SECURITIES AND FUTURES COMMISSION
證券及期貨事務監察委員會

SFC 證監會

Speech

Keynote speech at 8th Pan Asian Regulatory Summit

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10 October 2017

Today I want to talk about the special relationship between the Hong Kong and Mainland financial markets. And how the way in which this is regulated will go a long way to secure Hong Kong's future as an international financial centre.

Back in 2014, I delivered a keynote address at this conference just one week after the launch of the new Stock Connect programme.

Most of you will know that this was a groundbreaking move to start direct cross-border trading between the Hong Kong and Shanghai equity markets. But at the time I said that it would probably take at least two years for the success of Stock Connect to be fully apparent.

We are now three years down the track. In the first few months after launch, there were worries about low trading volumes. And certainly there were some technical impediments, some of which have been ironed out.

But at the time our view was that the sheer size of the opportunity meant that trading was bound to increase very significantly.

The reality was that Stock Connect opened up a vast onshore equity market to the rest of the world and also enabled a huge pool of Mainland investors to diversify outside of their home markets.

Up to September 2017, trading from Shanghai and Shenzhen into Hong Kong resulted in a total net investment of RMB520 billion, with RMB315 billion invested in the A-share markets through Hong Kong.

The percentage of Hong Kong market turnover attributable to Mainland investment through Stock Connect is also eye-catching. It has been around 6% so far this year. This will grow even more, as will trading volumes heading into the Mainland.

This is all very impressive, and clearly there is still huge untapped potential.

But does this success mean that we can be complacent about Hong Kong's future development as an international financial centre? Definitely not.

In fact, much ink has been spilt in recent months over this question. Some of this has been prompted by our joint consultation with the Exchange on listing regulation, as well as the

Note: This is the speech as drafted and may differ from the one delivered.

Exchange's own consultation on a proposed New Board for new economy companies and weighted voting rights.

However they turn out, the New Board proposals basically respond to concerns that the Exchange may not be attracting some of the best technology companies, losing out to New York for some big initial public offerings (IPOs).

Hong Kong's competitiveness

But what I want to get across today is that this is only part of a much bigger picture. The fact is that there are some fundamental aspects to Hong Kong's market development which call for a wider understanding.

This includes work done by the Mainland and Hong Kong regulators to establish an important series of arrangements to enable both markets to integrate and develop in a way that has never been attempted anywhere else.

And I should be clear that this isn't about merging the two markets or even so-called "mainlandisation" of the Hong Kong markets.

Instead, it's about a range of realistic ambitions which lie at the core of the SFC's strategy as a regulator focused on Hong Kong's competitiveness.

First and foremost, it has to do with expanding Hong Kong's role as a place where Mainland markets can open up to overseas investors and which can enable Mainland investors – which represent an enormous pool of liquidity – to have more choices to invest outside the Mainland.

At the same time, Hong Kong will host a growing number of Mainland financial services firms alongside the local and international firms that already have a big footprint here.

Hong Kong also has the potential to be Asia's leading centre for asset management. This means real fund management expertise in Hong Kong, more funds domiciled here and the full suite of supporting services physically located here.

Much of this hinges on mutual market access deals the SFC is striking with other regulators – first with the China Securities Regulatory Commission (CSRC) in 2015 and over the past year with Switzerland and France. We continue to work on more of these.

And finally, but crucially, Hong Kong will be the place where investors can use financial markets to manage some of the more complex risks arising from cross-market flows between Hong Kong and the Mainland.

The SFC has deliberately taken a broader and longer term perspective on market development than you may have heard in other discussions. To me, some of these have sounded more like ideas for short-term business sector development rather than real market development.

My central point for today is this. Much of our vision for Hong Kong's future can only be realised if it is underpinned by a sophisticated and unique set of cooperative arrangements between the regulators in the Mainland and Hong Kong.

These arrangements will be essential to give each of us sufficient confidence to pursue the type of market access and other goals on which Hong Kong's development as an international financial centre will rest.

So I want to make clear that work on developing and operationalising these arrangements is now a key part of the SFC's job.

Stock Connect was a good start because it was underpinned by new, bespoke Memoranda of Understanding between the CSRC and SFC.

Our task is to build on this beginning to realise a far more ambitious goal. This is to guarantee Hong Kong's long term pre-eminence as the international financial centre where international capital connects with China and Mainland investors connect with overseas financial markets.

And in truth this can't happen without a very high level of mutual trust and confidence between the SFC and CSRC. It's obvious that cross-border capital flows will expand as our markets integrate, and that this activity must be safeguarded by a strong regulatory partnership.

The good news is that in our many interactions with the CSRC it's clear that they are as fully committed as we are to forging a deeper relationship fully aligned with the goals of both organisations.

A unique position

Before giving some real-life examples of what this means, I want to deal with a common misconception.

This is the assumption that Hong Kong risks being by-passed, even sliding into irrelevance. Those who hold this pessimistic view completely misunderstand the reality.

The CSRC has made it plain to us that, first and foremost, it focuses on the risks that come with greater opening up which may rebound back into Mainland markets. We, of course, have very similar concerns in the other direction.

It is understandable that the CSRC should be cautious about further market development ideas – including an expansion of Stock Connect to other products – unless it can be confident that potential risks can be identified and contained.

In their shoes, we would take the same view.

But this caution signals with absolute clarity that Hong Kong will have an even larger role to play as an international financial centre than at any time in the past. My own view is that those who talk about the possibility of Hong Kong being by-passed just don't appreciate what is going on.

The reality is that only Hong Kong, and no other overseas financial centre, can deliver the type of regulation able to give investors and, crucially, the Mainland regulators the level of assurance necessary to enable our markets to play a leading part in China's opening up.

And the reverse is also true – the SFC's relationship with the CSRC is crucial to enable us to regulate Mainland companies listing in Hong Kong, Mainland investors trading in Hong Kong and Mainland firms operating in Hong Kong.

Now I want to highlight what all this means in practice.

Regulating two-way flows

It goes without saying that for many years a core part of Hong Kong's value proposition has been to do with its role as a bridge for capital flows between the Mainland and the rest of the world. This was true when the first H-share was listed in 1993 and is no less true with Stock Connect in 2017.

But in the years before Stock Connect, the SFC only really had to worry about one main element of cross-border activity. This was its ability to police potential misconduct in Mainland businesses listed in Hong Kong. Of course, this became of greater importance over time as Mainland companies came to dominate market capitalisation and turnover.

However, in 2017 the picture is very different – reflecting changes that have only taken place over the last three years or so.

To be clear, our ability to regulate Mainland companies listed in Hong Kong remains an essential part of what we do. In many cases, successful investigations depend on our ability to access information in the Mainland through the CSRC.

But now we need to get a handle on a whole new category of players. This includes anyone based in the Mainland who trades on our markets through Stock Connect and who may be intent on market manipulation.

At the same time, Mainland financial services firms have established a very large presence in Hong Kong.

Subsidiaries of Mainland firms together with other firms owned by Mainland shareholders are now the largest group of non-Hong Kong firms licensed by the SFC, accounting for about one-eighth of the total. They have over 86% of Hong Kong's IPO business measured by funds raised and about half of all margin finance activity.

These statistics alone should demonstrate why cooperation with between the Mainland and Hong Kong regulators is so important. As a result we now work far more closely with the CSRC to supervise these firms, and also with the China Banking Regulatory Commission (CBRC) in relation to subsidiaries of Mainland banks.

And importantly, this is a two-way street. The CSRC is understandably focussed on the potential risks of misconduct on the part of non-domestic investors who can now trade in the Mainland markets through Hong Kong.

They also are alive to the potential for the overseas activities of Mainland-headquartered firms to affect the whole group.

And here I should make clear how much has really changed for the Mainland regulators. It's hard to overstate the significance of this. For years China's domestic markets were almost entirely closed to foreign investors, and even the small measure of overseas participation was tightly controlled via quotas allocated to each institutional investor.

On top of this, the Mainland's "see through" market surveillance system relied on a distinctive form of domestic investor registration, giving regulators a direct line of sight into each investor's trading activity. This is particularly effective in a retail-dominated market.

Stock Connect changed all that. For the first time, Mainland regulators had to think about overseas investors who were able to trade in A-shares without any need to obtain a quota or otherwise identify themselves in advance. They also had to think about partnering with regulators in Hong Kong to properly supervise internationally active Mainland firms.

And the fact that Stock Connect is a two-way street meant that for the first time we and the CSRC were in much the same position. To protect our markets each of us need to rely on the other far more than in the past – for supervision as well as enforcement.

I have explained this new reality in other speeches, but make no apology for doing so again. This is because it now informs much of what we do as a market regulator. It's also part of the background to a big change of emphasis in our operational work which we've termed "front-loaded" regulation.

Front-loaded regulation recognises that, with the best will in the world, enforcement against cross-border misconduct can never be as straightforward as enforcement in a purely domestic setting.

Now I said a great deal about this new approach in a published speech I delivered back in July at the Hong Kong Securities and Investment Institute.

Tomorrow Tom Atkinson, who heads our Enforcement Division, will say a lot more about this.

I'll finish with two examples of the way in which we are working closely with the CSRC on the development of our own markets in sync with the continued opening up of the Mainland's markets.

A larger role in risk management

The first is to do with Hong Kong's ability to take on a larger role in the management of risk for international investors with exposures to the Mainland markets and for Mainland investors with exposures in Hong Kong.

This could include the hedging of Mainland risks by using equity index and other futures – a real possibility following MSCI's inclusion of A-shares in its Emerging Markets Index earlier this year. It also means enabling international access to Mainland futures and options as well as Mainland investor access to derivative contracts traded on our own markets.

Bond Connect, although only launched this year, is another initiative which should lead to the development of Mainland-related currencies and fixed income derivatives in Hong Kong.

In my view, the market potential for the trading of risk management products in Hong Kong is enormous. This is because larger, more diverse capital flows will demand better all-round risk management tools subject to a world-class regulatory environment.

Even if Mainland futures markets become accessible to overseas investors, they are likely only to meet some of the demand.

But as I have pointed out, Hong Kong can only realistically develop this offering if it is fully alive to possible concerns that untoward trading in these types of products could affect a systemically important underlying Mainland asset class. I'll give you a recent example.

In August, HKEX decided that trading in a new China Ministry of Finance Treasury Bonds Futures contract would be discontinued. In its announcement, it referred to the need for clearer regulatory requirements and cooperation between Hong Kong and the Mainland to support the further development of offshore derivatives of this type.

And this is exactly what the SFC and CSRC have been working on. We hope to establish a comprehensive framework for information exchange and cooperation for new Hong Kong futures, options and other derivatives which reference important Mainland asset classes.

The aim is to use this framework to properly manage the complex interaction between the onshore and offshore markets.

And in doing so to anchor Hong Kong as the premier offshore centre for investors to manage their China risks.

More effective surveillance

Another key initiative connected with the development of our market is the implementation of enhanced investor identification systems. This is part of a growing global trend for more effective market surveillance.

In fact, the SFC has been looking at this for some time. This is because the way in which we normally obtain trading information – by requiring individual brokers to identify clients and trades – was becoming a strain on our internal resources as well as the industry.

But the immediate issue is that Mainland investors each have a unique identification code, and with this the CSRC can monitor their trades in real-time in the domestic market.

The problem is that when global investors trade Mainland securities through Stock Connect the regulators have no meaningful data for surveillance purposes.

By the same token, the SFC is unable to ask local brokers to identify trades made through Stock Connect by anyone from the Mainland for the simple reason that all of these trades are routed only through Mainland brokers.

The SFC and CSRC are therefore working on a new system for Stock Connect which would give both regulators direct, real-time line of sight into cross-market trades at the client level. This is expected to begin for northbound trades around the middle of next year. At about the same time, we expect that the CSRC will provide an equivalent level of transparency for the SFC to cover all southbound trading.

I should also mention that any system like this would need to be fully in line with Hong Kong data protection laws – a point accepted by all involved in this project.

Conclusion

In the time available, I have only been able to scrape the surface. But I hope I have got the point across that there is far more to Hong Kong's future as an international financial centre than is often supposed.

From the SFC's perspective it stacks up something like this:

First, Hong Kong's markets will increasingly be characterised as the global centre for a range of complex and sophisticated capital flows to and from the Mainland.

Second, the Mainland's incentives to cooperate on the regulation of these flows are fully aligned with our own. This of itself promotes a balanced and reciprocal relationship between the SFC and the Mainland regulators.

Third, as the Mainland opens up and becomes increasingly aware of new offshore risks affecting its domestic markets it will be keen for many of those risks to be managed in Hong Kong.

This is because it can establish regulatory ties with the SFC which cannot be replicated in any other international financial centre.

And I'm sure that international investors will also want to manage a large proportion of their onshore risks in Hong Kong.

Fourth, this should be a self-reinforcing strategy. With experience gained from innovations such as a new client ID system, or a new framework for offshore derivatives, Hong Kong's position as a trusted intermediary to handle cross-market risk will strengthen.

I am aware that developing more regulatory ties with the Mainland could provoke a negative reaction amongst some.

To this I would say that none of what we are doing in any way compromises the independent and distinctive system of regulation administered by the SFC.

I also hope I have made plain that much of Hong Kong's future success as an international financial centre should be founded on a new set of relationships between ourselves and the Mainland authorities based on reciprocity and equivalent interests.

Finally, I hope that what I have said today encourages firms to think a lot deeper about their future development plans for Hong Kong. I think it would be safe to assume that there will be far greater demand for the whole range of financial services relevant to the bright future I have described for our international financial centre.

Thank you.