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# The Dematerialization of Stock Certificates in Japan

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In June of this year legislation was enacted to enable Japanese companies to do away with stock certificates. As a result, private companies have had the option to do this since October of this year, while all public companies will be obliged to do this on a date still to be determined by cabinet order but not later than June 2009. This report examines the impact this decision will have on all the parties involved, especially with regard to public companies.

## 1. The Reasons for the Decision

In June of this year the "Law for Partial Amendments to the 'Law Concerning Book-Entry Transfer of Corporate Bonds and Other Securities'" ("the Law") was enacted. As a result, private companies have had the option to do away with stock certificates since October of this year provided they follow a certain procedure, while all public companies will be obliged to do this on a date still to be determined by cabinet order (the "implementation date") but not later than June 2009.<sup>1</sup>

In Japan there is a long tradition that transactions involving different classes of securities are settled using different systems. Moreover, in many cases, settlement has required the delivery of actual certificates. In recent years, there have been a number of initiatives to remedy these inefficiencies and introduce a more efficient, transparent and consistent procedure governed by a single set of rules, and, at the same time, to make settlement more efficient and secure by doing away with actual certificates ("dematerialization"). Settlement of transactions involving commercial paper and Japanese government bonds has already been dematerialized, while settlement of transactions involving corporate bonds and beneficial rights in investment trusts is

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<sup>1</sup> In theory, even public companies have been able since October of this year to do away with stock certificates provided they follow the necessary procedure. If they did this before the implementation date, however, they would find themselves in violation of the listing rule of many Japanese stock exchanges that "companies must agree to allow their stock certificates to be processed by JASDEC." (This is because the existing system—the Custody & Book-Entry Transfer System—is predicated on the existence of stock certificates.) In practice, therefore, all public companies will automatically switch to the new system with effect from the implementation date.

due to be dematerialized in 2006.<sup>2</sup> The latest legislation marks the culmination of these initiatives in that, when it comes into full effect, settlement of all securities transactions in Japan will be dematerialized.

Inasmuch as stock certificates entitle their owners to more complex rights than, for example, bond certificates (such as the right to exercise some control over how a company is managed), they have been dematerialized in only a minority of countries (such as France), while in most (including countries, such as the United States and the United Kingdom, with major stock markets) stock certificates are still kept in depository centers (e.g., DTC in the United States) or held by shareholders themselves. The current initiative has therefore attracted considerable interest, marking, as it does, the most ambitious initiative to dematerialize stock certificates so far. The hope is to make Japan's stock markets more attractive by helping to make stock trading and record keeping more efficient and secure at a time when other major stock markets still rely on stock certificates.

## **2. Private Companies**

As has already been mentioned, private companies have had the option since October of this year to either continue to issue stock certificates or to do away with them.

If a company opts to do away with stock certificates, it must state this in its articles of incorporation. This involves calling a general meeting of shareholders to vote on such an amendment, establishing a two-week grace period in the run-up to the dematerialization deadline, publicizing the amendment in the way prescribed in the articles of incorporation and informing shareholders individually.

When the dematerialization deadline arrives, the stock certificates become null and void, and all the rights associated with the shares (e.g., shareholder rights and rights of pledge) are from then on governed by the details in the register of shareholders. When shares are exchanged, transfer of name is carried out at the joint request of the person whose name is recorded in the register of shareholders (the assignor) and the assignee.

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<sup>2</sup> Settlement of transactions involving Japanese government bonds has been done by electronic book-entry transfer since 27 January 2003 and that of transactions involving commercial paper since 31 March 2003. Settlement by electronic book-entry transfer of transactions involving subscription warrants and convertible bonds is due to begin on the implementation date.

Whether or not it will be to the advantage of a private company to do away with its stock certificates will depend on its particular circumstances. However, anyone planning to set up a company will save time and money by dispensing with stock certificates from the outset.

### **3. Public Companies**

As has already been mentioned, public (unlike private) companies will not have any choice in whether they do away with stock certificates: all public companies will be obliged to do this on a date still to be determined by cabinet order (the "implementation date") but not later than June 2009. This means that the new system will have a much bigger impact on public companies. The rest of this report outlines the new system as it will affect public companies and assesses the impact on the parties involved: investors (shareholders), issuers and anyone using shares in public companies as collateral.

#### **1) A comparison of the existing and new safe-keeping and record-keeping systems for shares in public companies**

Figure 1 compares the existing and new safe-keeping and record-keeping systems for shares in public companies.

Broadly speaking, there are currently two safe-keeping and record-keeping systems for shares in public companies. One system is for shareholders to keep their stock certificates themselves. The other (the Custody & Book-Entry Transfer System or JASDEC system) is for shareholders to deposit their stock certificates with an institution such as a securities company, which then re-deposits the certificates with the Japan Securities Depository Center (JASDEC) and maintains an account on the shareholders' behalf. It is up to shareholders which system they choose. If they choose the former system, their rights are governed by the details recorded by the issuer in the register of shareholders. If they choose the latter system, their rights are governed by the details recorded by the issuer in the register of beneficial shareholders on the basis of the details provided to it by JASDEC.<sup>3</sup> When the new system is introduced, however, shareholders' rights will be governed not by the details in either the register

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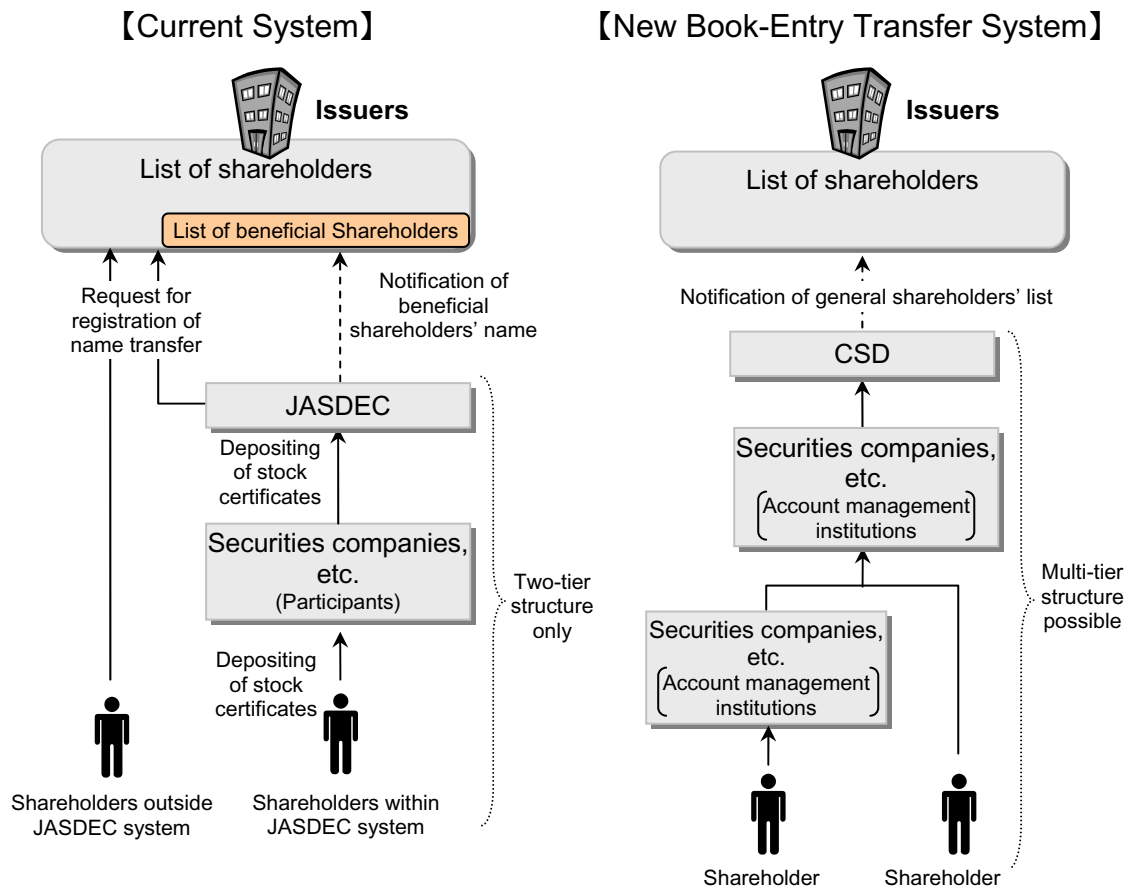
<sup>3</sup> The stock certificates deposited with securities companies and then re-deposited with JASDEC are registered in the name of JASDEC in an issuer's register of shareholders. The issuer is therefore initially unable to obtain the details of those of its shareholders whose stock certificates have been deposited in this way. In order to overcome this problem, JASDEC therefore informs issuers of the beneficial owners of these stock certificates, and issuers use this information to produce their register of beneficial shareholders, which, in turn, enables them to obtain the details of individual shareholders. Readers may be interested to know that, in Japan, the payment of dividends and exercise of voting rights are carried out directly between issuers and shareholders.

of shareholders or the register of beneficial shareholders but by the details recorded in a ledger of book-entry transfer accounts maintained electronically by the Central Securities Depository (CSD) and the securities companies or similar institutions operating under the Depository's supervision. As a result, all shareholders will have to have an account with a securities company or similar institution in order not to lose their rights. The hope is that a standard electronic system of safe keeping and record keeping will make settlement much more efficient and secure.

Dematerialization would produce major benefits for issuers as well as for the settlement of securities. For example, (1) issuers will no longer have to print stock certificates if they carry out a capital increase or stock split; (2) with no stock certificates to transfer, the procedure for stock splits, reverse splits and share-for-share transactions will be simpler; and (3) there will be no need to keep a register of beneficial shareholders as one set of records will cover all shareholders (see below for further details).

Finally, with the Custody & Book-Entry Transfer System, securities companies and other participants in the system with a JASDEC account have been responsible for their customers' stock certificates (in a two-tier structure). Once the new system is in operation, however, securities companies and similar institutions will be able to act as so-called "account management institutions" via other account management institutions that have an account with the Central Securities Depository (in a multi-tier structure).

**Figure1 Comparison of Existing and New Safe-Keeping and Record-Keeping Systems for Shares in Public Companies**



(Source) NICMR

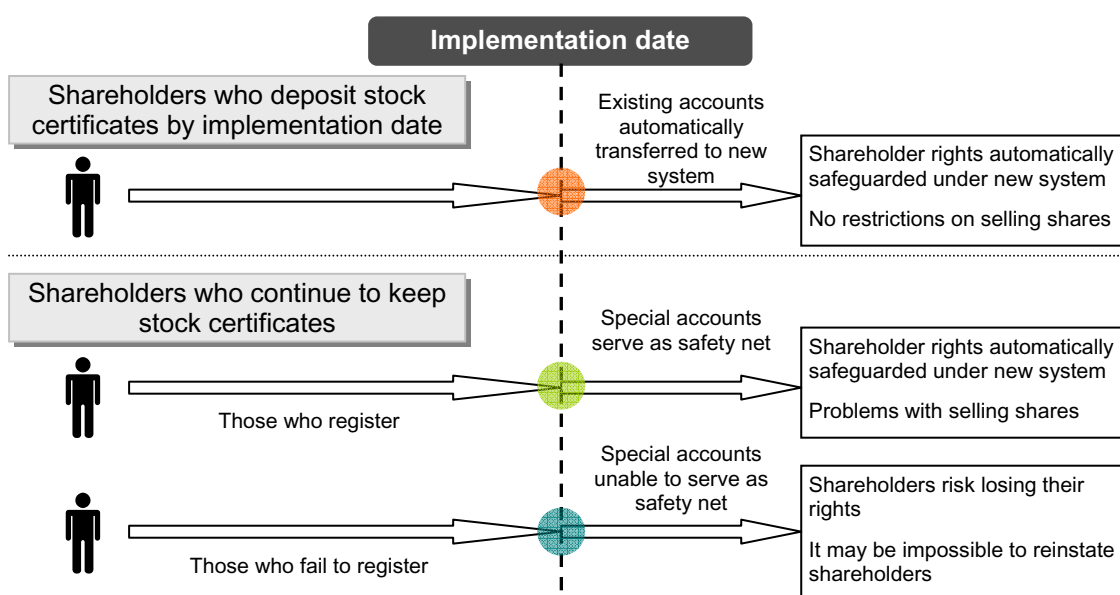
## 2) Impact on shareholders (investors)

To ensure that all public companies make the transition to dematerialization smoothly, shareholders will be encouraged to deposit their stock certificates with an institution participating in the JASDEC system by the implementation date and all the data currently recorded in JASDEC's ledger of customer accounts will be transferred automatically to the new system. On this basis, the impact of dematerialization on investors who currently hold their shares in a variety of forms will be as follows.

- (1) Investors who deposit their stock certificates with JASDEC before the implementation date by opening an account with a participating institution<sup>4</sup>

In the case of such shareholders, all the data currently recorded in JASDEC's ledger of customer accounts will be transferred automatically to the new system. As they themselves will not have to do anything in particular on the implementation date and will not be subject to any restrictions (e.g., on their rights as shareholders or on their ability to trade their shares), this is the simplest and most secure way for shareholders to deal with the transition. The hope is that most shareholders will decide to go down this route before the implementation date.

**Figure2 Impact of Dematerialization on Different Types of Shareholders**



(Source) NICMR

- (2) Investors who fail to open an account before the implementation date and hold onto their stock certificates

Shareholders who hold onto their stock certificates will not be able to make this automatic transition because they will not have opened an account via which their certificates can be deposited with JASDEC. In other words, no data on the shares will be recorded in the ledger of book-entry transfer accounts under the new system. Furthermore, after the implementation date any stock certificates still held by an investor will become null and void. Therefore, unless such an investor takes evasive action, he will automatically lose his rights as a shareholder. Provided they follow certain rules, the new system provides a safety net for investors who carelessly or

<sup>4</sup> Strictly speaking, the deadline for depositing stock certificates is the day before the fourteenth day before the implementation date.

intentionally do not go down route (1). This safety net takes the form of a system of so-called "special accounts."

(i) The "special accounts" system

A "special account" is an account which an issuer should open with any account management institution for a shareholder who holds onto his stock. In order to do this, the issuer uses the data in the register of shareholders. As can be seen in Figure 1, investors who keep their stock certificates themselves are usually registered with the issuer under their own names. On the implementation date the issuer checks its register of shareholders and identifies those shareholders who still have their own stock certificates. (Those shareholders who have already deposited their certificates are registered under the name JASDEC and are therefore not identified.) It then chooses any account management institution (e.g., a securities company or trust bank) it likes and opens an account in the name of each of the shareholders on its register. This means that any shareholders who hold onto their stock certificates will not normally lose their rights. Nevertheless, special accounts are not a panacea. As we shall see next, it is not always possible to open a special account, and, even when it is possible, many shareholders may not be satisfied with their limitations.

(ii) Cases where the safety net does not work

In (i) above an issuer identifies shareholders who still have their own stock certificates from the register of shareholders and opens an account on behalf of each of them. Normally, an investor who keeps his stock certificates himself will follow the established procedure to ensure that he is registered under his own name and does not lose his shareholder rights. However, some shareholders forget, while others choose not to do so. Issuers will not be able to open special accounts for such shareholders, and they (the shareholders) will automatically lose their rights on the implementation date. Although it is possible to restore a shareholder's rights in theory, the procedure is complicated and fraught with difficulty, and in some cases it may prove impossible in practice.<sup>5</sup> Investors who keep their stock certificates themselves should therefore ensure that their shares are at least registered correctly.

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<sup>5</sup> If a shareholder has failed to have his shares registered in his own name, they will probably be registered in the name of the previous shareholder. Therefore, when the changeover to the new system takes place, the issuer will automatically open a special account in the latter's name. In order to be reinstated as the rightful shareholder, the person with the stock certificates will have to either (1) declare jointly with the previous ("nominal") shareholder that he is the rightful shareholder or (2) attach a court decision (or similar document as stipulated by cabinet order) to his request for reinstatement. However, if the previous owner has already sold his shares to a third party who is unaware of the situation, the rightful shareholder will be unable to make good his claim to be reinstated.

### (iii) The other shortcomings of special accounts

Provided a shareholder who still keeps his stock certificates himself is registered correctly, the issuer will open a special account on his behalf and he will not lose his rights as a shareholder. However, these accounts exist solely for that purpose and do not offer anything like the full range of features offered by the securities accounts which shareholders themselves can open with securities companies and similar institutions. For example, a special account cannot be used to trade shares. If the owner of shares that have been deposited in a special account wants to sell them, he will have to open a normal securities account with a securities company or similar institution and transfer his shares from the special account to that account before he can sell them. He may therefore be restricted in his timing.

We also saw that that an issuer can open a special account with any account management institution it likes. This is a problem for shareholders because they cannot choose the institution. Furthermore, someone with shares in a number of companies may end up with special accounts with a different institution for each company. This will make it very inconvenient for him to keep track of his shares.

It should be clear from the above that the safety net provided by this system of special accounts is, from a shareholder's point of view, vastly inferior to the automatic data transfer that takes place if a shareholder opts to have his stock certificates deposited with JASDEC before the implementation date.

### (3) Changes to the way shareholders exercise rights

Dematerialization will not significantly alter the way in which shareholders exercise their rights or receive dividends. However, there will be a few minor changes to the way in which shareholders who satisfy certain criteria exercise a few particular rights such as the right to propose a motion at a general meeting of shareholders. Under the existing system, a shareholder who wishes to exercise such rights has first to apply to the issuer, which checks the applicant's status in its register of shareholders or beneficial shareholders. Under the new system, however, such a shareholder will have to apply to the Central Securities Depository instead. The Depository will then check the shareholder's current holdings in the ledger of book-entry transfer accounts and inform the issuer. Only then will the shareholder be able to exercise his rights.



### **3) Impact on issuers**

#### **(1) Benefits**

As was mentioned above, dematerialization will benefit issuers in many ways.

First, they will no longer have to issue new stock certificates and stamp them when they carry out capital increases or stock splits. Also, the procedures for stock splits, reverse splits and share-for-share transactions (increasingly common in mergers and acquisitions) can be simplified as there will no longer be any need to send out and collect stock certificates.

Second, dematerialization should considerably reduce the administrative burden and cost of keeping shareholder records. As Figure 1 illustrates, stock certificates are kept in one of two main ways, and issuers have to maintain two different registers accordingly (a "register of shareholders" and a "register of beneficial shareholders"). As this distinction will disappear when dematerialization is adopted, issuers will no longer have to maintain two different registers. Also, whereas issuers have traditionally had to record a transfer of name each time a shareholder requested this, the fact that under the new system they will only have to do this at certain times means that they may be able to reduce the fees they have to pay transfer agents for this service.

Third, dematerialization will enable issuers to keep more accurate records of their shareholders and to be more pro-active in how they do this. Traditionally, if an issuer has needed to find out something about a shareholder, it has had to check the information in one of two different ways, depending on how that shareholder is registered. If the shareholder keeps his stock certificates himself, the issuer can expect to find the information in its register of shareholders. While the register of shareholders should always be up to date as issuers have to record a transfer of name each time a shareholder requests this, it will not contain the latest information where a shareholder has failed to make such a request. Under this system, issuers have been unable to identify shareholders who have either forgotten to register or have, for one reason or another (e.g., because they are about to make an impending hostile takeover bid), chosen not to do so. If, on the other hand, a shareholder has deposited his stock certificates with an institution such as a securities company (under the Custody & Book-Entry Transfer System), the issuer should be able to find the information in its register of beneficial shareholders. As shareholders have to open a securities account in order to use the Custody & Book-Entry Transfer System, the securities company or other institution involved will have required them to prove their identity when they opened their account, so an issuer's register of beneficial shareholders should contain

the correct details of all its shareholders.<sup>6</sup> However, issuers are only able to transfer shareholders' names when they receive an update from JASDEC, which only happens at regular intervals. Between updates, their register of beneficial shareholders will not reflect any changes that have taken place in the meantime. Therefore, for much of the time, issuers do not have access to the latest information on their shareholders. Both of the existing systems therefore have shortcomings. The new system is an attempt to remedy these. First, by requiring all shareholders to open securities accounts deposit their stock certificates with a securities company or similar institution, it will ensure that issuers normally have access to the details of all their shareholders.<sup>7</sup> Second, in addition to ensuring that the Central Securities Depository notifies issuers of their list of general shareholders at regular intervals (similar to the existing system of updates from JASDEC), issuers will be able to request updates from the Depository. Under the Law, issuers will be allowed to do this, albeit at their own expense, whenever they have a "valid reason." However, as the details (e.g., of what will constitute a valid reason, what exactly the fee for requesting an update should be, how often issuers should be allowed to do this, and how much time the Central Securities Depository should be given to provide the information) have still to be decided, it remains to be seen how useful the system will be. Nevertheless, if it gives issuers greater flexibility (e.g., in administering shareholders' perquisites or in responding to rumors of takeover bids by checking their latest list of shareholders), it should fully justify its existence.

## (2) Costs

We have seen some of the major benefits that should accrue to issuers from dematerialization. However, there will also be some costs—particularly in relation to special accounts, as we saw in 2) above ("Impact on shareholders (investors)"). Issuers will be required to set up these accounts so that any shareholders who continue to keep their own stock certificates even after the implementation date do not lose out as a result of the new system. Although nothing has been finally decided, it looks as if issuers will have to bear the cost of setting up and maintaining these accounts. In addition, they face the prospect of having to deal with enquiries from the shareholders on whose behalf they have set up these accounts as well as from those who are confused by the change.

In order to minimize this financial and administrative burden as well as to ensure that their shareholders are not disadvantaged, issuers would be well advised to make the most of general meetings of shareholders and investor relations to ensure that their shareholders are fully informed not only about dematerialization but also the need to register their shares and deposit their stock certificates before the implementation date.

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<sup>6</sup> In cases where an investment has been made using a trust account, the register of beneficial shareholders will contain only the name of the trust account—not that of the actual owner of the shares.

<sup>7</sup> However, shares held in a trust account will be registered in the name of the trust account—as under the current system.

#### 4) Impact on pledgees and pledgors

##### (1) The nature of the problem

The ease with which shareholders can realize the value of their shares or transfer their ownership has made shares eminently suited for use as collateral in financial transactions. In most cases, the pledgor (the shareholder) deposits his stock certificates with the pledgee (the creditor), who then has the right of possession and control over the shares (but shareholder's rights still remain with the pledgor unless he violates conditions in the contract). With the advent of dematerialization, however, stock certificates cease to have any legal value, and shareholders lose their right of pledge. Nor will it any longer be physically possible for someone to acquire shares as collateral by taking possession of stock certificates.

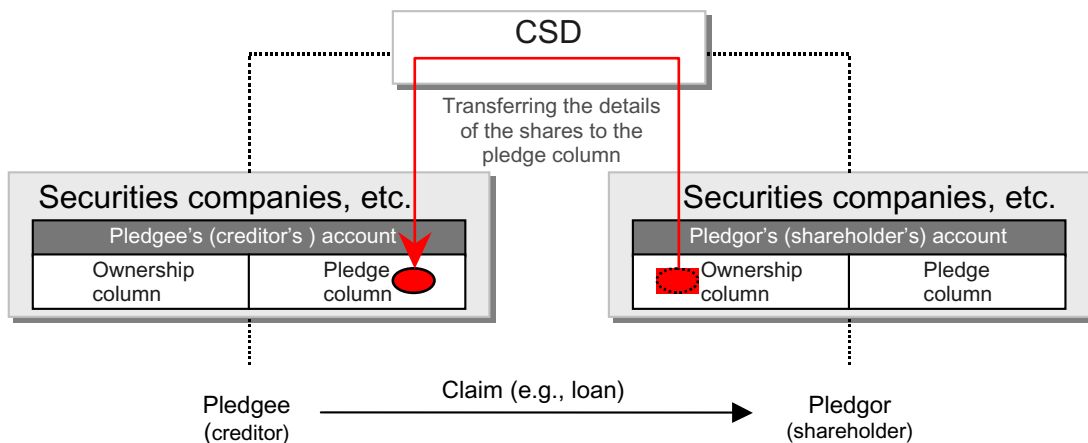
##### (2) Method of acquiring shares as collateral after the implementation date

After the implementation date, the only way to acquire shares as collateral will be via the Book-Entry Transfer System. Figure 3 illustrates how a shareholder would pledge his shares as collateral (e.g., for a loan). Under the new system, the fact that stock certificates will cease to exist means that shareholders will no longer be able to pledge them as collateral. However, provided pledgors (shareholders) have followed the correct procedure by the implementation date, they should have their own securities account with a securities company or similar institution, and the same details that used to be recorded when they held their shares in the form of stock certificates will now be recorded as an electronic data entry. If a shareholder wishes to pledge his shares, all the pledgee needs to do is to open an account with a securities company or similar institution and to have the details of the shares recorded in the ownership column in the pledgor's account transferred to the pledge column in the pledgee's account.<sup>8</sup> This way, the Central Securities Depository will inform the issuer that there has been no transfer of ownership even though the shares are entered in the pledgee's account.

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<sup>8</sup> If both parties agree, it is also possible to acquire shares as collateral by transferring the details of the shares recorded in the ownership column in the pledgor's account to the ownership column in the pledgee's account ("transferred collateral").

**Figure3 Procedure for Acquiring Shares as Collateral under the New System**



(Source) NICMR

### (3) Transitional arrangements

Under the existing Custody & Book-Entry Transfer System there is an arrangement for dealing with the widely used system of pledging shares on the basis of possession of stock certificates in the run-up to dematerialization: the "pledge account."

This is an account which can be set up within an existing securities account (opened by a pledgor with a securities company or similar institution) to manage the right of pledging the shares held in the existing account. By first depositing in his securities account stock certificates hitherto deposited as collateral, then setting up within that account a pledge account with the creditor as the pledgee and finally transferring the shares to the pledge account, a shareholder can use book-entry transfer to pledge shares as collateral even under the existing system. Shares pledged in this way will be covered by the new system with no effect on the right of pledge—in the same way as stock certificates deposited by an investor with a securities company or similar institution will be transferred automatically to the new system.

However, this pledge account system is not without its shortcomings. First, although the Custody & Book-Entry Transfer System has provisions for regulating such accounts, it would seem that the back offices of many prospective account management institutions are not yet able to offer such accounts. This is because possession of stock certificates has been the simplest and most secure way of pledging shares as collateral, and there has been little need to use book-entry transfer for this purpose. Second, under the existing provisions for these accounts, it is not sufficient for the pledgee (creditor) to agree to accept the shares as collateral: the pledgor (shareholder) must also agree to use book-entry transfer. This need for both parties to give their separate assent is likely to make the process time-consuming.

The transitional arrangements for pledging shares will probably depend very much on the discussions that take place between now and the implementation date. Once these have taken place and securities companies and banks are in a position to cope with pledge accounts, the changeover can go ahead.

#### **4. Conclusion**

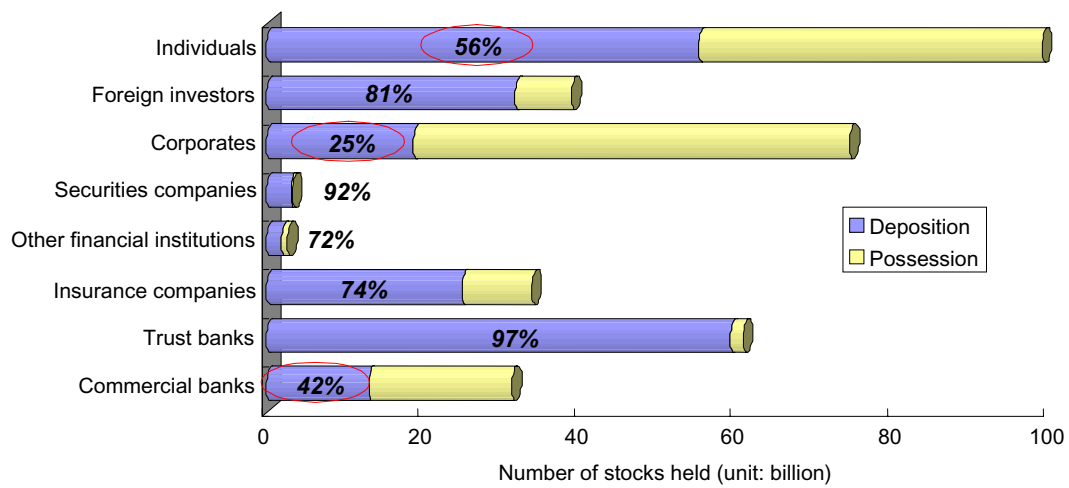
As we have seen, the impact of dematerialization is likely to be felt particularly by public companies. The benefits (e.g., in terms of quicker and more secure settlement, and more efficient shareholder record keeping) are likely to be considerable, and all those involved with the legislation should be congratulated for their initiative. Nevertheless, the Law as passed in June represents only the bare bones of the new system, and many practical details (not least those concerning the use of shares as collateral) must still be fleshed out before the system comes into effect. In addition, it remains to be seen what the best system environment would be and what dematerialization will cost. Hopefully, the discussions that are due to take place in the coming months and years will be productive, and steady progress will be made towards implementing the new system.

Finally, we need to remember just how attached many Japanese investors are to their stock certificates and bear in mind that this could prove problematic during the transition to dematerialization. As can be seen from Figure 4, which shows what percentage of different categories of investors hold their stock certificates themselves and what percentage have deposited them with securities companies or similar institutions, a significant percentage of individuals, nonfinancial corporations and banks have still not deposited their stock certificates with JASDEC. Many older investors, in particular, have a strong physical attachment to their stock certificates and are likely to be reluctant to accept the new system.<sup>9</sup> As we have already pointed out, however, investors need to deposit their stock certificates (including those pledged as collateral) with a securities company or similar institution before the implementation date if the transition to the new system is to go smoothly. It is therefore vital that the government, the financial industry, and business in general do all they can to make such investors and shareholders aware of the new system and the need to deposit their stock certificates as soon as possible.

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<sup>9</sup> The attachment of (especially older) individual investors in Japan to their stock certificates is indicated by the term *tansu-kabuken* (literally "stock certificates kept in one's drawer"), which refers to certificates kept by shareholders at home.

**Figure4 Percentage of Shareholders in Possession of Stock Certificates**



(Source) JASDEC