

**Institutional Structure of Financial Regulation:
International Perspectives and Local Issues in Hong Kong
and Mainland China**

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**“Financial Regulation in Hong Kong:
A Securities Regulation Perspective”**

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26 May 2012

I am delighted to be here today and would like to thank the organizers for inviting me to participate in this conference.

The recent financial crisis had its origins in the US, spreading quickly across to London and Europe and paralyzing financial markets in its wake. The affected markets had different institutional regulatory structures, suggesting that there is no ideal universal regulatory structure that is immune to crisis. The G20 reforms did not make any specific recommendations on regulatory models as such, but it focused instead on recommendations to amend our regulatory systems to take account of macro-prudential risks across the financial system to limit the build up of systemic risk. The reforms also extended the supervisory net to previously unregulated areas such as credit rating agencies, hedge funds, OTC derivatives market and shadow banking.

The US decided to retain its multiple agencies while the UK is in the process of moving from a unified regulatory model to a Twin Peaks model. In addition, to address systemic risks, the Financial Stability Oversight Council was established in the US and the Financial Policy Committee in the UK; the EU established the European Systemic Risk Board.

The crisis presented the opportunity for public policy debate on how to improve the regulatory structure for greater effectiveness, including what is an ideal universal regulatory structure. In Hong Kong, the Lehman Minibond episode raised issues on how to improve the regulatory framework to better protect investors in the sale of investment products.

In my brief presentation, I will focus my remarks on the regulatory structure in Hong Kong, the regulatory response of the Securities and Futures Commission (SFC) to the Lehman episode and other measures we have adopted in response to the G20 initiatives. Next, given that Hong Kong is a hub for international capital flows, I will discuss the challenges this presents and the overall regulatory approach of the SFC to maintain the quality of its securities markets.



Regulatory structure in Hong Kong

The regulatory approach in Hong Kong may be classified as an institutional approach with functional characteristics, where the legal status (bank, broker or insurance company) determines which regulator is tasked to oversee its activity from both a safety and soundness and a business conduct perspective.

The SFC regulates intermediaries (brokers, investment advisers, asset managers and investment bankers). The Hong Kong Monetary Authority (HKMA) is the de facto central bank, prudential regulator, and conduct regulator in respect of banks that conduct regulated activities under the SFO.

Where banks conduct securities and futures business, the banks must be registered with the SFC as Registered Institutions (RIs) but the HKMA is the front line supervisor and oversees their compliance with regulations of the Securities and Futures Ordinance (SFO). There is an MOU between the SFC and the HKMA which sets out how both parties share responsibilities in respect of regulated activities under the SFO that are conducted by the RIs. The objective of the MOU is that all intermediaries, including RIs, should be subject to consistent regulatory measures.

Under the MOU, the HKMA investigates complaints against RIs and where it considers appropriate the HKMA will refer the complaints to the SFC that appear to relate to the SFC's functions under the SFO. The SFC and the HKMA consult one another as appropriate in relation to complaints. The SFC reviews all cases referred to it by the HKMA and takes such action as it considers appropriate.

The institutional-based approach is also being adopted under the proposal of the Administration to establish a statutory regulatory regime for Mandatory Provident Fund (MPF) intermediaries. This reform is in anticipation of more intensive sales and marketing activities by MPF intermediaries when employees will be allowed to manage their own MPF investments more actively in future.

Under the proposed regime –

- The MPF Authority (MPFA) will administer the registration of MPF intermediaries, prescribe conduct requirements and impose disciplinary sanctions.
- The HKMA, Insurance Authority (IA) and the SFC will be the frontline regulators (FRs) responsible for the supervision and investigation of registered MPF intermediaries whose core business is in banking, insurance and securities respectively.

The Lehman Minibond episode and enhanced investor protection measures

The collapse of Lehman Brothers affected many investors in Hong Kong who had invested in structured products linked to Lehman group entities, or where Lehman group entities were counterparties to transactions underpinning the products. The HKMA and the SFC received tens of thousands of complaints, the most common of which was about misrepresentation, complexity and suitability of the structured products.

Following the Lehman crisis in 2008, global financial markets were in turmoil, triggering international debate on a host of issues, including the role of credit rating agencies, the OTC derivatives market, hedge funds and the shadow banking system in creating the crisis. I would just mention here that the SFC has introduced a new regulatory regime for credit



rating agencies, and is in the process of implementing the recommendation to regulate the OTC derivatives market. With regard to hedge funds, a regulatory regime was already in place before the crisis.

There were also discussions on clarifying regulatory objectives and strengthening the regulatory structure to maintain overall financial stability. The institutional structure of financial regulation also came under the spotlight in national debates with different outcomes, reflecting domestic realities of legacy, politics or philosophy.

Turning back to Hong Kong, the impact of Lehman on our banks was limited and our financial system remained intact. The greatest impact was on the retail investors, and there were protests and demands by investors for compensation for their losses. There were also calls for more stringent regulation, particularly in respect of complex investment products and the conduct of intermediaries. Questions were also raised on the regulatory structure, which is a policy matter.

The SFC's immediate priority then was to investigate the complaints of investors on the selling practices of the intermediaries in order to take appropriate enforcement action and introduce necessary reforms. Let me explain our regulatory structure for the sale of investment products and the measures the SFC introduced to strengthen investor protection.

Disclosure and suitability are two important pillars of the regulatory structure for sale of investment products. The SFC is responsible for disclosure and has to ensure that the issuer provides sufficient information in the product documentation to enable a reasonable person to make an informed decision. The intermediary is responsible for product suitability, taking into account a full understanding of the client's profile and investment needs.

As investor protection is an important objective of the SFC, this was our priority and we introduced measures in May 2010 to enhance the disclosure requirements for investment products offered to the public and further fine-tuned the conduct requirements of intermediaries regarding the sales process.

The measures include –

- A Key Facts Statement to summarise the key features and risks for investment products to help investors to understand and compare different products.
- Ongoing disclosure obligations throughout the life of certain products, so that investors are updated on material information.
- Provision of a post-sale “cooling-off” period to give investors a window to exit certain publicly offered unlisted structured investment products.
- The product must be “fair” to investors; the needs of the investor must be considered, and the payout and design cannot be skewed one way.
- Requirement on intermediaries –
 - Assess a client's knowledge of derivatives and characterise the client accordingly before sale;
 - Disclose to clients benefits received from the product issuer and their affiliation; and
 - No offer of any gift other than a discount of fees or charges.



The Administration is also in the process of implementing two cross-sector measures to safeguard the interest of investors and financial consumers –

- To improve financial literacy and capacity of the general public, the law is being amended to enable the SFC to set up an investor education body to holistically oversee the needs of investor education and delivery of related initiatives in Hong Kong.
- To provide an affordable and simple redress mechanism to financial consumers, preparations are underway for the establishment of a Financial Dispute Resolution Centre to administer a dispute resolution scheme by way of primarily mediation, and failing which, arbitration.

In addition, the coordination of cross-sector issues and information sharing among regulators was further strengthened through the two forums that were established by the government in the aftermath of the Asian Financial Crisis –

- The Council of Financial Regulators, chaired by the Financial Secretary, aims to minimize regulatory gaps or duplications, and share information and views on regulatory and supervisory issues and important trends.
- The Financial Stability Committee, chaired by the Secretary for Financial Services and the Treasury, monitors events or developments with cross-sector and systemic implications, and formulates and co-ordinates responses, where appropriate.

Cooperation, coordination and information sharing are important for effective regulation in an increasingly interconnected financial system. There is a need for communication, consultation and dialogue among regulators and with industry.

Hong Kong as a hub for international capital flows

I will now move on to discuss the structure of Hong Kong's securities market and the institutional arrangements we have in place to maintain the quality of our markets.

Hong Kong has flourished as an international financial centre, attracting a large and growing number of Mainland and overseas companies to list on the stock exchange in Hong Kong. There is strong overseas interest to trade in Hong Kong's stock market and in its fund management business. In terms of market capitalisation, Hong Kong is the 6th largest worldwide with a market capitalisation of US\$2.5 trillion. Hong Kong has been the top IPO fund raising market for the past three years, raising US\$33.3 billion in 2011.

Let us take a closer look at the extent of international participation in Hong Kong's securities markets:

- Mainland Chinese enterprises accounted for 58% of total market capitalisation at the end of March 2012, 46% of the total number of listed companies and 48% of total market turnover.
- There is a growing number of overseas companies from an increasing number of countries seeking to list in Hong Kong. They include Glencore (Switzerland), Prada (Italy), Vale (Brazil), Prudential (UK), and South Gobi (Canada).
- Overseas investors account for almost half (47%) of stock trading in Hong Kong.
- Non-Hong Kong investors are the primary source of funds based on fund management activities survey conducted by the SFC, consistently accounting for more than 60% of the Hong Kong asset management business.



As the gateway to the Mainland, Hong Kong acts as the hub for two-way capital flows. International investors look to HKEx as a “proxy” for the Mainland market. Similarly, Mainland investors can invest in the financial products or consume the financial services available in Hong Kong or sourced by intermediaries from around the world.

Hong Kong is different from major stock markets in North America and Europe in one important aspect; it has a significant direct retail participation accounting for 26% of trading in the stock market and 20% of trading in the derivatives market.

Maintaining investor confidence is important for the continued success of Hong Kong, and I will now talk about the institutional arrangements and the SFC’s regulatory approach to maintain the quality of our markets.

Maintaining quality markets

Hong Kong has a tradition of strong institutions that uphold the rule of law and protect property rights. The regulatory framework is robust and benchmarked to international standards, providing investors with certainty and predictability of consistent and clear rules. This is Hong Kong’s value proposition to international investors that has established its reputation as an IFC that is open, fair and competitive.

The “one country two systems” has helped to create the symbiotic relationship between Hong Kong and Mainland China and the unique role that Hong Kong has played in the integration of the Mainland with global capital markets.

The listing of Mainland companies in Hong Kong was motivated by a conscious and deliberate policy of the Mainland authorities to expose and subject Mainland enterprises to Hong Kong standards and fast track their transformation to world class companies that meet international norms on governance and performance. Hong Kong’s regulatory and corporate governance standards and our Listing Rules are on a par with international standards, and Mainland companies seeking to list in Hong Kong have to comply with the Listing Rules.

The practical challenge for regulators is that national regulation stops at the border. Therefore, to conduct an investigation on Mainland enterprises that are listed in Hong Kong, the SFC would need the regulatory assistance from Mainland regulators such as the China Securities Regulatory Commission (CSRC). In addition to the bilateral MOU, both the SFC and CSRC are signatories to the IOSCO MOU that facilitates the exchange of enforcement-related information.

Over the years, the relationship between the SFC and the CSRC has been strengthened through consultation, cooperation and exchange of personnel. The SFC and the CSRC conduct regular staff exchanges, which helps to foster better understanding of one another’s securities markets and regulatory approach and in strengthening regulatory cooperation.

In addition, the market intermediaries in Hong Kong have built up its knowledge base and understanding of Mainland enterprises as auditors, lawyers, and financial intermediaries worked on the IPO process to bring Mainland enterprises to market.

Similarly, Mainland enterprises acquired new corporate governance practices expected of companies seeking to tap international capital markets. In the initial phase, as the companies were state-owned or regulated, the due diligence process was much more



straightforward as they were more established and information on their track record was more readily available.

The next wave of listing in Hong Kong came mainly from private enterprises. This was a new challenge for the intermediaries that worked on bringing these companies to market given the different nature of their operations and management culture.

In Hong Kong, sponsors play a key role in bringing companies to list on the stock market; they act as gatekeepers of market quality. As the majority of companies wishing to list in Hong Kong have their management and major activities outside of Hong Kong, sponsors have to gain a full understanding of the local environment in which a company operates and determine how this should be reflected in meaningful disclosure.

The quality of the due diligence conducted by sponsors therefore affects the quality of companies that are listed in Hong Kong and its overall reputation as a leading financial centre.

The SFC has been concerned that standards of sponsor work have fallen short of reasonable expectations. To address these concerns, the SFC recently issued a consultation paper on proposals to provide a regulatory basis for defining the expected quality of sponsor work which are in the interests of public investors and all other stock market participants. The consultation includes a proposal to make clear that a sponsor has civil and criminal liability for untrue statements (including material omissions) in a prospectus under the Companies Ordinance.

Concluding remarks

In conclusion, I would say that regulators, irrespective of the regulatory structure in their jurisdiction, must keep their regulatory tool kit under review, and adopt new regulations or adapt its regulations as appropriate to ensure that they remain relevant and effective in achieving the objectives of investor protection; fair, efficient and transparent markets; and orderly and stable markets.

Indeed, all regulators have to remain at the forefront of adopting and adapting international standards, and in responding to local issues, in order to maintain a robust regulatory framework that promotes a sound and resilient financial system.

Regulatory cooperation is imperative; there must be communication, sharing of information and coordination among the regulatory bodies. This includes cross-border regulatory cooperation given the global nature of financial markets. International coordination of reforms is also important to avoid unintended consequences,

Hong Kong's success as an international financial centre is a privilege; with it comes the responsibility to maintain the trust of investors.

Market participants and investors are important partners of the SFC in promoting and maintaining healthy and resilient markets. To maintain the trust of investors and other market participants, market intermediaries must act in line with the conduct and due diligence that is expected of them. Investors also must act with responsibility in making investment decisions.



On its part, the SFC will continue to carry out its functions, including enforcing the law to punish and deter misconduct, and to reach out to investors through targeted investor education.

Thank you.