SLAUGHTER AND MAY

Hong Kong Uncertificated Securities Market Proposals Explained

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Summary

On 8 April 2020 the Securities and Futures Commission, Hong Kong Exchanges and Clearing Limited and the Federation of Share Registrars Limited (**FSR**) jointly published consultation conclusions on a proposed operational model for implementing an uncertificated securities market (**USM**) in Hong Kong.

The conclusions relate to a consultation paper issued on 29 January 2019. The consultation paper was triggered by market concerns that the operational model proposed in 2010 and legislated for in 2015 would compromise some of the settlement efficiencies enjoyed by the market, leading to a significant impact on participants' funding needs.

The 2020 consultation conclusions show broad support for the model put forward in the 2019 consultation paper.

This briefing explains the current plans for a USM in Hong Kong as outlined in the 2020 consultation conclusions. It also summarises how the 2019 consultation paper has modified the 2010 operational model.

Background

At present, Hong Kong law requires the use of paper documentation to evidence the transfer of legal title in shares (that is, a share transfer certificate). The practical limitations of this system mean that most investors in listed shares hold and transfer their shares via the Central Clearing and Settlement System (**CCASS**), whereby shares are registered in the name of a single nominee, HKSCC Nominees Limited (**HKSCC**). A downside of this system is that legal title to the shares is held by HKSCC and not the ultimate investor, who only holds a beneficial interest in the shares. Investors have no direct relationship with the issuer of the shares, and day-to-day responsibility for the administration of the shares held in CCASS, such as the exercise of voting rights and the payment of dividends, rests with HKSCC.

The idea of implementing a USM in Hong Kong has been touted since at least 1988, when the Government-appointed Securities Review Committee delivered the 'Hay Davison Report', which recommended that "the central clearing and settlement system for share transfers be based on uncertificated book-entry transfers, with the clearing house's transfers being valid instruments of title".

USM Proposals Explained

1. Application

USM applies only to certain securities (including ordinary shares)[1] of issuers listed on the Hong Kong Stock Exchange. Shares in private companies will not be covered.

USM will also apply to non-Hong Kong companies who have listed shares on the Hong Kong Stock Exchange, although this will be implemented at a later stage.

2. Types of account

The Hong Kong listed issuer's register of members, listing the holders of legal title to the shares, will be divided into four different types of holder:

(A) Certified Securities Holder

A holder of a physical share certificate.[2]

(B) USI Holder

USI refers to an Uncertificated Shareholder who will effect corporate actions in respect of those shares via the Issuer's share registrar.

(C) CCASS (with the shares held in the name of HKSCC)

As with the existing model, an investor may hold indirect beneficial interests in the Hong Kong listed shares by way of an account with a CCASS participant, where legal title to all those shares within CCASS are held by the CCASS nominee, HKSCC. HKSCC holds legal title on behalf of the relevant CCASS participants, who hold on behalf of the relevant investors. While such a holding may be more efficient in effecting settlement of trades made on the Hong Kong Stock Exchange, the holder will suffer the disadvantages of not being recorded on the issuer's register of members (and so will not have a direct line of communication with the issuer in respect of, for example, corporate actions).

(D) USS Holder

USS refers to an Uncertificated Shareholder who would effect corporate actions in respect of those shares via a Sponsoring CCASS participant.

This way of holding has caused confusion (in part due to previous terminology which has now been clarified).

The USS holder will be listed on the issuer's register of members and hold legal title.

However, the USS Holder will appoint a 'sponsoring CCASS participant' to deal with day-to-day administration of the shares. The holder will give instructions to its sponsoring CCASS participant, who will then act as the holder's agent in effecting corporate actions.

The USS Holder therefore enjoys the benefits of being on the register of members and also enjoys the service of a sponsoring CCASS participant for administrative matters.

3. Continuation of CCASS

Under the USM proposals CCASS will therefore continue. We expect a substantial number of investors will continue to hold shares in this form.

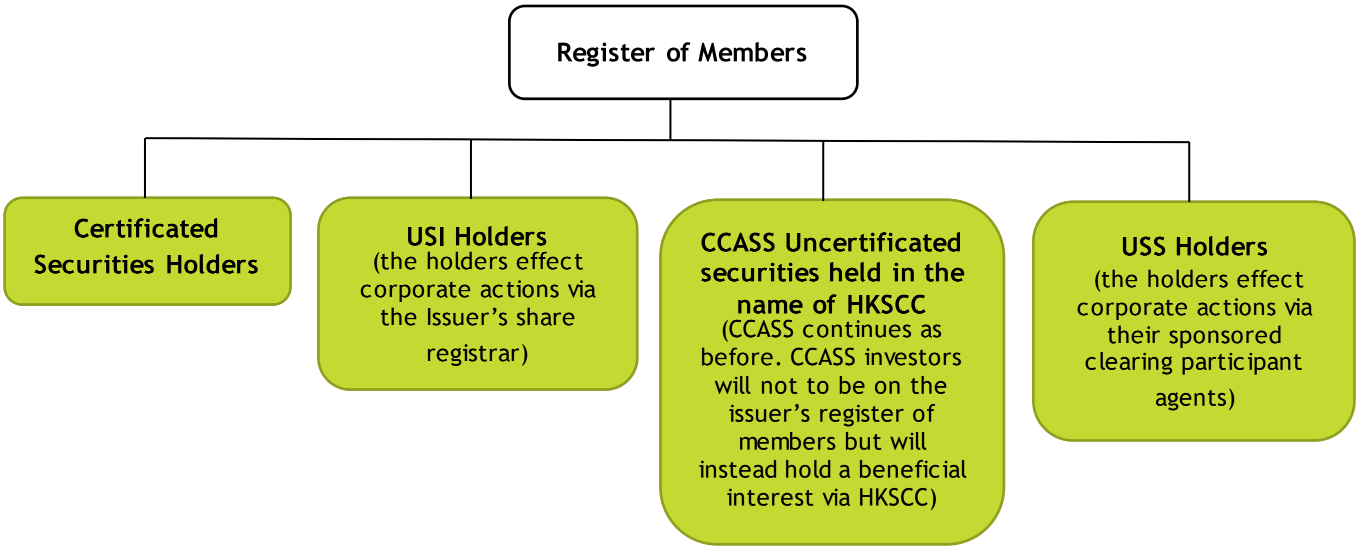
[1] In order to simplify concepts, this paper refers to shares rather than securities. Other types of securities are however within the scope of the USM proposal.

[2] Certificated shares, and this type of holder, will be phased out gradually after the introduction of USM.

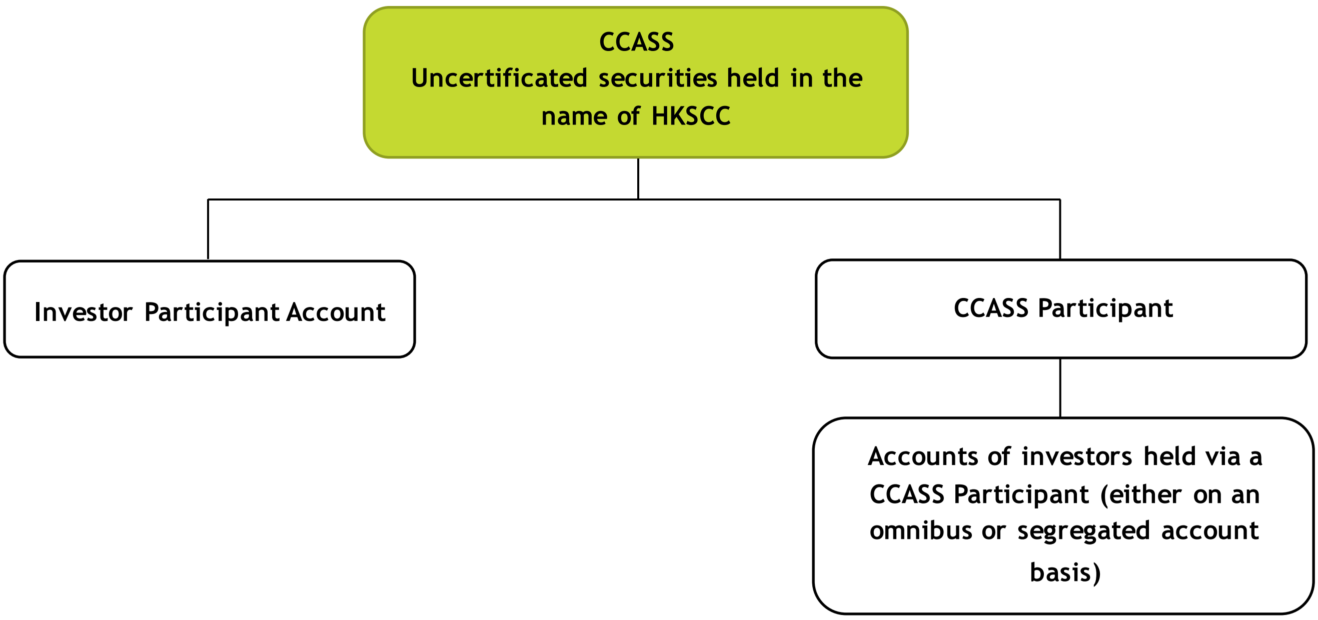
4. Explanatory Diagrams

The structure of the proposed USM is shown in the diagrams below.

1. Overview of the Share Registrar System



2. Types of Account Held in CCASS



Registered securities holders whose names appear on the issuer's register of members / register of holders as holding legal title.

The 2010 Model

The so-called '**2010 Model**' advocated a 'split-register model' whereby shares could be held within CCASS (with HKSCC maintaining directly part of the relevant issuer's register of members, in uncertificated form). The 2010 model meant that a CCASS investor would hold its interests directly, with the CCASS investor's name included on the issuer's register of members. Only a relatively small number of certificated shares would be held outside CCASS (with the issuer's share registrar maintaining this uncertificated part of the issuer's register of members).

A far-reaching change proposed in the 2010 Model was that the role of the HKSCC as the central nominee was to be removed. All accounts within the system would have been name-on-register accounts (with provision for bank and broker nominees where necessary or desirable). While this approach would have ensured full shareholder rights for all investors holding shares in CCASS, the model posed various challenges.

In particular, there were concerns that the 2010 Model could cause liquidity issues for investors. At present, HKSCC as nominee moves shares between CCASS accounts in scheduled daily batches. There is flexibility within the current system to allow for shares to be kept "on hold" while awaiting payment for transfer, allowing recipients visibility as to the shares available in their accounts daily. The removal of the central nominee would mean that any movement of shares would have to constitute a legal title transfer, with payment for the transfer due at the same time (rather than at day-end as at present). This raised concerns that participants would lose visibility over the shares in their account for prepayment, and that consequently those investors wishing to take delivery of shares before day-end would have to arrange for significantly more funding than is required at present. The 2020 consultation conclusions estimated that the maximum amount needed intraday on each trading day under the 2010 Model would be approximately HK$100 billion, representing a five to eightfold increase compared to the current system.

2019 Consultation Paper and 2020 Consultation Conclusions

Under the 'Revised Model' put forward in the 2019 consultation paper, the role of the HKSCC as central nominee is to be maintained. However, a dual system will operate whereby investors have flexibility as to how they hold their shares and will choose between holding them directly in their own name (or indirectly in the name of their designated bank or broker) or through HKSCC. Whether this will encourage more market participants to hold shares in their own name remains to be seen. In our response to the 2019 consultation paper, Slaughter and May noted that this will depend on several factors, including: the cost of holding uncertificated shares relative to holding via HKSCC; the ease and speed for uncertificated holders to transfer legal title to HKSCC (a required step before shares can be traded on the Hong Kong Stock Exchange); and how user-friendly the system is. Although not specifically mentioned in the consultation conclusions, it seems unlikely that USS Holders will face difficulties related to the ease and speed of transfer for on-exchange settlements. It will now be possible, the conclusions state, for any investor (rather than just institutional investors) to be a USS Holder. This means that any investor may choose to be a USI Holder or a USS Holder (or hold indirectly via CCASS).

The conclusions note that investors who hold shares in their own names (including USI Holders and USS Holders) will need to first move their shares into the CCASS system before they can be used to settle trades executed on the Hong Kong Stock Exchange. It is expected that an electronic interface will mean this transfer process can be completed intraday. We expect that the investor will need to be a direct or indirect client of a CCASS participant in order to effect such a transfer process. Furthermore, the KYC process required to become a direct or indirect client of a CCASS participant is more rigorous than the KYC process that applies to those holding shares directly in their own names (this is because CCASS participants and underlying brokers are subject to KYC requirements under the Anti-Money Laundering and Counter-Terrorist Financing Ordinance (Cap. 615), whereas share registrars are not). We expect this point will have little practical effect on USS Holders as they will be existing clients of a CCASS participant, but will be a concern for USI Holders.

In any event, the conclusions note that both USS Holders and USI Holders will only need to transfer shares from the issuer register to CCASS in time for settlement within the current T+2 settlement period – i.e. they will not need to effect such transfer before placing a sell order.

Next Steps

Implementation of the USM is expected to begin in 2022. A phased approach will be taken, focussing first on Hong Kong incorporated companies listed on the Hong Kong Stock Exchange, followed by companies incorporated in Mainland China, Bermuda and the Caymans Islands which are listed on the Hong Kong Stock Exchange.

The FSR continues to explore the feasibility of building a common platform amongst all issuer share registrars, which may act as a single access point for USI Holders to manage their entire portfolios.

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