Maintaining financial well-being against systemic risks
Hong Kong Chinese Enterprises Association Seminar

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Good morning, ladies and gentlemen.

The theme of today's workshop is maintaining financial well-being against systemic risks, which is a particularly meaningful topic for discussion on the tenth anniversary of the collapse of Lehman Brothers.

During the ten years after the outbreak of the global financial crisis, the resilience of financial institutions has been significantly enhanced thanks to repeated increases in capital for international banks and efforts to reform derivatives regulation.

However, markets evolve according to their own cycles. After adopting quantitative easing measures for many years, major markets have now reversed their monetary policy stances. There have been interest rate hikes across the globe as well as tightening market liquidity. This is in addition to the deleveraging drive and higher credit default risk in the Mainland, the depreciation of the renminbi against the US dollar and the escalating trade war between China and the United States.

Financial market integration

Apart from these external factors, it is also noteworthy that the financial well-being of Hong Kong is closely tied to that of the Mainland as a result of the remarkable development of the financial markets in both places over the last decade.

First, the Mainland and Hong Kong financial markets have been increasingly integrated in the wake of the launch of the Stock Connect links with Shanghai and Shenzhen as well as Bond Connect. Northbound trading by foreign investors accounts for 2.3% of turnover on the Mainland exchanges, and stock transactions by Mainland investors now contribute 6.4% of our total daily turnover. Last year, the increase in the net inflow of southbound capital was a factor driving up the prices of Hong Kong stocks. However, tightening liquidity on the Mainland is expected to have an impact on cross-border investments.

Note: This is a translation of the speech as drafted in Chinese. It may differ from the one delivered.

Second, with a view to reinforcing Hong Kong's position as a preferred overseas capital-raising platform for Mainland companies and enhancing our appeal to new economy companies, Hong Kong Exchanges and Clearing Limited (HKEX) allowed listings of companies with weighted voting rights structures and pre-revenue biotech firms. During the first six months of this year, 98 companies made their listing debuts in Hong Kong, 50% higher than the same period last year. A total of $51.6 billion was raised through initial public offerings (IPOs). Mainland companies accounted for 78% of the total IPO funds raised and 67% of our total market capitalisation as of 30 June 2018.

Thirdly, there were 2,775 licensed corporations in total as of 30 June 2018, up 8.9% year-on-year. Out of the 133 newly-licensed corporations in the first half of 2018, nearly half of the non-local firms are Mainland-backed. The Mainland has overtaken the United States as the source of the largest number of shareholder groups controlling non-local licensed corporations.

Moreover, Mainland securities brokers leverage their strong Mainland presence to contribute 20% of our total daily turnover of stocks and 55% of margin loans. Among the top 20 securities margin financing providers, 12 are Mainland-backed. In addition, Mainland-backed firms share 60% of our IPO sponsor business.

Compared to a decade ago, our stock market has become more complex, with issues ranging from cross-shareholdings between listed companies to placings of shares and issuances of convertible bonds at a substantial discount, overstatement of sales figures in listing applications, over-concentration of shareholdings in GEM stocks and surges in prices of small-cap stocks followed by intra-day declines of 80-90%.

An example was the small-cap stock turmoil in June 2017 when the stock prices of 19 small-cap listed companies plummeted by over 50% on the same day, with the largest decline being more than 90%. For a securities broker, its excess liquid capital was cut down by nearly 50% in just one day.

To protect minority investors and maintain an orderly and fair market, the Securities and Futures Commission (SFC) is committed to tackling market misconduct. We now adopt a front-loaded approach to nip wrongdoings in the bud. Our aim is to take action to intervene directly at an early stage when we identify emerging risks in the market to prevent the problem from spreading.

Internal collaboration

As market problems tend to cut across different sectors and market players, this front-loaded approach is complemented by cross-divisional collaboration within the SFC, which aims to tackle specific risks in a more coordinated manner. Two years ago, we set up an internal taskforce called ICE, which is comprised of three of our operating divisions, namely Intermediaries, Corporate Finance and Enforcement. When a case or incident comes to our attention, these divisions will immediately communicate, discuss and coordinate with one another. Since its formation, ICE has been focusing on two areas:

The first area is to strictly guard against the listing of "bogus" companies and immediately suspend trading in shares of listed companies involved in serious breaches. "Real-time" regulation is our main theme in tackling corporate misconduct.

Currently, we also apply the front-loaded regulatory approach to listing applications. Pursuant to the powers conferred by sections 6 and 8 of the Securities and Futures (Stock Market Listing) Rules (SMLR) to object to listing applications and suspend dealings in securities, coupled with the powers under the Securities and Futures Ordinance (SFO) to conduct inquiries and take investigative actions in respect of cases, we would intervene in serious cases at an early stage to safeguard the investing public and suppress illegal, dishonourable and improper market practices.

This also means that when we suspect a potential breach of the SMLR, we may, at the listing application stage, conduct investigations into the listing applicant, the sponsors and other parties involved in the listing process. If it is confirmed that there is a breach of the SFO, we would take enforcement action accordingly, whether or not the listing application is withdrawn. We have seen a significant increase in the number of cases involving potential or actual exercise of the powers under the SMLR from two or three cases per year in the past to approximately 40 cases in 2017.

The second area is to enhance the regulation of sponsors. Over the past five years, 44 listing applications were returned or rejected. In a number of cases, the sponsors' work or the listing application materials were below the expected standard. It is also noteworthy that some individual sponsors handled a relatively large number of the listing applications which were returned or rejected.

Depending on the circumstances, more frequent inspection visits will be made to sponsors with a history of returned or rejected listing applications or serious deficiencies and instances of non-compliance which cast doubt on a sponsor's capability to discharge its responsibilities. Future listing applications submitted by these sponsors may also be subject to closer scrutiny by the regulators.

We issued a circular in March this year to reiterate the standards expected of sponsors. With respect to due diligence, we expect sponsors to apply professional scepticism. For example, extra caution should be exercised where business revenue was derived from unusual arrangements such as third party payments made on behalf of customers.

Securities margin financing

In addition to the work of ICE, prevention of systemic risks is also a priority of the SFC this year. The irregular operation and malicious exit of quite a number of online lending platforms on the Mainland demonstrates once again that financial institutions engaging in lending activities must be subject to strict regulation as a precaution against risks.

A review of securities margin financing activities conducted by the SFC last year revealed that margin loans granted by brokers have grown nine times over the past 11 years, and indicated a deterioration in the loan quality and slack risk controls. In light of the findings of this review, the SFC suggested providing brokers with additional guidelines to strengthen their risk management of securities margin financing activities. We are now consulting the public on the relevant guidelines. Your comments are most welcome.

Where there are brokers with serious problems or those which have failed to address high risks in a proper and timely manner, we will intervene at an early stage by issuing warning letters. If there is no improvement, especially when there are problems which present considerable risks to investors or the market, we may impose licensing conditions on, and issue restriction notices to, those brokers if necessary.

Some may ask why the SFC needs to regulate the size of brokers' financing business and why it bothers to govern these trivialities. They believe that Hong Kong is a free society, where people are free to grow a business and when a wrong bet is placed they naturally have to bear the consequences of failure on their own.

My response is that brokers are not engaged in an ordinary business but rather they operate as licensed intermediaries. Brokers can pledge clients' securities to banks to fund their securities margin financing business. If a broker collapses and becomes insolvent, would clients be able to get back their securities?

Our regulatory regime does not guarantee zero failure, but we need to make sure brokers will have sufficient resources to support an orderly winding down and minimise any impact on clients.

Strengthening cooperation with Mainland regulators

The cooperation between the SFC and China Securities Regulatory Commission (CSRC) is all-round, also covering the exchange of market information. The SFC and the CSRC have reached an agreement on the implementation of an investor identification regime for northbound trading under Stock Connect which will take effect from 17 September. A similar regime will also be introduced for southbound trading under Stock Connect in the near future, allowing both regulators to more effectively combat illegal conduct including market manipulation.

In addition, we maintain regular contacts with the China Banking and Insurance Regulatory Commission and the CSRC and exchange information with one another about the operation and compliance of Mainland-backed licensed corporations.

Manager-In-Charge Initiative

Last year, the SFC introduced the Manager-In-Charge initiative which helps foster a stronger sense of senior management responsibility and a compliance culture to drive proper conduct and behaviour. The initiative was fully implemented for all licensed corporations in October 2017. Amongst other things, it sets out eight core functions including Overall Management Oversight, Risk Management, Compliance and Anti-Money Laundering. A licensed corporation must appoint at least one senior manager to be in charge of each core function, and submit information about its senior managers and organisational charts to the SFC.

After the implementation of this initiative, we noted significant improvements in the management transparency, terms of reference and accountability of the senior managers of some sizable licensed corporations, including certain Mainland-backed corporations. This not only greatly improves the governance of these corporations, it also increases the effectiveness of our daily supervision and enforcement work.

Conclusion

Ladies and gentlemen, in today's remarks, I outlined our new supervisory approach which is more front-loaded, targeted and real-time, as well as the Manager-In-Charge regime which aims at clearly defining who has responsibility for what. Through these supervisory approaches, we would like to exercise more effective supervision and provide better protection to the local market and investors.

Mainland-backed brokers have made significant contributions to promoting the financial development of Hong Kong and are playing an increasingly important role in the market. When expanding their businesses, they must not focus too much on economies of scale and short term benefits and ignore risk controls and compliance. A strong corporate governance culture, prudential risk management mechanism and robust compliance system lay the foundation for the long term development of corporations. We expect Mainland-backed brokers to raise their awareness in these areas and build a solid foundation for the continuous development of their businesses in a healthy manner.