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on 27 June 2014

Legal Service Division Report on
Securities and Futures and Companies Legislation
(Uncertificated Securities Market Amendment) Bill 2014

I. SUMMARY

1. **The Bill**	The Bill seeks to amend the Securities and Futures Ordinance (Cap. 571), the Companies Ordinance (Cap. 622) and other enactments to facilitate the establishment and implementation of an uncertificated securities market regime under which legal ownership in prescribed securities that are listed (or to be listed) on a recognized stock market can be held and transferred without paper documents.
2. **Public Consultation**	According to the Administration, a public consultation exercise on the proposed uncertificated securities market regime was conducted from December 2009 to March 2010. The consultation conclusions were published in September 2010. The vast majority of market respondents supported the proposed regime.
3. **Consultation with LegCo Panel**	The Panel on Financial Affairs was consulted on 1 February and 1 November 2010, and 6 January 2014. Panel members have raised various concerns on the legislative proposal for implementing an uncertificated securities market regime in Hong Kong.
4. **Conclusion**	In the light of the concerns raised at the above Panel meetings, Members may consider whether to set up a Bills Committee to study the Bill in detail.

II. REPORT

The date of First Reading of the Bill is 25 June 2014. Members may refer to the LegCo Brief (File Ref: CO/2/10C (2014)) issued by the Financial Services Branch, Financial Services and the Treasury Bureau on 11 June 2014 for further details.

Object of the Bill

2. The Bill seeks to amend the Securities and Futures Ordinance (Cap. 571), the Companies Ordinance (Cap. 622) and other enactments to facilitate the establishment and implementation of an uncertificated securities market regime in Hong Kong and to provide for related matters.

Background

3. Under the existing law, the regulatory regime for securities market in Hong Kong is primarily paper-based. The Companies Ordinance (Cap. 622) requires a company incorporated in Hong Kong to issue paper certificates for proof of its members' title to the shares in the company and on allotment or transfer of shares in the company.[1] The Stamp Duty Ordinance (Cap. 117) requires the use of paper instruments of transfer in respect of units in a unit trust scheme.

4. As regards the securities that are listed on the Stock Exchange of Hong Kong (SEHK), which is a recognized stock market[2] in Hong Kong, according to paragraph 2 of the LegCo Brief, interests in the securities can be transferred without paper through the Central Clearing and Settlement System (CCASS), which is an immobilized securities system[3] operated by Hong Kong Securities Clearing Company Limited (HKSCC)[4]. When the securities stay in CCASS, legal title to them remains vested in HKSCC Nominees Limited. Hence, people who hold securities in CCASS only hold a beneficial interest in the securities. However, when people transfer securities in CCASS, only the beneficial interest in the securities is transferred; legal title remains vested in HKSCC Nominees Limited.

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[1] See sections 137, 144 and 155 of the Companies Ordinance (Cap. 622).

[2] "Recognized stock market" is defined under the Securities and Futures Ordinance (Cap. 571) as a stock market operated by a company recognized as an exchange company under section 19(2) of Cap. 571.

[3] According to the LegCo Brief, an immobilized securities system is one in which paper certificates for securities are issued and deposited with a central depository which is electronically linked with a settlement system.

[4] The recognition and regulation of clearing houses in Hong Kong are governed by provisions in Part III Division 3 of Cap. 571.

5. In June 2009, the Administration informed the Panel on Financial Affairs that a working group (Working Group), comprising representatives from the Securities and Futures Commission (SFC) together with Hong Kong Exchanges and Clearing Limited and the Federation of Share Registrars Limited, was established to work on the operational model for implementing a scripless security market in Hong Kong[5]. On 30 December 2009, the Working Group issued a consultation paper on the object[6]. To take forward the uncertificated securities market initiative, some amendments were introduced by the Companies (Amendment) Ordinance 2010 (Ord. 12/2010) which have been incorporated into Schedule 8 to Cap. 622. According to the Administration, Schedule 8 to Cap. 622 would only come into operation when the market is ready to implement an uncertificated securities market model and after more detailed requirements have been worked out[7].

Provisions of the Bill

6. The Bill seeks to amend mainly the Securities and Futures Ordinance (Cap. 571), Cap. 622 and Cap. 117 to facilitate the establishment and implementation of an uncertificated securities market regime (the proposed regime) in Hong Kong. The major legislative amendments are summarized in the following paragaraphs.

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

7. Part 2 of the Bill consists of amendments to Cap. 571. The main framework of the proposed regime is contained in clause 12 of the Bill which is to be added to Cap. 571 as a new Part IIIAA.

Definition of "uncertificated securities market system"

8. Under Division 1 of the new Part IIIAA of Cap. 571, an "uncertificated securities market system" (USM system) means a computer-based system, together with procedures and other facilities, that (a) enables title to prescribed securities to be evidenced and transferred without an instrument and (b) facilitates supplementary and incidental matters.

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5 See the Administration's paper on the Legislative Proposals in the Companies (Amendment) Bill 2009 and Business Registration (Amendment) Bill 2009 issued to the panel on Financial Affairs in June 2009 (LC Paper No. CB(1)1829/08-09(01).

6 A copy of the consultation paper was provided to the Panel on Financial Affairs vide LC Paper No. CB(1)978/09-10(05).

7 See footnote 1 of the LegCo Brief.

Scope of application of the proposed regime

9. The proposed regime would only apply to "prescribed securities" which are securities that fall within a class or description of securities specified in Schedule 3A and that are listed or to be listed on a recognized stock market. The securities proposed to be specified in the new Schedule 3A to Cap. 571 are "Shares". Under the new section 101AAB(2) of Cap. 571, Schedule 3A may be amended by SFC, after consultation with the Financial Secretary, by notice published in the Gazette. Such notice would be an item of subsidiary legislation subject to the negative vetting procedure of the Legislative Council under section 34 of the Interpretation and General Clauses Ordinance (Cap. 1).

10. According to paragraph 4 of the LegCo Brief, the proposed regime will be implemented in phases with the initial phase covering shares that are listed or to be listed on a recognized stock market. It will not apply to unlisted securities, such as shares or debentures of private companies. 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.

Regulation of the uncertificated securities market system

11. The Bill proposes to confer on SFC various regulatory powers to regulate the USM system. These powers include-

(a) the power to approve a recognized clearing house[8] (RCH) to operate and maintain an USM system and to withdraw such approval (new sections 101AAG and 101AAI);

(b) the power to impose, amend or revoke conditions in granting approval to a RCH (new section 101AAH);

(c) the power to direct a RCH to cease operating the USM system (new section 101AAK);

(d) the power to require a RCH which is also the system operator of an USM system to supply documents and information in respect of the operation and maintenance of the system (amendments to section 42); and

(e) the power to make rules for the proposed regime, including rules providing for activities and matters relating to prescribed securities, the operations and procedures of an USM system, service fees that may be charged for performing functions under the rules (new section 101AAO), and prescribing offences for contravention of the rules.

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[8] A recognized clearing house is company recognized as a clearing house under section 37(1) of Cap. 571.

Duties of a RCH which is also an USM system operator

12. Under Cap. 571 as amended by the Bill, a RCH which is also an USM system operator has to ensure that an USM system is properly operated and maintained and that the activities and instructions carried out, executed or processed by the system are carried out, executed or processed by the USM system in an orderly, fair and expeditious manner. It is also proposed that an USM system operator would have the power to make rules for the proper regulation and efficient operation of an USM system that it operates. Further, certain duties are proposed to be imposed on a controller of a system operator. Regarding the duties of an USM system operator or a controller of the system operator on the proper operation and maintenance of the USM system, the Bill does not propose to prescribe any offences or sanctions for breach of such duties.

Amendments to the Companies Ordinance (Cap. 622)

13. The Bill does not seek to repeal the provisions under Cap. 622 relating to the requirements for the issue of paper share certificates and the use of paper instruments to effect the transfer of shares. Instead, it seeks to introduce provisions that would facilitate the implementation of the proposed regime. The effect is that the proposed regime, upon its implementation, would co-exist with the existing paper-based securities market regime. The proposed amendments to Cap. 622 are summarized below-

(a) new terms are introduced in Cap. 622 to define the shares and companies ("participating shares" and "participating company") that would be regulated under the proposed regime (amendments to section 2);

(b) the register of members of a participating company would consist of two parts, one recording certificated shares and the other recording uncertificated shares, and the requirements for such register would be set out in the rules to be made by SFC under Cap. 571 (new section 626B);

(c) new provisions are added to Cap. 622 to govern registration of allotment of shares in a participating company in uncertificated form (new sections 143A and 143B); and

(d) certain existing requirements under Cap. 622 relating to issue of share certificates and the delivery of instruments of transfer on various situations would not apply to participating companies (amendments to sections 144, 150, 151, 152, 153 and 158).

Amendments to the Stamp Duty Ordinance (Cap. 117)

14. Under section 19(1) of Cap. 117, any person who effects any sale or purchase of Hong Kong stock as principal or agent shall forthwith make and execute a contract note and cause the note to be stamped under the relevant heads in the First Schedule to Cap. 117. At present, ad valorem stamp duty (0.1% of the amount of the consideration or of value of the contract note at the date on which the contract note falls to be executed) and $5 fixed rate stamp duty are chargeable on the instrument of transfer in respect of any sale or purchase of Hong Kong stock under head 2 of the First Schedule to Cap. 117. The ad valorem stamp duty is currently collected electronically through the SEHK for transfers of shares effected through the trading system of the SEHK pursuant to the provision in section 5A(1) of Cap. 117.

15. Under the proposed regime, participating shares in uncertificated form, which are Hong Kong stock, may be transferred without an instrument of transfer, and therefore, the $5 fixed duty would not be chargeable on such transfers.

16. As regards the participating shares in uncertificated form which will not be transferred through the trading system of the SEHK, clause 54 of the Bill adds new provisions to Cap. 117 to provide for a new stamping method for collection of ad valorem stamp duty in relation to transfers of such shares under the proposed regime.

Miscellaneous amendments to other legislation

17. Part 4 of the Bill also seeks to make consequential and related amendments to provisions of the Mental Health Ordinance (Cap. 136), Crimes Ordinance (Cap. 200) and Companies (Winding-up) Rules (Cap. 32H) relating to shares and their transfer or disposition.

Commencement

18. The Bill, if enacted, will come into operation on a day to be appointed by the Secretary for Financial Services and the Treasury by notice published in the Gazette.

Public Consultation

19. According to paragraph 23 of the LegCo Brief, a public consultation exercise on the proposed regime was conducted from December 2009 to March 2010, and the vast majority of market respondents supported the proposed regime. The consultation conclusions were published in September 2010.

Consultation with LegCo Panel

20. The Clerk to the Panel on Financial Affairs has advised that the Panel was briefed on the development of an uncertificated securities market regime at the meeting on 1 February 2010. The Panel further discussed with the Administration the proposed 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 concerns including, the timeframe for implementing a fully uncertificated securities market regime and securities to be covered in various phases of implementation, comparison of the proposed regime with those of other jurisdictions, the cost impact on market participants and fees implication on investors, measures to encourage investors to hold securities in uncertificated form, and data protection for uncertificated securities.

Conclusion

21. The Legal Service Division is scrutinizing the legal and drafting aspects of the Bill. In view of the above concerns expressed by members of the Panel on Financial Affairs on the proposed regime, Members may wish to consider whether to set up a Bills Committee to study the Bill in detail.

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