HSBC is broadly in support of the initiative to dematerialise the Hong Kong securities market. A more robust settlement process is expected as a result of the enhanced efficiency made possible by moving to scripless which will reduce risk and overall market costs.

HSBC serves multiple sectors in Hong Kong ranging from retail to institutional investors and this response encapsulates the key issues for these investors. We have also included suggestions on how to address the issues that have been identified.

- Institutional Investors – we have consulted the international global custodian community. Whilst broadly welcoming the plans, until key financial implications are made available they are unable to comment in greater depth on the proposals. The key concerns of this group of investors surround the topic of cash finality against the change in title and changes in market costs.

- Retail Investors – The model provides a degree of protection to investors from broker insolvency, which is an important development. The electronic transfers for trading or pledging purposes lack an immediate credit between the two registers that will cause unnecessary delays to these transfers. The model seeks to provide corporate communications and benefits directly to investors which we support.

- Listed companies – The scripless market model would increase the number of registered shareholders and thereby improve the transparency of the register of members. This model would provide listed companies with more information regarding their shareholders whilst allowing information about each company to reach a wider spectrum of shareholders. We believe that this is in the best interests of the Hong Kong market as a whole and would stimulate investment on the local exchange.

Key Issues with Proposed Model

1. Cash Finality

The ability to show ownership at the participant level is a major benefit of the model but the disconnect between the change in legal title of the securities and the movement of cash is of concern. Under the proposed model, the legal title of securities will change at the time of settlement in CCASS whilst cash legs will continue to be cleared overnight.

Counterparty and credit risk continue unless the current securities and money settlement is more closely synchronised. The proposed model does not offer refinements to existing workflow so that the overnight risk is eliminated.

Steps should be taken to integrate the cash settlement more closely with the securities leg during the development of the scripless model. Working within current systems, the use of RTGS should be made mandatory for securities cash settlement in order to align more closely the change of securities title with the receipt of cash. As an alternative, if cash finality was moved to end of day T+2, change of title could be delayed and then 'perfected' at this time under a scripless model. This compromise will eliminate the overnight risk, but it will not make Hong Kong a true DvP market, which must be the ultimate goal.

The issue is an important one especially amongst our more sophisticated institutional investors who, even under the current arrangements, have voiced concerns about the cash/securities settlement delinkage. We believe that the creation of a truly scripless market in Hong Kong is an excellent opportunity to address these concerns.

2. Day-end Transfers from Issuer Registrar to CCASS Registrar

The current model proposes that share movements between the CCASS register and the issuer register will be conducted end of day, in an overnight batch without comprehensive validation checks by CCASS.

This is a significant degradation from the existing arrangements for three main reasons:-

- The overnight batch model prevents investors and/or their agents from effectively and efficiently managing their holdings between the registers and therefore restricts their ability to offer investor choice.
- The limited validation checks mean that it is not possible to ensure that an inter-register transfer will be successful in the overnight batch. This increases the chances that this transfer may fail for technical reasons with a detrimental knock-on effect on settlement performance. This heightened settlement risk is an unnecessary feature of the inter-register transfer mechanism.
- CCASS participants, who receive physical shares for deposit into their clients'

accounts, will no longer be able to offer immediate credit to clients. This is a rollback of existing standards.

The restrictions embedded in the proposal do not serve the investor community well as they limit choice, a key underlying principle of the proposals. It is our view that the proposed over-night inter-register transfer methodology is therefore unworkable, introduces greater risk to the market and increases costs.

It is imperative that transfers take place on-line or at a minimum that there is an intra-day transfer mechanism included in the model. This will ensure that errors can be rectified during the processing day, thus mitigating settlement risk through the non-delivery of shares onto a register. Such a facility will also ensure that the principle of investor choice between the registers is promoted while not reducing service standards.

3. Shareholder Reference Numbers (SRN)

Concerns have been voiced about the handling and usage of SRNs, in particular their efficacy and security. It is not clear what exact arrangements will be made for SRNs and this lack of clarity needs to be addressed. The maintenance of SRNs for either retail or institutional investors will be very cumbersome and error-prone, particularly if it is at a holding level or on a trade basis. The market does not perceive this as a shareholder-friendly arrangement.

The SRN or the shareholder identification system developed should provide sufficient security protection so that a shareholder does not need to pass control of this 'security key' to an party unnecessarily unless the shares are part of an underlying transaction.

It is critical that the system retains effective security in an efficient manner so that it facilitates settlement and transfer.

4. Corporate Actions

The model proposes that HKEx will have responsibility for corporate action processing for shareholders on the CCASS register. Currently, share registrars provide such a service without charge for all shareholders, irrespective of the nature of their holdings. The changes envisaged are welcomed if HKEx is able to provide the same service to the standards to which share registrars currently perform without increasing the costs of corporate action services for holders on the CCASS register.

5. Financial Implications

The implementation of a scripless model will inevitably result in changes to HKEx's fee structure. It is not clear from the documents presented so far what the possible financial implications of the proposed model are in terms of (a) the costs involved in transitioning to a scripless market and (b) the on-going costs of HKEx's service as the central depository.

The current HKEx fee structure is not designed on a user pays basis and we expect that this will be addressed in the model. We welcome the statement that any proposal will be based on this important principle.

It is critical that the practical design of a scripless market is discussed while concurrently addressing the financial implications of the changes. An underlying principle set forth in the consultation is that the model should introduce greater efficiency to the Hong Kong market and thus create cost savings. HSBC expects to see overall market cost reductions from the exercise. However, we have been advised that HKEx is seeking to make this exercise revenue neutral. We do not see how the two concepts can be reconciled.

The financial implications will be important determinants in moulding the design of the scripless market into a form that is acceptable to the market. An airing of the implications will also lead to more active engagement by a wider spectrum of market participants in the development of the model. The issue of transition costs and on-going HKEx costs within a scripless market should be tabled as a matter of some urgency, albeit in a manner congruent with HKEx's position as a public company.

HSBC re-emphasises it position that the scripless market should be more efficient for the market including HKEx and that costs savings should be passed onto participants in an equitable manner.