SECURITIES AND
FUTURES COMMISSION
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SFC Regulatory Forum 2014

New perspectives on the future of regulation in the aftermath of the Global Financial Crisis

Summary of discussions

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Preface

The SFC's first regulatory forum, held on 24 January 2014 in Hong Kong, brought together senior regulators, policymakers, academics and participants from leading financial institutions, industry associations and professional bodies, to discuss a range of issues around a common theme: the future of regulation in the aftermath of the 2008 Global Financial Crisis.

The complexity and scale of the crisis posed considerable challenges to the industry, investors, regulators and governments around the world. Five years on, as financial institutions and regulatory frameworks continue to undergo significant reform and restructuring, it seemed a good time to host this discussion.

This report includes transcripts and summaries of the speeches, remarks and discussions presented at the forum. I would like to warmly thank Hong Kong's Financial Secretary John C Tsang for his keynote address, and also SFC Chairman Carlson Tong and IOSCO Secretary General David Wright for their remarks.

Inevitably, a one-day forum will raise more questions than answers. Speakers took up big questions such as whether we now have a safer financial system and whether we will be able to prevent the next crisis. They also considered the roots of the crisis and whether global and local regulatory responses are addressing its causes or merely its symptoms.

More pressingly, the forum explored the key question of how to rebuild the public trust which was damaged by the crisis. This will require a closer look at what firms and individuals can do to foster a more ethical culture and ways to adjust incentives to promote the right behaviours. International co-operation and cross-border collaboration will be essential, particularly in strengthening sanctions regimes and guarding against regulatory arbitrage.

We might not have all the answers to these questions. But there is a clear consensus that we should look beyond the crisis, collaborate to strengthen the resilience of the financial markets in Asia and globally, and build a cohesive cooperative framework between regulators. And that is encouraging.

Finally, the forum proved an invaluable opportunity for us to interact with the financial industry and market participants, and I would like to express my gratitude to everyone who took time to attend. We look forward to hosting similar events in the future.

Ashley Alder
Chief Executive Officer

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Opening Remarks

Carlson Tong, JP, Chairman, SFC

It is with great pleasure that I welcome you to the SFC's first ever Regulatory Forum.

I would first like to thank the Financial Secretary for taking time from his busy schedule to present the keynote address. I would also like to thank all the distinguished panelists, guests and delegates who are here today. I know some of you have flown in specially to participate in this event. Welcome to Hong Kong.

The SFC is proud to host this Forum. It is an excellent and interactive way to communicate with a wide cross-section of our stakeholders and the senior management of the financial institutions which we regulate. I hope you will all enjoy and benefit from the discussions with fellow regulators, industry professionals and experts from Hong Kong, the Asia Pacific region and around the world.

Impact of global regulatory reform

Since the collapse of Lehman Brothers in 2008, governments and regulators have responded to the global financial crisis by a massive overhaul of the regulation of the financial system. New regulatory philosophy and tools have emerged and both financial institutions and the global regulatory framework have undergone significant restructuring and reform.

Although the G20 reform agenda drives the process at the highest level, much of the regulatory changes are coming from the United States (US) and Europe. There is great international pressure for Asian markets to conform with international regulatory and accounting standards. Hong Kong, along with other Asian jurisdictions, has not been immune to the spill-over effects arising from extraterritorial implications of significant post-crisis reform measures implemented by the US and Europe.

Taking stock in Asia

Here in Asia, we are well aware that we must take into account the important lessons learnt from the recent global financial crisis in developing and strengthening our financial markets, even though the crisis did not originate from Asia. This is all the more challenging given that Asia's regulatory responses are also a product of local economic and political factors.

We believe it is time to take stock of Asia's

approach to regulatory change. It is time to ask some key questions; Are we heading in the right direction, are we optimizing our often limited resources, managing the most pressing risks and are all these reforms relevant to the next crisis?

We need to look beyond the global financial crisis and chart the way towards creating stronger, deeper and more resilient financial markets in Asia and globally. Not to mention building a cohesive cooperative framework between regulators.

Today, we will have the benefit of hearing views from our distinguished panelists on subjects that are high on the agendas of both regulatory authorities and industry players. These and other themes have been carefully selected for debate during the panel sessions where we will hear the views of our global regulators if they think the reforms to date have made the financial system safer, we will look at the regulation of investment products and finish the morning sessions tackling the issues of market integrity and investors protection. We will then break for lunch and in the afternoon, we will look at corporate conduct which is something close to my heart and we will finish the day looking at business conduct and the culture in our intermediaries.

Final remarks

Now, I hope I have whet your appetites for what I am sure will be stimulating discussions. Before I close, for the benefit of our overseas guests, I would just like to mention that we will shortly be celebrating the Chinese New Year and welcome the year of the Horse. Let me take this opportunity to wish you all a very healthy, prosperous and successful year of the Horse.

Thank you and enjoy the Forum.

Keynote Address

Lessons learned from the global downturn

John C Tsang, GBM, JP, Financial Secretary, HKSAR Government

Good morning, and a warm welcome to everyone, especially to our guests from the Mainland and overseas.

Congratulations also to SFC on successfully hosting the International Organization of Securities Commissions (IOSCO) Asia-Pacific Regional Committee meeting this week. And thank you for according me this opportunity to speak with you all today.

It is often said that those who forget the past are doomed to repeat it.

It is unlikely that any of us will forget the impact of the recent global financial crisis. The big question today is this: Are we doomed to repeat these difficult financial times?

With this in mind, allow me to share with you some of the areas where Hong Kong has learned important lessons, and the measures that we have taken, and shall continue to take, in the aftermath of the global financial crisis.

Since the onset of the financial crisis in 2007, the Hong Kong Government, together with our regulators, have worked hard to limit fallout from the financial and economic turmoil while we strengthen our regulatory framework. Our efforts have been broadly based on key areas of financial selling practices, business conduct of intermediaries as well as investor education.

Regulatory regime strengthened

To strengthen the regulatory regime of publicly offered investment products in Hong Kong, the SFC published a handbook in June 2010 covering the product codes for Unit Trusts and Mutual Funds, Investment-Linked Assurance Schemes (ILAS) and Unlisted Structured Investment Products. The handbook helps enhance the transparency for various types of investment products and promote investor protection.

The SFC has also imposed new business conduct requirements on intermediaries under its supervision. The measures include client

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assessment before the sale of derivative products, timely disclosure of sales-related information, and restrictions against offering gifts as inducements to clients.

In parallel, our banking regulator, the Hong Kong Monetary Authority, has imposed new requirements on banks in respect of their securities business. These include audio recordings of sales process of investment products in branches, clear segregation between general banking business and securities-related activities in branches, enhanced product disclosure and a pre-investment cool-off period to allow less sophisticated customers more time to understand certain investment products.

Reinforcing consumer education and providing effective dispute-resolution mechanisms are equally important for improving our market. This led to the launch of the Investor Education Centre and the Financial Dispute Resolution Centre in 2012. With the full support of our financial regulators in Hong Kong, the Investor Education Centre aims to enhance the financial literacy of customers in a broad range of financial products and services.

As a result, the general public hopefully will be in a stronger position to make informed financial decisions and manage their money more wisely. When things do go wrong, the Financial Dispute Resolution Centre provides consumers with an independent and affordable alternative avenue for resolving monetary disputes with financial institutions under the principle of 'mediation first, arbitration next'.

We are also striving to improve our regulatory regime further in view of the rapid market development. For example, we have strengthened the reporting requirement in relation to short-selling activities and also provided statutory backing to the obligation of disclosure of price sensitive, or so-called "inside", information.

Reforms for resilience

On the international front, ongoing efforts have been made in implementing various fundamental policy reforms to rebuild the global financial system as a safer and more resilient one since the outbreak of the global financial crisis. They cover mainly three areas.

First, strengthening the resilience of the global banking system through implementation of Basel III, which serves as a fundamental overhaul of the international regulatory standards for banks through substantially enhancing the requirements on the quantity as well as quality of their capital and liquidity.

Second, implementing reforms of the over-the-counter (OTC) derivative market with a focus on central clearing, exchange and electronic platform trading, reporting to trade repositories, margining requirements for non-centrally cleared transaction derivatives, capital requirements and standardisation. These reforms have helped improve the transparency and reduce counterparty risks in the OTC derivative markets.

Third, introducing measures to end the "too big to fail" phenomenon associated with systemically important financial institutions (SIFIs). Measures include additional capital surcharges, more intensive and effective supervisory oversight to reduce the likelihood of failure and the development of a regime to resolve cases of non-viable SIFIs.

As an international financial centre, Hong Kong

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has made every effort to keep pace with new global regulatory benchmarks and regulations. Through Hong Kong's participation in the Financial Stability Board (FSB), the IOSCO, as well as international standard-setting bodies, such as the Basel Committee on Banking Supervision (BCBS), Hong Kong also contributes to the development of global financial regulatory reforms and is committed to implementing these reforms in accordance with internationally agreed timetables, having regard to local circumstances.

On Basel III implementation, the first phase of Basel III capital standards was brought into effect in Hong Kong on January 1, 2013, covering three new risk-weighted capital-adequacy ratios computed with more stringent definition of capital and enhanced counterparty credit-risk coverage. The disclosure standards associated with the new capital standards were implemented in Hong Kong on June 30, 2013. Meanwhile, we are preparing for the implementation of the capital-buffer requirements contained in the next phase of Basel III capital standards, and also the Basel III liquidity standards in order to meet with the Basel Committee's implementation timetable.

On OTC derivative regulation, we introduced an amendment bill into our legislature last summer to enable the imposition of mandatory obligations on reporting, clearing and trading of specified OTC derivative transactions. Scrutiny of this bill is at its final stage. On the development of the necessary infrastructure, the reporting function of the local trade repository was launched in August 2013 to support reporting of OTC derivative transactions, whereas OTC Clear, the local central counterparty, commenced operation in November last year.

On the development of SIFI resolution regimes, we are taking steps to implement the Key Attributes of Effective Resolution Regimes for Financial Institutions, which is the new international standards endorsed by the FSB for an effective resolution regime. We launched the first stage of public consultation earlier this month on our initial thinking and proposals for establishing an effective resolution regime for financial institutions in Hong Kong. We shall analyse the views and comments received in order to further develop the proposals for the second stage of public consultation later this year.

Meeting international standards

We are also taking forward two major financial regulatory reforms to keep Hong Kong's regulatory regime aligned with international standards.

The first ongoing reform is to establish an independent Insurance Authority that is both financially and operationally independent of Government. The new independent Insurance Authority would take over the work of the current Office of the Commissioner of Insurance, which is a government department. This would help modernise the insurance industry's regulatory infrastructure to facilitate development of the insurance industry and provide better protection for policyholders. We aim to introduce the relevant enabling legislation into our legislature this year with a view to setting up the independent Insurance Authority in 2015.

The second ongoing initiative aims to strengthen auditor oversight. Auditors perform a crucial role in corporate governance of listed companies by providing assurance for the integrity and accuracy of the companies' financial reports. The Government has been working closely

with relevant parties to develop proposals on enhancing the independence of our auditor regulatory regime in line with international trends. We plan to consult the public later on this year on a package of reform proposals.

I have mentioned some of our recent regulatory reforms that are either directly or indirectly related to the impact of the global financial crisis. However, as policymakers, we also need to ask ourselves whether or not these reforms in response to a past crisis can really prevent a future crisis. Have the reform measures really made our financial market more resilient to future crises? Or do they simply provide us with a false sense of security?

Striking a balance

It is also timely for us to review and reflect on where the balance is for financial regulation: Have we done too little to guard against future crises? Or have we done too much to stifle market innovation and development? If we believe that the pendulum has swung too far to the regulatory side, is it time for us to adjust the pendulum? And if we are really going to let the pendulum swing back in the other direction, how can we prevent it from swinging back too much to the other extreme?

The best answer I have to these questions is that I think we have been able to achieve the proper balance, but only time will tell.

Over the years, our market has been manufacturing increasingly complex financial products that cut across the traditional boundaries of our banking, insurance and securities sectors. It is believed that investors have different risk appetites and investment goals, depending on their own circumstances such as age, life plans, income and education levels, and perhaps personalities too. We have, indeed, seen the growing participation of retail investors in these products. We have been practising a largely disclosure-based regime for investment product authorisation. As such, we seek to ensure that the regime will allow investors equal and timely access to all relevant information so that investors can make their own decisions wisely.

The events of the global financial crisis showed that over-reliance on the principle of caveat emptor ("buyer beware") might not be ideal. In the aftermath of the global financial crisis, some jurisdictions have opted for an interventionist approach by introducing new measures to control investment products, such that products which may put investors at unreasonable level of risk could not find their way to the market.

So would this result in better investor protection? Some question whether the regulators are in the best position to decide what's good for investors. Others worry that this new approach would lead to moral hazard and put investors at a disadvantage. Some caution that this may even stifle market innovation and narrow the choices for investors. Others consider this more a defensive measure for the benefit of regulators against political risks.

But one thing is certain: we are all part of a highly interconnected global economy. The global financial crisis, and the painful recession that followed, clearly demonstrates that virtually no single economy can be spared from problems of its neighbours in our global village. And as such, it is increasingly important for us to foster even closer international and regional co-operation.

Hong Kong has been working closely with our regional and international regulatory counterparts to discuss issues of common interest or matters that need collaboration. As part of the global and regional efforts, we have also been actively contributing to the international standard-setting process through our participation in the alphabet soup of task forces and committees of various multilateral institutions and forums including, just to name a few, the IOSCO, the G20, the FSB, the BCBS, the Asian Development Bank (ADB), The Asia-Pacific Economic Cooperation (APEC) and the Executives' Meeting of East Asia Pacific Central Banks (EMEAP).

Regardless of the choice of acronyms, collaboration is an indispensable component for effective regulation. And effective regulation, which promotes competition, quality, trust and confidence, are in turn essential to the sustainable development of the entire financial-services industry. We all benefit from an exchange of views in a regional and global context, not least at this forum today.

Finally, as Carlson has mentioned earlier, we prepare to celebrate the Chinese New Year next week. It just remains for me to wish you all a successful Forum, and a happy and prosperous Year of the Horse.

Thank you very much.

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Summary of discussion

Is regulation working after Lehman?

The panel took up the question of whether local and global regulatory reforms post-Lehman had made the financial system safer. Panellists agreed on the need to focus on corporate governance as a means to help the financial industry deal with its trust deficit and restore its basic function of assisting the growth of real economies. They also discussed strengthening the "Asian voice" on global reforms and how to identify, prevent and address the next crisis.

Post-crisis reforms

The panel started off with an overview of the reforms that emerged after the biggest and most complex financial crisis since the 1930s. The crisis challenged both regulators and the financial industry and exposed a lack of understanding of how markets work. While recent regulatory reforms have made the system safer in a broad context, much still needs to be done, and a complete understanding of the cumulative effects and costs of the new initiatives is lacking. The financial community is still trying to come to grips with what went wrong.

"Too big to fail" and cross-border resolution remain the most crucial and difficult global issues, it was noted. Meanwhile, over-the-counter (OTC) derivatives reforms are mired in regional disputes. Most remarkably, according to a recent report by the Financial Stability Board (FSB), there is still uncertainty and a lack of knowledge within large financial institutions about counterparty risks, which were at the heart of the Lehman Brothers' collapse.

One panel member remarked that the focus should be on quantitative cost benefits, as well as on evaluating the overall impact of the new initiatives to avoid unintended consequences. A special challenge is to build a solid non-discriminatory cross-border legal framework to resolve failing financial institutions.

Financial markets are shaped by crises which occur when innovation outstrips the ability to regulate and there is a lack of understanding of globalisation, another panellist noted. It is almost impossible to prevent the next crisis. What regulators and the financial industry can do best is focus on emerging risks and collaborate to strengthen the resilience of the financial system.

Tackling the root causes

The panel addressed the need to look at fundamental principles such as the impact of market failure and how the financial industry supports economic growth and the development of society. The world lost about 15% of GDP as a result of the 2008 crisis and economic hardship has emerged as a problem in certain regions.

The crisis exposed tremendous myopia in the industry, one panellist commented. Financial institutions' excessive short-term focus and insufficient regard for long-term strategy, as well as their departure from their basic function of supporting the real economy, is the crux of the problem. The financial services industry is widely perceived to be hard-wired to serve itself first and put the needs of its users second.

Panel members agreed that to rebuild trust and confidence, the financial community should focus on corporate governance, which is largely missing in the global reform agenda. This is vital as a

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funding gap in Asia needs to be filled by properly functioning capital markets and there was a real danger that recent global reforms ranging from Basel III to Dodd-Frank Act and EMIR could sharply reduce capital flows. There should also be strategies to facilitate the growth of capital markets and provide more diverse wealth generation, which would, in turn, assist the real economy.

Extraterritoriality and the Asian voice

The panel discussed the extraterritorial application of EU and US policy preferences which dominate the international reform agenda. Reforms could potentially backfire by fragmenting markets around the world, a panellist noted. This will reduce capital flows further and, in turn, jeopardise regional economic growth.

The EU and US have first-mover advantage in the form of rules that they already put in place, the panel heard. They are therefore unlikely to yield to demand for change. The lack of synchronous decision-making by legislators was another problem. In addition, the fact that financial institutions from the EU and US are big players in Asia, which operate as the main enablers for the export of EU and US policy preferences, which may not suit local markets, highlights the complexity of the extraterritoriality issue. In response, a panellist suggested strengthening the "Asian voice". Regional collaboration was needed to articulate the Asian viewpoint on global reforms, while stressing the clearly varied stages of development in different jurisdictions.

While it is important to develop a global approach to financial regulation, sufficiently granular rules were needed to facilitate mutual recognition and equivalence, a panel member observed. To this end, he suggested extending the IOSCO Multilateral Memorandum of Understanding (MMOU) to supervisory co-operation for large cross-border financial firms. Within Asia, regulators should focus on cohesiveness and commit to collaborating on common interests in areas such as enforcement and capacity building.

Panel members generally agreed there was a need to build a framework of institutions and

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practices that would help move the world's financial regulators toward convergence. One suggestion was to move from the current non-binding legal framework to a regime with binding dispute settlement. The idea was to bolt systems together across borders without regulatory friction and unnecessary costs to firms.

Looking ahead

Discussing the way forward, panel members highlighted the importance of more granular risk assessment, naming areas that warranted close attention: LIBOR and other benchmarks and fixings, crowd funding, cybercrime, social media and the property sector. Better data as well as good macro-prudential analysis should be developed to help regulators identify any exposure in a timely manner.

Root causes of problems in financial markets may lie in firms' warped incentives, cultures, conduct, or risk management practices, panel members noted. Hence, one panellist urged, the financial community needed to go deeper. To ensure a culture of governance and ethics is established at financial institutions, questions such as what drives behaviour and incentives needed to be asked.

Insights from behavioural economics should be applied not only to investor behaviour but also firm behaviour. For one panel member, industry self-regulation should be encouraged to address the problem of unintended regulatory consequences. The industry can identify its own problems earlier, he said, adding that this would be a great help for regulators. At the same time, global regulators would also require greater capacity and resources, as well as the skills needed to function effectively in a complex market.

Panellists suggested that regulators should not be consumed by fighting the last war, but instead should be proactive and forward-looking. They concurred on the importance of structural reforms, consistent implementation, and the need for a global institutional framework to encourage harmonisation. Special attention also needs to be paid to emerging market risks and capacity building in surveillance and enforcement.

Given the nature of financial markets, it was the general consensus that there will be future crises and regulators need to put a system in place to deal with them effectively. As one panellist put it, the challenge facing regulators is to be wary of the unknown unknowns: they should facilitate innovation and avoid being too conservative. At the same time, another said, the industry should be able to articulate market innovations clearly for regulators to understand, otherwise there will be potential risks.

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Summary of discussion

Investment product design and intervention

The panel discussed current regulatory trends focusing on the internal product approval process, governance of product design and product intervention. Panellists also shared their perspectives on how to strike the right balance between enhancing investor protection and stifling product development.

Regulatory convergence on implementing principles for internal product approval process and product design

All the speakers on the panel agreed that product design and governance principles are not new obligations. Product providers and issuers should have adhered to these principles from day one. The principles remind issuers to put in place robust processes to ensure that products are designed and manufactured with a target market in mind, and with the objective of delivering fair outcomes to meet the investment objectives of that target market. As such, issuers should not just create products they want to sell, but rather products that investors want and need to buy. However, regulators around the world have recently converged on bringing these principles under their radar, making it clear that they expect nothing less from issuers.

Panel speakers ascribed this to the fact that the traditional reliance on the twin approach of clear disclosure and point of sale suitability seems not to have worked well enough and is no longer sufficient. Regulators around the world are considering looking higher up the product creation cycle, asking issuers to ensure fair product design and proper product governance. The UK, Europe, and IOSCO have done a lot of work in this regard.

Before regulators come up with product design principles, it is important for them to find consensus on the notion of “complexity” of products so that they can decide on what is too complex for retail investors, a regulator stated. For example, EU member states have different ways of determining whether a product is too complex – some will reference whether a particular product can be sold on simple execution-only mode without advice. Others may look at whether complex techniques are used or the risk profile is intelligible. Without a set of common principles, it is difficult to understand what other EU members have been doing in assessing the design and manufacture of products which are sold into their own state through passporting. Hence, a consistent set of principles governing product design is certainly essential under the EU context.

Pre-vetting of products versus product intervention

The panel discussions revolved around a full spectrum of product regimes, with a full pre-vetting regime on one end and on the other end a regime based on disclosure by a product provider supplemented by suitability requirements. For instance, Hong Kong pre-vets disclosures to the extent a judgment is made about whether the disclosure is clear and full, and in addition it relies

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on point-of-sale suitability requirements. Australia, which does not pre-vet, can force a prospectus to be withdrawn if the disclosure is misleading. UK is the first jurisdiction to have the power of product intervention whereby in urgent situations it can stop a product which is already on the market from being sold.

For jurisdictions that pre-vet products offered to the public and their offering documents, panel speakers agreed that there would be a danger of the public thinking that before the regulator authorizes a product, it has looked into the product design process and is satisfied that it has been conducted in a reasonable manner. Say, for a product with a stated return, investors might expect regulators to have satisfied themselves as to the reasonableness of the rate of return during the vetting process. In fact, pre-vetting does not mean that the regulator is privy to all stages of a product's design and this is not what the regulator is supposed to do. The principles on internal product approval process are there to remind product providers that when they bring forth a product, that they have a target audience in mind and that the product is designed fairly for them.

For those regimes without pre-vetting and pre-approval, panel members generally agreed that there are merits in imposing these principles. In fact, some jurisdictions have already introduced product intervention mechanisms to stop or ban the sale of problematic products as they want to prevent detriment before it actually arises.

Regulators may also encounter difficulties in establishing product intervention mechanisms. A regulator pointed out that although the joint statement of the European Authorities talked about product design and MiFID II has certain product intervention rules on process governance for use when encountering systemic issues, one EU member state cannot really ban products from another state that are being sold through passport measures. As such, it is almost impossible for EU members to introduce product intervention at the distribution level.

Certain panel speakers held the view that while product intervention can be a useful tool for protecting investors' interests, it creates moral hazard issues. Firstly, investors will rightly assume that products are safe given regulators are there

watching. Secondly, given that regulators are expected to scan the market for problematic products, investors will question why they have not stopped a product from being sold. This issue is further aggravated by the regulators' lack of sufficient resources to use the additional power and information that they now have. As such, the product intervention power may also send wrong expectations to the market.

A panelist added that although intervention is expected to be rare, it is essential to establish an analytical framework for implementing product intervention mechanisms. He added that it will be interesting to see how regulators exercise this new power of intervention to prevent bad things from happening, and for this to work regulators need to establish consistent principles for product design and intervention.

Ongoing monitoring

Product design principles are applicable to the whole product life cycle on an ongoing basis and not only before a new product is approved. This means that product providers need to closely monitor their products to assess if they are still suitable for the target market on an ongoing basis, given that market circumstances change over time.

An industry expert shared with us as a distributor that his firm has been reducing the number of products it carries on its distribution platform. This enables distribution network staff to better serve investors, who in turn are better informed about the products they buy. He reckoned that while investors have better protection, they are now offered fewer choices. He believed that given the changing environment, and the fact that investors' risk profiles can change as they age, the ongoing monitoring of products beyond three years of their issuance might be unrealistic.

Ongoing monitoring is part of product providers' existing management processes, one panelist pointed out. However, he added that the industry would push back against regulators' prescriptive monitoring requirements given that products and marketing circumstances are highly variable. Monitoring should be the judgment of managers and product providers, and not regulators.

Moreover, it is important that the introduction of product design principles does not lead to the abolition of suitability. Nowadays the whole value chain is very complex - in many cases issuers do not know the identities of the ultimate investors as distributors might not divulge them. Product providers are not in a position to accept responsibility for what goes wrong at the end of

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the value chain, especially when these products are sold on an advised basis. The decisions on suitability are not issuers to make. The obligation to comply with suitability requirements falls squarely on distributors.

Investors should take responsibility

We have now moved to a new paradigm, from "investor beware" to "issuer beware" or "distributor beware", a panelist emphasised. If a product is completely inappropriate, regulators will come to you. We have seen this phenomenon in recent incidents such as collateralised debt obligation (CDO) products in Australia, payment protection insurance (PPI) products in the United Kingdom and Lehman Mini-bonds in Hong Kong.

Panel members agreed that better disclosure was still key, along with ensuring that investors take more responsibility for their actions. As such, it is important for investors to do their part, understand what they are buying, and be responsible for their own investment decisions.

While disclosure is a good tool, it needs to be reconsidered – other than being clear and concise, the problem is being "effective". To achieve this, Australia is considering ways to make disclosure to investors more "effective" through introducing a two-page-only requirement for key facts statements of simple collective investment schemes, and allowing the option of providing product information online. It is also considering an optional online self-assessment to be performed by investors before they buy a product. The self-assessment consists of a suitability assessment and a comprehension assessment which aims at making sure that investors understand the disclosure in the key facts statement. An investor who "failed" to demonstrate that he has understood the disclosure would be given a warning on line. He could still proceed to buy, but would have an uphill battle later if he tried to claim that he did not understand and had been mis-sold. With these measures, the regulator is trying to make investors take responsibility and also ensure that issuers do the right thing. Other panel members agreed that tools of this sort could help to test investors' engagement in an online environment.

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Summary of discussion

Market integrity and investor protection

Panellists expressed a range of views about the correlation between market integrity and investor protection. They agreed that while regulators, intermediaries and investors shared responsibility for sustaining a sound financial system, a strong regulatory regime was essential to ensure appropriate market development. Recent trends in law enforcement were also discussed.

Market integrity, investor protection and market development

The panellists held different views on the effects of market integrity and investor protection on market development. One side maintained that although, from the listing perspective, investor protection and market integrity formed the bedrock of Hong Kong legislation, excessive regulation could be an inhibiting factor. Therefore the key is getting the balance right. Investor protection itself is a dynamic concept that evolves over time and should be constantly evaluated as the market develops to maintain an appropriate and efficient regime.

An opposing view considered that the need to strike a balance between market development and regulation was a false proposition. Furthermore, quality regulation providing appropriate rights for investors would improve market development rather than hold it back. In this view, investor protection should instead be referred to as investor rights, since investors have certain rights such as governance provisions, voting rights, and the right to information. Companies adhering to these standards would achieve higher share prices because investors trust the regulatory framework to secure rights and remedies. In the absence of full investor rights, the market relies excessively on regulators, which would bring remedial actions as in recent insider dealing cases.

Considering the question of whether less investor protection for listed shares led to lower share prices, panellists agreed that if the quality of the regulatory framework was poorer, investors would pay less for stocks. When they buy Hong Kong-listed securities they are pricing in the legal and regulatory regime in Hong Kong and will pay more if their expected loss from bad governance or malfeasance is lower.

Investor protection and moral hazard

During a discussion of whether investor protection creates disincentives for investors to take responsibility for their own financial decisions and other moral hazards, a panellist observed that rigorously enforced investor protection rules are fundamental to a successful and dynamic market, but some jurisdictions outside Hong Kong were getting dangerously close to a situation where more investors took on unreasonable risks because, under strong investor protection rules, they win even if there was a loss.

The moderator added that although there were no bank failures in Hong Kong during the financial crisis, investors who suffered investment losses still needed help from regulators. The perception in Hong Kong was that everyone received some

compensation simply by asking for it, but in reality a regulator can only act where misconduct can be established.

Retail sale of investment products

The panel considered whether investors needed to be protected from dangerous products or if disclosure is a panacea. One speaker believed that for unlisted products, the dynamics of the sales process and the interaction with the intermediary could overwhelm an investor regardless of the quality of the disclosure. This creates an additional layer of responsibility for intermediaries because disclosure alone is not sufficient and depends on an intermediary's ability to explain complex concepts in a comprehensible manner.

The moderator raised the point that regulators could no longer depend on intermediaries to give good advice and new regulations were needed to address this. He mentioned that one feature of many mis-selling cases in Hong Kong was that investors only noticed the disclaimers of liability in the fine print when something went wrong. This eroded public trust in the market.

When asked whether financial intermediaries should be held responsible for giving quality investment advice, one panellist considered it dangerous to put the blame solely on intermediaries when things went wrong because in fact various parties were involved. For example, the products may not have been properly regulated. On the other hand, consumers may not have read the documents carefully or understood them.

Behavioural economics

During a consideration of the role of behavioural economics in the marketing of investment products to retail customers by financial institutions, a panellist stated that all banks and distributors, like any advertiser of any product,

will pitch products to customers in the most attractive way they can under the law. It is up to the regulator and legislators to impose restrictions on how far promotions which play on human psychology can go. At the same time, it is up to the salesperson to make the customer clearly understand that he is a salesperson and not an advisor, as he cannot be both, in the panellist's view.

Regulators have often been accused of the wisdom of hindsight, one panellist noted, and when behavioural economics was added into the mix, the danger of hindsight in the event of actual loss became even more acute. However, one has to recognise that behavioural economics is not a precise science and an individual consumer's behaviour is not predictable.

Restoring public confidence by law enforcement

One panellist identified two factors contributing to the loss of trust: conflict of interests and the complexity both of the law and of financial products. For example, a conflict of interest occurs when a bank customer suffers investment losses induced by the bank, which is not conducive to trust. Secondly, the Securities and Futures Ordinance (SFO) is a long piece of legislation, and also some investment products are too complicated for customers to understand.

It should be made clear that those who breach the law would be prosecuted and properly dealt with, he continued. However, there are limits to what law enforcement agencies could do, given that it is not an offence simply to sell over-complicated products or to be in a conflict of interest situation, unless there is fraud.

The role of law enforcement agencies during the financial crisis

Following the financial crisis law enforcement agencies worldwide faced challenges bringing individuals to account for their conduct, one panellist stated. Often it was difficult to prove criminal liability, or responsibility was shared among individuals within the corporation. For example, in the United States, corporations were found liable, but not individuals. As a result, the real problem had not been solved. In addition, the moderator pointed to the perception that large

fines imposed by regulators are not deterrent because institutions already budgeted for them.

An industry panellist disagreed, stating that large fines imposed on corporations are painful and carry a strong deterrent effect. Settlement agreements with regulators are not budgeted, as this is not allowed under accounting rules.

Remedies for breach of listing rules

The panellist from Hong Kong Exchanges and Clearing Limited (HKEx) explained that as the frontline regulator for listed companies in Hong Kong, HKEx saw deterrent sanctions, which are not statutory, as largely reputational because they may affect share prices. On the other hand, remedial sanctions are about engaging professional parties to monitor compliance with the relevant listed companies for a certain period of time. These are all about educating the market and improving market standards, rather than punishing a particular individual in a particular case. He acknowledged that in reality sanctions are limited even in cases of very serious wrongdoing. He believed that without the buttressing of the law and the SFC, the regulatory regime would be slightly ineffective.

Public policy and the criminal decision making process

The speaker from the Department of Justice remarked that involvement in the criminal prosecution process could already be detrimental to a suspect's reputation. Therefore, before the Department of Justice (DOJ) decides to prosecute a person, it has to consider the evidence to assess whether a reasonable prospect of conviction could be obtained. The DOJ would then consider whether to prosecute in light of public policy considerations and the public interests. He believed criminal prosecution can be used to restore public trust that has been lost.

A distinction should be made between the remedial and the penal functions of the law, he continued. The SFC exercises the remedial function pursuant to s.213 of the SFO. In terms of the penal function, the SFC could refer cases to the DOJ for criminal prosecution. He also noted there has been a practice of cooperation between the SFC and the DOJ.

In closing, the panel turned to cross-border collaboration on surrendering suspects in financial crimes. Market misconduct offences, including insider dealing and market manipulation, are regarded as extremely serious. When Hong Kong receives requests from other overseas jurisdictions to surrender fugitives in market misconduct cases, so long as there are proper mechanisms and treaties, Hong Kong would render assistance. Where appropriate, Hong Kong would make similar requests to foreign jurisdictions.

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Summary of discussion

Corporate conduct, integrity of information and responsible board

The panel considered that good conduct and the integrity of information are crucial to ensuring corporate governance. Responsible directors are essential for establishing and maintaining high standards, but shareholders, and in particular institutional investors, also have a vital role to play. Recent regulatory initiatives in Hong Kong were also discussed.

Sound governance

The main theme of the panel was that effective corporate governance does not solely depend on the regulatory framework. A more important factor in maintaining and promoting sound governance is the pursuit of ethical behavior, including corporate diligence, responsible board conduct and the provision of quality information to shareholders and investors. Shareholders also need to engage diligently with management. On the whole, good market conduct is driven by good behavior. Everyone involved has a unique and important role to play.

While emphasising that good governance means going beyond mere disclosure, panellists agreed that disclosure still plays a vital role. Shareholders need accurate information about a company to make informed investments and voting decisions. This includes the financial condition of the company; how it operates; who is running it; and assessments of any business, operational or financial risks. Disclosure makes it possible for investors to assess companies and have the confidence to invest in them, which in turn help enhance efficiency of capital markets.

In a discussion of what regulators could do to enhance the level and quality of corporate disclosure, it was suggested that there needs to be a fine balance between the incremental benefits of increased regulation and inherent costs to the market. Nevertheless, light touch regulation is not necessarily the answer. Panellists remarked that sound regulation, quality markets and informed investors serve to enhance investor confidence in Hong Kong and make the city an attractive place for investment.

Role of directors

Responsibilities

The panel recognised that directors, including independent non-executive directors (INEDs), are an important component of corporate governance which at its most basic level could be considered the system by which companies are directed and controlled. One of the board of directors' leading functions is to promote the success of an enterprise by directing and supervising its affairs. The board's responsibilities include keeping investors informed of all material developments which potentially affect investment decisions, and directors play a crucial role in ensuring the quality of information. They are also responsible for upholding high standards of corporate conduct. In this respect, vigilant and responsible directors are essential for a company to operate effectively and efficiently.

During the discussion of directors' responsibilities, one panellist asked whether it would be

worthwhile to codify directors' duties and require them to receive training on specific areas to improve their awareness and skills.

Independence and diversity

The panel observed that although the Listing Rules require listed companies to appoint INEDs, the extent to which they are truly independent and add value to a company largely depends on how they are appointed and evaluated. One panel member noted that having independent shareholders elect INEDs is a reasonable proposal but may be difficult to achieve. Another panellist stressed that the system for nominating, appointing, training and evaluating INEDs could be better designed to help them provide good, independent advice to companies.

The topic of diversity also drew some attention. A panellist expressed support for having a diverse board across a broad range of factors and not necessarily gender. For example, measures of diversity should also include age, cultural and educational backgrounds, and professional experience. Companies need to assess their specific needs and business models in determining the skill sets that directors require.

Remuneration

A panellist voiced concern that new regulations and an increasingly challenging corporate environment makes it more demanding to serve as a non-executive director (NED). This role is very complex and requires an individual to have considerable skill and experience, not to mention unwavering integrity, sound judgement, and an inquiring and independent mind.

On account of these challenges, listed companies often have difficulty attracting suitable executives to act as NEDs. Furthermore, panellists noted that the level of remuneration for NEDs in Hong Kong is often unattractive and does not sufficiently reflect the amount of responsibility directors are expected to undertake, or the degree of legal liability to which they are exposed.

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Role of institutional investors

Panellists observed that in recent years an important aspect of a director's job involves shareholder engagement and ensuring that management is considering the needs of investors when making disclosures. While the primary responsibility for a company's success rests with a company's board, investors play an important role in keeping company directors on their toes. The panel agreed that a long-term objective should be for shareholders to take a more active role in engaging with the companies they invest in. One panellist pointed out that Hong Kong has experienced little in the way of shareholder and hedge fund activism. Institutional investors are not active in local markets and Hong Kong has a relatively large retail investor representation compared to the investor profiles in the United States (US) and the United Kingdom (UK). But overseas, shareholders aggressively promote corporate governance by attending companies' annual general meetings and raising questions. Positive and constructive confrontations with boards of directors should be encouraged, one panellist remarked. Institutional investors and shareholders should stand in the front ranks of corporate governance supporters.

A different panellist commented that markets have evolved dramatically over the years. In the US and the UK institutional investors now comprise a large part of the investor market and a very large portion of trading is now index-driven and unrelated to companies' economic fundamentals. This has presented a challenge to the legal and regulatory frameworks that were designed for a market structure that no longer existed. Additionally, shareholder engagement is a necessary ingredient of a well-functioning market, as markets are unable to function properly if shareholders remain passive and trading is merely index-linked.

It was suggested that agency concerns and short-termism may not be issues in Hong Kong as in the US or the UK given that many Hong Kong listed companies are controlled by families or states. Against this background the question arose as to whether it is appropriate for Hong Kong to directly adopt international practices and regulations relating to shareholder activism. One panellist commented that dramatic changes in the Hong Kong investor landscape over the decades, such as the shift from local investment companies to large global funds, make certain shareholder issues more relevant to our market.

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Regulatory initiatives

The panel heard a rundown of recent SFC initiatives in Hong Kong. These initiatives are meant to reinforce the SFC's role as a statutory regulator and aim to protect investors by instilling confidence in the reliability of public corporate information as well as by providing assurance that the misconduct of listed companies will be detected.

- The inside information disclosure regime came into force on 1 January 2013, providing statutory backing to the continuous disclosure obligation for price-sensitive information;
- On 1 October 2013, new rules relating to sponsors aimed at enhancing the initial public offering gatekeeping process and the quality of listings in Hong Kong came into effect;
- In late 2013, as a matter of priority, the SFC stepped up its supervision of listed companies by taking on broader, more proactive oversight of corporate conduct with a view to detecting serious misconduct at an early stage;
- The SFC is in the process of drafting a set of principles of responsible ownership which aim to encourage investors to engage with their investee companies and to establish clear voting policies.

International initiatives

The panel discussed regulatory efforts in the international arena, including the initiative by the International Forum of Independent Audit Regulators to deal with concerns about audit quality and the independence of auditors. This initiative prompted a growing number of countries to set up independent audit regulators and also facilitated the spread of best practices for regulating auditors.

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Summary of discussion

Business conduct and culture in intermediaries: New supervisory and business approaches

The panel focused on the challenges of recognising and ensuring good business conduct in the industry. Participants discussed new supervisory and business approaches that financial intermediaries can use to promote an ethical business culture.

Promoting business conduct and ethics

Changing of firm culture post-financial crisis

The panel discussion began with an overview of how the industry reached its current trust deficit and how these developments contributed to the ongoing challenges facing the industry. The focus on short-term performance was cited as a root cause of behavioural problems at firms. One industry participant recognised a shift in the industry from a 'should we' to a 'could we' culture – that is, from an ethical standard to a bare-minimum legal one. In support of this, another speaker called on the industry to comply with the spirit of the law rather than the letter of the law.

Panellists acknowledged the need to revive professionalism and elevate professional standards above the interests of the firm and of individual employees. One panellist commented that values such as individualism and short-term personal gain can result in short-termism and conflicts of interest. One speaker emphasised that a critical step to achieving the right behaviours at financial institutions is for senior executives to set the 'tone at the top' and lead by example. An industry panellist described how firms can improve professionalism and set standards by clearly formulating a mission statement that embeds compliance values and behaviours within the usually dominant performance culture or "DNA" of a firm. Nevertheless, he noted that this was more of a people management tool than a marketing tactic as his clients were not yet sufficiently interested in these types of company pledges.

On leadership, one speaker asserted the need to recapture the long-term professional standards of the financial services industry and promote role models in the industry. Another panellist cautioned that striking the right balance between conduct and culture is of increasing importance to achieve the best outcomes for the industry, regulatory community, market, and the economy. On whether ethical standards are good for business, one industry panellist commented that the industry still needed to work on viewing business ethics and the resulting compliance, regulatory and operational cost savings, from an expense savings perspective.

The panel also discussed ways in which indicators of good culture can be identified and applied at financial firms. Establishing a coherent culture across offices, business functions and geographic locations requires boards and leadership groups to take a razor-sharp focus when defining firm culture and clearly articulate and communicate the culture across the organisation, one industry expert noted. This also includes a focus on enabling people in authority at the operational levels to serve as conduits of good behaviours. Another speaker emphasised the need to enhance business ethics and values

training, and to tailor training initiatives around how to run a good business that also fulfils a broader social and economic purpose. There was a particular need for this additional professional and ethical training in the Asia-Pacific region where the training focus was usually on the development of technical competencies.

Realigning incentives to 'right' behaviours

The panel discussion next turned its focus to incentives and the way in which rewards have skewed the behaviours of and within firms. The delineation of duties at financial firms – especially the segregation of compliance responsibilities from front-office duties – resulted in a skewed culture where revenue and sales were the primary incentive drivers, often at the expense of client and ethical considerations. One speaker proposed that remuneration arrangements needed to better reward compliance with firms' values as a way to incentivise the 'right' behaviours. Firms also need to work harder in designing measurement and review systems, as well as metrics that recognise the 'right' behaviours and provide appropriate disincentives to prevent misconduct. The speaker also stressed how important it was for firms to reward behaviours that are not driven by short-term performance. This includes promoting client interests and protecting the long-term reputation of the firm. Many advanced financial institutions have started to develop internal frameworks to score conduct and compliance effectiveness but much work in this field remains to be done.

The panel discussed the public's perceived trust deficit of the industry and the importance of reputation to a firm's long-term business viability. Participants agreed that reputation was vital. A firm either acts in an ethical manner or risks losing its reputation. An industry panellist concluded that due to regulators' proactive enforcement measures and increased use of fines, investor interest in conduct matters had improved. Another speaker added that

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more investor education is needed to help the public understand the need to punish unethical behaviour and set higher expectations for firms.

Holistic regulatory approach to firms' conduct

One panellist asked whether increased regulation had been successful in improving the conduct of firms. It was acknowledged that a significant increase in legislation enacted prior to the financial crisis did not deter poor conduct or numerous scandals. A panel member pointed out that good behaviour cannot be legislated, but the role of the regulator can be crucial in catalysing improved behaviour and cultures. To do this, regulators need to develop a better understanding of how firms make money and, in particular, they need to identify the industry's revenue pressure points. These factors are key because firms that are under revenue pressure sometimes alter their behaviour and standards negatively, or even encouraged clients to take excessive risks. The panellist encourage regulators to evaluate incentive structures holistically, communicate with the industry, use a tailored approach to enforce regulation in addressing these market dynamics, and at the same time to refrain from engaging in over-regulation.

Fostering a virtuous behavioural cycle

Panellists discussed ways for the industry to foster and reinforce values, cultural norms and ethical standards that were applicable across the industry via self regulation by individual firms and active supervisory attention. To create a virtuous cycle within markets, the industry needed to facilitate a 'race to the top' for ethical standards. This would entail more self-regulation by individual firms as relying on regulators alone to police the ethics and behaviours of firms may create moral hazard and a false sense of security. Referring to other regional securities markets, one panel member pointed out that a lack of self-regulation by firms themselves may cause an erosion of public trust that may in turn hinder the progress of capital market reforms in those markets.

Participants agreed that regulators play an integral role in creating a virtuous cycle for ethical conduct at firms. As seen in examples from the United States and Europe, regulators were encouraged to look carefully at how firms think about, encourage, and incentivise good conduct, and how business models reflect firms' values and behaviours. The panel also concluded that it was appropriate for regulators to take an active supervisory interest in the cultural values and leadership of market participants.

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Closing Remarks

David Wright, Secretary General, IOSCO

IOSCO Secretary General David Wright closed the Forum by sharing his thoughts on the challenges facing markets in the Asia Pacific region. He underlined the importance of the region taking a more proactive role in setting international policy, particularly in regard to corporate governance, and also suggested ways for Asia to help establish a more stable global financial system. The highlights of Mr. Wright's remarks are presented in the edited excerpts below.

I found this to be a really high quality day. We got to the regulatory frontiers, testing out and discussing new ideas, and reached quite wide agreement on a number of things.

If you look at the five panels, three of the five have dealt with conduct, corporate governance, culture, integrity, which I think is very good. These issues are the missing fifth column of the global financial repair agenda. The agenda five years ago would have been totally different. It would all have been about systemic stability. So there's a feeling of improving things going forward. There has been a lot of progress. The system is safer, but not entirely, prudentially safe yet.

Resolution to me is the key issue. It's remarkable how mild the public reaction all over the world has been at the 15% loss of GDP, the world has suffered post-crisis. But it may not be the same next time. I heard those words from one of the most prominent central bankers in the world, who said, 'if it happens again, capitalism will be switched off.' That's why I take these things very, very seriously. And this issue of resolution is at the core of whether we succeed.

Our risk analysis needs to be improved, and I don't think we can do enough of that. We've got to focus on where the dangerous points are. There is an industry outside this room whose sole purpose is basically to collapse the global financial system. I am talking about cybercrime. That's their full-time job. So I think we'd better take this very seriously indeed.

If I'm to be frank, Asia Pacific today is a global regulatory taker, not a shaper. The question this region has to ask itself is "Is this normal? What are our common interests?" In probably 20 or 30 years' time, this region will be the biggest capital market in the world, if all your markets are summed up, so I don't think you should sustain that proposition. I therefore encourage, both through the Chair of the IOSCO Asia Pacific Regional Committee and at the FSB level, to build a common Asian view if possible. Although there are national differences, there are real benefits for the region to start building on common interests, which can be practical and not necessarily institutional.

If you look at the issues that are coming before us in a regulatory sense, such as non-bank non-insurance systemically important financial institutions (SIFIs), benchmarks, derivatives reform, shadow banking, risk analysis, funding for small and medium enterprises (SMEs), crowd funding, cybercrime, audit quality, etc. I just don't think any single jurisdiction can deal with them on its own without reference to the global framework. I therefore urge you to support building a serious, intellectual and responsible global convergent regulatory model.

The stronger the link between good corporate governance practices and financial penalty, the better. When you look at the correlations between those big firms that failed in this crisis, and the type of people who were running them, the way the board did not function, the risk management that was non-existent... they led their firms and society into dangerous situations. I would strongly encourage this part of the world to be a thought leader, and a real champion, of top-class corporate governance.

I think we all have a global interest in strengthening sanctions regimes and making sure that those who want to abuse markets find no respite in another jurisdiction. Corporate governance is crucial, but I think it has to be backed up by very strong sanctions regimes.

I also think that, quite possibly there is overregulation. If we see a continuance of the financial scandals that we have seen, the political pressure on regulators to act becomes incessant. There has probably been an over-reaction already, but it's not going to stop until acceptable behaviour is assured.

Disclosure is only part of the policy framework; it can't be the whole policy. All the evidence shows that consumers basically understand very little. I would have thought the smartest countries in the world would make financial education mandatory from the youngest age onward, which would build a much stronger demand for financial products. For instance, Martin Wheatley of the Financial Conduct Authority (FCA) in the United Kingdom has mentioned that when you sign up for a bank account in London, you have to read 29,000 words. Of course nobody does it and everyone just signs off. That's just one illustration of why disclosure is not sufficient.

I do think it is incumbent on all of us to start thinking about the new ideas from a behavioural economics perspective to try and help consumers make the right decisions – not to make decisions for them, but to help them get to the right place. Over time that will result in a more stable financial system.

This has been an excellent day and I would like to thank our hosts who have put on a remarkable conference. Thank you.

List of speakers

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Chief Executive Officer, SFC

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Secretary General, Asian Corporate Governance Association

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Affiliations are as of the date of the Forum. View the conference programme for speakers' biographies.

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About the SFC

Established in 1989, the SFC is an independent statutory body set up to regulate the securities and futures markets in Hong Kong.

Our work is defined and governed by the Securities and Futures Ordinance, which sets out our powers, roles and responsibilities. There are six statutory objectives that underpin the execution of our regulatory work.

- Develop and maintain competitive, efficient, fair, orderly and transparent securities and futures markets
- Help the public understand the workings of the securities and futures industry
- Provide protection for the investing public
- Minimise crime and misconduct in the market
- Reduce systemic risks in the industry
- Assist the Government in maintaining Hong Kong's financial stability

In carrying out our duties, we strive to strengthen Hong Kong's standing as an international financial centre.

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