

Supervision of intermediaries: key initiatives and focus in 2014

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Introduction

If we could take stock of the regulatory responses to the financial crisis, we would see that many regulators, including the Securities and Futures Commission (SFC) here in Hong Kong, have been busy with fortifying supervisory approaches around prudential regulation, such as the regulatory focus on capital requirements, risk and counterparty regulation and key market sector regulation like over-the-counter (OTC) derivatives. These have been the regulatory priority, and we at the SFC have been proactively engaged both locally and internationally in these important global regulatory reforms.

One could summarise that these regulatory responses have largely been prudential and market-structural in nature. Nevertheless, despite these massive regulatory reforms, it is striking that 97% of senior financial professionals recently surveyed by Kinetic Partners did not think enough has been done to prevent a future crisis.

This may be why there has been growing attention paid by international supervisors on issues of professionalism, culture and ethics in finance. William Dudley¹, President of the Federal Reserve Bank of New York, made the sobering conclusion last year that there is still evidence of “deep-seated cultural and ethical failures at many large financial institutions” and that solving “too big to fail” is not enough without cultural change by financial firms. Likewise, Christine Lagarde² of the International Monetary Fund (IMF) remarked just last week in a speech that “simply adding regulations is not the answer”. Restoring trust in the financial sector will require a shift towards greater integrity and accountability, paired with a stronger and systematic ethical dimension to firms’ actions. Mark Carney³ of the Bank of England and the Financial Stability Board (FSB) has also echoed these sentiments by recently calling for a systemic change amongst firms to see their business as a vocation, “an activity with high ethical standards, which in turn conveys certain responsibilities.”

Our old friend Martin Wheatley now leading the Financial Conduct Authority (FCA) in the UK has also spoken on ethics and culture at firms at great length. And weighty organisations like the FSB have issued worthy tomes on the subject. Importantly, what is clear is that regulators around the world are now emphasising that culture is an important subject for regulators to focus on when supervising firms.

¹ William Dudley, “Ending Too Big To Fail” (Nov 2013)

² Christine Lagarde, “Economic Inclusion and Financial Integrity – an address to the conference on inclusive capitalism” (27 May 2014)

³ Mark Carney, “Inclusive capitalism: creating a sense of the systemic” (27 May 2014)



A supervisory focus on ethics, culture and behaviours at intermediaries

It is fair to observe that the words “ethics”, “integrity”, and “professionalism” have been missing from our industry’s daily discourse for too long. I see that an important part of my job is to bring them back into conversation and back into vogue here in Hong Kong.

What is missing, in my view, in the regulatory responses post financial crisis, is consideration of the human element – that is how human decisions and behavioural considerations caused the financial crisis and indeed caused the front page conduct issues we have seen since then.

I want to emphasise an important point I have just alluded to. When we speak of conduct, behaviour and processes at firms we have to take a step back and remember that all these things originate from decisions of individuals within firms and from decision-making processes by those firms. Accordingly how decisions are made, what the incentives and disincentives behind them are, what processes apply and whether people actually realise a decision has been made is an important focus point for us as supervisors. But they should also be a key focus point for the industry itself.

Returning to the broader point about culture – personally I believe that corporate culture is made up of a number of component cultures – including, importantly, an ethical culture, a leadership culture and a culture of professionalism.

Whilst I am not the type of person to quote profusely from code and legislation during a speech, I think that it is very important for all of us to remind ourselves, at this point, of our overarching obligations to the market and to clients under the General Principles of the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission.

General Principles 1 and 2 requires licensees, both individual and corporate, to “act honestly, fairly and in the best interests of its clients and the integrity of the market”. Meanwhile, the fundamental requirement of each and every licensee, whether an individual or a corporation, is to be fit and proper and section 129 of the Securities and Futures Ordinance (SFO) has some very important guidance to us on what that means, including the requirements of:

- Competence
- Honesty
- Fairness
- Reputation
- Character and
- Reliability

These requirements are fundamental to the notion that professionalism, ethics and values are important to the outcomes of our industry. It also reinforces the point about the “root causes” of behaviour, decision-making and conduct within the industry and the need for supervisory focus on a firm’s people and not only on its processes.

At the SFC, this all means that we will be broadening our supervisory approach so that when we look at the control systems and procedures at firms, we will also consider the “control culture” – that is, the culture and leadership dimensions of firms - in order to more fully



understand how a firm's control systems operate in practice. In essence, more supervisory attention will be paid to the human dimension, the human element, particularly to the drivers of decision-making and conduct within firms.

This drives home the need for a more "judgment-based" and "forward-looking" approach to supervision. To do this, we will examine the "root causes" of decision-making, conduct and behaviour at firms – that is, looking beyond the mere existence of a compliance or control framework to see if it has a supporting culture. It also means that the SFC are adopting, as our own strategy, an outcomes-oriented and inquisitive approach.

An example of this is that we will keep in mind events and developments pertaining to a firm occurring outside Hong Kong, as this is a key indicator of the control and compliance culture of a firm's Hong Kong operation.

This judgment-based and outcomes-oriented supervisory approach also means that we will be looking at the "sum of the parts" and "joining the dots" when we supervise firms. In other words we will not look narrowly at particular instances or incidents, whether in Hong Kong or abroad. Instead we will look to see what such incidents say about a firm's control environment and culture and how it reflects on its decisions and decision-making processes.

This means, going forward, we will be taking an interest in:

- (i) how incentives and disincentives impact decisions and conduct within firms;
- (ii) the leadership and decision-making structures of firms; and
- (iii) the corporate values and professionalism of firms – in other words – their organisational culture.

We will take an interest in these three components as we realise that without them the internal control processes and procedures of a firm is likely to be ineffective.

Incentives / Disincentives

It is these three components that I wanted to elaborate on today as they are crucial for successful adherence to rules and regulations, particularly the general principles I mentioned earlier.

On incentives - I certainly agree with the consensus view that incentives have a lot to do with motivating decisions and conduct. Nevertheless, in my observation, there is not enough focus on incentivising the correct behaviour and an over-reliance on the various efforts to disincentivise bad behaviour. I think the principal way to make people proactively think about issues is the incentives in so doing. Punishment and deterrence only goes so far – the proverbial stick needs to be combined with the carrot. Here the industry needs to lead the way and needs to further enhance its incentive structures so that the right decisions are made in the first place.

In addition to the right incentives is the right work place and corporate environment, to not just encourage the right conduct, but to promote and nurture the right decisions, behaviour and outcomes – outcomes that are oriented to the market, the economy and the broader community. I have come to the view that corporate culture, corporate leadership, corporate professionalism and corporate ethics can, along with the right incentives, be a key driver of good behaviour, decision-making and conduct in firms.



There is actually a cost benefit here. Regulatory sanctions are expensive, and it is in everyone's interests that issues that would lead to sanctions are avoided at the very root. This means that the entire management structure has to take real responsibility for regulatory matters and avoid overly delegating responsibility to compliance or other control functions.

Leadership structure / Decision making

Nevertheless culture, values, ethics, professionalism and integrity will not go very far unless there is a "delivery and distribution mechanism" within market participants. This is where the second component – leadership – comes into play. Unless people in authority (note I did not say only "the Chief Executive Officer") lead – that is, inspire, motivate and cause to follow – on ethics, professionalism and values then they cannot be imbedded into a firm and cannot assist in ensuring a workable control environment.

Organisational culture and leadership is important since professionalism, ethics and values can only be individually generated up to a certain point. These values cannot be "brought to life" in an organisation unless there is an environment that nurtures and promotes these principles – that is, by supporting an organisational, or corporate, culture. That environment is established by people in authority. Again I refrained from using the expression "tone from the top" as I think this is a phrase that runs the risk of abrogating responsibility of the vast bulk of the would-be "leaders" and people with daily authority over teams in financial firms.

Sure, leadership needs to start at the top, but without it cascading, not just trickling, down into the depths of an organisation it will be "imprisoned in the tower". In my experience it is the senior vice presidents and junior managing directors who are responsible for teams that are the crucial conduits in this regard. So it is important that these people in authority have the right professionalism, values and supporting culture.

This highlights that every person in authority in a firm has very real responsibilities. Accordingly an important role of the more senior leaders is to appropriately empower, incentivise and reward this "operational management" strata.

To this end, we will be increasing our direct communication with the most senior leadership of firms who, under General Principle 9, are ultimately responsible for management and control of a firm. This also means that we will not rely on the exclusive medium of compliance and legal functions for interaction with firms on regulatory matters. We would also ask that business and operational leaders of firms engage with us directly and proactively and not wholly delegate communications to their legal or compliance colleagues.

To this end, we will also be paying attention to effective decision-making structures and taking a look at whether firms are properly identifying and delineating their management and leadership structure. This is in light of many firms in Hong Kong having what is called "matrix management and operational" structure where decision-making, control, compliance and business processes are often governed, or directed, in whole or in part by headquarters or offices that sit outside of Hong Kong.

Accordingly, we will be focused on ensuring that the governance structures are appropriate and that the right people are the responsible officers of licensed firms in Hong Kong.



Business ethics, values and principles

Turning to the third aspect I mentioned earlier – good corporate culture can, and should, differ between firms. There is no “one size fits all” corporate culture. Nevertheless we all know a good work place when we experience it – and the opposite holds true as well.

That said I hope some of my own observations may be useful on this topic. Firstly, I subscribe to the view that the industry has over the years surrendered an ethical standard for a legal one. Martin Wheatley⁴ has echoed this when he referred to the industry practising an “ethics of obedience” – or doing what is legally allowed, rather than doing the right thing. Worryingly a legal standard is also inherently subject to biased interpretations or “opinion shopping”.

What’s more, an ethical standard is to be preferred both because it will go a long way to bridge the trust deficit facing the industry as well as provide a “behavioural buffer” that will protect firms from both legal and reputational risks. If nothing else, applying an ethical standard is the right thing to do.

Accordingly, we will be looking at intermediaries’ business models to see if there is an alignment of their control priorities and their control culture with their business strategy and decision-making processes. What is more, we will be looking at intermediaries to see whether these principles are, in fact, imbedded in their businesses and operations. Again, this is because a core component of an effective control environment is a proactive corporate culture.

Other risk initiatives

Whilst a firm’s risks and control culture and decision-making processes will be a major supervisory focus going forward, I also wanted to quickly highlight another important initiative under way.

This is our focus on technology and electronification risks, trading and market and infrastructure risks and operational risks to firms.

For example, earlier this year, we completed a review on internet trading systems at a select number of firms which focused on the existing information technology and management controls for internet hacking risks and the potential damage arising from an internet attack⁵.

We identified certain security vulnerabilities in a number of internet trading systems, ranging from the ability for attackers to (i) make withdrawals or transfers of clients’ funds to the attackers’ desired bank accounts, (ii) retrieve client records such as account numbers, passwords, or transaction history; and (iii) execute unauthorized trading transactions on behalf of another client.

Our circular published this January urges the industry to review its existing internet trading systems, policies, and procedures and ensure that preventive measures are in place to reduce damage in the face of an internet attack. We have also suggested some control techniques and procedures for reducing internet hacking risks in that circular.

⁴ Martin Wheatley, “The Fairness Challenge” (24 Oct 2013)

⁵ Circular to all licensed corporations on internet trading reducing internet hacking risks (27 Jan 2014)



Creating a virtuous cycle and self-regulation

Returning to the challenges of professionalism, culture and leadership, I have already highlighted the enhanced role of regulators. Nevertheless, only through industry-led initiatives can there be real on-the-ground change. Ultimately I am speaking of a market ecosystem where there is a self-reinforcing culture of adherence to high standards by market participants.

What I have also observed in my almost 12 months at the SFC is that firms do not externally expect high enough standards of each other. Each firm appears to be reluctant to express, let alone require, the best standards of its counterparties.

I do not intend to romanticise the past, as there were other significant faults and failings in earlier periods of the capital market. Nevertheless something that did exist, but has gone out of fashion, is “cold shouldering” by the industry itself. Indeed, Mark Carney⁶ has forcefully come out to say that “professional ostracism” should be practised when bad behaviours arise. This element of self-regulation has been entirely delegated to the regulatory process – which is a shame.

Again it would be worthwhile for organisations like the Hong Kong Investment Funds Association (HKIFA), and its members, to look into ways and means that the industry can create a virtuous cycle of heightened expectations rather than the current stand-off that led to a decline in the standards of integrity and ethics in the market. Adherence to the HKIFA’s code of ethics by all its members is a good starting point. Rule 4 of that code is especially relevant, given that members are required to act in a manner which recognises that “integrity and responsibility are essential to win and maintain the confidence of members of the public in all aspects of the fund industry”.

Ladies and gentlemen, I will end with a challenge to you all: only by the industry taking up its responsibility to uphold and sustain a virtuous cycle of conduct and good behaviour by expecting more of each other, will we begin to restore the industry’s trust with the public.

Thank you.

⁶ Mark Carney, “Inclusive Capitalism: creating a sense of the systemic” (27 May 2014)