

# 2007 la<sup>k</sup>kyara

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**Preventing a panic  
when paper shares are abolished**



An agreement has been reached to scrap certificated, or paper, shares by January 2009. However, extensive advance preparations will be needed in 2007 to avoid confusion during the switchover.

### Paper shares to be abolished in January 2009

In preparation for the upcoming shift to the exclusive use of uncertificated, or electronic, shares, securities companies have recently sponsored numerous TV commercials and newspaper advertisements encouraging investors to tender their paper shares or deposit them with the Japan Securities Depository Center (JSDC).

The conversion of all paper shares to electronic form was mandated by the Stock Settlement Streamlining Law,<sup>1)</sup> enacted in June 2004, which mandated a transition within five years. In other words, the switch must be made no later than June 2009. The industry has set a target date of January 2009.

Since the passage of this law, stock issuers, securities companies, financial institutions, and the JSDC have made significant progress in preparing for the transition, but a number of issues remain. Most concern the specific procedures to be followed by securities companies, banks, and issuers. Now it is up to the involved entities to quietly iron out their differences and reach agreement. A number of other issues must also be dealt if the transition to the new system is to be a smooth one. This report focuses on these issues, which, if handled improperly, could lead to economic turmoil.

### Many paper shares are not registered to current owner

One issue is that of the shares that owners have kept under the mattress, so to speak.<sup>2)</sup> The conversion to electronic shares may cause problems for those holding certificated shares registered in the name of someone else.

As noted above, securities companies have encouraged investors to deposit their paper shares. But some have held onto their stock certificates because they prefer not to do business with a brokerage or wish to avoid the costs that would entail. There are limits to what can be accomplished by such efforts, and we think a certain number of shares are likely to remain locked away even after the conversion of to electronic shares.

But it is essential that the owners have the shares reregistered in their own names before the changeover. If they do not, the shares will be placed in special accounts created by the issuing companies especially for this purpose. These accounts will be established in the name of the individual to which the shares were registered at the time of the changeover, and rights attaching to the shares will reside in this account. If the shares are not registered to the current owner, the account will be set up in the name of someone else. In other words, all rights will pass to the individual in whose name the shares are registered regardless of who has physical possession of the actual certificates.<sup>3)</sup>

If the person whose name is on the special account sells the shares to someone else, the actual shareholder may be unable to reacquire them. Therefore, even shareholders who have no intention of depositing their shares with a brokerage must at the very least have the shares reregistered under their own names. Because investors unaware of the new system stand to incur substantial economic losses, extensive efforts are needed to inform and educate individual investors using a variety of media.

### Treatment of fractional shares

Japan's system of fractional shares<sup>4)</sup> was abolished in 2005 with the revised Company Law. All shares now fall

under the minimum trading lot system. However, fractional shares that existed before the new Company Law took effect were grandfathered in, and as a result many companies still have such shares outstanding.

Fractional shares will no longer exist under the new system, and therefore must be dealt with before the changeover. One way to do so would be to conduct a reverse stock split on the day of the changeover. For example, a company with fractional shares worth one 1/100<sup>th</sup> of a current share might conduct a 1-for-100 reverse split to make these shares whole. It might also alter the minimum trading lot. About 150 listed companies still have fractional shares, with significant variances in the number of shares and shareholders. If all of these companies were to conduct reverse splits on the day of the changeover, it could easily cause turmoil in the market. A change in the minimum trading lot, for example, could result in erroneous orders. In reality, we expect companies with relatively few fractional shareholders to issue requests to acquire the shares or employ some other means to eliminate the shares before the transition to the new system. Companies with many fractional shareholders, on the other hand, may opt for a reverse share split. In any case, securities companies and asset management firms will need to carry out review to gauge the potential impact in the event that many companies (eg, several dozens) decided to carry out reverse splits on the same day.

### Systems upgrades at securities companies

After the conversion of paper shares to electronic form, securities companies and financial institutions participating in the central depository system will need to set up systems to connect to the depository institution charged with managing all shares. The JSDC, viewed as the mostly likely candidate for this role, last year published a set of connection specifications. Based on these standards, securities companies and the computing firms that will oversee the actual design and operation of these systems are now engaged in design and development work.

At the end of last year the Japan Securities Dealers

Association (JSDA) conducted a survey of member firms to determine progress in achieving systems compliance. The Association found that fully 80% of securities companies (based on valid responses) were behind in their preparations based on a standard schedule envisioned by the JSDA. The Association hopes to shorten the necessary timeframe by asking the Japan Securities Depository Center to help in providing materials that will enable companies to design more accurate systems faster. It should be noted, however, that the 80% figure includes some brokerages that have yet to decide on their basic approach—ie, whether they will create a new system from scratch or upgrade existing systems.<sup>5)</sup> Providing support for the firms lagging farthest behind is an urgent issue, in our view.

2008 is the final year before the changeover, and securities companies will be busy readying system connections and engaging in other preparations. The JSDC plans to begin testing system connections in March next year. Effectively, therefore, brokerages have only one more year in which to develop the necessary systems. And from a practical standpoint, we think that from 2008—and particularly from mid-2008—onward, securities companies and trust banks will be too busy with transitional preparations to assign many staff to accepting share certificates or transferring share registrations. To avoid a surge of requests for share deposits or reregistrations in 2008, we think brokerages will need to undertake substantial efforts in 2007 to ensure that individual investors fully understand the new system.

In our view, their efforts in 2007 hold the key to a successful, confusion-free changeover to electronic shares, which would represent the final touch on the reforms to Japan's securities settlement system.



Note

- 1) The official name is the Law for the Partial Revision of the Law Concerning Transfers of Corporate Bonds and Other Financial Instruments to Streamline the Settlement of Stock Transactions.
- 2) According to a study conducted by the Reform Promotion Center for Securities Clearing and Settlement System and the JSDC, there were 18.8 billion such shares extant at end-March 2006, representing about 19% of all shares held by individuals.
- 3) Procedures for transferring shares into one's own account have been set up in anticipation of this scenario.
- 4) Japan also has odd-lot shares. (If the minimum trading unit for a stock is 100 shares, any number of shares from 1 to 99 is considered an odd lot.)
- 5) Most securities firms have hired outside companies to develop these systems, but some have yet to settle on a course of action because of a change in policy at the computing firm or other reasons.

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