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Panel on Financial Affairs

Meeting on 6 May 2024

Background brief on the implementation of an uncertificated securities market regime

Purpose

This paper provides background information on the implementation of an uncertificated securities market (“USM”) regime in Hong Kong. It also summarizes the major views and concerns expressed by Members when related issues were discussed by the Panel on Financial Affairs (“FA Panel”) at the meeting on 19 March 2019, and the Bills Committee on Securities and Futures and Companies Legislation (Amendment) Bill 2021 .

Background

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

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.

(“CCASS”), which is an 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 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 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 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”). In view of further feedback from the industry and the continuous evolvement of the market, SFC, HKEX and FSR developed a revised operational model (“the revised model”) for implementing the USM regime. 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”), the Companies Ordinance (Cap. 622) (“CO”) and the Stamp Duty Ordinance (Cap. 117).

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, CCASS serves as the central depository and securities settlement system.

Securities and Futures and Companies Legislation (Amendment) Ordinance 2021

5. The Securities and Futures and Companies Legislation (Amendment) Ordinance 2021⁴ enacted in June 2021 amends SFO, CO and other enactments to facilitate the establishment and implementation of a USM regime in Hong Kong under the revised model and provide for a regulatory regime for persons providing securities registrar services (“SRS”).

6. 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 feature⁵); or (b) a new feature provided within the HKEX’s clearing and settlement system and managed by a sponsoring clearing/custodian participant (i.e. the USS feature⁶). 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 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. An illustration of the revised model is set out in **Appendix 1**.

Major views and concerns expressed by Members

7. The major views and concerns expressed by Members during discussion on issues relating to the implementation of the USM regime under the revised model at the meeting of the FA Panel on 19 March 2019, and during scrutiny of the Securities and Futures and Companies Legislation (Amendment) Bill 2021 are summarized in the ensuing paragraphs.

⁴ The relevant bill (i.e. the Securities and Futures and Companies Legislation (Amendment) Bill 2021) was introduced into the Legislative Council in March 2021. A bills committee (i.e. the Bills Committee on Securities and Futures and Companies Legislation (Amendment) Bill 2021) was formed to study the Bill.

⁵ 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.

⁶ 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.

Phased implementation of the uncertificated securities market regime

8. Noting that the first phase of the USM regime would cover shares of IPOs of Hong Kong companies, Members enquired about the timetable for implementing the USM regime in Hong Kong in full and the considerations involved.

9. The Administration responded that it would adopt a phased approach to implement the USM regime. In terms of products, the regime would start first with listed shares of Hong Kong companies and then listed shares of non-Hong Kong companies. In terms of processes, the plan was 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 would 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 would focus on three main jurisdictions namely the Mainland, Bermuda and Cayman Islands. In order to implement the USM regime for non-Hong Kong companies, SFC had commenced discussion with the China Securities Regulatory Commission, and would also liaise with the relevant authorities of Bermuda and Cayman Islands on the matter.

10. Members enquired about measures the Administration and SFC would 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 preferred to hold securities in certificated form in migrating to the USM regime.

11. On the operation of the USM regime, SFC explained that investors who hold securities in their own names through the USI or USS feature would 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 would effectively constitute a legal title transfer of securities from the relevant investor to HKSCC Nominees Limited. Similarly, investors who had acquired securities through buy transactions conducted on SEHK and wished to have them registered in their own name would need to move them out of the clearing and settlement environment. This would also constitute a legal title transfer, but from HKSCC Nominees Limited to the relevant investor. To ensure that such transfers could be effected securely and efficiently, share registrars would

become participants of the HKEX's system, thus essentially creating an electronic interface between their respective systems.

12. Regarding assistance to investors in migrating to the USM regime, the Administration pointed out that upon implementation of the USM regime, some investors might need to sign up for the USI feature with the approved securities registrars ("ASRs"). FSR was looking into establishing a centralized platform to facilitate investors so that it would be unnecessary for them to approach individual ASRs. The Administration understood that some investors might 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 would collaborate with SFC to conduct publicity work to promote the benefits of the USM regime, and it was anticipated that investors would gradually adapt to the regime and recognize the advantages including a digitalized environment for the holding and transfer of legal title to securities, which would enable straight-through processing and shorten turnaround time for related processes, as well as enable investors to enjoy both better legal protection and greater convenience.

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

13. As regards the impact of implementing the USM regime on the securities industry, Members expressed concern that it might increase the operating costs of the industry, especially the small and medium-sized securities firms, and enquired if the Administration would 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, Members stressed the need for the Administration and SFC to continue engaging the firms to address their concerns about the implementation of the USM regime.

14. The Administration and SFC responded that the initial development costs of the new systems to support the revised model would largely be borne by HKEX and share registrars as part of their commitment to the ongoing technological development of Hong Kong's markets. SFC added that HKEX would launch the next generation of securities clearing and settlement system to cater for its future development, and the new system would incorporate functions to support the USM regime. Regarding the cost impact of the USM regime on securities firms, SFC responded that the existing operating procedures of securities firms would remain largely unchanged under the USM regime. The cost implications for securities

firms would be limited. The implementation of the USM regime would also help reduce the operating costs of securities firms in the long run through streamlining some of their administrative procedures.

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

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

Code and guideline for approved securities registrars

17. In response to Members' enquiry on the kinds of conduct of ASRs which would be included in the relevant code or guideline to be published by SFC, SFC advised that the code or guideline would set out in more detail the standards and practices expected of ASRs and would 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 was rectified quickly might only cause minor inconvenience or delay in processing an instruction from an investor. However, repeated failures of a similar kind or nature of matter might be indicative of a more serious deficiency in the ASR's internal controls or risk management practices and was more likely to have a greater adverse impact on investors.

Fixed stamp duty on the instrument of transfer of securities

18. Members noted that upon implementation of the USM regime, as the transfer of prescribed securities would not involve any paper instrument, the current \$5 fixed stamp duty would no longer be chargeable and only the ad valorem stamp duty would continue to be collected. Members sought the Administration's confirmation on such arrangement, and enquired

whether the aforesaid arrangement would affect how legal titles of securities might be established for the purposes of Court proceedings.

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

20. As regards how legal title in respect of prescribed securities transferred in paperless form under the USM regime might be established for the purposes of Court proceedings, the Administration responded that the legal title to such securities would 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 was 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 was also preserved.

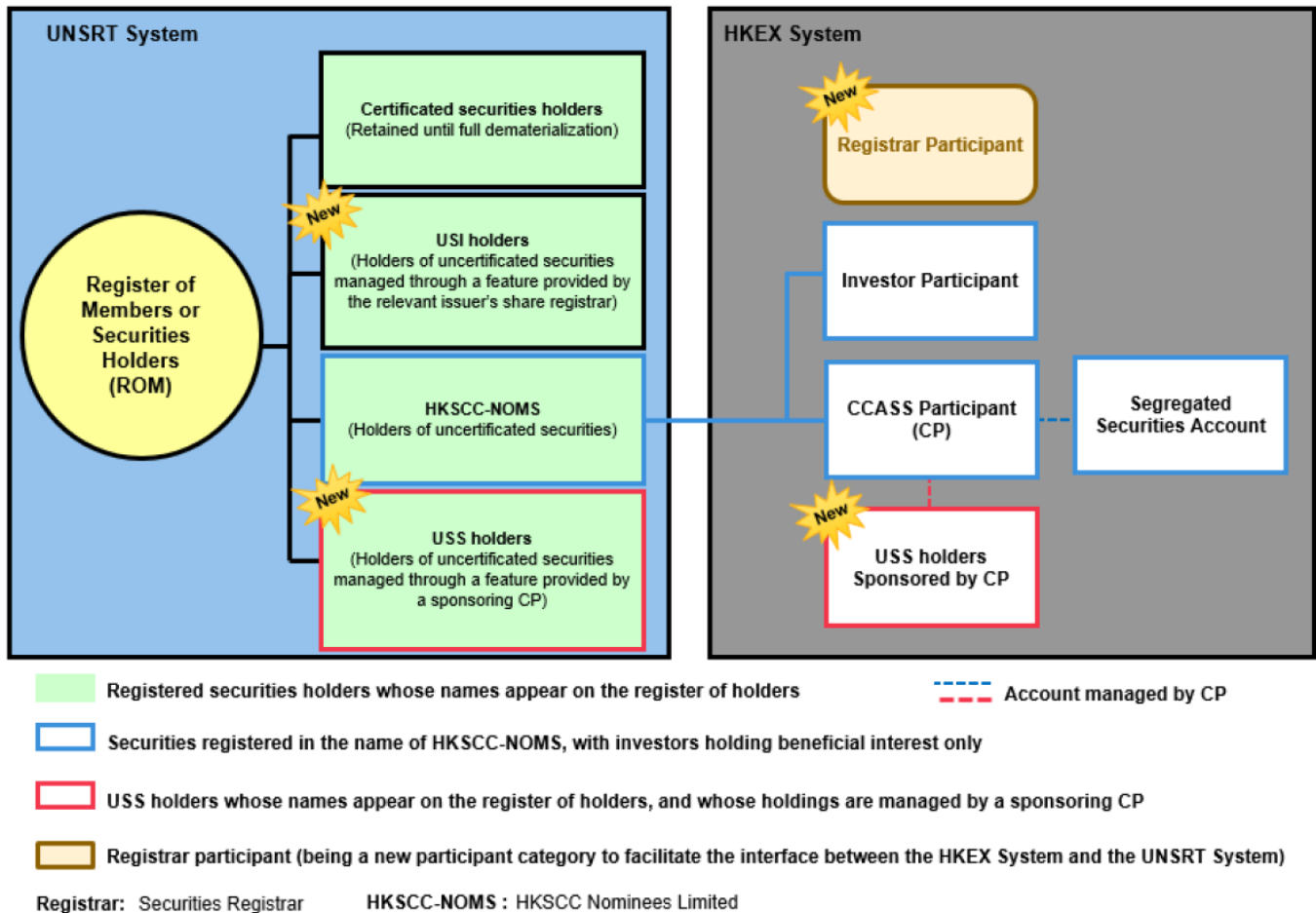
Latest development

21. The Administration and SFC will consult the Panel on the proposed arrangements for implementing the USM regime and the relevant legislative proposal at the meeting on 6 May 2024.

Relevant papers

22. A list of relevant papers is in **Appendix 2**.

Revised operational model for the implementation of the uncertificated securities market regime



Source: Legislative Council Brief on Securities and Futures and Companies Legislation (Amendment) Bill 2021 (File Ref: CO/2/10C(2021)).

List of relevant papers

Committee	Date of meeting	Paper
Panel on Financial Affairs	19 March 2019	Agenda Item V: Consultation on uncertificated securities market regime Minutes
Bill Committee on Securities and Futures and Companies Legislation (Amendment) Bill 2021	*28 May 2021	Report of the Bills Committee on Securities and Futures and Companies Legislation (Amendment) Bill 2021

*Issue date of paper