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

SFC
證監會

SFC Regulatory Forum 2016

Summary of discussions

SFC Regulatory Forum 2016

The SFC Regulatory Forum 2016 was held at the Hong Kong Convention and Exhibition Centre on 23 February. The full-day event was attended by more than 700 senior regulators and leaders from the financial industry, listed companies and professional bodies.

The Forum focused on the opportunities and challenges arising from increasing market connectivity and Hong Kong's evolving role as an international financial hub. Forum participants shared perspectives and insights on current regulatory trends in light of recent events in global capital markets.

About the SFC

Established in 1989, the Securities and Futures Commission (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.

SFC Regulatory Forum 2016

Opening remarks

Mr Carlson Tong, SBS, JP, Chairman, SFC

Distinguished guests, ladies and gentlemen, good morning.

As Chairman of the Securities and Futures Commission (SFC), it gives me great pleasure to warmly welcome you all to our second biennial SFC Regulatory Forum.

On behalf of the SFC, I would like to thank you all for coming, and I want to add a special thanks to our distinguished speakers—some of them flew all the way from the US, London and Australia to take part in today's panel discussions.

When we planned for our first Regulatory Forum two years ago, it was a pilot event as we were not sure how it would be received. We were therefore delighted that the feedback afterwards was very positive with strong support for another forum. So this is the reason why we are back again, because of popular demand!

Our first forum held in January 2014 focused on the future of regulation in the aftermath of the Global Financial Crisis. This topic is still very timely and we will touch on it again today, but we did not have Stock Connect or Mutual Recognition of Funds back then. China's forecast GDP growth for 2013 was around 8% and oil price was US$110 per barrel. Who would have believed that oil price could come down to US$30 per barrel and China's GDP growth may be down to 6.5% or even lower?

The lesson from all these is that we are living in a rapidly changing world and as a regulator, we need to be prepared for the unexpected, and our regulatory system needs to be able to withstand the most volatile market environment.

Engaging our stakeholders

So first of all, let me share with you what we hope to achieve today.

In order to keep up-to-date with the changing markets, we must look for ways to foster closer communication with those we regulate, as well as with listed companies and professionals, about issues that are most important to them.

On one level, our aim is to have a two-way conversation, so we can hear what our stakeholders are concerned about, and all of you can hear from the SFC.

Second, we hope we can have some meaningful discussions today about some of the opportunities and challenges facing the financial markets in Hong Kong as well as in other parts of the world.

We are also looking for better ways to regulate and we will talk a bit about that today too, although we recognise the simple truth that there are no easy answers to many of the challenges we face. Nonetheless, today we hope to have an honest exchange of perspectives, experiences and insights. Hopefully this will bring up some good ideas for how all of us can address future challenges.

Connection with China and market connectivity

As I just pointed out, a lot has happened in the past two years so from our perspective, what has been the biggest change since our last Forum?

One obvious answer must be our closer connection with the Mainland. The integration of Mainland and Hong Kong capital markets will play a critical role in our future as an international financial centre.

The launch of Stock Connect and then Mutual Recognition of Funds were both watershed moments for Hong Kong's financial markets, but their significance goes far beyond the short term. For one thing, they marked a new era of enforcement cooperation and information sharing across borders. This in itself was a milestone in China's reform and opening up.

Considering our increased connectivity with mainland China at the same time when the global financial system is becoming more interconnected and complex, we have therefore decided to spend some time and focus at this second forum on the opportunities and challenges presented by increasing market connectivity with China and the rest of the world.

International cooperation

Furthermore, with a globally connected market, it is clear to us that the way of the future must surely be closer international and regional cooperation.

This is a hugely important agenda for us at the SFC. In fact, it is pivotal for us to maintain and enforce a robust level of world-class regulation to provide a level playing field for companies and protect investors.

Hong Kong is a large and open market which is increasingly intertwined with other parts of the world. More importantly, for a long time now Hong Kong has played a unique role in capital flows between the Mainland and the rest of the world.

At the same time, we have common interests with other Asian jurisdictions who also feel the effects of policies coming out of the US and EU, and are often significantly affected by events outside their borders. We feel strongly that Asia's voice should be heard in the global arena. After all, this region accounts for over 30% of global GDP.

So we have been working together with our fellow regulators to find a common voice on global regulatory policymaking. This is essential if we are to build stronger, deeper and more resilient financial markets all across the region.

Now you can see that market connectivity is a very important issue for the SFC and for Hong Kong and the region. You will hear more about these issues throughout today.

Regulation for quality markets

Not surprisingly, the markets we regulate have grown considerably in a few years' time.

In terms of IPO activities, Hong Kong was first in the global ranking last year and has been either number one or number two over the past several years.

And just since 2008, the number of listed companies in Hong Kong grew from 1,261 to 1,866, up nearly 50%, while market capitalisation more than doubled from $10.3 trillion to $24.7 trillion.

Hong Kong has also seen a large increase in the number of asset management firms, which increased 64% to nearly 1,200. Overall, the number of SFC licensees is on the rise, and they are engaging in more different regulated activities than ever before.

Those are impressive statistics. But in terms of our regulation, it only scratches the surface of the expanding scope of our work. As I said earlier, markets are now more complex than ever and are getting even more complex every day.

We have to keep up with these developments. For example, we made substantial efforts to step up our supervision of global and regional firms operating in Hong Kong, to promote better compliance by listed companies, and to deal with increasingly complex enforcement cases. We have also taken steps to facilitate market growth and product innovation.

What to anticipate

We have an exciting line up for you today. Ashley will kick off with a panel on Hong Kong's evolving role in global markets. This is just the start, as we will continue with four more panels through to the end of the day. We hope to touch on the most important areas of our current regulatory agenda, including corporate behaviour—a topic that is near and dear to my heart. We will also talk about the future of intermediaries, cross-border financial cooperation, and of course we will have a discussion of major trends in enforcement.

I hope you can stay with us and enjoy the conference. We would love to hear from you. This year we have set up a webpage so you can use your phone or iPad to send questions to our panellists and to take part in our interactive polls. We would also appreciate hearing your feedback after the event.

Before I hand over to Ashley and the first panel, let me take this opportunity to wish you all a happy, healthy and prosperous Year of the Monkey. I hope you will find today's discussions highly stimulating.

Thank you.

Summary of discussions

Panel 1: Hong Kong, Mainland China and Global Markets: Perspectives of Industry, the Exchange and Regulators

The panel discussed recent events in Mainland capital markets with a focus on the role of Hong Kong and the potential opportunities and challenges presented by increasing market connectivity. Panellists considered the need for appropriate regulation to respond to changing market conditions and the growth of cross-border trading schemes, and suggested options for Hong Kong to redefine its role as both an international financial hub and a centre for managing Mainland risk.

A rapidly changing environment

The moderator kicked off the panel by reviewing the unprecedented events since the large run-up in the Mainland markets starting in mid-2014. In the second half of 2015, Mainland indices dropped around 40% and turnover plummeted. Multiple interventions were attempted to stabilise the markets. For the first time, China featured explicitly in US and European monetary policy decisions. During this period the Hong Kong market functioned without interruption with no need for special measures, but still fell roughly by one-third.

Recently, the moderator continued, a dominant theme has been connectivity between Hong Kong and the Mainland market with the launch of Stock Connect and Mutual Recognition of Funds. The aim is to attract greater participation from overseas institutional investors in Mainland markets and in the longer term to allow Mainland citizens to put their savings to work outside the Mainland, and Hong Kong is a major facilitator to achieve these goals.

The moderator's first question for the panel was "are we putting all our eggs in one basket?" Regulators needed to ensure that integration between markets is matched by a high level of regulatory cooperation, and the question was whether that is achievable. For the industry, the question was how to participate in a rapidly changing environment. For Hong Kong, the question was how to position itself in light of rapidly changing conditions in Mainland and local markets.

The first panellist explained that boosting the equity markets was one way for the Mainland to tackle deleveraging in a bank-focused economy, recapitalise the system and generate real growth. The key question was how to get the financial system to finance a major structural adjustment away from a manufacturing base towards a service economy. He also commented that international financial regulation had been too complex after the global financial crisis. "One size fits all" rules were undesirable as what fits the Mainland does not necessarily fit Hong Kong and vice versa.

The panellist from Hong Kong Exchanges and Clearing Limited (HKEX) addressed the question of whether we are putting too many eggs in one basket, namely China. He emphasised that unless we play a role on the Mainland, we will not be truly international, but if we are not international, we cannot play a role on the Mainland: we have to be

Chinese to be international and to be international to be Chinese. HKEX's vision is to be the global exchange of choice for both Mainland clients and international clients seeking Mainland exposure. As the Mainland becomes one of the world's largest exporters of capital, Hong Kong should position itself in the middle where international and Chinese liquidity come together for a variety of products, not only equities but also commodities, fixed income and currency.

He explained that in the past 20 years, Hong Kong's market served two customers: Mainland enterprises with financing needs and foreign investors looking for exposure to Chinese equity. In the future, our market must serve four customers: Mainland issuers, foreign investors, Mainland investors and overseas issuers. The arrival of Mainland investors through mutual connectivity is set to attract more international issuers to Hong Kong for exposure to Chinese liquidity.

The panellist noted the contradiction between having a large retail-driven market and a strong derivatives market on the Mainland, and also that restrictions on futures and short-selling prevented the Mainland capital market from being a fully functioning market. Given this, could Hong Kong become an offshore risk management centre for the Mainland, while the Mainland maintained a reliable, stable and secure domestic growth base for investors?

The panellist said that HKEX is well placed to help mainland China develop and internationalise commodity benchmarks, thereby transforming it into a "price setter" instead of a "price taker". HKEX aims to bring the London Metal Exchange's model into the Mainland to create an effective spot trading platform there. In time, the platform could generate a series of "China price" benchmarks, and would provide a foundation for the sustained development of commodity futures trading either onshore or in Hong Kong.

Regulation in a time of change

The SFC panellist expressed that to navigate a turbulent world, regulators had to stick to three principles: protecting investors, maintaining a fair and orderly market and reducing systemic risk. The Mainland's size combined with the speed of its reforms meant that regulators needed to be careful of associated risks. The next five years will be critical as the Mainland aimed to double its gross domestic product from 2010 to 2020. The SFC enjoys very good cooperation with the China Securities Regulatory Commission (CSRC) and the mutuality of Stock Connect created new incentives for the two regulators to work together to resolve problems.

The moderator added that against the background of recent events in the Mainland markets, this is potentially a major turning point for Hong Kong's international financial market and is as significant as the first Mainland listing in Hong Kong in 1993.

He noted that the SFC spent a lot of time dealing with the ambition of global regulators who wanted to export their solutions to Asia on the grounds

that, otherwise, businesses would engage in regulatory arbitrage. However, not all the rules were justifiable for Asia. The SFC had been pushing back against the export of inappropriate global rules into Asia with increasing success.

The single largest issue the SFC has worked on, he continued, was connectivity with the Mainland from a regulator's perspective. It was absolutely vital that the degree of connectivity between the two markets was matched by the degree of regulatory cooperation. And because of the mutuality of connectivity, the incentives to cooperate are now much higher.

New roles for markets

The panellist from the industry explained that when it came to Hong Kong and the Mainland, global institutions are interested in, firstly, the role capital markets can play to help the Mainland reduce leverage and increase corporate profitability, and secondly, the difficulty of accessing the Mainland market and the disconnect between the Mainland's economic stature and the size and openness of its capital market.

To address these issues, capital markets needed to play a much larger role in financial intermediation. This called for a transparent communication strategy so market participants are clear about reform plans. In times of volatility, the inclination was to roll back some structural reforms, but the time for painful reforms was when the economy faces tough challenges.

As a leading offshore renminbi centre with a well-regulated financial market, Hong Kong is well positioned to help Chinese companies go global. Moreover, if more of the US$21 trillion in Mainland bank deposits could be mobilised to invest in Chinese and international companies through Hong Kong, the market here would be an even more attractive destination for multinational companies, she concluded.

The moderator added that over the past 20 or so years, Hong Kong has grown its financial centre largely by listing Mainland businesses, and this utterly transformed the market. The opportunities were now far broader and the situation far more complex. In particular, Hong Kong cannot be assured of exclusivity in its relationship with the Mainland.

The first panellist agreed that Hong Kong was being tested, adding that this was a tremendous opportunity to show how it can help manage risk, which is exactly its historic role as an intermediary between the Mainland and the rest of the world.

The panellist from HKEX emphasised the importance of properly understanding the Mainland market, which is dominated by retail investors. The market is uniquely organised to help meet their specific needs while many policy decisions are made with a strong orientation toward their interests. This, however, would contradict the goal of institutionalising the market and developing the necessary tools for institutional players.

For Hong Kong, another area is to fully leverage its role as the largest offshore renminbi market. HKEX launched USD/CNH[1] futures in 2012. In the near future, HKEX will launch a cluster of new futures contracts which cross CNH with a range of currencies.

The SFC panellist added that Hong Kong also needs to understand some limitations as a risk management centre for the Mainland, noting that the size of its economy is much smaller than the Mainland's.

The industry panellist concluded that Hong Kong and the Mainland have a symbiotic relationship but everyone needs to recognise Hong Kong's unique status in the context of the Mainland's financial reforms. Hong Kong is the primary beneficiary of close connectivity with the Mainland. Investors can benefit from market inefficiencies such as trading A-share premiums over H-shares.

The moderator wrapped up the panel by querying whether it was dangerous for the Mainland to open its markets before it has an effective regulatory framework. Mainland authorities themselves did not shy away from talking about this, and back in January, Xiao Gang, who had just stepped down as chairman of the CSRC, answered this question by saying that "the abnormal stock market volatility had revealed an immature market, inexperienced investors, an imperfect trading system and inappropriate supervision mechanisms." This indicated a high level of self-reflection and realism, the moderator concluded.

[1] CNH denotes the value of renminbi traded outside mainland China.

Summary of discussions

Panel 2: Spotlight on Corporate Behaviour

The panel considered the state of Hong Kong's capital markets after a year when Hong Kong ranked number one in IPO fundraising but also saw violent volatility. The panel discussed whether Hong Kong's listing rules were too lenient, whether high demand for shell companies resulted in sharp share volatility, and whether the positioning of GEM should be reconsidered. Panellists also gave their views on corporate governance and the importance of investing for the long term.

Manufacture of shell companies

The moderator began by considering how much the behaviour of companies listed in Hong Kong contributed to recent market volatility and asking what should be done about controversial corporate behaviour such as backdoor listings, reverse takeovers (RTOs) and the manufacture of shell companies. He asked whether volatility was the new norm that came with Hong Kong embracing Mainland opportunities and whether the existing Listing Rules can stand up to this new norm.

An SFC representative presented figures from 2013 through the end of 2015 which showed the scale of the recent market volatility. During this period, 56 companies saw market capitalisation increase by over 1,000% within six months. Of these, 39 were loss-making and 10 had price-to-earnings ratios of over 50 times.

In addition, in the 12 months to the end of July 2015 there were 227 companies with a market capitalisation of more than $1 billion which saw their market capitalisation at least double. Of these, 110 were loss making and another 44 had price-to-earnings ratios of over 50 times. He added that the SFC was working with the Stock Exchange of Hong Kong (SEHK) to look deeper into any correlation between these companies and themes such as public float, frequent use of general mandates, use of convertible securities and backdoor listings.

One panellist gave two reasons for the recent extreme share price volatility: the rise in the number of backdoor listings and investors' changing sentiment towards the Mainland against a backdrop of increasing integration between the Mainland and Hong Kong markets. He noted that while the standard of corporate governance on the Mainland had improved, this was from a low base and the growth path had been uneven. He attributed share price volatility to the gap between the two markets.

The panellist added that Hong Kong should raise its standard to protect its premium brand. In the last 25 years, international investors chose to play China through Hong Kong and Hong Kong benefited tremendously. There was a premium associated with a Hong Kong listing because of Hong Kong's more stringent requirements, he said. Shell companies had been around for a long time but the problem in Hong Kong was

that some companies were set out to be a shell company from day one and there was a degree of dishonesty involved. It sounded counterintuitive, he added, but the solution was to raise the bar, ie, tighten the regulations for companies seeking a Hong Kong listing.

A panellist who chairs the Listing Committee of SEHK agreed that the large increase in the number of backdoor listings, acquisitions of questionable assets and shell company transactions were concerns. SEHK continued to monitor these issues to make sure its rules were robust, particularly in regard to RTOs and backdoor listings, and to ensure that the Listing Rules were not circumvented.

The demand for shell companies was probably driven by Mainland companies due to the Mainland's lengthy IPO process and its restrictions on fundraising, he added. This demand has driven up the share prices of potential takeover targets. In response, the Listing Committee issued a guidance letter in 2014 which tightened the RTO rules governing asset injections. This had a significant effect with the number of such cases falling from 11 to one. But then there was a shift to acquiring shell companies via cash injections which fell outside the RTO anti-avoidance rules.

Listing Rules must evolve with the developing market and SEHK should apply principles rather than bright line rules in order to act more nimbly, he continued. As long as this demand exists, market participants were always going to find ever more ingenious ways to circumvent existing rules. The panellist emphasised that SEHK was not trying to stop valid transactions going through, but was looking at those that did not meet the criteria for a viable and sustainable company.

In association with the SFC, SEHK was conducting a holistic review to make sure the rules were more integrated and responsive to market developments. The SFC played a very important role in this with its power to enquire and investigate companies involved in these activities, he concluded.

Review of GEM

The panel agreed that GEM was not serving its original purpose of providing a fund-raising platform for growth companies and it was time to re-examine and revitalise this market. It was noted that only 18% of GEM listings were IT companies and the rest were traditional businesses such as manufacturing, consumer goods and construction.

One panellist pointed out the need to look at GEM holistically and establish what purpose it is supposed to serve before changing the rules. He believed that GEM was not intended to be just a stepping stone to the Main Board but it now resembled a smaller version of the Main Board.

Another panellist, the former GEM Listing Committee Chairman, said that while a strong policing and monitoring system was needed to catch that one thief, Hong Kong should not close its door on 999 good people who want to come to its market.

Sound corporate values and governance

A panellist from an institutional investor cited Volkswagen's emissions scandal as a demonstration of the consequences of poor corporate governance. Her institution was a long-term shareholder for most of its investments in this region, she said, and from a corporate governance perspective its focus was on competent independent directors.

The panellist explained that broadly speaking there were three categories of companies in the region. Some family companies ignored the rights of minority shareholders and lacked transparency, and it was hard to understand what was going on with these companies. For the majority of companies, which saw corporate governance as a compliance issue and focused on ticking all the boxes, disclosure was a problem and it was difficult to understand the risks they faced and how they were managed. Finally, some companies embraced corporate governance as a strategic issue and valued the constructive input that independent directors provided, and their disclosure was generally comprehensive. This last category of companies do stand out from an institutional investor's perspective, she added.

Although Hong Kong had a strong regulatory environment for related-party transactions, she said the accountability and transparency of independent non-executive directors needed to be improved. In particular, greater transparency was needed when an independent director did not have the support of a majority of the minority shareholders. Overboarding was also an issue, she added, citing an example where a director sat on the boards of 17 companies.

Another panellist agreed, adding that it was very important to have a corporate governance culture that cared about long-term sustainability. He noted that capital markets exerted pressure on managers for short-term gains and that regulations should aim to alleviate this pressure by reducing overly frequent reporting. He concluded that the stewardship concept, promoted in a report by Professor John Kay, was important and the solution was to go back to the basics of why a company was listed and why people invest in it.

Summary of discussions

Panel 3: Future Proofing Intermediaries: Supervisory and Risk Challenges Ahead

The panel discussed the importance of promoting the right corporate culture and senior management responsibility amid the supervisory and risk challenges facing the industry. In particular, cyber security and money laundering were highlighted as crucial issues for market intermediaries as they pose increasing risks.

Getting the culture right

The moderator kicked off the discussion by saying that there is still a long way to go for market intermediaries to improve in the areas of conduct, control and culture. One panellist agreed, acknowledging that a lot more needs to be done to promote proper corporate culture. This, along with the right people, is needed to make internal systems and controls effective. It was noted that a lot of work has to be done and more management responsibility and accountability is needed. Another panellist pointed out that sub-cultures within firms were the cause of many of the conduct problems in the last few years. Identifying risky sub-cultures in an organisation is a great challenge for market intermediaries today.

A particular challenge highlighted was that while financial firms are selling more financial products to overseas customers in the banking sector, particularly those from the Mainland, firms are facing two challenges – how to minimise the selling risk and ensure that sufficient information is gathered from customers for discharging the firms' anti-money laundering (AML), counter-terrorist financing (CTF) and suitability obligation responsibilities.

The panel agreed that achieving these goals is not an easy task and will need constant ongoing attention by senior management.

Important role of senior management

To this end, the panel acknowledged the pivotal role of senior management in shaping a firm's culture and aligning the sub-cultures with it. Compliance and control functions cannot do this alone and senior management needs to take the lead.

One overseas panellist described the new Senior Manager Regime in the United Kingdom, which requires senior management to document their own roles, responsibilities and other important issues. The moderator highlighted that Hong Kong has an existing senior management responsibility regime imbedded in its General Principles and Code of Conduct.

A panellist elaborated that senior management in Hong Kong has to maintain appropriate standards of conduct and ensure adherence to proper procedures by the firm, and for its part the SFC stresses that the board of directors performs important governance, leadership and management roles. Another panellist agreed and said that the Hong Kong Monetary Authority (HKMA) is empowering independent non-executive directors of firms to take their key oversight functions properly. The moderator observed that licensed corporations also need to consider the important oversight and governance role that boards perform.

Key challenges and risk management

A panel member discussed three major challenges to the industry in the coming years. First, if the industry does not have an appropriate incentive scheme to achieve the right balance between risks and rewards, the cultures that led to problems will still exist. Second, technological advancements have been changing the financial industry and the nature of the services provided to customers, and to a certain extent shaping the regulation. Third, the regulator is concerned about the one percent of risks that risk managers say they cannot mitigate.

An overseas panellist viewed that the regulatory response is sometimes too complicated and regulators are micromanaging issues. For instance, the simple aspects of the United Kingdom's Senior Managers Regime – maintain up-to-date job descriptions and organisation charts – are fine, but are overcomplicated as a regime.

The panellist also observed that the largest investigations in recent years showed that financial institutions did not understand many of the risks facing them, even though an enormous amount of work was done within organisations to try to understand those risks. He added that firms' lessons-learned approach was not very effective or happened too late. Therefore the industry should not only think about existing risks, but also identify and address potential risks. On this, the moderator agreed that companies had a static response to inspections and investigations as opposed to adopting an ongoing, perennial and holistic response and mindset.

Strengthening cyber security

Increasing cyber risk

The panel next turned its focus to the challenge of cyber security. An industry panellist and technology specialist agreed with the moderator's view that technology is both the backbone and the future of the financial industry. However, senior management may not fully understand technology and its complexity and therefore may not know the associated risks. In reality, the magnitude of these risks is increasing.

The panellist added that the cyber security challenge is essentially a risk management issue and not just a matter of blocking external attacks. It is also about looking at everything going on inside the firm to identify internal vulnerabilities. Another panellist stressed that cyber risk is something that needs to be dealt with by the whole firm and senior management support is important to implement risk control measures effectively. Local offices of global firms should also be involved in global simulation exercises so that they could react if something happens.

Separately, one panellist pointed out that small firms may not have the in-house expertise or be able to afford to protect themselves from cyber risk and the moderator highlighted that this was a particular challenge for these firms. In addition, the panellist said that cyber security issues in Asia Pacific are compounded because of the use of pirated software.

One panel member cautioned the industry to monitor any unusual activities in client accounts and strengthen their password controls. In particular, firms should not allow clients to reuse their old passwords as investors are always the weakest link for hackers to access a firm's system.

International and local work is underway

One panellist pointed out that global coordination as well as coordination between the private and public sectors is vital on this issue. Another panellist noted that the International Organization of Securities Commissions is looking into the cyber risk issue and has set up a task force to study the matter from different perspectives including those of issuers, market infrastructure providers and intermediaries.

The panellist also reminded the industry to pay attention to five key areas in order to guard against any potential cyber attacks: identification, protection, detection, response and recovery. In addition, firms should have a management structure in place to identify cyber risks. Having effective systems such as an anti-virus programme and a programme to detect any unusual symptoms is important. When under attack, firms are able to respond appropriately and quickly and have an operable recovery plan to continue operations.

The moderator concluded that regulators need to open a dialogue with the industry on the issue. A panellist said that the SFC will share with the industry on both deficiencies and good

practices. Another panellist added that the HKMA is working with the banking industry to develop a comprehensive cyber security programme and a training and certification scheme to raise the level of competence in the industry.

Fighting money laundering

One panellist commented that although banks have invested an enormous amount of money on AML and CTF systems and controls, the front office may tend to overlook the detailed nature of client due diligence.

One panel member described the SFC's work on AML including a survey in 2015 to understand AML controls and breaches in the securities sector, a review of selected firms based on the survey results, and the provision of guidance and training. Among the findings of the SFC's survey, senior management in general are familiar with the AML requirements. The industry is aware of the requirements for customer due diligence and has done a lot of the work on this issue. However, the regulator has concerns about the identification and reporting of suspicious transactions by intermediaries.

Another panellist acknowledged great improvement in AML practices in the banking sector, but said more work was needed. In particular, a major concern relates to the ongoing monitoring and updating of customers' risk profiles. This is important as it helps minimise selling risk. The panellist also encouraged banks to adopt a risk-based approach to manage AML and CFT risks rather than trying to avoid or totally eliminate them.

Summary of discussions

Panel 4: Market Connectivity and Mutual Recognition: Financial Products across Borders

The panel discussed pertinent issues faced by fund managers and investors as a result of the Mainland's increased connectivity to global capital markets through cross-border initiatives. Panellists expressed views on major challenges in investment, risk management and market access issues emerging from cross-border initiatives and shared their perspectives on the market appetite and investment strategies for cross-border investment products.

Investing in the Mainland

The moderator started off with an overview of the evolving investment product landscape since the launch of Stock Connect and particularly Mutual Recognition of Funds (MRF) which is at the heart of the SFC's strategy to develop Hong Kong as a full-fledged asset management centre. These and other recent market developments, including market volatility and the depreciation of the renminbi, have brought new opportunities as well as challenges for the fund industry.

From a foreign institutional investor's perspective, one panellist remarked that it has become harder and harder to find the right long-term investments due to ever depressed yields, the concept of lower for longer and increasing liabilities. He described international capital as impatient, dynamic and highly fungible, noting that investors tend to vote with their feet and seize well-timed opportunities as they arise.

Over the past few years, the world of investing has focused on emerging markets, and especially on the Mainland. Nevertheless, investors seem to have lost sight of the most fundamental question: what is the strategic rationale for investing in the Mainland?

What most institutional capital is looking for is a highly efficient market which is mature and transparent. For this reason, panellists agreed, the Mainland's capital market development has to be accompanied by a very strong focus on corporate governance standards—whether

it is the protection of minority shareholders, transparency or creating a compliance culture—as well as capital market rules and regulations. In parallel, the Mainland needs to develop from a retail market into a fully-fledged institutional one.

One speaker believes that good corporate governance, transparency and confidence in the Mainland's capital markets are fundamental to driving the economy and to attracting patient, long-term capital. Another panellist agreed that these fundamentals can help regain investor confidence and stabilise the market.

An industry representative added that the Mainland is still in an early stage of development, hence patience is required on the part of investors. At the same time, the Mainland is a huge market. The full utilisation of all existing cross-border investment channels would only take up 1% of some RMB110 trillion in private assets, thus providing a wealth of opportunities for the industry.

Considering the question of how to put institutional money to work through a capital market system, one panellist noted that Mainland policymakers are more willing to diversify sources of capital and to allow alternative participants in the market. The ability of the authorities to regulate strongly, while at the same time allowing the diversification of sources of capital, would be one way to promote institutional capital flows.

Increased connectivity

When asked whether Mainland investors are truly diversifying their assets after the launch of Stock Connect and MRF, one panellist quoted a 2015 survey saying that the Mainland's demand for overseas assets has risen rapidly. However, more than 50% of high net worth investors had no experience in investing in overseas markets, indicating the need for more investor education.

While Mainland financial institutions are becoming increasingly sophisticated, they still need help from their overseas partners to develop a clear long-term strategy. Likewise, foreign institutional investors should also find an appropriate partner to tap the Mainland's vastly different regions.

Another panellist identified product availability and customer experience as positive developments as a result of the launch of MRF. He expects more foreign funds will be made available through MRF across a wider range of distribution channels such as banks and local distributors on the Mainland. It is also likely that Mainland technology companies will become an alternative to the established banks in providing not just financial products but also investment advice and a good customer experience.

Meanwhile, Stock Connect helps improve liquidity in the Mainland equity market despite three challenges for the fund industry: concentration of clients, portfolio concentration and market liquidity and suspensions.

Risk management

The panel next turned its focus to a heightened concern that liquidity risk may be exported from the Mainland as a result of increased connectivity and market events in the summer of 2015.

In dealing with liquidity risk, an industry expert asserted the need to monitor fund performance and fund flow patterns. History shows that there tends to be a higher likelihood of more significant redemptions when a fund goes through a period of underperformance. While monitoring fund flow patterns, fund managers can start making provisions for the fund when they see a pick-up in outflows.

The panellist recommended three lines of defence in managing liquidity risks: the investment desk, where fund managers should be prudent in the portfolio construction process; group risk and compliance monitoring, which is essential for companies to run their businesses on a day-to-day basis; and effective group internal audit procedures, so as to provide more periodic assurance of the effectiveness of the controls that are in place.

The panellist commented that, in reality, many funds invest in very liquid markets and in liquid instruments, hence extreme cases of funds getting into serious problems rarely occur, especially if companies manage their funds along these lines.

Market access

Panel members then moved on to evaluate various means of accessing the Mainland market. One panellist acknowledged that different market access channels have facilitated market entry and allowed the Mainland's tremendous private wealth to access overseas markets and diversify risks and have also enabled Mainland asset managers to develop and learn how to invest globally.

He identified five opportunities arising from these channels. First, given the complexity of different programmes such as Stock Connect, Qualified Domestic Institutional Investor and now MRF, it may be worthwhile to streamline some of them to make them easier for investors to understand.

Second, these programmes should also take into account the development of the Mainland's debt and fixed income markets, he suggested. Market volatility and a hunt for yield have prompted investors to look at the debt market, particularly debt instruments from the Mainland.

Next, he continued, some restrictions under MRF can be relaxed to encourage more investors or fund managers to participate in the scheme and utilise their capability.

Fourth, the foreign ownership limit for a joint venture, which is below 50%, can be relaxed. He believed that allowing foreign firms to conduct business and launch products on the Mainland can complement the local fund industry and help boost investor confidence.

Finally, he sees huge potential for the Mainland's pension scheme reform to shift the reliance on discretionary investment to other alternative means to channel retail investors' savings into the capital markets.

The panel agreed that the Mainland needs to focus on investor confidence, corporate governance and transparency. Among these, an industry panellist recognised that it is pivotal to have confidence in the long-term fundamentals of the Mainland's capital markets, as opposed to the investment thesis itself.

Summary of discussions

Panel 5: Trends in Regional Enforcement

The panel took up three questions: have enforcement actions had an impact on the culture of the financial industry, does strong enforcement stifle market competitiveness, and what should market participants do to reduce their exposure to enforcement actions?

Stringent and vigorous enforcement has become a hallmark of the securities market in Hong Kong, the moderator pointed out. The SFC has taken the issue of enforcement very seriously and, as experience shows, it does affect the bottom line of financial companies.

Enforcement as a driver of change

The first panellist stated that enforcement does have an impact on culture, but is not sufficient by itself to change culture, so a holistic approach is needed. She noted that a culture of compliance is emerging, but a culture of ethics is what will really ensure the right outcomes for consumers and the market. When supervision and enforcement go hand-in-hand with regulation, that is when you see a real impact.

Banks in Hong Kong are concerned about their reputations. However, she added, many firms see fines as the cost of doing business and therefore enforcement actions against individuals or senior managers would be a greater deterrent and be more effective in driving cultural change. However, so far attempts to introduce more individual responsibility, such as through the United Kingdom's Senior Manager Regime, have faced resistance from the industry.

Another panellist said it was clear that enforcement efforts have had an impact on how bankers think and behave. Previously, for many bankers the idea of going to jail or being held publicly accountable was an academic or theoretical prospect, but they now know that the actions of regulators can affect them personally. As a result, the industry now attracts more people who have a strong managerial sense and who understand controls, and this is transforming the industry.

For one panellist, the best definition of culture came from a recent G30 publication: culture is what one does when nobody is watching. He agreed that enforcement actions have had a big impact on culture, particularly since 2008, and institutions are taking enforcement risks very seriously. Senior management now spend a lot of time and money on culture issues. There is lower tolerance for bad conduct and more awareness of the consequences of misconduct, but the industry still has a way to go to get the incentives right. We are seeing the effects of enforcement actions in Hong Kong, despite lower fining powers, he added, which show that the real deterrents are reputation risk and the risk of losing your licence to do business.

One example of the positive impact of enforcement action on the regulated community was a recent self-reporting case, he continued. The message from the SFC and Hong Kong Monetary Authority about their expectations on self-reporting had been coming through loud and clear, and when the case emerged last year, the SFC made a statement to the effect that firms need to report immediately without investigation and without legal advice. The panellist believed that this was an overstatement of the position because it is sometimes appropriate to spend time to work out whether there is an issue and if necessary take legal advice.

Nonetheless, the panellist said he had seen quite markedly how the combination of pre-enforcement messages, the outcome of this case, and the media reports about it, had a major impact on the attitude of the industry to self-reporting. While enforcement action is a very important weapon, he believed there are concerns about due process and the need for empathy for institutions which are under enforcement action or investigation.

A panellist from an overseas regulatory body has seen significant improvements in the industry's culture over the past ten years owing in part to more robust and effective enforcement. Regulators have shown that they approach enforcement in a systematic way, and that demonstrates that enforcement is serious. But while certain things have changed, regulators are still not where they want to be. Echoing the comments of other panellists, he concluded that enforcement and other external drivers cannot drive culture change, it has to come from within firms as well.

Enforcement and market competitiveness

Panellists' opinions were divided on whether strong enforcement stifles market competitiveness.

Regulatory authorities were of the view that strong enforcement can facilitate more competitive markets and attract investment. Efficient and competitive markets are built on solid legal frameworks of which effective and consistent enforcement form a core part. For example, in the absence of effective enforcement, compliant firms would be on a level playing field with the non-compliant. One speaker agreed that enforcement actions give a clear signal to the industry on what is acceptable and what is not, and thereby promote market efficiency.

The complexity of financial markets makes them prone to collective action problems, one panellist noted. If your competitor is gaining market share at your expense, there is strong pressure to copy your competitor's conduct. After Australia took enforcement action on inappropriate and misleading sales practices for some investment products, some firms expressed relief that the regulator stepped in to ensure competition was fairer and more reasonable. In this way regulators can facilitate an appropriately competitive market.

An opposing view considered that in some cases business decision making is too heavily driven by enforcement activities to an extent that obstructs innovative and responsible risk taking. There is a reluctance to escalate issues that should be escalated, particularly at junior levels, which in the panellist's view reflects a fear of the consequences of enforcement actions as well as a lack of trust that senior management and regulators will react proportionately.

Advice for the industry

The moderator moved on to present statistics on the upward trend, and in some cases substantial increase, in SFC enforcement activities over the past six years. This trend was clearly visible in every category of investigation from corporate disclosure and misgovernance, insider dealing, intermediary misconduct, market manipulation and unlicensed activities. In light of these figures, he asked panellists for views on how market participants can reduce exposure to enforcement actions.

One speaker suggested that the most important rule is to obey the law, adding that Australian regulators focus on whether firms respond constructively and rapidly when misconduct is identified, and in particular whether misconduct is reported to the regulator in a timely manner.

Another panellist pointed out that firms should put more weight on internal monitoring and surveillance, rather than merely looking at policies and procedures. He believed that firms ultimately need to promote the right behaviour by asking the right question: should we do this, not can we do this?

A third speaker highlighted that putting internal accountability and a proper process in place is imperative. If firms fail to establish a consistent approach to dealing with accountability and develop a culture of fairness, they will be more prone to disciplinary issues. He also suggested that in particular management should supervise top performers to ensure they carry out their duties and do business in a proper manner.

The local regulator wrapped up the panel by underlining the importance of establishing an effective corporate governance system within firms and setting the tone from the top which affects everything from incentive systems to training and shapes the culture of the firm.

The moderator concluded that enforcement will continue to play a key role in setting the culture for the industry.

Closing remarks

Ashley Alder, JP, Chief Executive Officer, SFC

The content of today's panels was rich and the discussions were wide-ranging, but now I want to focus on how these may be of particular relevance to the SFC and its stakeholders. First, a key message is that the events of the last 18 months or so in mainland China are undoubtedly significant and are potentially a game changer, not only for Mainland markets but also for Hong Kong.

We spoke about Hong Kong acting as a connector. From our perspective as a regulator, when these connections increase, it is absolutely vital to ensure that the degree of regulatory cooperation matches the depth of those connections. We made this crystal clear when Stock Connect launched. With Mutual Recognition of Funds, we also worked very hard on cooperation and we will continue to do so as these programmes expand. The resolve of the CSRC in particular to ensure that this happens has been very clear.

Second, there is a view that Hong Kong has a very clear role to play as a risk management centre for mainland China. This is a complex subject but it comes down to the ability to launch and manage derivatives, futures and other instruments so as to manage more straightforward financial or market exposure on the Mainland. This is a major opportunity and is symbiotic with the way China wishes to develop. These instruments naturally carry greater intrinsic risk; as a regulator we need to be on top of this, working closely with Hong Kong Exchanges and Clearing Limited.

In the second panel discussion, it was also clear that it is time for a comprehensive review of the content and structure of listing regulation. When we talk about GEM or even a Third Board, we need to consider some of the difficult issues illustrated by price anomalies which seem to be affecting some of our market sectors.

Third, when it comes to regulated financial institutions, we are placing special emphasis on senior managers. Our codes and the Securities and Futures Ordinance already talk explicitly about senior management responsibility. But for firms, particularly larger ones which may have complex matrix management structures, it can be difficult to put our rules into practice. The UK report on HBOS plc talks about why the Financial Conduct Authority concluded that it could not pursue the CEO for the failure of a large institutional bank; this was due in part to a lack of clarity over responsibility. We think it is important for us to further clarify responsibility within firms.

We are determined to ensure that Hong Kong grows as a major asset management centre within Asia. One important recent change is mutual recognition, not only with mainland China but also with other jurisdictions. Over the last few years, Hong Kong has effectively acted as an inbound sales offices for UCITS[1] funds, and built a regime around UCITS funds being sold in Hong Kong. We think we can add to this so that Hong Kong can establish, manage and export its own funds. From the SFC's perspective, we need to ensure that this is accompanied by proportionate regulation for responsible product design and the responsibility for a disclosure and selling process which enables mutual recognition regimes to flourish with confidence.

Turning to enforcement, our power to fine intermediaries is low compared with overseas regulators, who can impose multi-billion dollar fines or settlements. But that has forced us to think harder about remediation. Over the last few years, we ensured that many who have caused harm have compensated those who were harmed, and we will continue along those lines. Another issue is that individual responsibility has lagged firm responsibility, and that goes back to the senior management issue mentioned earlier.

Another issue with enforcement is fast self-reporting. A key reason why this is emphasised is to stop continuing harm from spreading too far, too quickly. Fast reporting is also important because we can act to detain individuals who may wish to leave Hong Kong. Therefore it is vital for us to know quickly which individuals might be involved in misconduct.

Finally, there is what can seem to be an esoteric global conversation around firm culture, supervision and enforcement. One of the eye-catching aspects of a report published last year by the G30 on bank conduct and culture was there should be "distance" between the regulator operating as a supervisor and the same regulator operating as an enforcement agency. I disagree with the notion that supervision should be a "safe place". On the contrary, supervision is intimately linked with enforcement, although we fully understand that prudential supervisors have concerns about the size of financial penalties threatening the viability of a bank. We are now participating in a global discussion about how these different approaches can co-exist, and it will be interesting to see how this plays out.

I would like to thank all the panellists for a robust exchange of views and to thank the audience for participating. Thank you very much for coming.

[1] Undertakings for Collective Investment in Transferable Securities.

List of speakers

Opening remarks

Carlson Tong, SBS, JP
Chairman, SFC

Panel 1

Ashley Alder, JP
Chief Executive Officer, SFC

Charles Li
Chief Executive, Hong Kong Exchanges and Clearing Limited

Andrew Sheng
Distinguished Fellow, Asia Global Institute, University of Hong Kong

Jing Ulrich
Managing Director and Vice Chairman for Asia Pacific, J.P. Morgan

Keith Lui
Executive Director, Supervision of Markets, SFC

Panel 2

Carlson Tong, SBS, JP
Chairman, SFC

Pru Bennett
Director, Head of Corporate Governance and Responsible Investment for Asia Pacific, BlackRock

Dr Lo Ka Shui, GBS, JP
Chairman and Managing Director, Great Eagle Holdings Limited

Stephen Taylor
Partner, Deloitte Touche Tohmatsu

Tony Tsoi
Founder, Stand News

Brian Ho
Executive Director, Corporate Finance, SFC

Panel 3

James Shipton
Executive Director, Intermediaries, SFC

Raymond Chan
Executive Director Designate (Banking Supervision), Hong Kong Monetary Authority

Sophia Leung
Managing Director and Chief Information Officer for Asia Pacific, J.P. Morgan

Panel 3 (cont'd)

Andrew Procter
Partner, Financial Services Regulation, Herbert Smith Freehills LLP

Stephen Po
Senior Director, Intermediaries Supervision, Intermediaries, SFC

Panel 4

Julia Leung, SBS
Executive Director, Investment Products, SFC

Mark McCombe
Global Head of Institutional Client Business, BlackRock

Ding Chen
Chief Executive Officer, CSOP Asset Management

Lieven Debruyne
Chief Executive Officer, Hong Kong/China, Schroder Investment Management (Hong Kong)

Bruno Lee
Senior Managing Director, Wealth and Asset Management, Asia, Manulife Asset Management

Panel 5

Dr William Wong, SC
Non-Executive Director, SFC

Meena Datwani, JP
Director-General, Enforcement, Hong Kong Monetary Authority

Peter Kell
Deputy Chairman, Australian Securities and Investments Commission

Joseph Longo
Managing Director, General Counsel, Asia Pacific – Legal, Deutsche Bank

Matthew Newick
Head of Litigation and Dispute Resolution, Asia Pacific, Clifford Chance

Closing remarks

Ashley Alder, JP
Chief Executive Officer, SFC

Affiliations are as of the date of the Forum.
View the Speaker biographies for more details.

Publisher Securities and Futures Commission

Office 35/F, Cheung Kong Center
2 Queen's Road Central
Hong Kong
Telephone : (852) 2231 1222
Facsimile : (852) 2521 7836
Website : www.sfc.hk