



JOINT CONSULTATION ON A REVISED OPERATIONAL MODEL FOR IMPLEMENTING AN UNCERTIFICATED SECURITIES MARKET IN HONG KONG

The Law Society's Submissions

The Securities and Futures Commission ("SFC"), Hong Kong Exchanges and Clearing Limited ("HKEX") and the Federation of Share Registrars Limited ("FSR") issued a joint consultation in January 2019 on "*A Revised Operational Model For Implementing an Uncertificated Securities Market in Hong Kong*". The Law Society makes the following submissions on the consultation questions posed.

Q1. Do you agree that the revised operational model proposed in this consultation paper ("Revised Model") presents a better option for taking forward the uncertificated securities market ("USM") initiative? If no, please provide details.

Law Society's response:

The Law Society welcomes the initiative to implement a paperless securities market which it considers essential if Hong Kong is to maintain its edge as a leading international securities market. An uncertificated securities market for Hong Kong has been under discussion since 2001, while paperless trading has been adopted by the world's leading markets, including the New York, London, Shanghai and Shenzhen exchanges, and in many Asian jurisdictions, (including Singapore, India and the Philippines). It is imperative that Hong Kong modernises by introducing an USM, both to improve market efficiency and to reduce the environmental impact of paper use.

There were however different views as to whether the Revised Model provides a better solution than the 2010 Model.

One view is that the Revised Model offers a neat, if not necessarily perfect, solution in terms of improving settlement efficiency and eliminating paper shares on a phased basis. Its principal advantage is to provide an electronic interface to ease the process of selling paper shares on the Hong Kong Stock Exchange and increase efficiencies at IPO.

The other view is that the Revised Model's proposals is regressive, as the inability of listed company shareholders to enjoy the full benefits of legal title to their shares (in relation to voting and issuer communications in particular) is seen as a significant step

back from the 2010 Model, with the consequent continuance of the complex and antiquated arrangements for voting and shareholder communications.

However, the following views are unanimously shared:

1. The problem of perpetuating the currently complex and antiquated system whereby beneficial owners are not able to exercise their rights as legal owners of shares deposited in CCASS must be resolved as a matter of urgency.
2. While the Consultation Paper acknowledges this problem, it is of concern that there is no timeline to have the problem resolved. We therefore wish to highlight this issue prominently in our response.
3. In addition, we also wish to point out that there is a considerable perceptual problem with the Revised Model: unless and until beneficial owners are able to exercise legal ownership rights of shares deposited in CCASS, the Revised Model will continue to fail in showcasing Hong Kong as a modern and innovative market commensurate with its leading position as an international securities market.

Q2. Do you have any concerns or comments about the key features of the proposed Revised Model? If yes, please provide details.

Law Society's response:

Please see the response to Question 1 above.

Those willing to accept the Revised Model as a step in the right direction raise the need to cancel the antiquated "board lot" system, because once securities are dematerialised, the "board lot" system will become a pointless hindrance to trading. While the other view is that the Revised Model represents a step backwards, the following views are unanimously shared:

1. The Consultation Paper notes that the UK model, which allows simultaneous securities and money settlement throughout the trading day, would require major changes to Hong Kong's systems and regulations, and might not result in funding being made available to all market participants. While these are valid points, they should not be allowed to delay the inevitable implementation of the full-scale changes necessary to provide a fully dematerialised market with legal title for securities holders.
2. Non-institutional investors will hold uncertificated securities through an USI account operated by a share registrar. Share registrars will thus take on a far more significant role under the Revised Model since they will effect transfers of, and be responsible for evidencing, legal title to uncertificated listed securities. Accordingly, the latest consultation proposes a more stringent regime for the regulation of share registrars. The fact of the matter is that however stringent the new regulatory regime, it can only ever encourage, not ensure, compliance. This highlights again the urgent need to resolve the problem of enabling beneficial

owners to exercise legal rights over their shares.

Q3. Do you have any concerns or comments about the key features of the USS account¹?
If yes, please provide details.

Law Society's response:

No.

Q4. Do you have any concerns or comments about the key features of the USI account²?
If yes, please provide details.

Law Society's response:

No.

Q5. *Do you have any concerns or comments about our proposal that USS accounts be limited to institutional investors, and USI accounts be available to all investors, including institutional and retail investors? If yes, please provide details.*

Law Society's response:

We appreciate that USS accounts have features that are designed to suit the needs of institutional investors. However, as institutional investors having USS accounts are unlikely to open USI accounts but would have the option to do so, it appears that retail investors should also be able to choose the type of accounts that suits their needs.

Q6. *Do you agree with our expectation that institutional investors that open a USS account are unlikely to open or need to open a USI account as well? If no, please provide details.*

Law Society's response:

Subject to any feedbacks from institutional investors on this issue, even if institutional investors having USS accounts are unlikely to open USI accounts as well, we agree that institutional investors should have the option to open both types of accounts.

Q7. *Do you anticipate any difficulties or limitations in opening and managing USS accounts for retail investors? If yes, please provide details.*

¹ an account opened by an institutional investor with a sponsoring CP (*i.e. a clearing participant or a custodian participant in CCASS, or in the HKEX System, as the case may be*) to reflect uncertificated securities registered in the name of the institutional investor.

² an account opened by an investor with a share register that has been approved by the SFC under the new share registrar regime to reflect an uncertificated securities registered in the name of the investor.

Law Society's response:

The costs involved in opening and maintaining USS accounts would likely be higher than those for USI accounts. For their practical needs and cost reasons, retail investors would likely opt to open USI accounts instead of (even if they shall have the option to do so) USS accounts.

Q8. Do you have any concerns if cash entitlements payable in respect of securities held in an institutional investor's USS account had to be paid to the institutional investor direct, rather than to its sponsoring clearing or custodian participant? If yes, please provide details.

Law Society's response:

No.

Q9. Do you have any concerns or comments about our proposal to require registered securities holders to provide a unique identification number to the issuer? If yes, please provide details.

Law Society's response:

No.

Q10. Do you have any concerns or comments about our proposals on consolidating holdings belonging to the same registered securities holders but calculating securities entitlements separately in the case of USS holders with multiple USS accounts? If yes, please provide details.

Law Society's response:

We believe the same treatment of consolidating holdings belonging to the same registered holder for calculating securities entitlements should be applied to the holdings of USS holders as well, as otherwise there might be inequality in allocation of securities entitlements.

Q11. Do you have any concerns or comments about the proposals for establishing a Common Platform³ across all share registrars? If yes, please provide details.

Law Society's response:

No.

³ a platform the FSR is exploring to build across share registrars, which will be served as a single access point for USI holders

Q12. Do you have any concerns or comments about the proposed process flows for initial public offering ("IPO") applications in respect of securities that are to be credited to a USI account? If yes, please provide details.

Law Society's response:

No.

Q13. Do you have any concerns or comments about the proposed process flows for IPO applications in respect of securities that are to be credited to a USS account? If yes, please provide details.

Law Society's response:

No.

Q14. Do you have any concerns or comments about the proposed process flows for effecting transfers to or from HKSCC-NOMS⁴ under the Revised Model? If yes, please provide details.

Law Society's response:

No.

Q15. Do you have any concerns or comments about the proposed process flows for effecting other transfers under the Revised Model (i.e. between two USI holders, between two USS holders or between a USI and USS holder)? If yes, please provide details.

Law Society's response:

No.

Q16. Do you have any concerns or comments about our proposal to offer off-exchange trade settlement and transfer services on half-day trading days? If yes, please provide details.

Law Society's response:

No.

⁴ HKSCC Nominees Limited

Q17. Do you have any concerns or comments about the proposed process flows for effecting corporate actions in respect of holdings in a USI account? If yes, please provide details.

Law Society's response:

No.

Q18. Do you have any concerns or comments about the proposed process flows for effecting corporate actions in respect of holdings in a USS account? If yes, please provide details.

Law Society's response:

No.

Q19. Do you have any concerns or comments about including SFC-authorized listed funds within the USM initiative at an early stage? In particular, do you perceive any difficulties in doing so? If yes, please provide details.

Law Society's response:

No.

Q20. Do you have any concerns or comments about including rights issues, subscription warrants and depositary receipts within the USM initiative at an early stage? If yes, please provide details.

Law Society's response:

Rights issues are common equity fund raising activities of listed companies. For companies whose shares are brought within the USM initiative, their rights issues should be brought within the USM initiative at the same time.

Q21. Do you have any views as to whether the USM initiative should be extended to cover other products, in particular callable bull bear contracts ("CBBCs") and derivative warrants ("DWs")? If yes, please provide details.

Law Society's response:

In principle, we believe the USM initiative should cover all types of listed products. However, in terms of priority, products which investors are not allowed to hold in their own names could be brought within the USM initiative at a later stage.

Q22. Noting the general market consensus that Hong Kong should move to a USM regime, do you agree with the general approach for moving the market to full dematerialization? If no, please provide details.

Law Society's response:

Please see the responses to Questions 1 and 2 above.

Q23. Do you have any concerns or comments about our proposals for requiring paperless IPOs only? If yes, please provide details.

Law Society's response:

No. This should be a necessary step if the USM regime is to be implemented.

Q24. Do you have any concerns or comments about our proposal that there should be no option to rematerialize securities that are already in uncertificated form? If yes, please provide details.

Law Society's response:

No.

Q25. Do you have any concerns or comments about our proposals for dematerializing securities that are held in the new HKEX System? If yes, please provide details.

Law Society's response:

Sufficient advance notice should be given prior to each dematerialization exercise. The length of the notice period should duly take into account the time required for the intermediaries to notify the beneficial owners of shares and for such beneficial owners to give instructions to the intermediaries to make the necessary arrangements for withdrawing their shares from the HKEX System (if they wish to hold them in certificated form) or opening a USI or USS account if they wish to hold their shares in uncertificated form in their own names.

Q26. Do you have any concerns or comments about our proposal to cease the parallel trading arrangement for securities held within the new HKEX System that have already been dematerialized? If yes, please provide details.

Law Society's response:

No.

Q27. Do you have any concerns or comments about our proposals for encouraging issuers and registered securities holders to communicate electronically rather than in paper form? If yes, please provide details.

Law Society's response:

We agree that the proposals should only be implemented after public consultation and taking into account market readiness.

**The Law Society of Hong Kong
7 May 2019**



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OPERATIONAL MODEL FOR IMPLEMENTING
AN UNCERTIFICATED SECURITIES MARKET IN HONG KONG**

THE LAW SOCIETY'S SUPPLEMENTAL SUBMISSIONS

The Law Society of Hong Kong provided responses to a "*Joint Consultation Paper on a Revised Operational Model for Implementing an Uncertificated Securities Market in Hong Kong*" ("Consultation Paper") on 7 May 2019 ("The First Submission").

The following is the Law Society's supplemental submissions in response to further enquiries from the Securities and Futures Commission ("SFC") of 28 May 2019 on The First Submission.

Unless otherwise defined, the abbreviations in this Supplemental Submission follow those adopted in the Consultation Paper.

SFC Question (1)

"We note that one group of your members views the Revised Model as being regressive. The responses to Q1 and Q2 [*in The First Submission*] suggest that their main concerns revolve around the challenges faced by "beneficial shareholders" (i.e. investors in listed company who hold shares through CCASS/HKEX System, and whose shares are therefore registered in the name of HKSCC Nominees Limited rather than in their own name) in terms of receiving corporate communications and attending and voting at listed company meetings. Specifically:

- the response to Q1 (at the end of page 1 [*of The First Submission*]) notes the group's view "... that the Revised Model's proposals is regressive, as the inability of listed company shareholders to enjoy the full benefits of legal title to their shares (in relation to voting and issuer communications in particular) is seen as a significant step back from the 2010 Model, with the consequent continuance of the complex and antiquated arrangements for voting and shareholder communications"; and
- the response to Q2 (at paragraph 2 on page 2 [*of The First Submission*]) notes

that although there will be a more stringent regime in respect of share registrars, this will not suffice to “*resolve the problem of enabling beneficial owners to exercise legal rights over their shares*”.

The SFC would like the Law Society to clarify if its understanding, as set out above, is correct. If yes, the SFC asked the Law Society to clarify whether this group would regard the Revised Model as being acceptable if solutions can be developed to address the aforesaid challenges faced by beneficial shareholders, and if not, why not.”

Law Society’s response:

The concerns of this group of members whose views the SFC refers to relate to the ability of shareholders holding uncertificated shares to attend and vote in their own names at shareholder meetings and also to exercise other rights such as the right to requisition a shareholders’ meeting, petition for a winding up of the listed company and to nominate a person for appointment as director.

Of particular concern are the statements in paragraph 10 of the Consultation Paper:

“10...we appreciate that there will be investors who (for various reasons) prefer to hold securities within the clearing and settlement environment, and hence in the name of HKSCC-NOMS. These investors will continue to hold only a beneficial interest in their securities. In the context of shares, this means they will, as today, continue to have to rely on HKSCC-NOMS, and any intermediating entities in between, to pass any benefits on to or exercise any rights for them. We are mindful that the process for this can, in some cases, be inconvenient and inefficient. A prime example is the process for exercising the right to vote and/or attend meetings of a listed company. The current processes for these are largely paper-based and cumbersome, and hence not conducive to participation in the voting process. It would be in the interest of investors, and consistent with the USM objective of removing paper documents and manual processes, to develop an electronic alternative that facilitates and encourages participation in the voting process, but without creating undue costs or burden for either investors or their intermediaries. Any such alternative would benefit investors under the current market infrastructure also, and should therefore be implemented separately from the USM initiative and as soon as possible.

11. The SFC is working with HKEX to explore options in this regard, and will seek further views from the market in due course. In the meantime, we welcome any suggestions market participants may have.”

As set out in paragraph 9 of the Consultation Paper, one of the key differences between the current proposals and those of the 2010 Model is that the Revised Model will not allow shareholders to hold uncertificated securities in their own

names within the Central Clearing and Settlement System (i.e. CCASS). Shareholders wanting to hold shares in their own names in an USI account (in order to be able to vote in their own names) will thus have to transfer their shares electronically into CCASS if they want to sell them on the Exchange.

The statement in paragraph 10 of the Consultation Paper accepts that there will be investors who prefer to hold securities within CCASS despite the fact that the processes for attending and voting at shareholders' meetings are inefficient and inconvenient. The relevant members, whose views are noted in our consultation response, are concerned that for this group of investors, the Revised Model does not represent an improvement on, and can be regarded as regressive in comparison to, the 2010 Model which would have allowed shareholders to hold securities in their own names within CCASS.

A major concern for these members is that CCASS will not accept instructions from shareholders to exercise certain rights, for example the right to requisition a shareholders' meeting, petition for the winding up of a company or to nominate a person for appointment as a director which are all fundamental shareholders' rights. It would seem then that if a shareholder wants, for example, to nominate a person as a director, he or she would have to open a USI account and arrange for the shares to be transferred from HKSCC-NOMs into the shareholder's USI account. The Revised Model requires shares to be transferred between USI accounts and HKSCC-NOMs in order for shareholders to exercise certain shareholders' rights and to sell shares on the HKEX. The members concerned consider this to be an unnecessary complication which would have been avoided under the 2010 Model. Those members feel that whether or not the Revised Model is workable will depend on the efficiency and cost of transfer. It is imperative that fees are kept to a minimum so that they do not disincentivise shareholders from opting to hold shares in their own names in USI accounts, so that those shareholders who opt to hold shares within CCASS are not deterred from transferring them back into their own names in order to exercise their rights as shareholders.

The Consultation Paper does not mention the likely level of fees for making electronic transfers between HKSCC-NOMS and USI accounts. The cost of electronic transfers should be nominal and thus the transfer fees charged must reflect this. This should perhaps be highlighted to the relevant parties (i.e. share registrars and HKSCC-NOMs) to ensure that they are aware that fees must be kept to a minimum.

SFC Question (2)

“The response to Q2 (at paragraph 1 on page 2 *[of The First Submission]*)

acknowledges the structural differences in the UK but goes on to note that *“this should not be allowed to delay the inevitable implementation of the full-scale changes necessary to provide a fully dematerialised market with legal title for securities holders”* (emphasis added). However, the Revised Model does in fact provide options for investors to hold legal title to their securities, i.e. via a USI or USS account, and it is unclear why these options are considered insufficient. Further clarification of your members’ concerns in this regard would therefore be appreciated.”

Law Society’s response:

The first point to note is that even with the provision of legal title through USI/USS accounts, the Revised Model will not provide a dematerialised market as was advocated in 2003 by the G30 and in the 2010 Model. The G30 recommended that immobilisation should be implemented where regulatory obstacles to full dematerialisation exist, and that it should be a stepping-stone to dematerialisation rather than an end in itself. With the statutory changes already implemented in preparation for the implementation of the 2010 Model, there is no regulatory impediment to dematerialisation, only the trading/settlement systems obstacle noted in the Consultation Paper. The members’ point was simply that if the 2010 Model could be made to work with a system upgrade, then this would be preferable to the Revised Model given that the 2010 Model allows legal title to be held within CCASS avoiding the time and expense that will be incurred in transferring shares between USI accounts and CCASS under the Revised Model.

The second point is that, as noted in response to Question 1 above, some investors will continue to hold through CCASS and will remain subject to problems in exercising their full rights as shareholders (e.g. to requisition a meeting) because they hold beneficial titles only to their shares. Those shareholders will suffer inconvenience in having to transfer their shares to a USI account in order to exercise rights which CCASS is not willing to exercise on their behalf.

Whether or not this model can operate satisfactorily will likely depend on the cost and efficiency of making transfers between USI accounts and HKSCC-NOMS. If transfers are fast and incur minimal fees, which should be achievable with electronic transfers, the model may be sufficient. Our members would like to see further discussions held with registrars to gain some assurance as to fee levels before the Revised Model is formally adopted.

**The Law Society of Hong Kong
17 July 2019**