THE LAW SOCIETY OF HONG KONG 香港律師會

RESPONSE TO CONSULTATION PAPER ON PROPOSALS FOR A SCRIPLESS SECURITIES MARKET

GENERAL COMMENTS ON PROPOSALS CONTAINED IN THE CONSULTATION PAPER

1. Complexity and generality

As a general point, the proposals are expressed at a fairly high level of generality. While proposals for a scripless securities system are welcomed (for the reasons set out in the Consultation Paper) making the necessary legal changes to introduce such a system will be immensely complex and the lack of detail on the proposals makes it difficult to make specific comments on the effectiveness of the proposals from a legal perspective.

2. Overseas Companies

A particular complexity in relation to Hong Kong is that many of the companies listed on the Hong Kong Stock Exchange are incorporated outside Hong Kong (in Bermuda, the Cayman Islands or the PRC). If there is to be a single system for scripless holding and settlement of shares listed on the Exchange, changes to laws and regulations in those other jurisdictions will also be required.

If overseas laws prevent an overseas incorporated company having scripless securities, then some of the benefits of scripless securities could be obtained by requiring securities issued by issuers incorporated in such overseas jurisdictions to be held through CCASS (and enforced rather than voluntary immobilisation could be adopted).

Consideration will need to be given about how to effect transfers from the scripless Hong Kong register to the paper based/scripless overseas register for overseas incorporated issuers (especially those having a dual listing).

3. Legislative Changes

While some comments are made in the Consultation Paper on the changes that would be necessary to the Companies Ordinance, in our view, it is likely that changes to other Hong Kong legislation will be required, including:

- Stamp Duty Ordinance, section 19 (unless stamp duty on Hong Kong stock is to be abolished);
- (probably) Part III of the Securities and Futures Ordinance, in relation to clearing houses (see below); and
- (possibly) Part XV of the SFO (disclosure of interests). If an investor is on the uncertificated register of members, but uses a "sponsor" to act on its behalf in

connection with settlement of transactions, we assume that it is not intended that the "sponsor" will be treated as having a discloseable interest in the investor's shares.

4. Market Functionaries

In developing the new scripless securities system, in our view, it would be logical to split among separate legal entities (i) the functions of HKSCC as "guarantor" of trades executed on the Stock Exchange and, (ii) the functions currently performed by HKSCC as operator of the CCASS system. For example, in the UK, CRESTCO is not the central counterparty to transactions, but is simply the operator of the relevant computer system. This would mean that the system operator would not be exposed to financial risk in the event of defaults by exchange participants.

This also ties in to real time gross settlement v net end of period/day settlement. The Consultation Paper does not really address what is to happen on this - will the current continuous net settlement and some gross settlements regime continue?

5. Scripless registration on the issuer register

We find the proposal for scripless registration on the Issuer register very surprising and consider that it makes the proposals more difficult to implement. The SFC acknowledges that this proposal would pose the risk of operational failure and of theft or fraud. This proposal seems to be made in order to protect the business of the existing share registrars, and is not in line with international market practice. To the extent that there are concerns about giving HKSCC a "monopoly" in relation to maintenance of registers for listed companies, this concern could be minimised, as mentioned in 4. Above, by having that function performed by a separate independent entity (along the lines of CRESTCO in the UK).

6. Compulsion

How many people really want paper certificates or really want to be the registered owners (and understand the importance of this) - presumably this is a retail problem more than anything? This issue requires some consideration.

COMMENTS ON SPECIFIC PROPOSALS CONTAINED IN THE CONSULTATION PAPER

Part 1: Executive Summary and Objectives

Comments on matters summarised are made in the more detailed sections below and are not repeated here.

Part 2: Background

No comment.

Part 3: Scripless Registration on the CCASS Register

A. How CCASS works today

No comment.

B. Proposed registration on the CCASS Register

27. We agree that CCASS participants and their shareholdings in CCASS be reflected on listed companies' registers of members and with the other statements made in this paragraph.

However, some consideration should be given to putting in place procedures to address potential securities shortfalls. While such procedures are already imbedded in the CCASS rules and operating procedures (and, in our view, these procedures are sufficient for day to day purposes) because of the extensive nature of the dematerialisation/conversion exercise, there is potential for securities shortfalls to be material.

As a collateral point, the CCASS nominee will be transferring all (?) listed shares held by it (as legal owner) in the register of members of each listed company. The CCASS nominee is itself potentially exposed to liabilities in respect of such transfers (e.g. orders for the registers of members to be rectified (to the extent that this remedy is still available) and in damages). However, because the transfers on the registers will initially be to the relevant CCASS participants who would themselves be liable to CCASS in the event of defective title to the relevant securities (in theory), this risk is significantly reduced (but not eliminated).

30(a) It is stated that "withdrawals of certificates from CCASS would eventually be terminated …". It is unclear from the consultation paper whether:

(i) this is only intended to cater for deposits of securities made into CCASS after the adoption of the scripless securities market (see paragraph 39 below); or

(ii) this implies that some withdrawals of certificates would be allowed after the scripless securities market has been adopted.

If the latter, we do not understand why such a delay is necessary. If withdrawals of physical certificates from CCASS are permitted, then CCASS must retain (and not send to the relevant share register for cancellation and registration on the CCASS scripless register) sufficient certificates for the purpose - presumably this is not the intention?

In our view, surrender of the certificate to CCASS should result in immediate/automatic cancellation of the certificate and credit to the CCASS sub-register and account.

30(c) We note that it is intended that transfers on the CCASS register should be final and that there should be "very little" scope for a listed company or its share registrar to refuse to register a CCASS transfer or for third parties to "rectify" the CCASS register. We support this proposal subject to:

(i) our comments on investor compensation in paragraph 38 below; and

(ii) rectification should still be allowed if the CCASS system experiences a malfunction which results in holdings being transferred erroneously. If rectification is not allowed, CCASS will not be able to reverse the erroneous entries as title will have passed.

To support the position that transfers on the CCASS register are final, we suggest that amendment should be made to Part III of the Securities and Futures Ordinance, so that transfers of uncertificated securities in accordance with the scripless system cannot be set aside under the laws on insolvency, irrespective of whether the transaction involves a "market contract" (i.e. a transaction executed on the Stock Exchange).

30(d) Agree.

30(e) Agree.

30(f) Agree.

30(g) The new proposals should not limit the ways in which security over securities can be given.

31. In addition to amendments to the Companies Ordinance (and suitable other arrangements for overseas incorporated listed companies), amendments to the Listing Rules will also be required. If the proposals referred to in paragraph 57 are not adopted, then listed companies will need to make necessary amendments to their articles of association (or equivalent constitutive documents) in general meeting.

Part 4: Scripless registration on the issuer register

As noted in our General Comments, we question the need for scripless registration on the issuer register. However, if this proposal is to be taken forward, we have the following comments.

37. If user names and passwords are to be issued to investors, consideration should be given to requiring each investor to have a single unique name and password rather than separate names and passwords for each share register on which s/he hold shares. This (i) is more user friendly and (ii) will have the potential to aid market surveillance measures.

We understand that the proposal is for retail shareholders to be able to effect direct transfers (without using a financial intermediary) on the issuer register by the use of a user name and password. A comparison is made with CCASS' transfer methods which can be made by CCASS investor participants in person, by phone and through the internet. Given that not all investors will be able to use the internet for this purpose, we recommend that all three methods of effecting transfers (in person, by phone and by internet) be adopted. Consideration should also be given to allowing written requests for transfers.

38. It is stated that "maintenance of a scripless register by share registrars would pose risk of operational failure and of theft or fraud …." and that the Implementation Working Group should develop detailed operational system standards for share registrars, CCASS and CCASS participants. Protection of shareholders' interests will be particularly important given the proposed finality (see paragraph 30(c) above) of transfers under the scripless securities market.

We recommend that consideration be given to adopting a suitable investor compensation regime. Possibilities (put forward for consideration and not, at this stage, recommendations) are:

(i) schemes similar to those applying for bank deposits;

(ii) the use of an investor compensation company under Part III, division 5 of the Securities and Futures Ordinance (as and when that legislation takes effect); or

(iii) compulsory insurance to be taken out by share registrars who wish to provide scripless services.

39(a) We note that the use of scripless registration in substitution for physical share certificates would be phased in over time as shares are deposited into CCASS. We recommend that shareholders also be able to surrender physical share certificates directly to the registrar for entry on the issuer register.

We query whether voluntary surrender of share certificates (either to CCASS or the share registrar) is a complete solution as there will, in many instances, be pools of shareholders who either do not respond at all or who are unable to respond (e.g. deceased). This will effectively require share registrars to maintain parallel scripless and physical registers and to keep track of outstanding share certificates for, potentially, a very long time with the associated cost and other implications of running two parallel systems (physical and scripless). Accordingly, we recommend compulsory dematerialisation/conversion of all securities in listed companies to take effect either on a single date or, alternatively, to impose a long stop date.

39(d) We disagree with the proposal that transfer and registration fees should be borne by the issuer of the relevant securities (under service contracts between listed issuer and share registrar). This effectively means that passive long term shareholders are being asked to subsidise the trading activities of more active investors (albeit the costs are minor). We consider that the adoption of overseas practice whereby the transfer cost is paid by transferring shareholders is more equitable.

39(e) It is stated that "issuers should be free to offer fully scripless IPO". This suggests that issuers will have a choice whether to offer a fully scripless IPO or to issue physical share certificates. Is this correct? We recommend that, while allowance should be made for overseas issuers which are unable (e.g. due to the laws of their jurisdiction of incorporation) to offer scripless securities, issuers which can offer scripless IPO's should be required to do so.

39(f) It is stated that share registrars in CCASS should be able to "enable true eIPO". We recommend that it continues to be a requirement that paper prospectuses and application forms continue to be made available to investors - not all investors (particularly retail investors) have access to electronic submission facilitates.

41. It is stated that "FinNet" would provide the communications hub for the scripless market. Very little information about FinNet is provided. If FinNet is to provide a scripless communication hub, market participants will need to have absolute confidence in the integrity of FinNet both as to its financial steady and as to its system integrity. We recommend further information about FinNet, its capabilities and the systems procedures and other safeguards in place to preserve the integrity of FinNet and its relevant operations be adopted and publicly disseminated. This issue should be considered together with the investor compensation suggestions made in paragraph 38 above.

Part 5: Implications for Market Participants

Comments on statements and proposals made in this part have been addressed elsewhere in this response.

Part 6: Legislative Changes to Support a Scripless Market

57. We support statutory amendments to allow scripless holdings to be created and transferred without amending a company's articles of association.

62. We support the proposal to limit the court's power to rectify the register of members for the reasons stated in the Consultation Paper, at least if suitable investor compensation remedies are made available. In addition to provisions allowing for other remedies (e.g. damages, which are, in any event, generally available to shareholders who are wrongfully deprived of their shares), we recommend that this step only be taken in conjunction with other procedures to safeguard the integrity of electronic share registers and transfers and the suggestions regarding investor compensation made in paragraph 38 above. Damages can often be an inadequate or illusory remedy as (i) damages can be uneconomic and time

consuming to obtain due to the nature of the legal process and (ii) an award of damages is useless if the wrongful party does not have the financial capability to make payment. For these reasons, we recommend that additional remedies be made available to investors who have been wrongfully deprived of their securities.

Part 7: Conclusion and Consultation Period

No comment.

The Securities Law Committee
The Law Society of Hong Kong
8 May 2002

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