



**DTCC**

Strengthening the U.S. Financial Markets

# **A PROPOSAL TO FULLY DEMATERIALIZE PHYSICAL SECURITIES, ELIMINATING THE COSTS AND RISKS THEY INCUR**

A White Paper to the Industry • July 2012



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## EXECUTIVE SUMMARY

This white paper launches the final stage in the industry's long-standing campaign to achieve full dematerialization in the U.S. financial markets. It also opens a formal discussion among industry stakeholders to gain consensus on critical next steps.

Complete dematerialization will contribute to a more cost-effective, efficient, secure and competitive U.S. marketplace. It will also support the industry's move to a shorter settlement cycle, as handling physical securities, already a burden in today's markets, could be a source of risk in a shorter cycle. What's more, it will strengthen the global competitiveness of U.S. markets. Dozens of countries across Europe, the Asia-Pacific, Africa and Latin America have stopped issuing paper certificates altogether.

### WHERE WE STAND: THE HOMESTRETCH

The U.S. financial services industry has been grappling with physical certificates since the late 1960s, when it was overwhelmed by rising volumes on the exchanges that required paper certificates and checks to change hands by the thousands each day. The industry's initial solution was to "immobilize" stock certificates in a central location, recording changes of ownership with bookkeeping entries. The second solution was the concept of substituting paper certificates with book-entry securities, a process called "dematerialization."

Over the past half-century, the drive to immobilize and dematerialize physical certificates has made significant strides, providing cost and risk reductions to financial markets and investors. Today, most U.S. securities, including municipal and corporate bonds, U.S. government and mortgage-backed securities, commercial paper and mutual funds, are offered in paperless form. Still, certain asset classes are lagging, of which equities is the most significant.

Now, the industry has reached a tipping point, making it essential to push forward to full dematerialization. Thanks to the success of ongoing dematerialization efforts (measured by an 86% drop in the number of physical certificates held in DTCC's vault since the year 2000), the economies of scale for physical processing have been reversed: the fixed costs incurred to support physical certificate processing are being recovered through a dwindling number of transactions. That means, as the number of physical issuances and transactions declines, the unit cost of processing them rises. Yet until the U.S. markets are fully dematerialized, the industry will be obliged to support this fixed-cost structure for physical processing regardless of the volume of certificates processed.

The industry will also continue to bear the inefficiencies and risks associated with physical certificate processing. Given the heightened focus on risk management in financial markets globally, the need to eliminate the risks associated with the movement and manual processing of paper certificates is now greater than ever.

### PROPOSED PLAN

In the following pages, The Depository Trust & Clearing Corporation (DTCC) outlines the steps it plans to take, with the industry's input and cooperation, to reduce and eventually eliminate the remaining physical securities in the U.S. markets, and the costs and risks they incur.

With this paper, DTCC and its depository subsidiary, The Depository Trust Company (DTC), seek the partnership and feedback of all industry stakeholders, including banks, brokers/dealers, transfer agents, issuers, regulators and industry associations, to forge a multiyear plan to attain the following goals:

- Achieve the full dematerialization of U.S. financial markets.
- Eliminate the costs and risks associated with the physical certificates still outstanding.
- Identify key value-added services DTCC can offer market participants to accelerate the drive toward full dematerialization.

- Leverage existing relationships with the agent community to develop joint solutions that will benefit all parties.

The plan focuses on three key work streams in DTCC's physical processing infrastructure:

- **Traditional Physical Transactions.** These are transactions clients regularly send to DTCC for immobilization. DTCC will introduce alternatives that can be adopted in the near term in order to reduce the volumes, costs and risks associated with physical processing, and anticipates eliminating DTCC's centralized processing of physical deposit activity altogether by 2015.
- **New Issues.** DTCC is developing recommendations for new business practices for the primary issuance of securities that will eventually eliminate the need for physical certificate processing.
- **Existing DTCC Vault Inventory.** DTCC will work with the industry to reduce the physical certificates it holds. It will also make recommendations to pare down and ultimately eliminate its physical Cede & Co. inventory. These measures will not affect the depository's Non-Cede Custody Service, which offers limited services for assets that are not fully eligible. However, DTCC will explore ways to dematerialize restricted securities, which represent about 50% of the Non-Cede Custody inventory.

The success of this plan will require strong support from both the industry and regulators. It will hinge on the industry's adoption of new business practices that will call for changes in technology platforms, the legal landscape and in DTCC's pricing policy, as well as regulatory approval.

DTCC anticipates that any short-term incremental investments needed to implement this plan will be offset by the increased efficiencies and reduced risks that the elimination of paper certificates and the full implementation of book-entry processing will bring.

Depending on the outcome of this discussion, DTCC could begin implementing recommendations for its dematerialization campaign as early as 2013, with the goal of reducing and ultimately eliminating physical processing over the following three to five years.

We look forward to receiving your feedback on this paper by September 1, 2012. From that point, we can begin to schedule all necessary follow-up meetings in the appropriate forums. Please direct any questions and comments to Jon Ciciola at 212.855.4628 or [jciciola@dtcc.com](mailto:jciciola@dtcc.com) or your Relationship Manager.

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## BACKGROUND

### THE PAPERWORK CRISIS

The push to eliminate physical securities originated in the “paperwork crisis” of the late 1960s, when trading volumes surged and the back offices of banks and brokerages were inundated with stock certificates and the associated paperwork. Hundreds of messengers scurried through Wall Street lugging bags of checks and securities that had to be exchanged for each trade. The crisis became so severe that the exchanges closed every Wednesday, shortened trading hours on other days and extended settlement by a day to T+5 (trade day plus five).

To tackle the mounting backlog, the New York Stock Exchange (NYSE) and its Central Certificate Service “immobilized” stock certificates by maintaining them in a central location, registered in a nominee name. Ownership or transfer of stock was recorded using a bookkeeping entry. However, for various reasons, including the facts that the program was voluntary and individual state laws required brokers to give investors physical certificates, this initiative met with limited success.

In 1970, several leading banks and exchanges formed The Banking and Securities Industry Committee (BASIC) to overcome these challenges. Their efforts culminated in 1973 with the creation of DTCC’s depository as the central location for certificate immobilization.

### IMMOBILIZED THROUGH FAST

Aware that merely immobilizing certificates in its vault wouldn’t provide the economies of scale required to handle the rapidly expanding U.S. markets, DTCC’s depository soon launched the Fast Automated Securities Transfer (FAST) program. FAST minimizes certificate movements and streamlines transfer processing by recording the securities in book-entry form on the books and records of the issuer’s transfer agent. This reduces the risks associated with lost securities and eliminates the costs of insuring, handling and shipping physical certificates.

With FAST, transfer agents maintain a jumbo balance certificate for DTCC – one for each issue – registered in the depository’s nominee name, Cede & Co. Balances are automatically adjusted each day based on deposit and withdrawal activity at DTCC, and FAST transfer agents electronically confirm balances with DTCC on a daily basis. For exchange-listed equities, agents maintain only an electronic record.

FAST was an important step in helping the industry reduce the number of physical certificates being created and moved between DTCC and the transfer agent community. As the physical securities market consolidated around DTCC as a central depository, benefits to market participants included cost savings, efficiencies and reduced operational risk.

### A STEADY DEMAND FOR PAPER

In 1983, the NYSE required member organizations to settle eligible securities in book-entry form through DTCC and gave counterparties recourse to refuse the acceptance of physical certificates.

At the same time, market participants and U.S. government agencies began introducing securities that would be issued in book-entry-only (BEO) form. For DTCC, this meant that only global certificates would be created in the depository’s nominee name, Cede & Co., and no physical certificates would be available to investors. This change helped reduce physical certificates for select asset classes. Nonetheless, ongoing demand for physical certificates – by individual investors and in support of certain institutional purposes – generated millions of new paper certificates each year.

To support the processing of existing physical securities in a central securities depository and to bring more operating efficiencies to its clients, DTCC expanded its deposit services to complement the core Deposit Automation Management Service, adding the Branch Deposit Service (BDS), Restricted Deposit Service (RDS) and Reorg Deposit Service. This suite of services provided members with a full range of safekeeping and processing options. DTCC also updated and expanded its systems to address the complexities of processing paper securities. As DTCC expanded its services and systems to support the centralized processing objectives, it leveraged existing resources in order to minimize increases to its fixed-cost infrastructure.

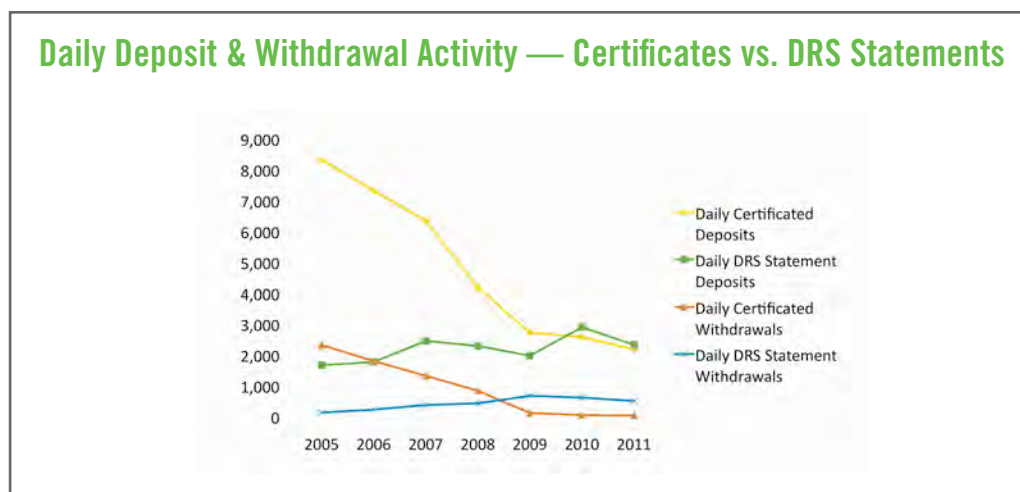
## DEMATERIALIZATION THROUGH DRS

In response to a transfer agent initiative urging the industry to develop an alternative to physical certificates, DTCC's depository (with SEC support) launched its Direct Registration System (DRS) in 1996, which allowed individual investors to have their share ownership reflected on the books of an issuer or an issuer's transfer agent. In lieu of physical certificates, investors received a DRS statement of ownership, dramatically reducing cost and risk.

In July 2004, the Securities Industry Association (SIA) issued the Securities Industry Immobilization & Dematerialization Implementation Guide, which reinforced the industry's commitment to full dematerialization and underscored the importance of DRS in attaining that goal. Two years later, the SEC rendered DRS eligibility a listing requirement for all new issues starting in 2007, and in 2008, it made DRS a listing requirement for all existing exchange-listed issues.

With regulatory backing, DTCC was in a position to lead the reduction of the issuance of physical certificates through its Withdrawal by Transfer (WT) service, which clients use to withdraw assets from DTCC.

With DRS and WT, issuers, investors and market participants finally had less costly and less risky alternatives to certificates as a way of recording ownership, promoting further progress on discouraging certificate issuance through the long-standing immobilization and dematerialization efforts.



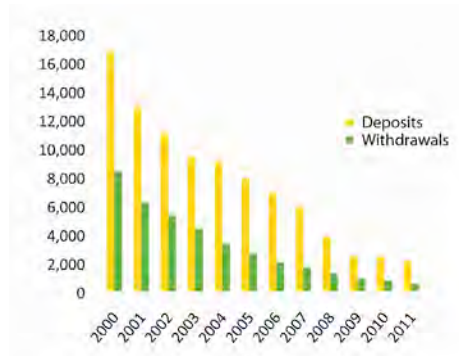
## STILL NOT THERE

The net effect of these programs led to an overall reduction in deposit volume of 87% and an overall reduction of withdrawal volume of 94% since the year 2000.

These gains have contributed to a significant reduction in overall cost and risk to the financial services community. However, until the industry eliminates physical certificates from the U.S. markets once and for all, its fixed-cost base will continue to be necessary and the risks associated with physical processing will remain.

### Deposit & Withdrawal Average Daily Activity 2000-2011

Deposit and Withdrawal Activity Is Down 87% and 94% (respectively)



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## TRADITIONAL PHYSICAL TRANSACTIONS

This first work stream will focus on deposit processing, primarily DTCC's core, and most widely used, Deposit Automation Management (DAM) service. This is due to the success of DRS in reducing the amount of physical certificate withdrawal activity to less than 2% of DTCC's overall physical volume.

With DAM, DTCC serves as a hub for clients and transfer agents re-registering certificates from the beneficial owner name to DTCC's nominee name with corresponding book-entry positions. DTCC provides a central collection and distribution point for the transfer agents, while the responsibility for examining the certificates for negotiability rests with the depositing entity. Because DAM relies on economies of scale to offer its low-cost solution, declining volumes of physical securities transactions are challenging this cost structure.

DTCC also offers ancillary deposit services, including the Branch Deposit Service (BDS), Restricted Deposit Service (RDS) and the Reorg Deposit Service. With these services, DTCC takes on a proactive role, providing specialized functions, such as deposit examinations, restrictive legend removals, certificate negotiability reviews and corporate action processing, with specific additional fees for each.

### THREE NEW DEPOSIT OPTIONS

In 2013, DTCC plans to begin offering three options to its traditional DAM service, subject to industry and regulatory support. These options will give clients alternatives for making deposits, allowing DTCC to reduce centralized deposit processing and realign resources with more critical industry needs. They will be offered for issues in the FAST program and will require the support of FAST agents.

#### SERVICE OPTION 1: DEPOSIT DIRECTLY TO FAST TRANSFER AGENT

This option leverages DTCC's Deposit and Withdrawal at Custodian (DWAC), an online facility that allows clients to transmit instructions to FAST transfer agents to deposit or withdraw securities into and out of their DTCC account. In short, this option removes DTCC from handling the physical certificates and redirects the client's distribution directly to the FAST transfer agent.

As transaction volumes continue to decline, this option will offer an effective means of immobilization, streamlining certificate movement while reducing costs and associated risks. It will also eliminate the costs and risks associated with deposit rejects and provide clients with the assurance that once the position has been established at DTCC, it will not be subsequently reversed.

DTCC will be offering new tools to identify the appropriate FAST transfer agent, and it will continue to work with clients and FAST agents to ensure they receive maximum support. In addition, as part of the DWAC process, clients will receive status updates to reflect the disposition of their deposits.

#### SERVICE OPTION 2: DEPOSIT TO DTCC FOR PROVISIONAL CREDIT, PENDING AGENT APPROVAL

Clients who wish to continue leveraging DTCC as a source for centralized processing and do not require immediate credit can choose this option. It offers a modified version of DAM that uses a longer cycle time based on clearly defined service levels. For example, the cycle could extend from receipt of deposit through to clearing transfer and the creation of the book-entry position, with processing only on certain days. Deposits to DTCC would be credited to a client's account as "provisional" at the time of receipt, in other words, subject to clearing transfer, a process that could last several days, after which, the deposit would be posted as an "actual credit," available for client use.



By extending the cycle time for the completion of a deposit, DTCC can reduce its cost base, which translates into lower fees for the depositing client, while reducing the risk of a deposit being used prior to clearing transfer. The length of the cycle would coincide with the amount of time necessary for deposits to clear transfer, with DTCC providing a mechanism to track their status.

## SERVICE OPTION 3: DEPOSIT TO DTCC FOR IMMEDIATE CREDIT

Clients can choose to continue using the existing DAM process, subject to a higher fee, to receive immediate credit for deposits. This process would follow the existing DAM procedure, where deposits received by DTCC are credited to a client's account at the time of receipt, which allows for immediate use of the book-entry position. This service option carries the risk of a credit being reversed due to a transfer reject (which is reduced through the use of service options 1 and 2). Fees will reflect the higher costs that DTCC will incur to provide this service option.

Clients may choose to use multiple service options for deposit activity (e.g., use service option 1 for the bulk of deposits with the major FAST transfer agents, but still send some deposits to DTCC for centralized processing under service option 2). Clients may also vary their deposit activity based on their need to receive immediate use of the book-entry position.

## FEE MODIFICATIONS

DTCC is planning additional service changes for 2013.

Physical deposits of DRS-eligible certificates with the issuance date of January 1, 2013, or later will incur a surcharge in addition to the deposit fee. The goal is to reinforce DRS as an industry standard and discourage the practice of converting DRS paperless statements into physical certificates.

In addition, the fee for BDS deposits, a specialized service by which DTCC takes on full certificate examination and negotiability review responsibilities will be increased to more effectively cover the depository's costs. DTCC will reevaluate BDS throughout 2013 to determine whether there is an opportunity to incorporate DAM deposit processing into BDS, creating one mechanism for direct deposit to DTCC.

DTCC believes that any incremental costs associated with operational changes will be recouped over time through the greater efficiencies and reduced risk that will come with the elimination of certificates and the full use of electronic book-entry processing.

## NEXT STEPS

This year DTCC will:

- Foster dialogue in the appropriate industry forums to gain support for measures aimed at accelerating dematerialization.
- Solicit industry feedback on the proposed service changes to ensure stakeholder concerns are addressed.
- Identify the specific steps to implement agreed-upon changes.
- Make any necessary regulatory filings that may result from service changes.

## TERMINATING PHYSICAL CERTIFICATES AT THE CLIENT

Once the first phase for this work stream is complete, DTCC and the industry can consider other ideas.

One concept involves expanding DTCC's electronic imaging platform to include an imaged certificate deposit capability. The technology works much like the setup that allows a commercial bank's customers to deposit their checks by scanning them in.

Clients would scan their certificate into DTCC's system (an earmark would be placed on the certificate indicating that it has been presented to DTCC for deposit via its deposit image mechanism), also creating an imaged copy of the certificate that DTCC and transfer agents could reference. Upon receipt of the electronic image, DTCC would provide a "provisional" credit to the client's account and forward the image to the transfer agent for inspection, re-registration and the ultimate disposition of the imaged certificate. Once approved by the transfer agent, DTCC would provide an "actual" credit, and the client would receive confirmation from DTCC that the agent has approved the transaction and that the client can destroy the original certificate.

In addition to a technology investment, this concept would require key stakeholder and legal support as well as changes to the rules that currently govern transfer agent activities and the destruction of certificates.

Use of an image technology solution (potentially) will be a key driver in meeting DTCC's goal to eliminate its role in centralized deposit processing, while directly helping to reduce the infrastructure costs and risks of transfer agents. This concept presents an opportunity to fully modernize the processing of physical certificates. Achieving an image solution would enable DTCC to evolve to a process whereby all deposits on FAST issues would go directly to the transfer agent and come to DTCC via DWAC, and all non-FAST certificates would be converted to electronic images and terminate at the client.

Throughout this campaign, DTCC will be examining volumes to assess the effectiveness of specific measures in reducing physical transactions.

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## NEW ISSUES

In an effort to eliminate the need for physical certificates at the time of issuance, proposals for this work stream pursue the modification of DTCC's new issuance eligibility process and recommend new business practices for the primary issuance of securities.

DTCC takes in over 50,000 new physical certificates each year through its new issuance eligibility process. The majority of these are municipal debt and retail certificates of deposit (CDs). In 2011, DTCC began an initiative to reduce the volume of physical securities at issuance by expanding the FAST program to include retail CDs. This has helped decrease the volumes of physical CDs by converting them to the FAST program.

This year, DTCC will continue efforts to reduce physical inventory through the new issuance process by advancing two programs that are in development. DTCC will also evaluate its eligibility criteria at the asset-class level to provide issuers, underwriters and other market clients with greater transparency.

### E-CERTIFICATE PROGRAM

DTCC proposes expanding its retail CD dematerialization drive with a new initiative – the e-Cert program – in which DTCC would accept retail CDs in electronic form.

Currently, CD underwriters request that issuers produce a certificate when issuing a new CD. The issuer must ensure the certificate is delivered to DTCC, where it is registered in book-entry-only (BEO) form in DTCC's nominee name; the BEO securities remain on deposit in DTCC's vault until maturity. Beneficial owners cannot request a physical certificate on a BEO security.

With the e-Certificate (e-Cert) program, the depository will accept an electronic certificate, rather than requiring a paper certificate to be deposited. All other CD processing procedures will remain essentially the same. E-Cert CDs will still be registered in the depository's nominee name, and DTCC will still receive and credit interest and maturity payments to its clients, who then credit their customers (the beneficial owners) with these payments.

Issuing banks will still be responsible for executing the certificate and will comply with this requirement by providing an electronic signature via a real-time connection with DTCC. This will eliminate the need to print, sign and courier the physical certificate to DTCC, saving the industry money and time.

As the e-Cert program moves ahead, DTCC plans to solicit additional input from issuers, underwriters and other key stakeholders. In general terms, the e-Cert program will work as follows:

- The CD underwriter will access DTCC's secure, web-based underwriting system to complete an eligibility request and create the terms of the CD, the same process used today.
- Next, through an automated prompt, the issuing bank will securely access the web-based application to validate the terms of the CD, as entered by the underwriter, and acknowledge the issuance of the e-Cert CD via electronic signature.
- On the settlement date, DTCC's system will automatically reflect the CD position in the underwriter's DTCC account, offset by the e-Cert, and, as happens today, the underwriter will remit the CD's purchase price directly to the issuer.

DTCC will need to work with the appropriate industry partners and agencies to determine the necessary regulatory approvals to proceed with this initiative.

OCC regulations also allow banks to perform authorized activities and provide authorized services, such as accepting deposits and issuing CDs, through electronic means.

In addition, DTCC has determined that the use of electronic certificates will not affect the eligibility of CDs held at DTCC for Federal Deposit Insurance Corporation (FDIC) pass-through insurance.

## PAPERLESS BEOs

Another initiative DTCC is exploring is the dematerialization of BEO certificates for non-FAST issues, referred to as “paperless BEOs.”

In the current process, when issuers issue new securities they want held at DTCC rather than through a FAST agent, the underwriter requests that they execute a physical certificate for each CUSIP within the new issue. After the issuer delivers the certificates to DTCC to be registered in BEO form in the depository’s nominee name, the BEO securities are held in DTCC’s vault until maturity. Again, the beneficial owners do not have the option to obtain the physical certificates.

The Paperless BEO program will substitute an electronic image of the certificate for the physical certificate. The issuer or underwriter can email the image to DTCC. The electronic certificates will then be stored in an “electronic vault.” All other procedures for processing these securities will remain essentially the same – the paperless BEOs will still be registered in the depository’s nominee name, and DTCC will receive and credit interest and maturity payments to its clients, who, in turn, will credit their customers.

## NEXT STEPS

- Throughout 2012, DTCC will continue to work with industry partners to determine their IT and operational needs for the e-Cert program. DTCC will also begin documenting specifications for internal IT development, targeting deployment in 2013.
- DTCC will be working with industry partners and regulatory agencies to determine the steps necessary to gain legal and regulatory approval for the Paperless BEO program. Based on that outcome, DTCC will develop communication plans and create working groups to advance this initiative.



## EXISTING DTCC VAULT INVENTORY

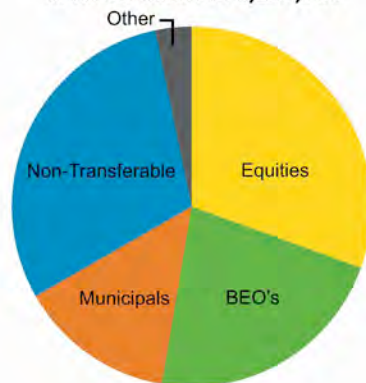
The third work stream focuses on the remaining DTCC vault inventory associated with those assets registered in its nominee name, Cede & Co. These recommendations will not impact inventory held as part of DTCC's Non-Cede & Co. Custody Service, with the exception of restricted certificates that DTCC will endeavor to dematerialize.

DTCC's Cede & Co. inventory consists of:

- Non-FAST eligible issues, serviced by FAST agents
- Non-FAST eligible issues, serviced by non-FAST agents
- Bearer municipals and registered municipals
- Non-transferable issues

### Composition of Cede & Co. Vault Inventory as of January 2012

Total Certificates: 1,255,980



Asset Class	Certificates	Issues	Overall%
Equities	383,400	9,768	30.53%
BEO's	278,083	256,597	22.14%
Municipals	176,430	11,166	14.05%
Non-Transferable	376,986	16,161	30.02%
Other	41,081	6,407	3.27%
<b>Total</b>	<b>1,255,980</b>	<b>300,099</b>	<b>100%</b>

## FAST ELIGIBILITY AND JUMBO BEARER BOND CERTIFICATES

In 2009, DTCC set a four-year goal to reduce its Cede & Co. vault inventory from 2 million to 1 million certificates. Since then, about 300,000 certificates have been added to the inventory.

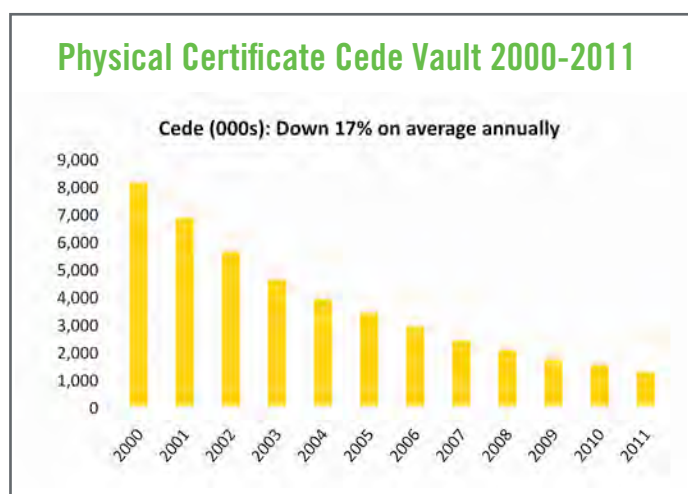
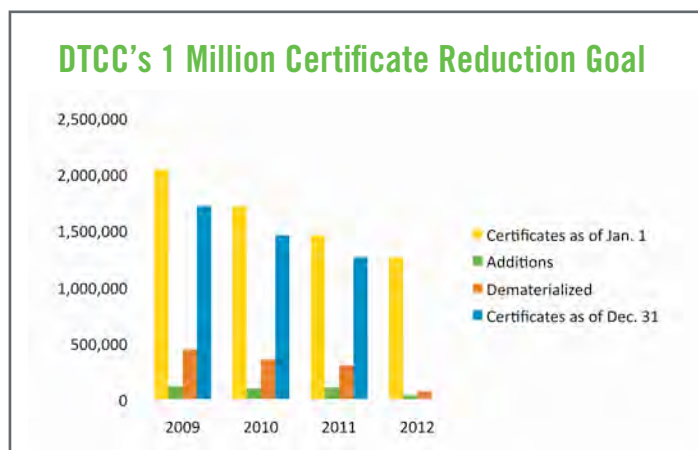
By December 2011, DTCC had eliminated 1,095,432 certificates. Two key developments helped make this possible.

- DTCC has worked closely with FAST agents to increase participation in the FAST program and further support dematerialization.

In 2011, both retail CDs and unsponsored American Depositary Receipts (ADRs) were made FAST-eligible. DTCC and FAST agents have also made significant headway in reducing the number of non-FAST eligible issues serviced by FAST agents.

- The bearer municipal bond inventory in DTCC's vault has a limited shelf life. The 1982 Tax Equity and Fiscal Responsibility Act discontinued the issuance of new bearer bonds, and existing issues are reaching maturity. That said, the limited number of bearer bonds issued after 1982 that are still outstanding will, for the most part, mature over the next three to five years.

DTCC has made significant inroads by converting its bearer municipal inventory to jumbo certificates in registered form (when permitted in the offering indenture). Most bearer bonds are issued in denominations of \$5,000 or less and are often accompanied by coupons redeemed biannually for interest payments. Consolidating these securities into registered jumbo certificates has helped reduce the volume of certificates in the vault and the number of coupon presentations made, as well as minimizing the cost and risk of maintaining this inventory.



## NON-TRANSFERABLE ISSUES

The balance of DTCC's vault inventory is made up of non-transferable issues. These securities, most of which are low-priced equities, are no longer serviced by a transfer agent and are often categorized as "distressed assets." With DTCC's Non-Transferable Deposit program, clients receive credit in their general free account, allowing continued use of most depository services, such as deliver orders for trade settlement. Deposited non-transferable certificates are held in DTCC's vault "as is" until such time as an issue emerges from non-transferable status. Upon reactivation, the certificates are presented to the new agent for re-registration into DTCC's nominee name.

While providing liquidity on what otherwise would be illiquid assets, the Non-Transferable Deposit program

presents risks to both DTCC and its clients. Non-transferable certificates held by DTCC can remain in a client's customer's name anywhere from several months to indefinitely. Should an issue emerge from non-transferable status, problems with negotiability may arise when the certificates are presented to the agent. This can result in DTCC charging the depositing client long after its customer has sold the securities and closed the account.

In addition, some issues never emerge from non-transferable status, which has led to a buildup of certificate inventory in DTCC's vault, where these issues now account for about 30% (375,000) of DTCC's physical inventory.

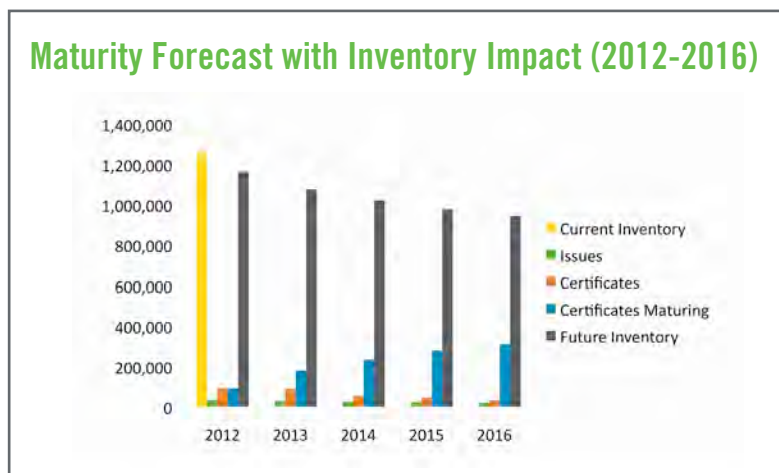
## ACCELERATING DESTRUCTION

The 375,000 number would be significantly higher without the Destruction of Non-Transferable Securities Certificates program, which DTCC implemented in August 2004 to help reduce the number of certificates in its vaults, as well as the cost of housing them. The program is based on the length of time that an issue has been non-transferable.

At the direction of clients, non-transferable assets can be moved off their books (via the position removal function PREM) and placed on track for destruction. Only assets that have been removed from client accounts via PREM and identified as non-transferable for more than six years are eligible for destruction.

To further accelerate the program, DTCC will solicit industry feedback to reduce the required holding time of non-transferable certificates from six years to four years. All other aspects of the program will stay the same. Clients will benefit by retiring the costs associated with holding these positions sooner.

While a shortened cycle raises the potential for an issue to emerge from non-transferable status after the certificates have been destroyed, a three-year look back revealed that only a small number of issues emerged from non-transferable status after four years. In the unlikely event that a destroyed certificate needs to be replaced, DTCC will work with the new transfer agent to obtain new certificates.



## NON-TRANSFERABLE DEPOSITS

DTCC will seek industry feedback on the practice of accepting non-transferable deposits to ensure that this service continues to be value-added for our clients. Depending on that feedback, DTCC will determine if this service should be moved to its Non-Cede Custody service (in order to allow clients to clean out their vaults but not permit book-entry delivery on these positions to mitigate the risks that this service imposes). Most issues that come in under this program are sub-microcap issues (publicly traded companies with market capitalization of less than \$50 million) that, for one reason or another, stopped paying their transfer agent fees.

Members incur the risk when DTCC's depository accepts certificates before knowing if they are negotiable, a practice that leaves little recourse when the original depositor cannot be located. As a result, it should be incumbent upon the issuer to seek out a new agent to ensure uninterrupted depository services.

## RESTRICTED SECURITIES

As noted, the aforementioned changes will not affect DTCC's Non-Cede Custody service, which provides for the safekeeping and processing of physical certificated issues not eligible for full DTCC services. In the course of business, however, DTCC will look at ways to streamline the processing and handling of these assets to minimize their movement and the associated costs.

DTCC will also try to leverage programs that promote dematerialization of the Cede & Co. inventory for use in the Non-Cede Custody space. For instance, DTCC is considering processing alternatives for restricted equities in a DRS-like environment.

Networking for Equities (NFE), a service DTCC originally proposed several years ago, is one alternative for leveraging the DRS concept. With NFE, investor-level account details are held on the books of the transfer agent, but full control of the account and the underlying "book shares" are with the depositing client (broker). Full client control means the transfer agent acts as the "custodian" for the depositing client and, as such, will only accept transfer or re-registration instructions from the depositing client.

NFE provides an automated system link that connects the client, issuer, transfer agent and the depository, streamlining and expediting the client's ability to update and service the controlled investor's accounts, while maintaining the transfer agent's role as the gatekeeper of all transfer processing.

Upon deposit, NFE captures the certificate's key data elements, such as registration, issue date and, for restricted certificates, restriction type and corresponding lock-up dates, which are accessible to the depositing client and transfer agent via electronic links provided and maintained by the depository. These features are designed to ease the burden of handling cumbersome restricted physical certificates and to promote a book-entry environment for greater efficiencies as the restriction periods elapse.

## NEXT STEPS

- Evaluate the non-transferable deposit service to determine how best to serve our clients' needs. Make any necessary rule filings and pricing adjustments based on the outcome of feedback and potential service changes.
- Explore accelerating the non-transferable destruction program from six years to four years to reduce the length of time DTCC is required to hold a non-transferable asset before it can be destroyed.
- Pursue implementation of DRS for restricted securities, i.e., Networking for Equities (NFE). This will require a plan to address concerns around "good control location" for use of the assets in collateral situations and consensus on approaches for funding the necessary build from an industry perspective.



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## PROPOSED DEMATERIALIZATION TIMELINE

### 2012

- Q3** DTCC will solicit feedback from industry stakeholders.  
DTCC will clarify implications of proposed service changes.  
DTCC and industry partners will pursue the development of the e-Certificate program for new issues.  
DTCC and industry partners will pursue legal solutions for the Paperless BEO program.  
DTCC will pursue acceleration of the Destruction of Non-Transferable Securities Certificates program.
- Q4** DTCC will make necessary regulatory filings based on the proposed changes for 2013.

### 2013

- Q1** DTCC will implement service options for deposit services.  
DTCC will implement differential pricing and disincentive fees.  
DTCC will make non-transferable securities eligible for destruction at four years. Safekeeping will incur a surcharge.
- Q2** DTCC and industry partners will pursue DRS for restricted securities.  
DTCC and industry partners will pursue an imaging solution to terminate certificate handling at the client's office.
- Q3** DTCC and industry partners will develop a plan to implement DRS for restricted securities.  
DTCC and industry partners will begin onboarding for the e-Certificate program.
- Q4** DTCC will evaluate the impact of service modifications.

### 2014

- Q1** DTCC will identify potential changes to eligibility requirements. This includes determining the feasibility of no longer making non-FAST certificated securities eligible for DTCC.
- Q2** DTCC will implement an imaging solution to serve as a substitute for the physical transfer of a certificate.
- Q3** DTCC will evaluate the impact of the service modifications based on current volumes to determine their effectiveness.

### 2015

- Q1** DTCC will seek to make the FAST, e-Certificate and Paperless BEO programs the sole options for eligibility.

*These dates are meant to be a high-level guide and are subject to revision based on industry and regulatory feedback from all our key stakeholders.*

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## REQUEST FOR FEEDBACK

The drive to fully dematerialize U.S. financial markets has lagged behind the industry's overall modernization during this era of unprecedented economic and technological growth.

Just as U.S. Treasury securities have already achieved full dematerialization and commercial banks are accepting checks scanned in by their customers for deposit, we need to apply 21st-century ideas and practices to the task of fully eliminating physical certificates from the U.S. markets.

Working together as an industry, we can finalize the proposals outlined in this paper and take the remaining steps to achieve this important goal. DTCC hopes that this paper and the questions that follow will initiate a dialogue with industry partners to gain consensus on critical next steps.

## QUESTIONS FOR THE READER

### Executive Summary

- Should the industry approach the exchanges about removing the status “eligible but not participating in DRS”?
- Are firms continuing to promote DRS statements (in lieu of certificates) for clients who request withdrawals?
- Have firms been successful in educating clients about the benefits of holding assets in “street name”?

### Traditional Physical Transactions

- What are the implications, for clients and FAST agents, of sending deposits directly to FAST transfer agents?
- Will system modifications be required?
- How much value do clients derive from the BDS, RDS and Reorg Deposit Service? And should these services be consolidated?

### New Issues

- Do issuers or agents have ideas or concerns regarding the proposed e-Cert or Paperless BEO programs?

### Existing DTCC Vault Inventory

- Would reducing the time interval for destruction of non-transferable issues help clients?
- Would your firm support efforts to dematerialize restricted securities?
- Is the Non-Transferable program effective for making deliver orders?

## CONTACT DTCC

The deadline for input is Sept. 1, 2012.

Please direct all questions and comments to Jon Ciciola at 212.855.4628 or [jciciola@dtcc.com](mailto:jciciola@dtcc.com) or your Relationship Manager.

*This paper is only available in electronic format. To download it, visit [www.dtcc.com](http://www.dtcc.com).*