*Following is an unpublished essay written by Susanne Trimbath in the 1990s for an audience of broker-dealers. It describes industry efforts to create a system that would allow issuers and shareholders to maintain a relationship while providing investors access to capital market liquidity. In the essay, Dr. Trimbath describes some issues that remain important today: stock lending from customer accounts and inhibited shareholder communication for proxy voting.*

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# Direct Registration for the 90's

By Susanne Trimbath

Since 1970, the financial services industry has flirted with individual bookentry ownership for corporate securities. The latest proposal, staunchly supported by the Securities Transfer Association, Inc. (STA) is known as Individual Registration Option (IRO). IRO would let shareholders have bookentry accounts on the books of issuers. The advantage of bookentry is that the shareholder will not have to keep certificates in safe deposit boxes if they want their names on the issuer's books. There aren't many disadvantages, at least not for long-term shareholders. The disadvantages accrue to the broker/dealer segment of the industry. Once a shareholder (read "broker's customer") is on the books of an IRO company, the broker pretty much loses that customer: no more custody or account maintenance fees, no more commissions.

Brokers and depositories have fought the idea of direct registration on the grounds that any shareholder in the program would have limited access to the securities market. They argue that the best way for individuals to have free access to the securities market is to leave their shares with the brokers, who in turn deposit those shares with depositories. This leaves a trail of custody fees, most of which are ultimately born by the shareholder. It also leaves a wall of nominee names separating shareholders and issuers.

The insertion of nominee names between corporations and shareholders is a favorite industry topic. Each time a new Shareholder Communications Act is passed or proposed, a new system for direct individual bookentry registration comes to the table.

Back in 1971 the Banking and Securities Industry Committee (BASIC) argued against the Transfer Agent Depository (TAD), that year's direct registration scheme, while creating the national depository system that gave the Depository Trust Company to the industry. TAD is the earliest known reference to direct registration. Since then the idea has surfaced no less than five times. In 1986, the program was called "Direct Registration System." In 1988 it was referred to as "Morgan's new Shareholder Plus program."

TAD became DRS then IRO and gained momentum in 1990 when the Group of Thirty began discussions about eliminating certificates by forcing every shareholder to leave its shares with brokers for a more effective settlement system. Some saw this as the only way to get to T+3.

Transfer agents, who make a living out of issuing certificates and maintaining shareholder records, saw their fee-based revenue diminish with the advent of the depositories 20 years earlier. They took specific issue with the elimination of certificates. They used this one aspect of the Group of Thirty discourse to provoke the hottest debate yet on direct registration.

The agents led a very organized effort in 1991 to exert pressure on legislators and regulators. With the support of various transfer software and system vendors, plus the National Association of Individual Investors, they stirred up and organized individual investors with talk of institutional ownership taking over American corporations, of small investors being pushed out of the market for high priced brokerage services, of shady brokers making off with securities left in their custody. They distributed form letters to be sent to Congress, the Securities and Exchange Commission and the Group of Thirty members. They accused the brokerage sector of profiting from stock lending based on customer accounts, inhibiting shareholder communications and overcharging for services.

The STA, along with the Corporate Transfer Agents Association, are now supporting the IRO Implementation Committee. In its current incarnation as IRO, the operative word in these days of Group of Thirty, immobilization and bookentry-only securities is *Option*. While they don't deny the investor the right to hold a piece of paper evidencing their right to ownership, they are making it more difficult to get stock certificates. IRO does not permit financial intermediaries to request certificates on behalf of investors. The investor will get only a transaction advice at first, regardless of how the transfer is requested. The individual must then call or write to the agent to get a certificate.

Americans may have rejected the cashless society but American investors are flocking to bookentry ownership for registered securities. Some corporations already have enhanced dividend reinvestment programs with optional cash purchases. These enhanced dividend programs are the template for IRO. When articles appeared in a few investment newsletters mentioning the companies that have cash options in their dividend programs (like Texaco, Chevron and Union Electric) individual investors signed up by the thousands. One company mentioned in an article received tens of thousands of requests for information. A high percentage of those applications came back with checks attached. No certificates were issued to these new shareholders. Bookentry accounts were opened and transaction statements were mailed. Another company received so may calls for information that they had to set up a voice mail recorder to take the names and addresses.

The brokers and depositories didn't think it would happen. They had been hearing this idea in various forms for 20 years. They didn't think that the transfer agent industry would be able to organize anything on such a grand scale. They still don't think that individual investors will be interested. But IRO is coming; in fact, it is already here in some hybrid forms.

When direct registration was proposed before IRO, its major stumbling block was how to get the bookentry customer's shares from the issuer to the broker in order to make trade settlement. There was no equivalent to a bookentry signature guarantee. So the only solution seemed to be to deliver certificates to the shareholder for delivery to the broker for delivery to the depository (who would send them back to the transfer agent for re-registration into a nominee name). There didn't seem to be a way to do all that and still make a settlement deadline.

The same line of reasoning was used in 1990 to say that IRO would never work. But this time the agents and issuers were ready. They would sell the customers shares upon request, eliminating the need for investors to go to brokers for that transaction. The issuers could do this at a massively discounted commission. By combining many shareholders' sell orders into one transaction, the portion of the commission born by any individual investor would be very small.

By not cooperating to find an automated solution to the sell side of individual bookentry ownership, the brokerage sector, in essence, cut themselves out of the loop. The cumbersome method of moving stock certificates to sell shares through a broker will still be available. But with the issuer offering a sell feature in IRO at little or no cost to the shareholder, few investors will take that route no matter how loyal they are to their broker. T+3 and other settlement questions are no longer relevant. Individual investors are directly registered on the issuer's books. All trades are settled through the program's trustee, usually a bank with a broker/dealer arm. Dividend payments and proxy cards go directly to shareholders.

Right now it would be impossible to spell out a specific scenario for how an IRO program works. None of the enhanced dividend reinvestment programs available today actually claim to be IRO. Confirmed rumors are that IBM, Exxon, Houston Industries and Ohio Edison will be among the first to offer IRO programs in 1993. All are said to be preparing their filings for the SEC. Although each company is expected to tailor its program, some of the most common features are:

- The issuer stops printing new certificates and starts sending transaction advices for bookentry shareholder accounts.
- Shareholders can make optional cash purchases of shares directly through the issuer with little or no commission fees, including buying their first share.
- IRO members can sell all or some of their shares through the issuer at a minimal cost (e.g., $5.00 per transaction).
- IRO members can elect to receive all or some of their dividends in cash or to have them reinvested.

- Account statements will be sent out for each transaction but no less than once each year.
- Buy and sell orders will be executed no less frequently than once every 5 business days.

So IRO is here, accepted by investors and workable. The first question you'll be asking yourself is: How will it affect my business? To answer that you need to look at your customer base. What type of investor do you service? Institutional investors are unlikely to be affected by IRO. You also need to look more closely than just that your customers are individual investors. IRO is not right for every investor. There are basically three types of individual investors:

1. Intermediate traders who play market prices for gain;
2. Passive investors (e.g., whose initial stockholdings came from inheritance) who are not interested in increasing their position; and
3. Long-term investors.

The first two types are not likely to be interested in IRO.

IRO, as it is proposed does not offer immediate buy and sell capabilities. The Securities and Exchange Commission is considering issuing no-action letters for IRO programs with a minimum buy/sell frequency of 5 days. For the intermediate trader, a lot can happen to the price of a share in 5 days. Direct access to the market is a better option than IRO. That level of access is possible only with a nominee account held by a brokerage firm.

Passive investors tend to own few shares. Issuers are more likely to target them for buy-back program than for an IRO program with a buy/sell feature. IRO programs will allow investors to buy shares through the issuer at little or no commission: passive investors don't buy additional shares.

IRO offers clear advantages to the long-term investor. They are most likely to be targeted by issuers who offer IRO. Therefore, your customer base will be most affected if your firm caters to this type of investor. Long-term investors take advantage of share price averaging by making frequent, small purchases. They are put off by rising commission and account maintenance fees at brokerage firms, making them ripe candidates for IRO programs. A retail brokerage firm interested in retaining these clients in the face of RO will have to look seriously at their fee structure.

IRO may put your clients at more risk than they realize. The greatest danger is that an individual will invest too much money in an inappropriate security: "Putting all of your eggs in one basket." IRO is great for active, informed investors, those who like to watch Financial News Network. IRO investment decision must be made without the benefit of a financial professional. Securities law prohibits solicitation by issuers. Their literature will be geared to inform even though that information can be persuasive.

Any financial services firm that intends to maintain or develop a product line of services for individual investors needs to be aware of and prepared for the advent of IRO. By evaluating your client base and reviewing your service/fee structure, you can protect your customer base from the potential drain of IRO.

For those firms that handle open market trades for issuers in connection with dividend reinvestment programs, IRO offers new opportunities. In addition to the dividend money now being invested into shares, there will be a new inflow of cash from optional cash purchases. This means executing trades more often and in bigger lots.