

## LEGISLATIVE COUNCIL PANEL ON FINANCIAL AFFAIRS

### CONSULTATION CONCLUSIONS ON A PROPOSED OPERATIONAL MODEL FOR IMPLEMENTING A SCRIPLESS SECURITIES MARKET

#### **Purpose**

In February 2010<sup>1</sup>, Members were informed that a working group (Working Group) comprising representatives from the Securities and Futures Commission (SFC), Hong Kong Exchanges and Clearing Limited and the Federation of Share Registrars Limited had jointly issued a consultation paper in December 2009, seeking views on a proposed operational model for implementing a scripless securities market in Hong Kong (Consultation Paper). The consultation ended on 31 March 2010 and a joint conclusions paper (Conclusions Paper) was issued on 21 September 2010. This paper updates Members on the conclusions and the next steps for taking the scripless initiative forward.

#### **Background**

2. The Working Group received a total of 44 responses to the Consultation Paper. The feedback was fairly representative as respondents included banks, brokers, individual investors, law firms, listed companies, share registrars and professional bodies. The Working Group also met with different market participants both before and after issuing the Consultation Paper to explain and exchange views on specific aspects of the proposal and to better understand and address market concerns.

3. The majority of respondents supported the scripless initiative in general, although many also had comments, suggestions and questions on some aspects of the proposed model. In view of the generally positive feedback from the market, the Working Group has decided to proceed with the operational model as proposed in the Consultation Paper, with a few adjustments to address some of the concerns raised during the consultation. The final model is summarised in the Conclusions Paper, a copy of which is

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<sup>1</sup> A discussion paper dated January 2010 (Ref: CB(1)978/09-10(05)) was prepared for the meeting of the Legislative Council Panel on Financial Affairs in February 2010. Among other things, the paper summarised the benefits of implementing a scripless securities market and the key aspects of a proposed operational model that was put out for consultation from 30 December 2009 to 31 March 2010.

attached at the **Annex** for ready reference.

4. The paragraphs below highlight some of the more significant aspects of the operational model that will be implemented, as well as some of the key concerns raised in the consultation exercise and how these will be addressed.

### **Key features of the operational model**

#### *Dual system and full dematerialisation*

5. The scripless initiative will be implemented gradually and there will be a transitional period during which a dual system will operate, i.e. during which the existing paper-based system will continue to operate in parallel with the proposed scripless system. During this transitional period, investors will be able to choose whether to hold their securities in paper form or scripless form. They will also be able to convert their holdings from one form to the other at any time. The duration of the transitional period will not be specified at the outset. Instead, the timeline for full dematerialisation will be kept open and full scripless would be implemented only when there is general market readiness, which will be gauged through regular reviews and discussions with market participants.

6. Most respondents supported this proposal. Many also acknowledged the strong demand from certain investors to retain a paper option. Some respondents such as intermediaries who disagreed were mainly concerned about the costs of maintaining two systems. The Working Group acknowledges the cost implications, but notes that this is only an interim measure as full dematerialisation remains the ultimate goal. Moreover, cost concerns need to be balanced against investors' demand for a paper option, and the general readiness of the market to proceed to full dematerialisation.

7. Some respondents objected to implementing full dematerialisation at all and felt the paper option should be retained indefinitely as it would be cheaper and more convenient. Some respondents were also concerned that they might not be able to adapt to the scripless environment as they were unfamiliar with using computers and the internet. To address these concerns, the Working Group will conduct appropriate investor education programmes to help investors familiarise with the scripless environment and better appreciate the benefits it can bring.

### Removal of the immediate credit arrangement<sup>2</sup>

8. The existing immediate credit arrangement will be removed such that paper securities should have been dematerialised before they can be used for settlement. Although respondents understood and accepted this, there was concern as to whether investors holding securities in paper form would be able to complete the dematerialisation process in time to meet their T+2 settlement obligations.

9. To address this concern, share registrars will provide different service level options for dematerialisation, i.e. they will offer options for standard or premium dematerialisation services, with corresponding fees. This will allow investors to meet their settlement obligation even if they present their paper securities for dematerialisation quite close to the settlement deadline.

### Unique identification numbers

10. The proposed model will require investors' unique identification numbers (unique IDs) to be passed to the Central Clearing and Settlement System (CCASS)<sup>3</sup> and the relevant share registrars. There were mixed views on this issue. There was also uncertainty as to the purpose of requiring unique IDs, and concerns about data security.

11. The purpose of passing investors unique IDs to CCASS and share registrars is to enhance investor protection and improve overall efficiency and system integrity. In particular, unique IDs will provide indisputable proof of an investor's identity. It will hence enable CCASS and share registrars to distinguish one investor from another, and provide an added check on the accuracy of movements between accounts. It will also make it easier for investors to keep track of their portfolio.

12. The Working Group's current thinking is that the identification to be provided will be the Hong Kong identity card number (in the case of individuals who are Hong Kong residents), passport numbers (in the case of individuals who are non-Hong Kong residents) and company registration or similar numbers (in the case of corporate entities). Additionally, clear and

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<sup>2</sup> Under the existing Central Clearing and Settlement System (CCASS) rules, subject to certain risk management measures and HKSCC Nominees Limited's right of rejection, securities held in physical form can be immediately credited to the account of a CCASS Participant (other than an Investor Participant) when the certificates are deposited with CCASS Depository without having to complete the process of registering the securities in the name of HKSCC Nominees Limited.

<sup>3</sup> CCASS is the securities clearing and settlement system established and operated by the Hong Kong Securities Clearing Company Limited, a recognized clearing house.

stringent requirements and obligations will be put in place to ensure that the unique IDs are used for legitimate purposes only and properly protected from theft and unauthorized use or transfer.

### Attendance and voting at shareholder meetings

13. The proposed model allows investors to hold their securities through nominees. In the case of shares, this raises the question of whether beneficial owners will be able to attend and vote at company meetings, and if so how.

14. Currently beneficial owners who hold their shares in CCASS can attend and vote at company meetings by arranging for HKSCC Nominees Limited (which is the legal owner of all shares held in CCASS) to appoint them as corporate representatives. Alternatively, if they wish to vote only but not attend the meeting, they can do so by relaying their voting instructions to HKSCC Nominees Limited which will then send a member of its own staff as a corporate representative to vote on their behalf and as instructed. The Consultation Paper asked whether this existing arrangement should be extended so that banks and brokers who act as nominees can also appoint multiple corporate representatives thus enabling their beneficial owner clients to attend and vote, or just vote, at shareholder meetings.<sup>4</sup>

15. We received mixed responses on this issue. Banks considered that the extension was important as it ensured beneficial owners would be able to continue attending and voting at shareholder meetings as they do today. They were also concerned that without the extension, beneficial owners would have to transfer their shares into their own name if they wanted to attend and vote at shareholder meetings. However, that might not always be feasible given the often tight time frame, and involvement of multiple layers of beneficial owners.

16. On the other hand, brokers were concerned about the manpower and cost implications of having to appoint a member of their own staff to attend meetings on behalf of clients who were beneficial owners and who wished to vote but not attend meetings.

17. Given the concerns raised, and recognizing the importance of preserving beneficial owners' ability to attend and vote at shareholder meetings, the Working Group proposes to allow for the appointment of

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<sup>4</sup> This is not currently possible as the Companies Ordinance only allows corporate shareholders (other than HKSCC Nominees Limited) to appoint one corporate representative only (see section 115).

multiple proxies (as opposed to multiple corporate representatives). Such an approach will address both banks' and brokers' concerns because –

- (a) a beneficial owner can then be appointed as proxy if he wishes to attend and vote at a meeting, and
- (b) the chairman of the meeting (as opposed to the banks' or brokers' own staff) can be appointed as proxy if a beneficial owner wishes to vote at, but not attend, a meeting.

18. This approach is also in line with the draft Companies Bill which proposes that all shareholders should be allowed to appoint multiple proxies to represent different shares held by them.<sup>5</sup>

### Scope

19. It was originally proposed that the operational model would apply to all securities that are publicly traded in Hong Kong. Most respondents agreed but a significant number had concerns about applying it to Exchange Traded Funds (in view of unintended stamp duty implications) and Callable Bull / Bear Contracts and derivative warrants (which are already scripless and do currently have a paper option), etc.

20. In light of the concerns raised, the Working Group proposes to first implement the initiative vis-à-vis shares, and subsequently extend it to other securities as and when the concerns are addressed.

### Costs

21. A number of respondents raised concerns about costs and the fee structure under the scripless environment. The Working Group is mindful of these concerns. However, until development of the proposed model reaches a more advanced stage, it is not possible to provide more specific details on costs. The Working Group maintains however that it will abide by the guiding principles that fees should be reasonable (for all parties concerned), commensurate with services provided, conducive to encouraging innovation and market development, and do not offset the longer term benefits of a scripless environment.

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<sup>5</sup> In contrast, under the existing Companies Ordinance, shareholders can appoint up to two proxies only unless the articles provide otherwise (see section 114C).

### Other features

22. Respondents did not raise any significant issues or concerns with the other key features of the proposed model as summarised below-

- (a) the register of holders will consist of two parts – an uncertificated sub-register which will be kept and maintained by Hong Kong Securities Clearing Company Limited, and a certificated sub-register which will be kept and maintained by the relevant share registrar. This is to ensure there is no gap between settlement in CCASS and registration in the register of holders;
- (b) there will be a name-on-register feature which will allow investors to hold securities in CCASS in their own names, i.e. investors can become legal owners of the securities held in CCASS. This will improve investor protection and investor choice;
- (c) share registrars will become a new category of CCASS participants. They will also be more directly and robustly regulated by the SFC than today as they will be taking on new roles and responsibilities in the scripless environment; and
- (d) to test the scripless environment, there will be pilot runs during which issuers will be invited to participate in the scripless environment and test out the related systems and processes. This will allow unforeseen issues to surface and be addressed with minimal disruption to the market. Separate pilot runs will be conducted for existing securities and new issues.

### **Next steps**

#### Legislative amendments and timetable

23. The SFC is currently working with the Government on the legislative amendments for implementing the scripless initiative. Some amendments have already been introduced and approved by the Legislative Council under Part 7 of the Companies (Amendment) Ordinance 2010, No.

12 of 2010<sup>6</sup>. These amendments represent an important step in the legislative process for implementing the scripless initiative, and also signify the Government's support for taking the scripless initiative forward. Further and more detailed amendments are still needed and the SFC is currently working with the Government on them.

24. The further amendments will essentially set out the framework for regulating the scripless environment and those who play a key role in that environment. The SFC is also currently working on related subsidiary legislation and hopes to issue a separate consultation paper in that regard in early 2011. Subject to the legislative process, implementation of preparatory arrangements, and other relevant considerations, the Working Group hopes to launch the first pilot run in late 2013.

#### Overseas companies

25. Separately, the Working Group will also continue to review the position of overseas companies to see what further steps and changes are needed before the proposed operational model can be extended to shares and debentures of such companies. The initial focus will be companies incorporated in Bermuda, Cayman Islands, Mainland China and the UK as they together make up the vast majority of companies listed in Hong Kong.

### **Working Group on Scripless Securities Market October 2010**

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<sup>6</sup> Part 7 of the Companies (Amendment) Ordinance 2010 removes or provides exceptions to existing provisions in the Companies Ordinance that compel the issue or use of paper documents of title and transfer. The Ordinance was passed on 7 July 2010 but has not yet come into operation.