

立法會

Legislative Council

LC Paper No. CB(1)1790/13-14(02)

Ref: CB1/BC/9/13

Bills Committee on Securities and Futures and Companies Legislation (Uncertificated Securities Market Amendment) Bill 2014

Background brief

Purpose

This paper provides background information on the legislative proposal to enable the introduction of an uncertificated securities market regime in Hong Kong ("the proposed regime"). It also summarizes the views and concerns expressed by members of the Panel on Financial Affairs ("FA Panel") on the subject.

Background

The existing paper-based regime and its limitations

2. Hong Kong's securities market is currently largely paper-based. The Companies Ordinance ("CO") (Cap. 622) requires the issue of paper certificates and the use of paper instruments of transfer in respect of shares and debentures. The Stamp Duty Ordinance ("SDO") (Cap. 117) requires the use of paper instruments of transfer in respect of units in a unit trust scheme. However, investors can hold and transfer securities in electronic form through the Central Clearing and Settlement System ("CCASS"), which is an immobilized securities settlement system¹ and is operated by Hong Kong Securities Clearing Company Limited ("HKSCC").

¹ An immobilized securities system is one in which securities are issued in paper form and deposited with a central depository which is electronically linked with a settlement system. The paper securities are immobilized in the central depository in the sense that they are held by the depository at all times and do not need to be moved or re-registered to effect a transfer within the system. In Hong Kong, CCASS serves as the central depository and securities settlement system. The paper securities are deposited into the CCASS depository and registered in the name of HKSCC Nominees Limited. So long as the securities stay in CCASS, legal title to them remains vested in HKSCC Nominees Limited. Investors who hold securities in CCASS therefore hold only a beneficial interest in the securities – they are not registered holders and do not hold legal title. Likewise, when investors transfer securities in CCASS, they transfer only the beneficial interest in the securities – legal ownership of the securities remains with HKSCC Nominees Limited.

3. While the existing immobilized system has greatly reduced scrip circulation, and improved speed and efficiency in the trading and settlement process, the system also has its shortcomings. Firstly, it is not completely electronic. Some transactions still require the use of paper, e.g. the Initial Public Offerings ("IPO") process to some extent still requires the use of paper. Secondly, investors who hold securities within CCASS hold only the beneficial interest in the securities. Unlike registered holders, they do not generally receive corporate actions directly from issuers, nor can they respond directly to the issuers, for example, to exercise voting rights, which must instead be exercised by submitting instructions indirectly via their broker/bank/custodian and the CCASS nominee (i.e. HKSCC Nominees Limited).

Public consultation on proposals for an uncertificated securities regime

4. The Securities and Futures Commission ("SFC") and the Hong Kong Exchanges and Clearing Limited ("HKEx") had separately consulted the market on proposals for implementing an uncertificated securities market in Hong Kong in 2002 and 2003. There was however difficulty in reaching consensus on the operational model on those occasions. In early 2009, the Working Group on Scripless Securities Market ("the Working Group"), comprising representatives from SFC, HKEx and the Federation of Share Registrars Limited ("FSR"), was established to revive discussion on the matter. On 30 December 2009, the Working Group issued a joint consultation paper on "A proposed operational model for implementing a scripless securities market in Hong Kong" ("the Consultation Paper"). The consultation conclusions ("the Conclusions Paper") were published on 21 September 2010. The Consultation Paper and the Conclusions Paper are hyperlinked in **Appendix I**. In view of the generally positive feedback from the market, the Working Group 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.

Companies (Amendment) Ordinance 2010

5. Separately, to take forward the uncertificated securities market initiative, amendments were introduced under Part 7 of the Companies (Amendment) Ordinance 2010 (Ordinance No. 12 of 2010) to remove, or provide exceptions to, the limitations arising from the provisions in CO that compel the use of paper documents of title and paper instruments of transfer in relation to shares and debentures. These amendments are subsequently incorporated (as appropriate) into Schedule 8 to CO². The Government had made clear that these amendments to CO would only come into operation when the market is ready to implement an uncertificated securities market model and that further and more detailed requirements would still need to be worked out.

² The Companies (Amendment) Bill 2010 was passed by the Legislative Council ("LegCo") on 7 July 2010. The new CO was enacted in July 2012.

The Securities and Futures and Companies Legislation (Uncertificated Securities Market Amendment) Bill 2014

6. The Securities and Futures and Companies Legislation (Uncertificated Securities Market Amendment) Bill 2014 ("the Bill") was published in the Gazette on 13 June 2014 and received its First Reading on 25 June 2014.

7. The Bill covers amendments to the Securities and Futures Ordinance (Cap. 571) ("SFO"), CO and a few other ordinances including SDO. The broad framework for the regulation of the uncertificated securities market is set out in SFO and CO, while details relating to operational matters and the regulation of the uncertificated securities market environment are provided in new subsidiary legislation to be made under SFO. The main features of the proposed regime set out in and the relevant major clauses of the Bill are highlighted as follows:

- (a) Shares to be specified as "Prescribed Securities" (clause 19): The amendments to SFO will apply to all securities that are, or are to be, listed on a recognized stock market³ and specified in the legislation. A new term "prescribed securities" will be introduced in SFO to refer to such securities, and they will be specified by class or description in a new Schedule 3A to SFO. Since the initial focus of the proposed regime will be on shares, the new Schedule 3A will only specify shares at the outset. SFO will be amended to empower SFC to amend Schedule 3A, after consultation with the Financial Secretary ("FS"), by means of subsidiary legislation subject to negative vetting by LegCo.
- (b) Dual system for securities market (clauses 20 - 48): The uncertificated securities market initiative will be implemented in phases, and there will be a transitional period during which a dual system will operate, i.e. the existing paper-based system will continue to operate in parallel with the proposed uncertificated securities market system. Investors will be able to choose whether to hold their securities with paper certificates issued or alternatively in uncertificated form. They will also be able to convert their holdings from one form to the other at any time. Only when the market is ready, and after further consultation, will the proposed regime for listed securities be made compulsory.

³ The proposed regime will not apply to unlisted securities (e.g. shares and debentures of private companies). Moreover, the proposed regime will be implemented in phases, and the initial phase will only cover shares that are listed or to be listed on a recognized stock market. Other securities (e.g. debentures and unit trusts) that are listed or to be listed on such a stock market will be covered at a later stage. "Recognized stock market" is defined under SFO as a stock market operated by a company recognized as an exchange company under section 19(2) of SFO.

- (c) Participating shares and companies (clauses 20 - 48): New terms will be introduced in CO to refer to those shares and companies that will be regulated under the proposed regime. "Participating shares" will refer to shares that are "prescribed securities", and that are permitted by the system operator of an "uncertificated securities market system" to be transferred through the system. Investors will have the option to hold "participating shares" in uncertificated form or certificated form. "Participating company" will refer to a company that has issued any shares that are participating shares.
- (d) Register of members of participating companies (clauses 20 - 48): Under the proposed regime, the register of members of a participating company will consist of two parts: one recording uncertificated shares which will be kept and maintained by the system operator of the uncertificated securities market system ("members register (uncertificated shares)"); and the other recording certificated shares which will be kept and maintained by the relevant share registrar as agent of the participating company ("members register (certificated shares)"). Investors holding shares in uncertificated form will have the option to register their shares in their own names or hold their uncertificated shares in the name of a nominee.
- (e) Regulatory oversight and rules (clauses 3 – 12): Regulatory and operational matters relating to the new uncertificated securities market environment will be overseen by SFC which will be empowered to make relevant rules and prescribe penalties for breach. As the operator of an uncertificated securities market system may only be a recognized clearing house⁴ ("RCH") that is approved by SFC after consultation with FS, the existing regulatory regime for RCHs will be correspondingly expanded to cover the operation of such systems. SFC will also be empowered to authorize and regulate share registrars who wish to provide share registrar services in respect of participating companies. The above rules to be made by SFC are subsidiary legislation subject to negative vetting procedure of LegCo.
- (f) Fees and charges (clause 9): The guiding principles with respect to fees under the proposed regime are that fees should be reasonable (for all parties concerned), commensurate with services provided, conducive to encouraging innovation and market development, and should not offset the longer term benefits of an uncertificated securities system market

⁴ A recognized clearing house is a company recognized as a clearing house under section 37(1) of SFO.

environment. The fees to be charged by a RCH are subject to SFC's approval⁵.

- (g) Stamp duty (clauses 52 – 58): Currently, \$5 fixed rate stamp duty is chargeable on the instrument of transfer in respect of any sale or purchase of Hong Kong stock unless it is specifically exempted. Under the proposed regime, participating shares (which are Hong Kong stock) may be transferred without an instrument of transfer in certain circumstances, and consequently, the \$5 fixed duty will no longer be chargeable on such transfers. The chargeability of the ad valorem stamp duty will however not be affected⁶.

Members' views and concerns

8. The FA Panel was briefed on the development of an uncertificated securities market at the meeting on 1 February 2010. The Panel further discussed with the Administration the proposed operational model for the uncertificated securities market regime and the related legislative proposal at the meetings on 1 November 2010 and 6 January 2014 respectively. While Panel members supported the direction of developing an uncertificated securities market in Hong Kong in general, they raised a number of issues at the meetings. The ensuing paragraphs summarized the major views and concerns expressed by Panel members.

Comparison with the operational models in other places

9. On members' enquiry about the comparison of the proposed operational model for developing an uncertificated securities market in Hong Kong with those adopted in other places, the Administration advised that different jurisdictions had unique experiences in implementing the uncertificated securities initiative, and their regimes had been developed having regard to their backgrounds and unique circumstances. For instance, some of the major financial markets, such as the stock markets of Australia and the Mainland, had already become fully uncertificated. The stock market of the United Kingdom ("UK") adopted a dual system despite the introduction of an uncertificated securities market regime since 1996. The stock market of the United States was still paper-based, although many of the share certificates were immobilized. The Administration had studied experiences of other jurisdictions and the

⁵ Under section 76 of SFO, SFC shall have regard to, among other matters, the level of competition, if any, in Hong Kong for the matter for which the fee is to be imposed, in deciding whether or not to approve a fee under that section.

⁶ Ad valorem stamp duty is chargeable on all transfers of shares listed in Hong Kong involving a change in beneficial interest. Under the proposed regime, ad valorem stamp duty will continue to be collected electronically through the the Stock Exchange of Hong Kong for all on-Exchange transfers in the same manner as it is currently collected. However, for off-Exchange transfers involving participating shares in uncertificated form, SDO will be amended to enable the setting up of a new stamping arrangement for the collection of ad valorem stamp duty.

proposed arrangements for Hong Kong were mainly based on the practice of the UK and Australia stock markets. In response to members' request, the Working Group provided in February 2010 a comparison between the arrangements for the uncertificated securities market in the UK and Australia and those proposed for Hong Kong which is given in **Appendix II**.

Timeframe and prescribed securities for implementing a fully uncertificated securities market

10. Some members expressed concern that it might take a long time to establish a fully uncertificated securities market as companies would be allowed to adopt the uncertificated operational model on a voluntary basis. There were suggestions that the legislative proposal for introducing the proposed regime in Hong Kong should include incentives for market participants to hold their shares in uncertificated form, such as allowing investors to open their uncertificated securities accounts in CCASS, and transferring their securities from the paper based accounts to the new accounts free of charge.

11. Some members considered that the proposal of applying the proposed regime only to the shares of Hong Kong incorporated companies listed on the Stock of Exchange of Hong Kong at the initial stage could not achieve market efficiency and cost-effectiveness. They urged the Administration to put forth a concrete timetable for expanding the regime to cover shares of companies incorporated in other jurisdictions as these companies accounted for the majority of listed companies in Hong Kong. There was a view that all companies seeking to be listed should be required to adopt the uncertificated operational model.

12. The Administration/SFC advised that as the uncertificated securities regime was a new initiative, it should be taken forward in a progressive manner. Consideration would be given to implementing a fully uncertificated regime, including shares of all listed companies in Hong Kong, taking into account experience in operating the dual system, market readiness, and investors' adaption to holding their shares in an uncertificated form. However, the timeframe for expanding the scope of "prescribed securities" to cover shares of companies incorporated under other jurisdictions would depend on when the necessary approvals or law amendments of jurisdictions concerned would be given or put in place. The Administration/SFC would discuss with the relevant authorities of other jurisdictions in parallel when proceeding the legislative exercise in Hong Kong with the objective of covering companies from as many jurisdictions as possible when the proposed regime started to operate. SFC further explained that during IPO of shares, the companies concerned would be required to provide the option of uncertificated securities to the subscribers. SFC would launch educational programmes to familiarize market participants with the uncertificated regime, and HKEx and FSR would consider means to encourage market participants to use the model.

Fees on investors and market participants

13. As regards members' concerns about fees to be imposed on investors and market participants under the uncertificated operational model and the business costs on securities firms arising from investment in new system infrastructures and provision of additional services to clients, SFC advised that both HKSCC and share registrars would need to establish new system infrastructures under their respective purviews in order to tie in with implementation of the uncertificated securities regime, and bear the costs involved. While the costs for HKSCC or share registrars might be lowered with benefits gained as a result of enhancement in market efficiency and market competition thus conducive to growth in business, market development would essentially hinge on the extent of acceptance of the model by market participants.

14. SFC further advised that the fees of HKSCC would be subject to SFC's approval; and share registrars, banks and securities firms would be subject to market forces in setting their fees. The detailed fee schedules would be worked out later. It was believed that the fee level would be reasonable and set having regard to the acceptance of market participants. SFC would work with HKSCC and share registrars to enhance understanding of market participants on the setting of fees, as well as communicate with the securities industry on details for implementing the uncertificated securities regime including the relevant system requirements with a view to reducing the costs on the trade.

Protection of data on scripless securities

15. The Panel had discussed measures to ensure accuracy and security of the data on uncertificated securities held in CCASS. Members considered that there should be arrangements to ensure the accuracy and safety of shareholders' information in CCASS in an uncertificated environment. Also, the Administration and regulators had to ensure that the level of security for the computer systems of Hong Kong's securities market would be in line with, or even higher than, the international standard. SFC advised that HKEx would enhance the security of its computer systems in order to ensure the stability and reliability of the securities clearing and data storage systems. Back-up systems would be established for safe storage of the records.

Latest development

16. At the House Committee meeting on 27 June 2014, Members agreed to form a Bills Committee to study the Bill.

Relevant papers

17. A list of relevant papers is in **Appendix I**.

Council Business Division 1
Legislative Council Secretariat
17 July 2014

Appendix I

List of relevant papers

Date	Event	Paper/Minutes of meeting
30 December 2009	Joint consultation paper on a proposed operational model for implementing a scripless securities market in Hong Kong	Consultation paper
1 February 2010	Meeting of the Panel on Financial Affairs ("FA Panel")	Administration's paper (LC Paper No. CB(1)978/09-10(05)) Minutes (LC Paper No. CB(1)1493/09-10)
21 September 2010	Joint consultation conclusions on a proposed operational model for implementing a scripless securities market in Hong Kong	Conclusions paper
1 November 2010	Meeting of FA Panel	Administration's paper (LC Paper No. CB(1)217/10-11(05)) Background brief (LC Paper No. CB(1)215/10-11) Minutes (LC Paper No. CB(1)906/10-11)
April 2013	Special meeting of Finance Committee for examination of Estimates of Expenditure 2013-2014	Written question raised by Hon Christopher CHEUNG (Reply serial number: FSTB(FS)035)

Date	Event	Paper/Minutes of meeting
6 January 2014	Meeting of FA Panel	<u>Administration's paper</u> (LC Paper No. CB(1)625/13-14(06)) <u>Background brief</u> (LC Paper No. CB(1)625/13-14(07)) <u>Minutes</u> (LC Paper No. CB(1)1310/13-14)

Appendix II

Information on the scripless arrangements for the securities markets in the United Kingdom ("UK") and Australia and those proposed for Hong Kong ("HK")

	UK	Australia	Proposal for HK
System	CREST Co Limited ("CREST")	The Clearing House Electronic Sub-Register System ("CHES")	The Central Clearing and Settlement System ("CCASS")
Voluntary vs compulsory	Voluntary – investors have the option to hold domestic securities in paper form	Compulsory – investors do not have the option to hold domestic securities in paper form	Voluntary – investors will have the option to hold domestic securities in paper form
Register	Register is made up of two parts, and uncertificated securities must be held within CREST	Register is made up of two parts, and uncertificated securities may be held within or outside CHES	Register will be made up of two parts, and uncertificated securities must be held within CCASS
Name on register	Securities in CREST can be held in the name of the investor	Securities in CHES can be held in the name of the investor	Securities in CCASS can be held in the name of the investor
Corporate action	Share registrars provide all corporate action services and corporate action communications are sent via CREST to uncertificated holders and in electronic or paper form to certificated holders	Most communications between issuers and investors occur directly between the issuer's share registrar and the investor without the involvement of CHES	To be discussed further within the Working Group – see paragraph 72 of the Joint Consultation Paper on a Proposed Operational Model for Implementing a Scripless Securities Market in Hong Kong (the "Consultation Paper") ¹
Overseas securities	Investors cannot directly hold and transfer overseas securities through CREST, and must instead hold and transfer depository interests	Investors cannot directly hold and transfer overseas securities through CHES, and must instead hold and transfer depository interests	To the extent that the laws of the jurisdictions outside HK allow, investors will be able to directly hold and transfer overseas securities through CCASS

(Source: Extract from the information paper provided by the Working Group on Scripless Securities Market in February 2010 (LC Paper No. CB(1)1221/09-10(03))