For discussion
on 6 January 2014

Legislative Council Panel on Financial Affairs

Legislative proposal to provide an enabling environment for the introduction of an uncertificated securities regime

Purpose

This paper briefs Members on the legislative proposal to implement an uncertificated securities (i.e. scripless) market in Hong Kong.

Background

2. Hong Kong currently has a paper-based securities market regime. The law requires the issue of paper certificates and the use of paper instruments of transfer for certain securities.[1] However, in the case of securities that are listed on the Stock Exchange of Hong Kong ("SEHK"), these can be held and transferred in electronic form through the Central Clearing and Settlement System ("CCASS"), which is an immobilised securities system[2] operated by the Hong Kong Securities Clearing Company Limited ("HKSCC"). So long as the securities stay in CCASS, legal title to them remains vested in HKSCC Nominees Limited. Investors who elect to hold securities in CCASS therefore hold only a beneficial interest in the securities – they are not registered holders and do not hold legal title.

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[1] Currently, the Companies Ordinance ("CO") requires the issue of paper certificates and the use of paper instruments of transfer in respect of shares and debentures. The Stamp Duty Ordinance requires the use of paper instruments of transfer in respect of units in a unit trust scheme. To take forward the uncertificated securities market initiative, some amendments were introduced under Part 7 of the Companies (Amendment) Ordinance 2010 (Ord No 12 of 2010), and then subsequently incorporated (as appropriate) under Schedule 8 to the new Companies Ordinance, to remove, or provide exceptions to, the limitations arising from the provisions in the CO that compel the use of paper documents of title and paper instruments of transfer in relation to shares and debenture. The Administration had made clear that these amendments to the CO would only come into operation when the market is ready to implement an uncertificated securities model and further and more detailed requirements would still need to be worked out.

[2] An immobilised 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 immobilised 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.

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. It is proposed that Hong Kong progresses to an uncertificated securities market regime, under which legal ownership in securities can be held and transferred without paper documents. This will bring the following main benefits -

(a) <u>To modernize the financial infrastructure of Hong Kong and enhance overall efficiency in our securities market.</u> By further reducing the use of paper, we can enable straight-through processing and enhance efficiency and the turnaround time for transactions.

(b) <u>To enhance corporate governance, and ultimately secure an improved level of investor choice and protection.</u> Through facilitating direct ownership, shareholder transparency can be enhanced and corporate communications and corporate action services can be carried out directly and more efficiently.

(c) <u>To ensure that Hong Kong is on a par with other leading markets.</u> Markets including Australia, Mainland China and the UK have already implemented an uncertificated securities market. This, together with other benefits of improved efficiency, enhanced corporate governance and better investor protection, will reinforce Hong Kong's competitiveness and position as a leading market. It could also provide greater opportunities for future linkages with other uncertificated securities markets.

4. A public consultation on the proposed operational model for an uncertificated securities market was conducted from December 2009 to March 2010. The consultation conclusions were published in September 2010. In general, the vast majority of market respondents supported the initiative.

Legislative and Regulatory Framework

5. The implementation of this initiative will necessitate legislative amendments, involving mainly amendments to the Securities and Futures Ordinance ("SFO"), the new Companies Ordinance ("new CO") and the

Stamp Duty Ordinance ("SDO") and related subsidiary legislation. The broad framework for the regulation of the uncertificated securities market will be set out in primary legislation, while details relating to operational matters and the regulation of the uncertificated securities market environment will be set out in new subsidiary legislation to be made under the SFO ("rules"). The amendments will apply to securities that are, or are to be, listed on the SEHK. Other securities (such as shares or debentures of private companies) will not be affected. The main features of the proposed regime and consequently the major legislative proposals are summarised in the following paragraphs.

Dual system for securities market

6. 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. during which the existing paper-based system will continue to operate in parallel with the proposed uncertificated securities system. Investors will be able to choose whether to hold their securities in paper form or 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 uncertificated securities market regime be made compulsory.

7. To enable the implementation of the dual system, we propose to amend provisions in the new CO that currently (either expressly or implicitly) require the issue of paper certificates and the use of paper instruments of transfer.

Phased approach for implementing the uncertificated securities market system

8. The proposed regime will be implemented in phases. The initial focus will be on shares listed on the SEHK. This is because, compared to other securities, shares raise the most concerns in terms of corporate governance and investor protection. We plan to start with shares of Hong Kong incorporated companies as these are governed by Hong Kong law and we are in a better position to initiate necessary amendments to such laws. We will extend the regime to shares of companies incorporated under other jurisdictions as and when the necessary approvals or laws of such jurisdictions are in place.

9. To allow for the implementation of the phased approach, we will introduce new terms in the SFO and the new CO (i.e. "prescribed securities", "participating securities" and "participating company") to refer to those securities and companies that will be regulated under the proposed regime -

(a) "Prescribed securities" refer to securities that are listed or to be listed, and that are eligible to be accepted into an uncertificated securities system – which refers to the system for evidencing, and effecting transfers of uncertificated securities. Prescribed securities will be identified by class – e.g. shares of Hong Kong incorporated companies listed on the SEHK.

(b) "Participating securities" refer to specific prescribed securities which have actually been accepted into the uncertificated securities system for holding and transfer through that system. If shares in Hong Kong incorporated companies listed on the SEHK are designated as "prescribed securities" and shares in a company fall within that designation, then once shares of that company have been accepted into the uncertificated securities system, they will become "participating securities". Investors will then have the option to hold shares of that company in uncertificated form or certificated form.

(c) "Participating company" refers to a company that has issued any shares that are participating securities.

Register of members of participating companies

10. 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 HKSCC (the "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 company (the "members register (certificated shares)") –

(a) The members register (uncertificated shares) will record all uncertificated securities held in CCASS.

(b) The members register (certificated shares) will record the certificated securities issued by an issuer and held outside CCASS.

11. To handle matters relating to the register of members of participating companies, we propose *inter alia* –

(a) to amend the new CO to re-define what constitutes the register of members in the case of a participating company (i.e. that it will be made up of two parts comprising a members register (certificated shares) and a members register (uncertificated shares)); and

(b) to introduce new rule-making powers under the SFO to enable the Securities and Futures Commission ("SFC") to provide for how the members register (certificated shares) and the members register (uncertificated shares) are to be kept, what matters may or must be entered in them, and the extent to which they may be available for inspection.[3]

Name on register

12. Currently, securities held in CCASS can only be held in the name of the HKSCC Nominees Limited. Investors who wish to hold securities in their own name must hold them in paper form outside CCASS. The proposed regime will allow investors holding securities in CCASS (i.e. in uncertificated form) to have the option to register their securities in their own names, and thus enjoy the full benefits of legal ownership. If investors prefer to hold their securities in CCASS in the name of a nominee, they will be able to do so as well. Investors would be able to hold uncertificated securities through four different account types as depicted in the diagram at **Annex**.[4]

Regulatory oversight and rules

13. We propose that regulatory and operational matters relating to the new uncertificated securities market environment be overseen by the SFC, and set out in a new Part in the SFO. Essentially, the new Part will define certain key concepts and principles. In particular –

(a) It will define what "prescribed securities" are.

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[3] The SFC's new rule-making powers are discussed in more detail under paragraphs 13 to 14 below.

[4] The four account types are: (i) the CCASS Participant Account, (ii) the CCASS Participant Sponsored Account, (iii) the Investor Participant Account, and (iv) the Issuer Sponsored Account.

(b) It will also define what an "uncertificated securities system" is, and require that such a system may only be operated by a recognized clearing house ("RCH") that is approved by the SFC to operate such a system. To complement this, the existing regulatory regime for RCHs will be correspondingly expanded to cover the operation of such systems.

(c) It will enable the SFC to make rules to provide for the operation and regulation of the uncertificated securities market environment and prescribe penalties for breach.

14. Additionally, as it is envisaged that share registrars will take on a more active and involved role in the uncertificated environment, we propose to empower the SFC to authorise and regulate share registrars who wish to provide share registrar services in respect of participating companies. The new rule-making powers described in paragraph 13 above will therefore also cover the authorization and regulation of such share registrars.

15. All rules made by the SFC as described in paragraphs 13 to 14 above will constitute subsidiary legislation and as such will be subject to negative vetting by the Legislative Council.

Fees and charges

16. The guiding principles with respect to fees under the uncertificated securities market 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 environment.

17. To that end, it is intended that the fees that may be chargeable by an operator of an uncertificated securities system (which, as noted above, must be an RCH) will be subject to the SFC's approval. This is in line with the existing legislation which requires fees charged by an RCH to be approved by the SFC.

Stamp duty

18. Currently, $5 fixed rate stamp duty is chargeable on the instrument of transfer in respect of any sale or purchase of Hong Kong stock. Under the uncertificated securities market regime, participating securities 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.

19. The chargeability of the ad valorem stamp duty will not be affected[5]. Under the uncertificated securities market regime, ad valorem stamp duty will continue to be collected electronically through the SEHK for all on-Exchange transfers[6] in the same manner as currently collected. However, for off-Exchange transfers[7] of participating securities in uncertificated form, we propose to amend the SDO to enable the setting up of a new stamping arrangement for the collection of ad valorem stamp duty. These are tax-neutral measures to allow electronic payment of ad valorem stamp duty for off-Exchange transactions in the uncertificated environment.

Next Steps

20. We are finalizing the Bill for introduction into the Legislative Council in the second quarter of 2014. The objective is to provide a legislative framework to allow for the introduction of an uncertificated securities market in Hong Kong. The next steps will be for the SFC, the Exchange and the stakeholders to work out the technical details of the operational model and prepare the relevant subsidiary legislation and Exchange rules which will underpin the new uncertificated securities market. The SFC will conduct a public consultation on the draft subsidiary legislation in due course. We shall continue to work closely with stakeholders.

Financial Services and the Treasury Bureau
Securities and Futures Commission
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[5] In general, ad valorem stamp duty is chargeable on all transfers of shares listed in Hong Kong involving a change in beneficial interest.

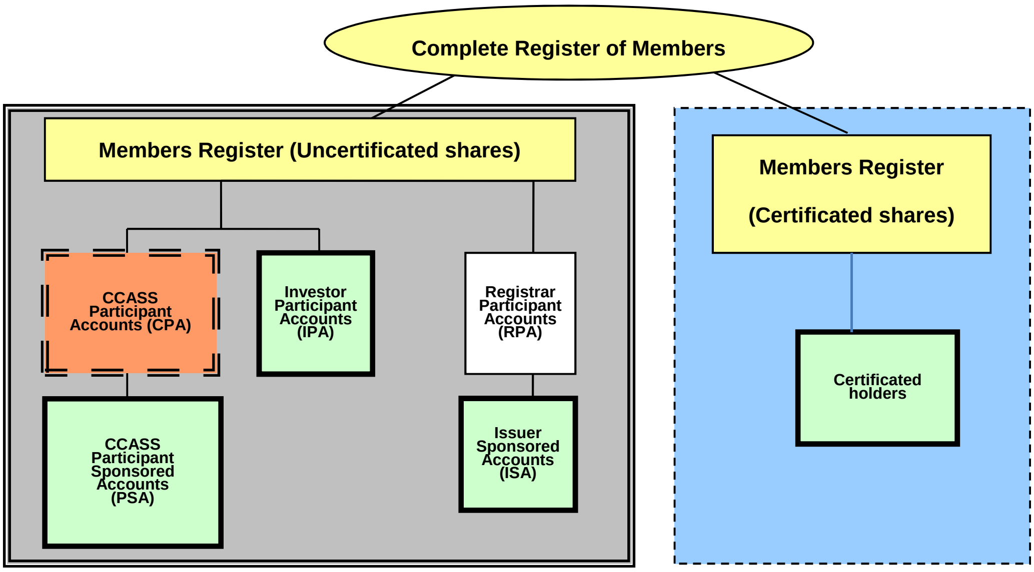
[6] On-Exchange transfers refer to: -

(a) transactions effected by brokers through the Exchange in accordance with the Rules of the Exchange and recorded in the trading system of the Exchange; and

(b) transactions effected by brokers otherwise than through the Exchange but in respect of which brokers choose to make payment of the contract note duty payable thereon through the Exchange Company.

[7] The proportion of stamp duty from off-Exchange transactions of listed stocks is small, just below 10% of all transactions in listed stocks in recent years.

Annex



* Securities in a CPA may belong to the CCASS Participant (if they are held in its proprietary sub-account) or its clients (if they are held in its omnibus client sub-account).

The CCASS environment – will only include securities that are in uncertificated form

Outside CCASS – will only include securities that are in certificated form

Securities that will be registered in the name of the relevant investor-client

Uncertificated securities that will be registered in the name of the relevant CCASS Participant that is the account holder – For securities held in the CCASS Participant's proprietary sub-account, the CCASS Participant will be both the registered and beneficial owner; but for securities held in its omnibus client sub-account, the CCASS Participant will be the registered owner and the relevant investor-client holding securities retain a beneficial interest only.