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Paper for the House Committee meeting on 21 May 2021

**Report of the Bills Committee on Securities and Futures and
Companies Legislation (Amendment) Bill 2021**

Purpose

This paper reports on the deliberations of the Bills Committee on Securities and Futures and Companies Legislation (Amendment) Bill 2021 ("the Bills Committee").

Background

Development of an uncertificated securities market regime

2. Hong Kong's securities market is currently largely paper-based.¹ The law requires companies to issue paper certificates as evidence of legal title and investors to use paper instruments to transfer legal title to the securities.² However, investors can hold and transfer securities in electronic form through the Central Clearing and Settlement System ("CCASS"), which is an

¹ The Companies Ordinance (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 (Cap. 117) requires the use of paper instruments of transfer in respect of units in a unit trust scheme.

² Investors who hold legal title to securities are registered with the issuer as the legal owner of the securities. They can exercise their rights as securities holders, and receive entitlements from the issuer, directly.

immobilized securities settlement system³ and is operated by Hong Kong Securities Clearing Company Limited ("HKSCC"), a subsidiary company of Hong Kong Exchanges and Clearing Limited ("HKEX"). All securities held within CCASS are registered in the name of a single nominee, i.e. HKSCC Nominees Limited. Investors who hold securities within CCASS hold only the beneficial interest in the securities, i.e. they are not registered with the issuer of the securities as the legal owner of such securities and do not hold legal title to the securities.

3. According to the Administration, it has been a common trend for international financial centres in the world to move towards uncertificated securities markets ("USM"). The implementation of a USM regime in Hong Kong will ensure that its financial market infrastructure is in line with that in other major international financial centres and capital markets. Furthermore, the USM regime will provide the option for investors to hold securities in their own name and without paper. Compared with the current paper-based regime where investors can only hold securities in their own name in certificated form, such option will enable investors to enjoy both better legal protection (through holding securities in their own name) and greater convenience (through holding securities in uncertificated form, i.e. without paper).

4. In order to take forward the USM regime in Hong Kong, the Securities and Futures and Companies Legislation (Uncertificated Securities Market Amendment) Ordinance 2015 ("the Amendment Ordinance 2015") was enacted in March 2015 to provide the legal framework for implementing the USM regime based on an operational model formulated in 2009/2010 jointly by the Securities and Futures Commission ("SFC"), HKEX, and the Federation of Share Registrars Limited ("FSR"). According to the Administration, in view of market concerns about the limitations of this model, SFC, HKEX and FSR developed a revised operational model ("the Revised Model"), and conducted a consultation in early 2019 to gauge views on the proposals and received support from the majority of respondents.

5. Under the Revised Model, investors can hold legal title to securities in uncertificated form through either: (a) a new feature provided by the relevant issuer's share registrar (i.e. the USI feature⁴); or (b) a new feature provided

³ 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, the Central Clearing and Settlement System serves as the central depository and securities settlement system.

⁴ The acronym "USI" denotes that the holdings in question belong to an uncertificated securities holder, and that the feature is provided by the issuer's share registrar.

within the HKEX's clearing and settlement system and managed by a sponsoring clearing/custodian participant (i.e. the USS feature⁵). Share registrars are expected to play a more significant role than at present as they will not only continue to maintain the complete register of members of the listed companies, but also operate the systems for evidencing and effecting transfers of legal title to securities without paper documents. SFC will approve and regulate share registrars for the provision of securities registrar services ("SRS"). A phased approach will be adopted to implement the USM regime. The regime will start first with shares of Initial Public Offerings ("IPOs") of Hong Kong companies.

6. The implementation of the USM regime under the Revised Model will necessitate amendments to certain pieces of legislation, including the Securities and Futures Ordinance (Cap. 571) ("SFO") and the Companies Ordinance (Cap. 622) ("CO") and the Stamp Duty Ordinance (Cap. 117). Details relating to more operational and technical matters under the USM environment will be set out in the new subsidiary legislation to be made by SFC.

Establishment of an over-the-counter derivative licensing regime

7. The global financial crisis of 2008 highlighted the structural deficiencies in the over-the-counter ("OTC") derivatives market and the systemic risk they pose for the wider market and economy. The Securities and Futures (Amendment) Ordinance 2014 ("the Amendment Ordinance 2014") enacted in April 2014 introduced an OTC derivative regulatory framework in Hong Kong which is being implemented progressively. Among others, the framework establishes an OTC derivative licensing regime which includes the introduction of two new regulated activities ("RAs") under Schedule 5 to SFO, namely (a) a new Type 11 RA (dealing in OTC derivative products or advising on OTC derivative products), and (b) a new Type 12 RA (providing client clearing services for OTC derivative transactions). Moreover, the existing Type 9 RA (asset management) and Type 7 RA (provision of automated trading services) are expanded to cover OTC derivative portfolios and transactions respectively. Section 53(23) of the Amendment Ordinance 2014 prescribes a list of carve-outs from the OTC derivative licensing regime.

8. According to the Administration, in further consultation with market participants, it is necessary to refine the scope of RAs and provide more clarity about the exceptions in order to better reflect the policy intent through making amendments to Schedule 5 to SFO and the Amendment Ordinance 2014.

⁵ The acronym "USS" denotes that the holdings in question belong to an uncertificated securities holder, and that the feature is provided by a sponsoring clearing/custodian participant.

The Bill

9. The Bill was published in the Gazette on 19 March 2021 and received its First Reading at the Council meeting of 24 March 2021.

10. The Bill seeks to amend SFO, CO and other enactments to:

- (a) facilitate the establishment and implementation of a USM regime in Hong Kong;
- (b) provide for a regulatory regime for persons providing SRS;
- (c) refine the scope of certain RAs relating to OTC derivative transactions;
- (d) make minor miscellaneous amendments; and
- (e) provide for related matters.

11. Amendments relating to the USM regime and the OTC derivative licensing regime are set out in Part 2 and Part 3 of the Bill respectively. The major provisions on the two parts are set out in **Appendix I**. Part 4 of the Bill contains miscellaneous amendments to enactments including SFO and the Securities and Futures (Fees) Rules (Cap. 571 sub. leg. AF). Part 5 of the Bill repeals the uncommenced provisions of the Amendment Ordinance 2015. Part 1 of the Bill, among others, provides for the commencement of the various provisions of the Bill, which if passed, will come into operation in different manners.⁶

⁶ Part 2 (except section 9(2)) and Part 5 of the enacted Ordinance (mainly relating to the USM regime) would come into operation on a day to be appointed by Secretary for Financial Services and the Treasury by notice published in the Gazette. Division 4 of Part 4 (mainly relating to the waiver of fees concerning certain regulated activities ("RAs") under the Securities and Futures (Fees) Rules (Cap. 571AF)) would come into operation on the day on which section 53(3) of the Securities and Futures (Amendment) Ordinance 2014 (which adds a new type of carve-out in respect of the definition of "advising on futures contracts" under Schedule 5 to the Securities and Futures Ordinance (Cap. 571)) comes into operation (i.e. on a day to be appointed by SFST by notice published in the Gazette). The remaining provisions (including the said section 9(2)) would come into operation on the day on which the enacted Ordinance is published in the Gazette.

The Bills Committee

12. At the meeting of the House Committee held on 26 March 2021, Members agreed to form a Bills Committee to study the Bill. The membership list of the Bills Committee is in **Appendix II**. Under the chairmanship of Mr Christopher CHEUNG Wah-fung, the Bills Committee has held one meeting to study the Bill with the Administration and SFC. The Bills Committee has invited the public to provide written views on the Bill, and has not received written submissions on the Bill.

Deliberations of the Bills Committee

13. Members of the Bills Committee in general support the Bill. The major deliberations of the Bills Committee are set out in the ensuing paragraphs.

The uncertificated securities market regime

Phased implementation of the uncertificated securities market regime

14. Noting that the first phase of the USM regime will cover shares of IPOs of Hong Kong companies, the Bills Committee has enquired about the timetable for implementing the USM regime in Hong Kong in full and the considerations involved.

15. The Administration has responded that it will adopt a phased approach to implement the USM regime, and the initial plan is to start implementing the regime from around end-2022. In terms of products, the regime will start first with listed shares of Hong Kong companies and then listed shares of non-Hong Kong companies. In terms of processes, the plan is to focus first on IPOs, to be followed by converting existing shares held within the clearing and settlement system to uncertificated form, before turning to existing shares held outside the clearing and settlement system. The pace and timetable for migrating to a full USM regime will be stipulated in subsequent subsidiary legislation and contingent on the then prevailing circumstances, market readiness and, for non-Hong Kong companies, the compatibility of the respective companies laws of their places of incorporation with the proposed USM regime. In the case of listed shares of non-Hong Kong companies, the Administration will focus on three main jurisdictions namely the Mainland, Bermuda and Cayman Islands. Listed companies incorporated in these jurisdictions, together with those incorporated in Hong Kong, account for over 96% (as at end 2020) of the market capitalization of all listed companies in Hong Kong. In order to implement the USM regime for non-Hong Kong companies, SFC has commenced discussion with the China Securities Regulatory Commission, and

will also liaise with the relevant authorities of Bermuda and Cayman Islands on the matter.

16. Some members of the Bills Committee have enquired about measures the Administration and SFC will take to facilitate investors in understanding the details of the USM regime and adopting various features, as well as to help investors, particularly the elderly, who prefer to hold securities in certificated form in migrating to the USM regime.

17. On the operation of the USM regime, SFC has explained that investors who hold securities in their own names through the USI or USS feature will need to move the securities into the clearing and settlement environment to settle sell transactions conducted on the Stock Exchange of Hong Kong ("SEHK"). This will effectively constitute a legal title transfer of securities from the relevant investor to HKSCC Nominees Limited. Similarly, investors who have acquired securities through buy transactions conducted on SEHK and wish to have them registered in their own name will need to move them out of the clearing and settlement environment. This will also constitute a legal title transfer, but from HKSCC Nominees Limited to the relevant investor. To ensure that such transfers can be effected securely and efficiently, share registrars will become participants of the HKEX's system, thus essentially creating an electronic interface between their respective systems. The operational model for the implementation of the USM regime is set out in **Appendix III**.

18. Regarding assistance to investors in migrating to the USM regime, the Administration has pointed out that upon implementation of the USM regime, some investors may need to sign up for the USI feature with the approved securities registrars ("ASRs"). FSR is looking into establishing a centralized platform to facilitate investors so that it will be unnecessary for them to approach individual ASRs. The Administration has re-iterated that it fully understands that some investors may need time to adapt to the USM regime, and thus the Administration would take into account market readiness in deciding the specific pace and timetable for the full implementation of the regime. The Administration will collaborate with SFC to conduct publicity work to promote the benefits of the USM regime, and it is anticipated that investors will gradually adapt to the regime and recognize the advantages including a digitalized environment for the holding and transfer of legal title to securities, which will enable straight-through processing and shorten turnaround time for related processes, as well as enable investors to enjoy both better legal protection (through holding securities in their own name) and greater convenience (through holding securities in uncertificated form, i.e. without paper).

Cost impact of implementing the uncertificated securities market regime on investors and market participants

19. As regards the impact of implementing the USM regime on the securities industry, Mr Christopher CHEUNG has expressed concern that it may increase the operating costs of the industry, especially the small and medium-sized securities firms, and enquired if the Administration will consider providing financial assistance to these firms to help them upgrade their systems to tie in with the implementation of the regime. Sharing the view that the Administration should examine the need of providing financial assistance to small and medium-sized securities firms, Mr CHAN Kin-po has stressed the need for the Administration and SFC to continue engaging the firms to address their concerns about the implementation of the USM regime.

20. The Administration and SFC have responded that the initial development costs of the new systems to support the Revised Model will largely be borne by HKEX and share registrars as part of their commitment to the ongoing technological development of Hong Kong's markets. SFC has elaborated that HKEX will launch the next generation of securities clearing and settlement system to cater for its future development, and the new system will incorporate functions to support the USM regime. Regarding the cost impact of the USM regime on securities firms, SFC has responded that the existing operating procedures of securities firms will remain largely unchanged under the USM regime. The cost implications for securities firms will be limited. The implementation of the USM regime will also help reduce the operating costs of securities firms in the long run through streamlining some of their administrative procedures.

21. Given that the holding and transfer of securities under the USM regime will be made through electronic means, members have enquired about room for lowering fees payable by investors with implementation of the regime.

22. The Administration has responded that if investors maintain their existing approach in holding securities, there will be no additional cost involved upon implementation of the USM regime. If investors opt to hold securities in their own names and in uncertificated form, the relevant fees and charges will be determined by the share registrars and sponsoring clearing/custodian participants. There may be room for lowering the fees and charges on investors in the long run with increased adoption of the regime.

Approval for provision of securities registrar services

23. The Bills Committee notes that under proposed section 101AAG(5) of SFO (clause 7 of the Bill), when considering an application for providing SRS, SFC will consider, among others, any information in its possession whether or

not it is provided by the applicant. Proposed section 101AAH(2) of SFO provides that SFC must give the applicant a reasonable opportunity of being heard before refusing the application. The Bills Committee has enquired about the form of the hearing and whether the applicant will have the right to be legally represented at the hearing, and whether SFC will inform the applicant of the reasons for refusing the application and disclose to the applicant the information which forms the basis (or part of the basis) of its refusal.

24. The Administration and SFC have explained that the arrangements in proposed sections 101AAG(5) and 101AAH(2) of SFO are in line with the procedures for refusing other applications under SFO. A decision not to grant an approval under section 101AAG of SFO may be appealed to the Securities and Futures Appeals Tribunal according to section 217 of and the amended Schedule 8 to SFO. As for the requirement for "a reasonable opportunity of being heard", it does not necessarily refer to a physical hearing. It is a process whereby SFC informs the applicant in advance of the reasons of its intention not to grant an approval, and the applicant is able to respond why the application should not be refused. The process is similar to that applicable for other applications to SFC under SFO. While the process is usually conducted through written correspondence, meetings can also be arranged where requested and/or necessary. Applicants can seek legal advice and invite their legal advisers to attend any meetings with SFC. In the case of refusal of an application for providing SRS, SFC would inform the applicant of the reasons concerned in writing. While SFC may not be able to inform the applicant of the source of all of the information to which it has made reference (e.g. because some information may be provided in confidence), the substance of the information which SFC has made reference to in coming to its view would be presented to the applicant in a sufficiently clear manner to enable the applicant to respond.

Code and guideline for approved securities registrars

25. The Bills Committee has noted that under section 193(1)(da) and (3) of SFO (to be amended by clause 10 of the Bill), SFC shall not form any opinion that an approved share registrar ("ASR")'s act or omission is or is likely to be prejudicial to the interest of the investing public or to the public interest unless it has had regard to the relevant code or guideline published under section 399 of SFO. As any code or guideline published under section 399 of SFO is not subsidiary legislation, the Bills Committee has requested SFC to provide examples of the kinds of conduct of ASRs which will be included in the relevant code or guideline.

26. SFC has advised that the code or guideline will set out in more detail the standards and practices expected of ASRs and will cover conduct and operational matters (such as honesty, fairness, diligence, capabilities, internal

controls and risk management, conflict of interests, compliance with applicable laws and regulations, etc.) and system-related matters (such as the security, reliability, availability, adequacy, etc. of the systems operated and used by ASRs). The breaches of these standards could, depending on their nature and extent, have varying degrees of impact on the investing public. For example, a one-off failure which is rectified quickly may only cause minor inconvenience or delay in processing an instruction from an investor. However, repeated failures of a similar kind or nature of matter may be indicative of a more serious deficiency in the ASR's internal controls or risk management practices and is more likely to have a greater adverse impact on investors.

Fixed stamp duty on the instrument of transfer of securities

27. The Bills Committee has noted that upon implementation of the USM regime, as the transfer of prescribed securities will not involve any paper instrument, the current \$5 fixed stamp duty will no longer be chargeable and only the ad valorem stamp duty will continue to be collected. Members have sought the Administration's confirmation on such arrangement, and enquired whether the aforesaid arrangement will affect how legal titles of securities may be established for the purposes of Court proceedings.

28. The Administration has explained that the \$5 fixed stamp duty is chargeable per instrument of transfer of securities. Since instrument of transfer will no longer be required for the transfer of prescribed securities under the USM regime, the \$5 fixed stamp duty will not be chargeable on prescribed securities transferred without such instrument.

29. As regards how legal title in respect of prescribed securities transferred in paperless form under the USM regime may be established for the purposes of Court proceedings, the Administration has responded that the legal title to such securities will continue to be reflected in the relevant company's register of members after completion of the relevant transaction. Further, pursuant to a specified request made by the relevant party to the relevant ASR after the said completion, the ASR is required to record the legal title to the securities accordingly by making a corresponding entry to the relevant register of members. Separately, investors' ability to apply to the Court for a rectification of the register of members is also preserved.

Appointment of proxies by individual shareholders of companies

30. The Bill proposes to amend section 596 of CO to limit the number of proxies that may be appointed by an individual shareholder of a listed company (clause 69 of the Bill). The Bills Committee has enquired about the rationale for the proposed amendment and whether the rights of shareholders would be adversely affected.

31. The Administration has responded that existing section 596 of CO allows shareholders to appoint multiple proxies without a limit. This provision applies to both individual and non-individual (e.g. brokerage firms) shareholders. There has been market feedback in recent years of cases where individual shareholders of listed companies have used this provision to appoint numerous proxies not for the purposes of participating in discussions on proposed resolutions or voting at shareholders' meeting but for other attractions, such as doorgifts. In order to strike a balance and to ensure the smooth and orderly proceeding of shareholders' meeting of listed companies, the proposed amendment imposes a limit on the number of proxies that may be appointed by individual shareholders of listed companies to two. The Administration has elaborated that the purpose of the proposed amendment is to prevent the appointment of multiple proxies by shareholders not for genuine purposes while taking into account the need for retaining shareholders' ability to exercise their rights and enjoy entitlements. The number of proxies to be appointed by non-individual shareholders (e.g. brokerage firms) will not be affected.

Amendments to the Bill

32. The Bills Committee and the Administration will not propose amendments to the Bill.

Resumption of Second Reading debate

33. The Bills Committee has no objection to the Administration's giving notice to resume the Second Reading debate on the Bill at the Council meeting of 2 June 2021.

Advice sought

34. Members are invited to note the deliberations of the Bills Committee.

**The main provisions of the Securities and Futures and
Companies Legislation (Amendment) Bill 2021**

**Part 2 – Amendments relating to the Uncertificated Securities Market
("USM") regime**

- (a) **Division 1 of Part 2** adds a new Part IIIAA to, and amends various provisions in, the Securities and Futures Ordinance (Cap. 571) ("SFO") to provide for the general principles to be adopted for the USM regime and a regulatory regime for persons providing securities registrar services and to empower the Securities and Futures Commission to make rules regulating the USM environment;
- (b) **Division 2 of Part 2** amends the Companies Ordinance (Cap. 622) ("CO") to provide for, for the purposes of the USM regime, matters including allotment and transfer of shares in a listed company and application for holding shares in a listed company in uncertificated form in case of loss of share certificates; and
- (c) **Division 3 of Part 2** contains related amendments, including amendments to the Stamp Duty Ordinance (Cap. 117) to provide for a new stamping method for the collection of ad valorem stamp duty involving shares in uncertificated form and other amendments to CO, including authentication of documents or information sent or supplied by or to a listed company in electronic form and limiting the number of proxies that may be appointed by an individual member of a listed company.

**Part 3 – Amendments relating to Over-The-Counter ("OTC") Derivative
Licensing Regime**

Part 3 amends Schedule 5 to SFO and certain provisions in the Securities and Futures (Amendment) Ordinance 2014 to carve out activities that are not intended to be covered by the OTC derivative licensing regime and to clarify the scope of relevant regulated activities and consequentially amends Rule 10 of the Securities and Futures (OTC Derivative Transactions) – Clearing and Record Keeping Obligations and Designation of Central Counterparties) Rules (Cap. 571 sub. leg. AN).

(Source : Adapted from paragraph 21 of the Legislative Council Brief File Ref : CO/2/10C(2021))

**Bills Committee on Securities and Futures and
Companies Legislation (Amendment) Bill 2021**

Membership list

Chairman Hon Christopher CHEUNG Wah-fung, SBS, JP

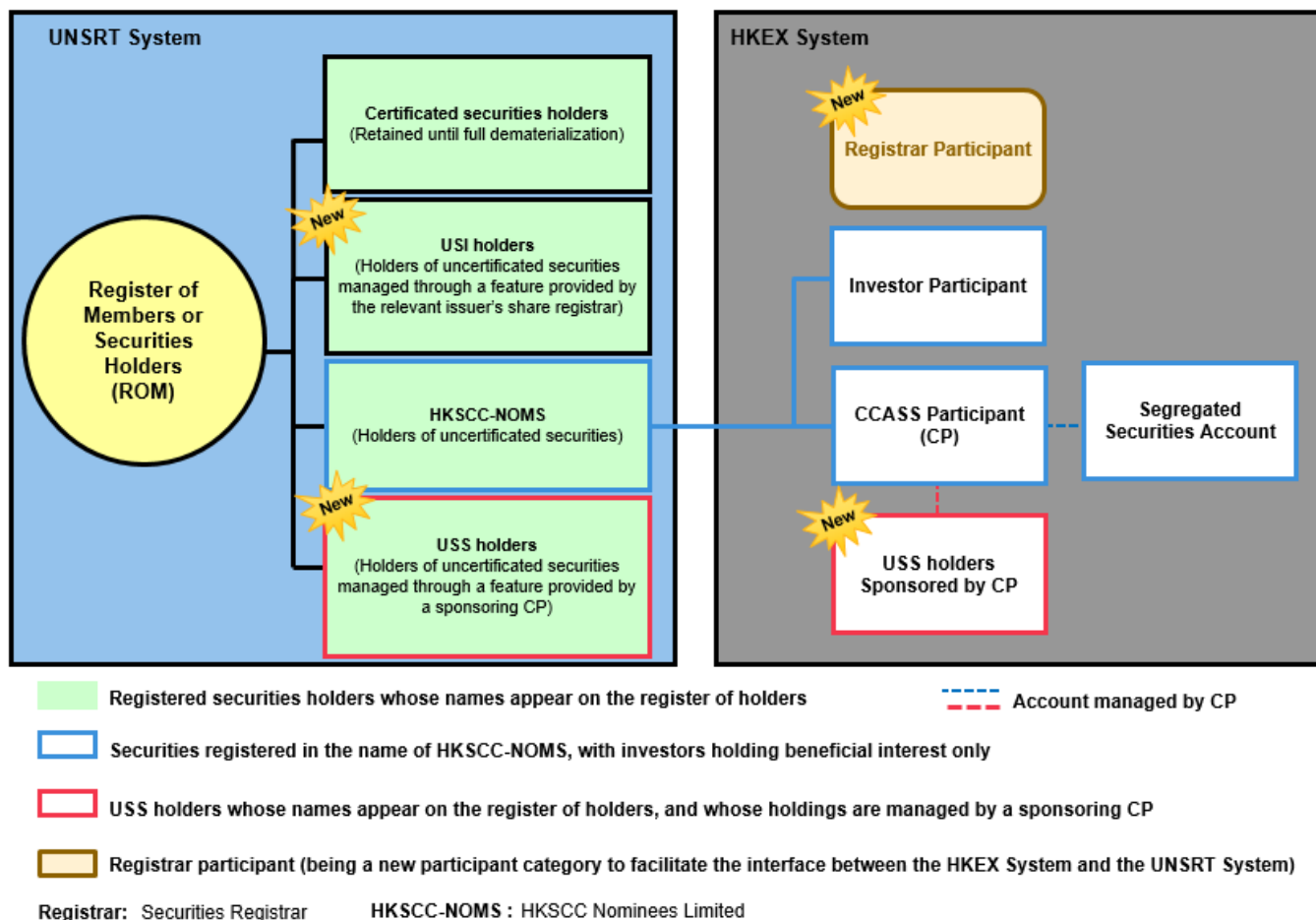
Members Hon WONG Ting-kwong, GBS, JP
Hon Starry LEE Wai-king, SBS, JP
Hon CHAN Kin-por, GBS, JP
Hon CHAN Chun-ying, JP

(Total : 5 members)

Clerk Ms Connie SZETO

Legal Advisers Miss Evelyn LEE

Revised Operational Model for the Implementation of the Uncertificated Securities Market Regime



(Source : Annex B to the Legislative Council Brief File Ref : CO/2/10C(2021))