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Panel on Financial Affairs

Meeting on 6 January 2014

Background brief on legislative proposal to provide an enabling environment for the introduction of an uncertificated securities regime in Hong Kong

Purpose

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

Background

2. Hong Kong's securities market is currently largely paper-based¹. However, investors can hold and transfer securities in electronic form through the Central Clearing and Settlement System ("CCASS"), which is an immobilized securities settlement system² and is operated by Hong Kong Securities Clearing Company Limited ("HKSCC").

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. First, it is not completely electronic. Some transactions still require the use of paper, e.g. the Initial

¹ The law compels the use of paper in respect of shares, debentures and units in unit trust schemes. Additionally, the Listing Rules also require the issue of a global certificate for certain securities. Some securities however, like Exchange Fund Notes, are wholly scrippless.

² 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.

Public Offerings 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 a scripless 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"), which is hyperlinked in **Appendix I**.

5. According to the Working Group, the main objectives and benefits of introducing an uncertificated securities regime in Hong Kong are as follows –

- (a) it will modernize the financial infrastructure of Hong Kong and enhance overall efficiency in our securities market;
- (b) it will enhance corporate governance, and ultimately secure an improved level of investor choice and protection; and
- (c) it will ensure that Hong Kong is in keeping with other leading markets that have already implemented dematerialization.

6. On 21 September 2010, the Working Group published the consultation conclusions on the proposed operational model for implementing a scripless securities market in Hong Kong ("the Conclusions Paper"). 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. The details are set out in the Conclusions Paper hyperlinked in the **Appendix I** and the main features of the operational model are highlighted below –

- (a) *Dual system and full dematerialization*: The existing paper-based regime will co-exist with the new uncertificated regime at the

initial stage, and full scripless would be implemented only when there is general market readiness, which will be gauged through regular reviews.

- (b) *Removal of the immediate credit arrangement*³: The existing immediate credit arrangement will be removed such that paper securities *should* have been dematerialized before they can be used for settlement. Share registrars will provide different service level options for dematerialization to allow investors to meet their settlement obligation even if they present their paper securities for dematerialization quite close to the settlement deadline.
- (c) *Unique identification numbers*: To enhance investor protection and *improve* overall efficiency and system integrity, the proposed model will require investors' unique identification numbers ("unique IDs")⁴ to be passed to CCASS and the relevant share registrars.
- (d) *Investor choice*: Investors will have a wider range of options in terms of the form, type of ownership and extent of control over their holdings. Specifically, investors may choose between -
 - (i) holding their securities in paper or uncertificated (i.e. dematerialized) form;
 - (ii) holding their securities in their own names or in the name of a nominee (including a broker/bank/custodian nominee that is a CCASS Participant), and
 - (iii) holding their securities through an account that they can control directly or through an account controlled by their broker, bank or custodian.
- (e) *Attendance and voting at shareholder meetings*: To preserve beneficial owners' ability to attend and vote at shareholder meetings, appointment of multiple proxies is allowed, i.e. a *beneficial* owner can be appointed as proxy if he wishes to attend and vote at a meeting, and the chairman of the meeting can be

³ Under the existing 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.

⁴ The Working Group's 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). Stringent requirement and obligations will be put in place to ensure that the unique IDs are properly protected from theft and unauthorized use or transfer.

appointed as proxy if a beneficial owner wishes to vote at, but not attend, a meeting.

- (f) *Register to comprise two parts:* To ensure there is no gap between settlement in CCASS and registration in the register of holders, an uncertificated sub-register will be kept and maintained by HKSCC, while a certificated sub-register will be kept and maintained by the relevant share registrar.
- (g) *Share registrars to become CCASS participants:* Share registrars will become a new category of CCASS participants which can use the existing CCASS infrastructure to communicate directly with CCASS, intermediaries and investors who hold securities through a broker/bank/custodian that is a CCASS Participant. Share registrars will also be more directly and robustly regulated by SFC than today as they will be taking on new roles and responsibilities in the scripless environment.
- (h) *Scope of coverage:* The proposed operational model is proposed to be first applied to shares of listed companies, starting first with those incorporated in Hong Kong and then those incorporated overseas, and subsequently extended to other securities⁵.

Legislative amendments in the Companies (Amendment) Bill 2010

7. As a first step in the entire legislative process to enable the introduction of an uncertificated securities regime in Hong Kong, the Administration has introduced technical amendments, through the Companies (Amendment) Bill 2010, to remove or provide exceptions to the limitations arising from provisions in the Companies Ordinance (Cap. 32)⁶ that compel the use of paper documents of title and paper instruments of transfer in relation to shares and debentures. The Bill was passed on 7 July 2010. The amendments were subsequently incorporated (as appropriate) under Schedule 8 to the new Companies Ordinance.

⁵ It was originally proposed that the operational model would apply to all securities that were publicly traded in Hong Kong. However, a significant number of respondents to the public consultation in 2009 expressed concerns about the application to Exchange Traded Funds (in view of stamp duty implications) and Callable Bull/Bear Contracts and derivative warrants (which are already scripless and do currently have a paper option), etc. Due to these concerns, 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.

⁶ After commencement of the new Companies Ordinance from 3 March 2014, the Chapter number will be changed to Cap. 622.

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

8. According to the Administration, the legal framework for introducing the uncertificated securities regime in Hong Kong will involve legislative changes primarily to the Securities and Futures Ordinance (Cap. 571) ("SFO"), the Companies Ordinance (Cap. 32) and the Stamp Duty Ordinance (Cap. 117), whilst the details will be provided in new subsidiary legislation to be made under SFO. The Administration's plan is to introduce the Securities and Futures and Companies Legislation (Uncertificated Securities Market Amendment) Bill in the second quarter of 2014.

Members' views and concerns

9. The Panel on Financial Affairs ("FA Panel") was briefed on the arrangement for development of a scripless securities market in Hong Kong at the meeting on 1 February 2010. The Working Group discussed with the FA Panel at the meeting on 1 November 2010 the consultation conclusions and the proposed operational model for implementing a scripless securities market in Hong Kong. Panel members in general supported the direction of developing a scripless securities market in Hong Kong but urged the Administration and regulators to conduct consultation on the details with market participants to ensure protection for investors and to address cost issue. The ensuing paragraphs summarized the major views and concerns raised by Panel members.

Comparison with the operational models in other places

10. On members' enquiry about the comparison of the proposed operational model for developing a scripless securities market in Hong Kong with those adopted in other places, the Administration advised that some of the major financial markets, such as the stock markets of Australia and the Mainland, had already become totally scripless. The stock market of the United Kingdom ("UK") adopted a dual system despite the introduction of scripless securities since 1996. The stock market of the United States was still paper-based, although many of the share certificates were immobilized. The 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 a comparison between the scripless arrangements for the securities market in the UK and Australia and those proposed for Hong Kong which is given in **Appendix II**.

Timeframe for implementing a fully scripless market

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

12. SFC advised that the scripless operational model was a new initiative, and initially, listed companies would be allowed to offer this option to their shareholders. After the dual system had operated for some time, and when market participants considered that the scripless operational model was convenient and cost-effective, consideration would be given to implementing the uncertificated regime on all listed companies. During the Initial Public Offer 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 scripless 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 scripless operational model, SFC advised that certain fees of HKEx and share registrars would be subject to SFC's approval, and banks and securities companies would be subject to market forces in setting their fees. The detailed fee schedules for CCASS and the share registrars 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.

Protection of data on scripless securities

14. The Panel had discussed the measures to ensure accuracy and security of the data on scripless securities held in CCASS. Members considered that there should be arrangements to ensure the accuracy and safety of shareholders' information in CCASS in a scripless 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.

Recent developments

15. The Administration and SFC will brief the FA Panel on the legislative proposal to provide an enabling environment for the introduction of an uncertificated securities regime in Hong Kong at the Panel meeting to be held on 6 January 2014.

Relevant papers

16. A list of the relevant papers is in the **Appendix I**.

Council Business Division 1
Legislative Council Secretariat
2 January 2014

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)

Appendix II

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

	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))