

Progress of the SFC's new approach to regulation HKSI Institute Roundtable Luncheon

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Today I will discuss key risks and opportunities in our markets and how the Securities and Futures Commission (SFC) is dealing with them. I will also talk about some crucial market development initiatives which I believe are at the heart of Hong Kong's bright future as an international financial centre.

This market development angle usually does not get much media attention as it is not as exciting as the large investigations and scandals which the media likes to cover. But market development cannot progress in the long term unless our markets are fair and clean. Both are necessary to secure Hong Kong's prosperity for many years to come.

With these goals in mind we have pursued more changes in our organisation over the last few years than ever before — and especially in the last few months.

This includes adopting a more sophisticated approach to misconduct. We also moved further away from a bureaucratic, box-ticking approach to one where, as an organisation, we concentrate on real risks across our supervisory, licensing and other work.

All of this is work in progress, but it is already becoming the new normal. The pace of change should slow down as we develop and bed down what we have now set in motion.

When I spoke at this event in July 2017, I made my first public statement about one vital aspect of our approach which we had begun to adopt not long before. The title of the speech was "front-loaded, transparent and direct". It was mainly about new techniques we were starting to use to get on top of problems we were seeing in initial public offerings (IPOs) and with misconduct in and around companies which were already listed.

We decided to get ahead of the issues by intervening in situations which threatened market integrity far earlier and more quickly than a traditional enforcement approach allowed.

This way of doing things was far more immediate, targeting the largest threats and the most significant and systemic risks. And it was meant to be transparent, as we wanted to make sure that both we and all the market participants were very clear about what we were doing and why we were doing it.

More than a year has passed and we have now got used to this new way of doing our job.

Note: This is an abridged version of the speech Mr Alder delivered.

It is important to realise that this was an extensive revamp of how we traditionally regulate our markets, and in some areas it was a major break from the way we did things in the past. The initial response from the public has largely been supportive — people like to know that we are energetic in watching out for their interests.

There was also broader recognition that the SFC plays a vital role in enabling markets to develop in a healthy and sustainable way as connectivity with mainland China deepens.

There is little doubt that various market access programmes will progress despite issues such as the trade war and concerns on the Mainland and elsewhere about unbalanced capital flows and spillover risks to financial stability. As I will explain later, Hong Kong's markets play a key role to calm many of these worries.

So far, our new approach has been largely effective. It helped us to get a proper handle on some persistent problems and also deal with emerging issues.

Regulation for changing markets

Before I get into how front-loaded regulation has worked in practice, I want to revisit the origin of these changes.

About three years ago, we began to take a hard look at all the new challenges we faced. Obviously, our markets were very different from when the SFC was set up in 1989.

Hong Kong had grown from a relatively small, local market to a major financial centre regularly topping the global rankings for IPOs. As a market development story, this clearly counted as a great success.

It was also clear that there were plenty of opportunities to do even better. But this would not be straightforward. Capital markets were becoming ever more global and interconnected. Technology was fundamentally changing how business was done. And these changes were happening incredibly fast.

More and more, Hong Kong was competing with London and New York as well as with other markets both within Asia and the rest of the world.

Then, with the introduction of programmes to link Hong Kong and Mainland markets such as Stock Connect and Mainland-Hong Kong Mutual Recognition of Funds (MRF), we had a whole new set of opportunities. But with them came another complex set of challenges for regulation.

Most importantly, greater connectivity with the Mainland and increasing two-way fund flows meant that even more of the people trading in our markets were not in Hong Kong. Without some adjustments, this would make it difficult for us to carry out our usual supervisory and enforcement work. And the same was true the other way round for our regulatory counterparts on the Mainland.

At the same time, we also faced some persistent conduct problems specific to Hong Kong's listed market.

Of course, it is impossible to entirely eliminate misconduct, but in this case we were seeing patterns which had persisted for quite some time. There were clear red flags pointing to activities which, if left unchecked, threatened the reputation and integrity of our markets.

The problems we were seeing were mainly to do with complex listed company accounting and other fraud, often seen together with different forms of market misconduct in the same case.

Now I want to be very clear that these problems involve only a minority of companies. Obviously, the shares of smaller listed companies with minimal public floats can be easier to manipulate. So we have seen a clutch of problems in that sector.

We have also seen issues in a few very large companies. For example, not so long ago, the non-executive directors of Hanergy Thin Film Power Group Limited — then the largest listed solar business by far — were sanctioned after we suspended trading in its shares. There have since been others, but they are still the exception.

Often problems were not confined to one company, but rather involved a whole network of smaller interconnected companies and brokers. These typically involved highly organised groups of people who controlled or influenced not only the companies but also related brokers, financial advisors or placing agents.

We found that these networks were gaming the system in a number of ways, from share warehousing and the use of nominees to disguise actual control, to selling assets at absurd discounts or extreme overvaluations to divert public shareholders' wealth into private hands, leaving investors high and dry.

Even if the most serious of these problems only involved a small number of companies, the reputational damage to the overall market could be severe. So doing nothing to tackle these hard problems was not an option.

A very different approach

This led to the question of whether the current system for regulation was delivering the best results for investors and the market, and how it might be improved.

So in 2016, we issued a joint consultation with The Stock Exchange on a proposal to make the existing system more efficient and accountable.

In the end this proposal was not fully implemented. But it led to an intense public debate which brought a lot of issues into the open.

This debate encouraged us to have a fundamental rethink about how to use our existing powers to tackle some of the problems I have mentioned. And in my view this led to an outcome that is now far more superior to the original consultation proposals, with far greater impact.

In short, we reassessed the way we were actually using all of the regulatory tools available to us. We wanted to see how they might be used together in different combinations to help crack harder problems. Tackling misconduct related to listed companies would be a top priority for this new approach.

Our starting point for this was to look at gatekeeping. That is, decisions about whether companies are fit to list and also oversight of transactions by companies which are already listed.

Now the SFC's functions as the statutory market regulator are very different from the important role of The Stock Exchange of Hong Kong Limited (the Exchange) when administering its own non-statutory Listing Rules. It was this statutory function which we repositioned and brought right to the front line.

In the past, the SFC's role in listing regulation had been to take a backseat in IPOs and other types of gatekeeping, operating largely behind the scenes. This was in fact a very long-standing convention in Hong Kong, under what is known as the dual filing system.

But times had changed. We needed to consider how we could best use our existing legal powers to prevent the more serious types of harm arising in the first place and better protect the reputation of Hong Kong as it continued to grow as a unique international financial centre in China.

Crucially, the Securities and Futures (Stock Market Listing) Rules (SMLR) did already allow the SFC to object to an IPO on specific legal grounds and also to object on the same grounds to capital raising proposals by companies which were already listed. But for many years the dual filing convention had got in the way of using the SMLR in this way.

As we quickly found, we could be more effective if we broke with convention and used these powers far more directly and independently, whilst embedding transparency, fair process and accountability in everything we did.

One important aspect of this was to ensure that all those on the wrong end of our decisions were given fully articulated reasons for our view, a chance to object before any decision was formalised as well as the right of appeal to an independent tribunal.

One year on, I think that this new approach has worked better than expected, synchronising well with the Exchange's own role.

More targeted supervision

Changing tack, a separate part of our new, front-loaded approach has been to reform how we supervise the brokers, asset managers and other firms we license. We started off by doing far more theme-based inspections, rather than over-relying on a standard checklist-driven approach. This helped us focus on the key, urgent risks identified from our market monitoring and intelligence gathering.

We also began to concentrate our energies on other more imminent, high-impact problems, such as serious internal control failures which result in actual harm to investors as well as the risks arising from significant margin lending activities secured by few highly-illiquid stocks. We give firms advance, public notice of some of the specific risks we plan to focus on during our inspections. We hope that this will prompt them to sort out any potential issues before we show up at the door.

Collaboration with other regulators has also been vital. We recently did a joint inspection where the Hong Kong Monetary Authority examined the wealth management unit of a bank which sourced in-house products, and we inspected the bank's securities unit, which sold

these products. This collaborative approach was new, and helped us better identify conflicts of interest which may well prejudice investors.

We will be doing more joint exercises like this in other areas.

More deterrence

We also made some changes to the way we carry out our enforcement role. We prioritised our investigations so that we could focus our finite resources on the most important cases. This helps us move more quickly in what are usually very complex cases.

Complex cases inevitably take time, so we also looked at how we could take more rapid protective measures. One was to use restriction notices on brokers to freeze the assets of suspects. These assets would then be available to fund eventual compensation for victims of misconduct.

I should also say, in case there is any doubt, that we are determined to pursue individual responsible directors very firmly. We know that not all problems can be solely attributed to IPO sponsors or advisers.

As with our supervisory efforts, we now work more closely with our local partners on enforcement cases. We have investigations in progress in collaboration with the Hong Kong Police as well as the Independent Commission Against Corruption. And of course we work every day in partnership with the China Securities Regulatory Commission.

More collaborative and multidisciplinary

All of these changes have depended on a more collaborative, multidisciplinary approach, pooling the industry knowledge and regulatory expertise spread across all of the SFC's functions so that they could be used in a more creative way.

We had an early success using this approach when dealing with price manipulation in GEM companies. This was after we formed a special operational team to tackle harder problems drawing senior staff from all our divisions.

The team began by focusing on one pattern of misconduct which we were seeing far too often. High concentrations of shares were placed with only a few shareholders. On the first day of listing, prices soared multiple times only to fall flat later. These looked a lot like pump-and-dump schemes.

Our team coordinated a multi-dimensional approach to tackle this, using tools usually only used in isolation in our Enforcement, Corporate Finance and Intermediaries Divisions.

The results were tangible and immediate. Following our interventions and some policy changes, the average first day price change of newly-listed GEM stocks dropped from extreme levels to a more normal average of about 20%, where it has remained through 2017 and 2018. We are now seeing fewer small-cap IPOs across the board.

We also took on dubious market activities associated with shell companies. This mostly involves backdoor listings and the manufacture of shell companies for sale. One pattern here was that many listing applicants did not have a convincing rationale for seeking a listing. The cost of the listing was often wholly disproportionate to the funds raised, and companies did not seem to have a real need for new capital.

Our response to this and other issues was more targeted gatekeeping at the listing stage and after.

Where we suspected that listing applicants were in fact being set up to be shells, or were reporting seriously inflated sales figures, we brought our SMLR powers to bear to ask very searching questions. This usually led to the withdrawal of the application.

Where we suspected that public shareholding floats or voting power was being rigged, usually through the warehousing of shares, or that information given to the market by a company was deficient, in more serious cases we have moved to suspend trading to protect the wider interests of investors.

Over the past two years, more than 70 cases have involved activities under our SMLR powers, compared to only seven in the two years before that. The majority involved companies which are already listed, not IPOs.

The results have been fairly stark. Whereas in previous years, we saw more than 20 companies with market capitalisations surging more than 10 times within a six-month period, we have only seen a handful in each of the past two years.

The number of stocks with extremely high valuations, more than 10 times sales, has also fallen, and the average of their valuations has also declined significantly. I should say that this is not a function of the decline in the index this year — it seems to reflect real changes in market behaviour.

We also worked with the Exchange on some key listing rule changes. These include new rules to tackle highly-dilutive capital raisings and proposals to catch backdoor listings as well as a fast-track procedure for delisting.

As part of our supervisory programmes we have identified sponsors with a history of having their proposed listings rejected because of substandard work. These sponsors are now more likely to be inspected by us, and if we identify problems, we will open an investigation even if the listing did not go ahead. We have a number of these cases on our books right now.

As I have said, all of this is now a new normal for us and for the market.

The future of Hong Kong as a leading global financial centre

I mentioned earlier that in our view Hong Kong has plenty of opportunities to develop as an even more successful international financial centre. So before I finish, I want to talk about our vision for Hong Kong's future.

Basically, we see Hong Kong's long-term success in three major areas.

The first is to grow our role as the place where vast pools of Mainland and global investment liquidity can merge in one market. The fact is that only Hong Kong can claim to be a credible bridge between these two investment pools. This means not only serving as an important fundraising platform for Mainland companies, but also connecting markets on the Mainland with markets across Asia and further afield.

Here we have a unique selling proposition in the one-of-a-kind regulatory relationship we have with Mainland authorities. We have unbeatable cooperation arrangements in place with

our Mainland counterparts to safeguard investors and market integrity. No other centre can rival this. No other centre could have introduced the new client identification system for Stock Connect which went live in September this year. And this is just one example. Without these cross-boundary arrangements, unique mutual market access programmes such as Stock Connect, Bond Connect or MRF would not have been possible.

A second goal is to become a global, full-service asset management centre, complete with the full range of ancillary services. This includes developing Hong Kong as an onshore fund management hub and a domicile for investment funds.

As well as offering new products and services, this also involves building market infrastructure. We have already introduced an open-ended fund company structure and entered into MRF arrangements with the Mainland, Switzerland, France and the UK. More are coming.

This hub and spoke model is an important channel through which we want to encourage growth. Success will not happen overnight — linking two or more different systems is bound to result in some technical frictions. But we will work hard with firms and the authorities to work them out.

We are now in discussions about cross-listing of ETFs between Hong Kong and the Mainland as well as including ETFs in Stock Connect.

We are also working on diversifying fund distribution channels, which have for years been highly concentrated in the banking sector. This has limited investor choice and raised “trailer fee” and other distribution costs. New fund distribution platforms can multiply distribution channels, lower costs and encourage competition.

We now have specific guidance on automated or robo-advice and how suitability assessments can be applied in the online environment. But we also want to look at how other utilities can be designed to connect more distributors and fund houses across the market, including the Mainland.

The third area is for Hong Kong to take on a larger role in the management of financial risk for international investors with exposures to the Mainland markets, and for Mainland investors with exposures in Hong Kong and globally. This is about a more sophisticated set of exchange-traded and over-the-counter derivatives for hedging and other risk management tools.

It means enabling international access to Mainland-related futures and options as well as the development of Mainland-related equity, currency and fixed-income derivatives which Mainland and global investors can access in Hong Kong.

In my view, the market potential for the trading of risk management products in or through Hong Kong is enormous.

This is because larger, more diverse cross-boundary capital flows will demand better all-round risk management tools under a world-class regulatory regime. Hong Kong has a real opportunity to anchor itself as the premier offshore centre for investors to manage their Mainland risks.



The overarching theme is that Hong Kong can enhance its current position to move up the value chain as it plays an even more important role to enable Mainland savers to access the world and international investors to access China.

But we also need to recognise that it is more important than ever that investors have confidence that our markets are fair and regulation is resolute and impartial. Our goal at the SFC is to pursue a world-class regulatory environment to secure the future.

Thank you.