Shaping the Future of Capital Markets - Blockchain finance Israel, January 2022

Focal theme for the Hackathon: Ownership of Securities and Government Debt.

Current practice

Shareholders have rights

When you invest in a company by buying its shares, you get two main rights:

- You can vote
- You receive dividends, which are the company's net earnings

You can also lend to a company, which is called a debt instrument. You then receive interest payments.

When a company exercises the rights of shareholders, it needs a "golden record" of ownership.

Who are the current shareholders ?

The Central securities depository (CSD) holds the physical deposit[1] of securities, it's the top tier holder of security. However the "Golden Record" is kept by various intermediaries involved in the settlement process. This is an outcome of the historical indirect holding systems[1]. There's a constant need to update each individual database, by communicating with the other institutions involved, at the different levels of post-trading, in order to be able to reflect the changes in each other's records.

In many jurisdictions, the beneficial owner is not the legal owner of the securities, but rather the intermediary on the top tier ownership chain (CSD), considered the formal legal share owner. **As an outcome, the exercise of shareholder rights is complex and requires the involvement of many intermediaries, regularly resulting in inefficiencies, mistakes and costly court cases.**

As the top tier holder of security, the **CSDs provide ongoing exercise of shareholder rights, including payment such as dividend distributions and interest payments, and allocation of voting rights. The CSDs provide custodian services at the top of the custody chain. This means that they manage the balances and movements in the securities accounts of the various**

[1] There are differences in this aspect between jurisdictions depending on the local legal framework.

clearing members who, in turn, render additional services to the customers and brokers on behalf of whom they hold the securities in the CSDs.

Note that custodian services are rendered and facilitated by CSDs through registration agents, clearing members and public corporate services companies.

In Israel, corporate law recognizes the direct ownership of the end investor, but the ownership of the investors is determined by the internal ledger of the broker (member of the stock exchange) who holds securities on behalf of its clients in an omnibus account held in one tier above in the chain of ownership (member of the clearing house). For more information on securities clearing and settlement in Israel see Part E of The Committee for Promoting and Institutionalizing Digital Markets in Israel Report.

In exercise of voting rights - Generally, a clearing house will execute a global proxy that allows its account holders (other custodians such banks and brokers) to cast their votes in proportion to their total allocation. The custodians may then do the same thing for individual clients (moving down through the layers as necessary) and fragment these proxy rights even further. Having been granted this proxy, the beneficial holders can then use their votes as (and if) they wish, which triggers a process, at the end of which the voting results are sent to the firm.

This is not an instantaneous process, and the need to gather and transmit information back and forth between multiple parties presents a fundamental timing concern: how to assign and freeze voting rights in an ever-churning river of stock trades. In the time that it takes to send information and collect responses, the pool of beneficial owners can change significantly, and the process would need to begin anew.

Corporate laws finesse this problem by establishing a bright-line “record date” when franchise rights attach to current owners—even if these owners choose to sell their shares before the date of the actual vote. This gives the firm time to distribute information and process the votes, even as it weakens the incentives of some ex-shareholders which no longer own the shares to participate . A record date could be set 30 days before its annual shareholder meeting. If so, an investor who buys stock after this T-30 date cannot normally vote the late-purchased stock.

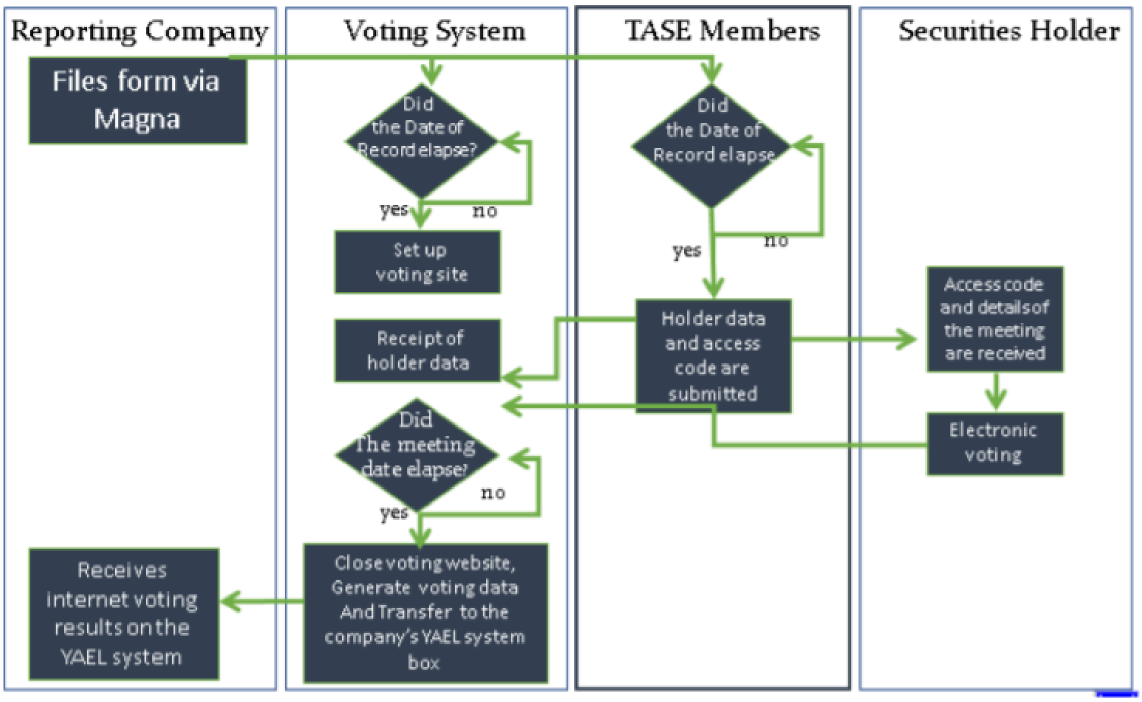
The same “snapshot” approach is taken with dividends, Interests or principal distributions: shareholders on the record date will eventually receive the payments, and the shares trade “ex-dividend” sometimes long before any checks are cut.

Delays between the vesting of voting rights (on the record date) and the time of the actual vote (at the shareholder meeting) can create more serious concerns which are elaborated further in the suggested reading.

The ISA's Internet Voting System

In Israel the ISA has developed an information system that enables investors to vote online at company meetings in which they are eligible to vote. This system encourages shareholders, bondholders, owners of option warrants and participation units to exercise their voting rights in meetings and increase their involvement in the decision making process.

Main Voting System Procedures – Flow Chart



Begin of Process : Magna file: Immediate Report of Meeting - link

End of Process : Voting result report which is sent to the company by Yael system - Link

The Internet Voting System is a convenient, user-friendly, easily accessible channel that can be used around the clock. One of the main advantages of this channel is that the securities owner is not required to obtain or submit any proof of ownership obtained from a TASE member, because the system confirms ownership automatically.

As part of the Internet Voting System, the ISA launched the Yael system — a secure email system for ISA communications with companies and their authorized representatives. Authorized parties are given access to an Internet site (using a digital certificate issued by an official agency) where they can retrieve their correspondence with the ISA.The Yael system is the infrastructure through .which voting results are transmitted to the companies in the most secure manner

The trigger which starts the voting process is an Immediate Report of Meeting - link.
The report includes the "determining date for entitlement to participate and vote in the meeting". In the end to the nominated date, each TASE member edit by his own system and process an up to date Captable and report it (XML) and send it to the Internet Voting System.

Can Blockchain improve the tracking of ownership of securities?

As described below, current systems for tracking securities ownership rely on highly intermediated "pass-it-along" architectures, which cause inefficiencies, the costs of which are borne by the shareholders themselves and raise questions in the context of collateralization. This theme examines whether increasing share ownership transparency" blockchain has the capacity to streamline the entire share ownership architecture.

Suggested reading:

- For a historical description, see: "Blockchain and Public Companies: A Revolution in Share Ownership Transparency, Proxy-Voting and Corporate Governance?" Stanford Journal of Blockchain Law & Policy 2019 University of Hong Kong Faculty of Law Research Paper No. 2019/039.
- About the ISA Internet Voting System and the Yael System - **link**
- Rules for Accessing and Registering in the ISA e-voting system by TASE Members August 2020 - **link**
- GEIS, George S. Traceable Shares and Corporate Law. Nw. UL Rev., 2018, 113: 227.
- FOX, Merritt B., et al. Distributed Ledger Technology and the Securities Markets of the Future: A Stakeholder Survey. Colum. Bus. L. Rev., 2021, 2021: 651.
- PINNA, Andrea; RUTTENBERG, Wiebe. Distributed ledger technologies in securities post-trading revolution or evolution?. ECB Occasional Paper, 2016, 172.
- VAN DER ELST, Christoph; LAFARRE, Anne. Shareholder Voice in Complex Intermediated Proxy Systems: Blockchain Technology as a Solution?. The Stanford Journal of Blockchain Law and Policy, 2021, 4.1: 29-52.
- VAN DER ELST, Christoph; LAFARRE, Anne. Blockchain and smart contracting for the shareholder community. European Business Organization Law Review, 2019, 20.1: 111-137.