

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

**The Administration's Response to Questions Raised by  
Assistant Legal Adviser of the Legislative Council Secretariat  
on Legal and Drafting Aspects of the Securities and Futures and  
Companies Legislation (Uncertificated Securities Market  
Amendment) Bill 2014**

**Purpose**

This paper sets out the Administration's response to the questions raised by the Assistant Legal Adviser ("ALA") of the Legislative Council Secretariat regarding the legal and drafting aspects of the Securities and Futures and Companies Legislation (Uncertificated Securities Market Amendment) Bill 2014 ("the Bill").

**Application of the Electronic Transactions Ordinance (Cap. 553)  
("ETO")**

2. The purpose of the ETO is essentially to give legal certainty to matters done in electronic form rather than paper/physical form. It is a piece of enabling legislation and leaves open the option to use paper documents. The key provisions of the ETO are sections 5, 5A, 6, 7 and 8. These provide that where a rule of law requires or permits information or documents to be or be given in writing, be served, be signed, be presented or be retained in its original form or in writing or otherwise, this may be done in electronic form rather than paper/physical form. This is subject to the following –

- (a) sections 3 and 13 provide that the above does not apply to the matters listed in Schedule 1 or Schedule 2<sup>1</sup> to the ETO as they are expressly excluded from the operation of the ETO (or certain provisions of the ETO) (see also paragraph 3(a) below);

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<sup>1</sup> Schedule 1 to the ETO sets out the matters excluded from the application of the key provisions of the ETO. Schedule 2 to the ETO sets out the proceedings in relation to which the key provisions of the ETO do not apply.

- (b) section 14 provides that the key provisions should not override provisions in other legislation that also provide for how matters are to be done in electronic form; and
- (c) section 16 provides that the key provisions should not have effect if their operation affects the operation of other statutory requirements.

3. The provisions of the Bill do not conflict with the key provisions of the ETO and sections 14 and 16 of the ETO would ensure that the provisions of the Bill prevail if otherwise. That said, there are two aspects of the ETO that are worth highlighting -

- (a) paragraph 4 of Schedule 1 to the ETO excludes the making and/or execution of documents that are required to be stamped or endorsed under the Stamp Duty Ordinance (Cap. 117) (“SDO”) from the application of sections 5, 5A, 6, 7, 8 and 17 of the ETO (“Relevant Provisions”). However, contract notes to which an agreement under section 5A of the SDO (i.e. a stamp duty collection agreement entered into between the Collector of Stamp Revenue (“the Collector”) and a recognized exchange company or an authorized Automated Trading Services (“ATS”) provider) relates (“section 5A contract notes”) are expressly carved out from this exclusion. This means that section 5A contract notes are not excluded from the application of the Relevant Provisions, thus providing legal certainty that section 5A contract notes can be made and/or executed electronically. Under the new section 5AAB of the SDO, there will be a new stamping arrangement to be approved by the Collector under the uncertificated securities environment. We are considering whether it will be necessary to amend paragraph 4 of Schedule 1 to the ETO for the purpose of this new stamping arrangement; and
- (b) we note that the ETO includes provisions (i.e. sections 18 and 19) on the attribution and time of sending or receipt of electronic records. Although no such provisions are included in the Bill, we expect such provisions to be included in subsidiary legislation to be made under new section 101AAO of the Securities and Futures Ordinance (“the Rules”). We will further consider this matter in the preparation of the Rules.

## **Uncertificated Securities Market System and ATS**

4. The uncertificated securities market system (“USM System”) may be viewed as a system that gives legal recognition to changes in the ownership of securities without the use of paper documents. An ATS however provides services that facilitate either the trading or clearing of securities. There should therefore be no overlap between the services provided by an authorized ATS provider and those provided by the operator of a USM System. Under the Bill, the operator of a USM System must be a recognized clearing house (“RCH”), and an ATS (as currently defined in the Securities and Futures Ordinance (Cap. 571) (“SFO”) excludes services provided by means of facilities provided by an RCH.

## **Amendments to the Securities and Futures Ordinance (Cap. 571)**

### New section 101 AAC

5. In the context of the provisions in the Bill, “instrument” in the new section 101AAC and other related provisions would mean a paper instrument. As can be seen from the Explanatory Memorandum and the provisions in the Bill, the whole thrust of the amendments is to provide for a computer-based or electronic system for the evidencing and transfer of title to shares and other securities as an alternative to the existing paper-based requirements for title and transfer of shares. The concepts of an uncertificated securities market and uncertificated shares (referred to in the Bill as shares in uncertificated form) connote the distinction between paper-based and electronic systems for holding and transferring title to securities. In particular, the new section 101AAC refers to a USM System as a “computer-based system” that enables title “to be evidenced and transferred without an instrument”. The point of distinction that is implicit from the provision is the use of a computer based or electronic system instead of the need for paper instruments.

### Use of Notes in Cap. 571

6. The Notes under the new sections 101AAD and 101AAE are not intended to have legal effect. This is made clear in section 13 of Schedule 1 to the SFO which provides that “A note located in the text of this Ordinance is provided for information only and has no legislative effect.”

#### New section 101AAD

7. As noted in paragraph 19 of the Explanatory Memorandum, sections 101AAD, 101AAE and 101AAF set out certain general principles to be adopted for the new USM regime. Section 101AAD sets out the main position, and this is then further elaborated/qualified by sections 101AAE and 101AAF. We believe the wording of the three provisions makes it clear how they relate to one another. We therefore do not see the need to provide expressly that one is subject to the other.

#### New section 101AAG

8. Sections 101AAG and 101AAH provide for the approval of an RCH to operate a USM System, and the imposition/variation of the conditions of approval. They are modelled on section 37 of the SFO which provides for the recognition of a company as an RCH. Section 101AAG does not provide for appeal where the Securities and Futures Commission (“SFC”) has refused to approve an RCH as a system operator. However, the affected party would nevertheless be entitled to seek redress through judicial review. We believe this approach is sufficient and appropriate given that the approval process is already a detailed and thorough process, incorporating a number of procedural safeguards to protect the applicant-RCH. In particular –

- (a) Section 101AAG(5) requires that an RCH must be given an opportunity to be heard before the SFC can make a decision not to approve it as a system operator. This ensures that the RCH is informed of the SFC’s concerns and given an opportunity to address these concerns as best it can; and
- (b) Section 101AAG(6) provides that if the SFC decides not to approve an RCH as a system operator, it must give the RCH written notice of its decision and the reasons for such decision. The requirement to give reasons ensures that the RCH is in a position to assess whether it is entitled to seek further redress through judicial review.

#### New section 101AAH

9. Although section 101AAH does not so require, the SFC would in practice give a system operator an opportunity to be heard before imposing or amending its conditions of approval. Such an approach also has the benefit of enabling the SFC to ensure that the system operator will

be able to meet and comply with the proposed conditions on an ongoing basis, and that any limitations or concerns are properly addressed. That said, it is also important to ensure that the legislation allows for sufficient flexibility so that the SFC is able to take prompt action in appropriate cases where conditions need to be imposed without delay. This is particularly important given that the USM System will be a key part of the financial market infrastructure. This approach is in line with other comparable provisions under Part III of the SFO.

#### New sections 101AAI and 101AAK

10. The essential difference between a withdrawal under section 101AAI and a direction under section 101AAK is that a withdrawal will disable the RCH from acting as a system operator on a permanent basis and apply in respect of all services provided by the system operator. In contrast, a direction may disable the system operator to provide certain services only (e.g. in respect of a certain participating company or companies only), and/or for a limited time only.

11. In the case of an RCH that has been directed to cease operating a USM system, it would not need to apply to the SFC to resume its operation of the USM System. It would be within the SFC's power to specify in the direction how long the cessation is to stay in place. This could be done by reference to a specific date, or to a date on which the SFC confirms that it is satisfied that the problem giving rise to the direction has been satisfactorily rectified.

12. The exercise of the withdrawal power under section 101AAI has the effect of taking away the approval needed to operate a USM System. This means the operator cannot operate its system again without going through the process of seeking approval once again. A withdrawal therefore has a more permanent effect, and it is hence appropriate that it should be subject to appeal, and that the withdrawal should not take effect until the appeal is withdrawn, abandoned or determined. In contrast, the power to direct cessation under section 101AAK does not have the effect of taking away the approval to operate a USM System. Rather, it only limits what, or how, services or facilities may be provided. Moreover, such limitations may need to be implemented urgently. The power to direct cessation can also be used to facilitate an orderly winding down prior to withdrawal, i.e. the SFC could use the powers under section 101AAI to limit or restrict the operations of a system operator before they are eventually wound down as the result of a withdrawal. We therefore do not see the need to include a provision similar to section 101AAI(7)

under section 101AAK (so that a direction to cease operation of the USM system would be suspended pending the determination (or abandonment) of an appeal lodged under the new section 101AAN(2)).

#### Sanctions for non-compliance

13. The objective of SFC's approval under the new section 101AAG is to limit what systems may be used to effect a legal transfer of prescribed securities without using paper. The legislation seeks to only confer benefits on an approved USM System (i.e. in the form of enabling such a system to be used to effect paperless transfers that are recognized at law as being legal transfers), but not prohibit the use of such systems without approval.

14. The Bill does not provide for sanction or penalty on an RCH or a recognized exchange controller ("RXC") for their failure to discharge the duties imposed by the Bill under the new sections 38(1A) and 63(1A) of the SFO. However, the SFC has power to serve on a recognized exchange company ("REC"), RCH or RXC restriction notices under section 92 in the event of a failure by them to discharge their duties, and to make a suspension order under section 93 relating to the functions of the board or officers of an REC, RCH or RXC.

#### Uncertificated Securities Market Rules

15. Section 398 of the SFO requires the SFC to publish a draft of any proposed rules and invite representations on them from the public. This requirement for public consultation will apply in respect of the Rules as well given that they will be made under the SFO (per new section 101AAO). The public consultation process will ensure that concerns from all relevant stakeholders are taken into account before the Rules are submitted to the Legislative Council.

#### New section 1AC of Schedule 1

16. The term "a person", as used in the legislation, is intended to be neutral and to include both natural persons and corporate entities. We note also that under section 3 of the Interpretation and General Clauses Ordinance (Cap. 1), "person" is defined to include any public body and any body of persons, corporate or unincorporate.

## **Amendments to the Companies Ordinance (Cap. 622) (“CO”)**

### Amendments to section 152

17. Section 150 (and consequently sections 151 and 152) of the CO will continue to apply in respect of transfers of shares where both the transferee and transferor hold in certificated form, i.e. where the transfer is a paper-to-paper transfer. For the processes for all other transfers (i.e. paperless-to-paperless, paper-to-paperless, and paperless-to-paper), the Bill contains enabling provisions and the details will be set out in the Rules. Since the processes for transfers other than paper-to-paper transfers will be set out in the Rules, provisions connected with such processes should also be set out in the same piece of legislation. Hence, provisions relating to Court applications in respect of such transfers are proposed to be set out in the Rules also.

18. The processes for transfers other than paper-to-paper transfers may also apply in respect of all prescribed securities. Besides shares and debentures of Hong Kong companies, there are also shares and debentures of non-Hong Kong companies. It is therefore more appropriate to provide for such processes in the legislation that deals with the uncertificated securities market environment (i.e. the Rules) rather than in the CO (which deals with the operation and regulation of companies, and does not in any case cover the transfer and registration of securities other than shares and debentures of Hong Kong companies).

19. The new section 101AAO(1) of the SFO enables the SFC to make Rules regarding orders that the Court may make in relation to the registration of a transfer under the Rules. In particular, the new section 101AAO(2)(b) of the SFO provides that the Rules may provide for the registration of prescribed securities, and the registration of issuers' shares that are not prescribed securities, including –

- (a) the registration of the allotment, transfer and transmission of such securities or shares;
- (b) the registration of holders of such securities or shares; and
- (c) the keeping of registers or other records or documents for such securities or shares.

### Amendments to section 633

20. The Note proposed under section 633 of the CO indicates that the Rules would deal with the Court's power to order a participating company (or other person) to pay damages for any loss caused by an act or omission of a system operator of a USM System other than an act or omission that meets the conditions described in section 633(2B). The new section 101AAO(2)(k) confirms that the Rules may provide for "the rights, duties and liabilities, including exemption from liabilities, of persons mentioned in paragraph (j)".

Financial Services and the Treasury Bureau  
Securities and Futures Commission  
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