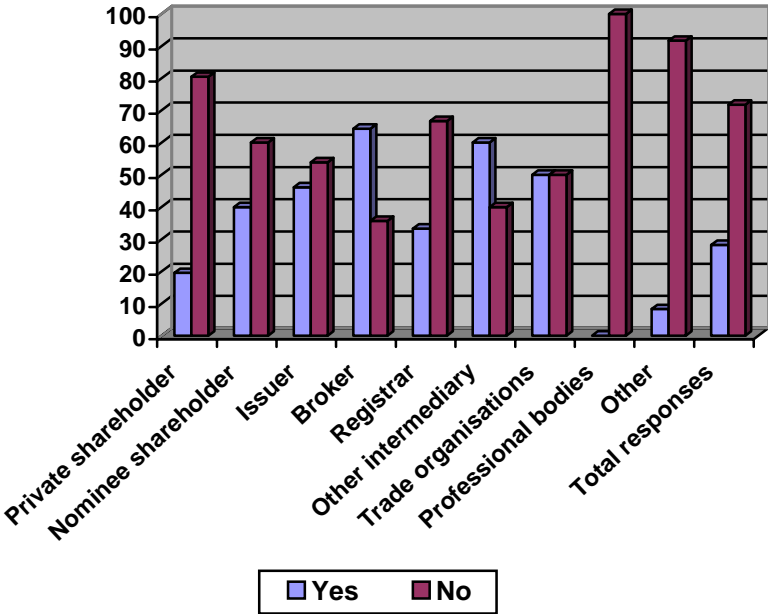


Fig 3

Question 4. *Do you agree that the use of a Shareholder Reference number for each holding coupled with the provision of a new statement of holding following each transaction, provides adequate means of identification and security?*

In total 58% of respondents agreed and 42% did not think the SRN and statement of holding sufficient. 75% of brokers thought the statement of holding and SRN provided adequate means of identification and security but only 33% of Registrars agreed illustrating their view that more needs to be done to improve security of the system overall.

The issue of security was probably the most common concern of those that went into detail in their responses, however, it was not just directed at the Demat proposal. Considerable concern was expressed about security of the current paper-based system also.

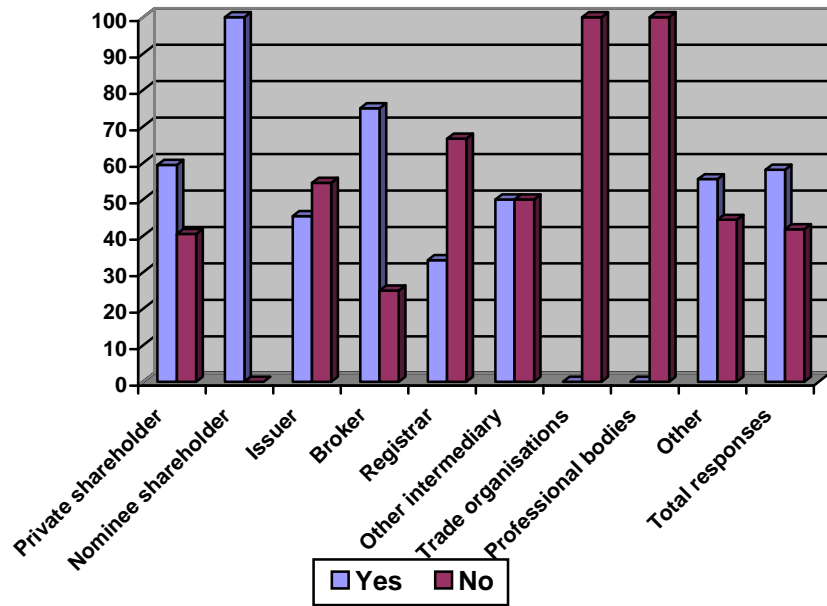


Fig 4

Question 5. *Do you agree with the broad scope of the model as described?*

Overall 72% of respondents agreed with the broad scope of the proposed model although it is fair to say that a number stressed the need for much more work on the detail before it could be considered fit for implementation. Again, it is interesting to consider how the different categories of respondents answered this question; thus the following chart shows the percentages for and against indicating general agreement across all categories.

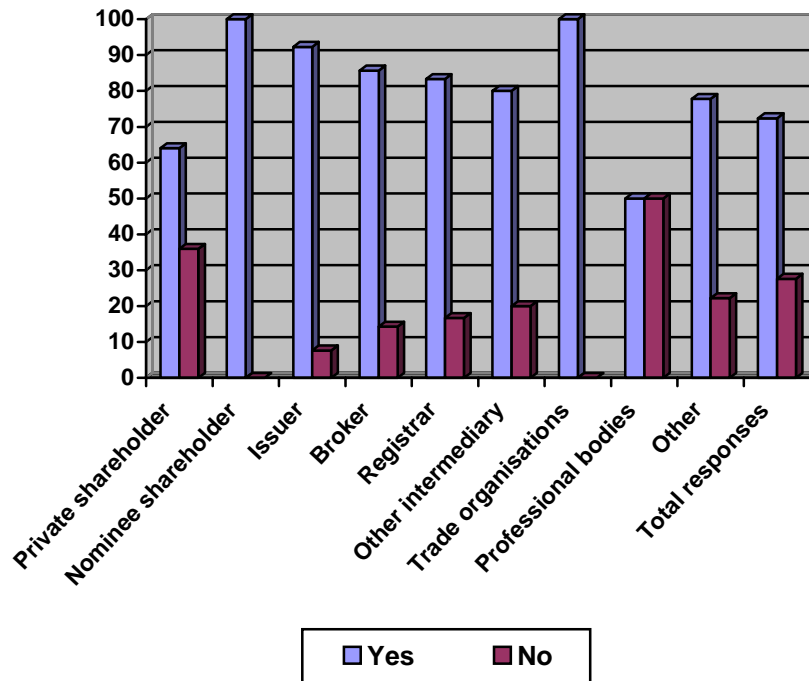


Fig 5

Question 6. Do you believe that the PIN is a necessary additional security measure?

Responses to this question were much more evenly divided with 53% answering Yes and 47% No, a result which reflected almost exactly the views of private shareholders. Somewhat surprisingly issuers were 83% to 17% in favour whereas all the intermediaries were heavily weighted against.

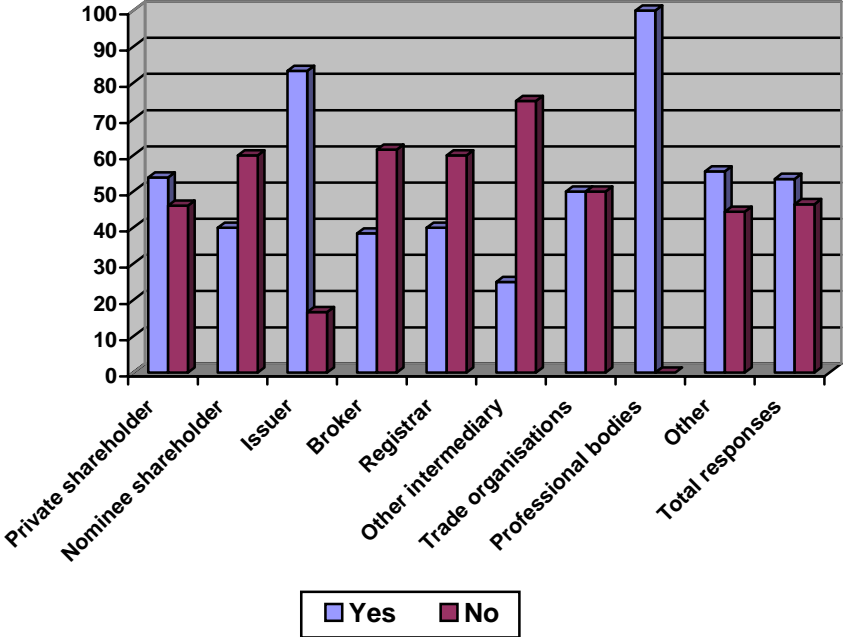


Fig 6

Question 7. Do you think that a facility for a broker to check the holdings of a client on the register pre-trade is valuable?

76% of respondents clearly thought the facility for a broker to be able to check holdings prior to trading to be useful with no category of respondents against the idea. The weakest support came from private shareholders where the vote split 68%/32%. This was still a significant majority although some respondents appeared not to fully understand the concept stating concern that such a facility would give the broker access to the shares, e.g. “only if the security around the broker is of the highest quality and there are no fraudulent brokers about”.

Question 8. Do you believe that all off-market transactions should be totally dematerialised?

Interestingly 68% of respondents overall, including 91% of issuers, thought all off-market transactions should be dematerialised. Three out of the five registrars that responded to this question, however, did not. See Chart

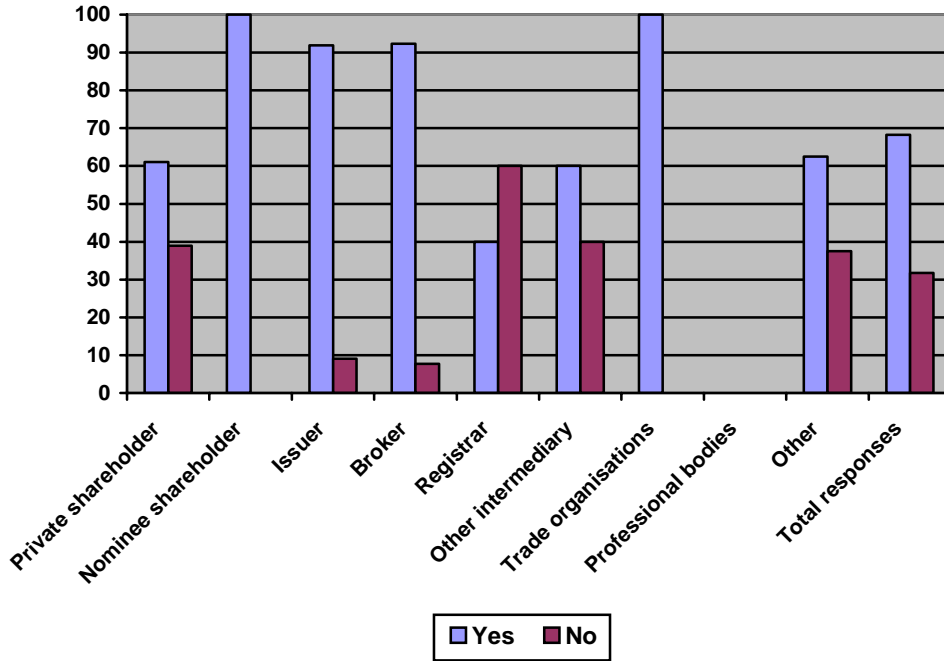


Fig 7

Question 9. *Do you agree that the method described provides a more secure method of share trading?*

61% of respondents agreed, again reflecting closely the opinions of private shareholders. Nominee shareholders were, however, much more positive showing 80/20 in favour.

Question 10. *Do you agree that the model described will provide the advantages listed in 3.9.1 through 3.9.7 [of the consultation]?*

Based on straight yes/no answers 75% of respondents agreed however several went on to explain that they agreed with some points more than others.

Question 11. *There is a view that the long term cost savings associated with the reduction in processing required for stock transfer forms would more than offset the short-term costs of any necessary front and back office enhancements. Do you agree with this view?*

Yes/no answers to this question split 73%/27% although the registrars, who might be expected to be incurring a large part of the costs involved, were split 50/50. Some brokers are also expected to have to incur significant development costs but 82% of them clearly thought such costs would be offset by gains elsewhere.

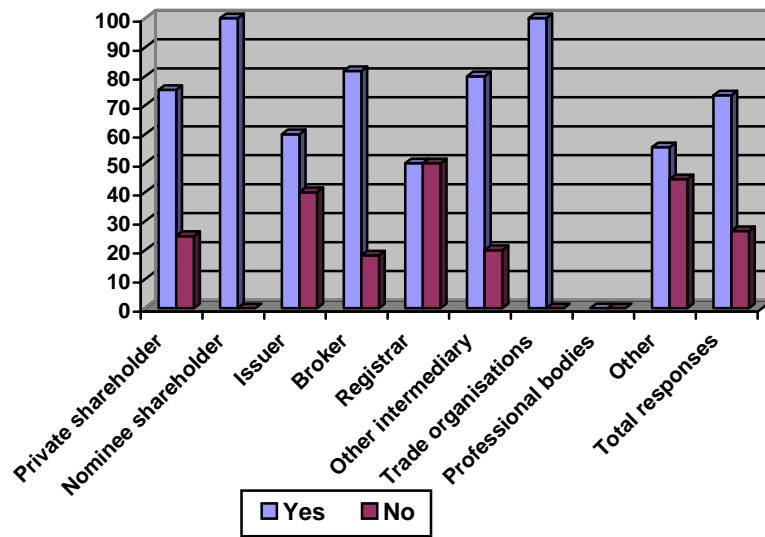


Fig 8

Question 12. *Do you agree that the model proposed will significantly impact on the market's cost of dealing with investors?*

Responses overall showed that 63% were of the opinion that the model proposed will not significantly impact on the cost of dealing with investors.

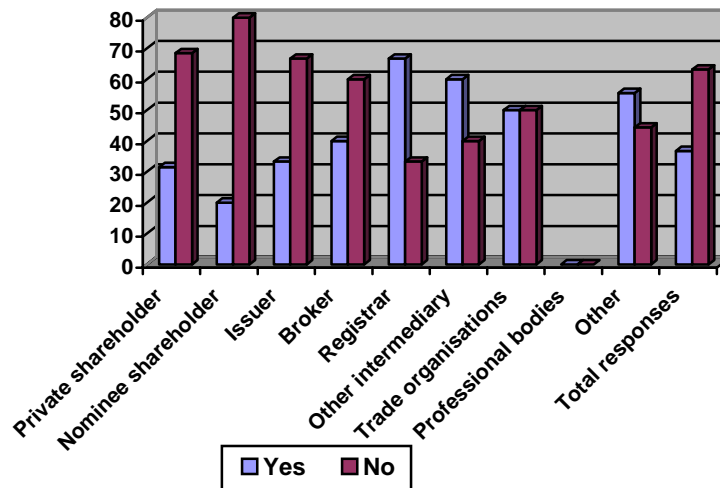


Fig 9

Question 13. *We welcome views from consultees on the alternative methods of implementation/transition described.*

There was not really a yes/no answer to question 13 however some of the comments and suggestions have been discussed in the body of this report above. All comments will be taken into account as the subject is taken forward.

Appendix 2. Short form Questionnaire



➤ Please take the time to fill out this form, your opinion really will count



dematerialisation – what it means to you

The Institute of Chartered Secretaries and Administrators (ICSA) is running a consultation on the proposal to introduce electronic share trading and its attendant benefits to the entire market. The consultation is the result of 15 months of detailed discussion by the Dematerialisation Working Group (DWG) which included representatives from the UK Shareholders Association, issuing companies, share registrars, stock brokers and other interested parties.

What will it mean for you as a shareholder if the change is accepted?

- You will retain all your rights to receive notice of, to attend and to vote at, company general meetings.
- You will retain your rights to any shareholder benefits.
- You will retain your 'name on register' status.
- You can continue to trade with any broker/s of your choosing.
- You will potentially receive the proceeds of any transactions more quickly.
- You will not have to hold your shares in nominee accounts.
- Electronic trading can provide intermediaries with greater opportunities to improve security
- Electronic trading can eliminate the need for costly indemnities for replacement certificates.
- Electronic trading can help reduce the cost of share transfer.
- Electronic trading will bring those shareholders with paper certificates in line with the majority of UK shareholders who trade electronically. Shareholders who require it, can also continue to receive paper confirmation of holding.
- Electronic trading can reduce costs as there will be no need for indemnities for lost certificates.

You can respond online at www.icsa.org.uk/demat or write to us with your comments to Dematerialisation, ICSA, 16 Park Crescent, London W1B 1AH

Alternatively please complete the shortened version of the questionnaire overleaf and return the hard copy either to your registrar or post it to ICSA at the address above.

The closing date for the consultation is 30th June 2006.

⏴ | questionnaire

1 In what capacity are you responding to this consultation? Please tick the most appropriate box.

- | | |
|---|--|
| <input type="checkbox"/> Institutional investor | <input type="checkbox"/> Private shareholder |
| <input type="checkbox"/> Nominee shareholder | <input type="checkbox"/> Issuer |
| <input type="checkbox"/> Broker | <input type="checkbox"/> Registrar |
| <input type="checkbox"/> Other intermediary | <input type="checkbox"/> Trade organisation |
| <input type="checkbox"/> Professional body | <input type="checkbox"/> Other |

**2 Do you agree that the United Kingdom should adopt a dematerialised share transfer system for listed companies?
If not please explain why.**

- Yes No

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.....
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3 Do you have any other comments which you would like to make about the consultation or dematerialisation in general?

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Name in BLOCK CAPITALS

Signed Date