

Speech at 7th Pan Asian Regulatory Summit

Mr Ashley Alder
Chief Executive Officer

8 November 2016

Thank you for asking me to speak today. What I want to do is to pick up on a theme I touched on at this event last year, and then move on to some thoughts prompted by reactions to the joint Securities and Futures Commission (SFC) and The Stock Exchange of Hong Kong Limited (Exchange) consultation on listing regulation we issued in June.

Last year I spoke about some key SFC projects then in train, most of which had a large cross-border dimension. I tried to make clear that the way in which we think about regulation operating across borders is of central importance to Hong Kong as an international financial centre. That's because Hong Kong is a true international financial centre, rather than one in name only.

Hong Kong is of course a major location for international companies to list, and for the last 20 years or so most of these listings have been from mainland China.

Hong Kong is also a place where European and US financial services firms have a major presence. They have now been joined by a growing number of firms and investors originating from the Mainland who are without doubt altering the competitive landscape.

A more connected market

From a regulatory point of view, all of this has major implications for how the SFC works, and part of this is to do with the importance of our supervision and enforcement relationship with the China Securities Regulatory Commission (CSRC). Put simply, the SFC cannot properly regulate listed companies based in the Mainland, or intermediaries headquartered in the Mainland, without being able to work closely with the CSRC.

And the type and intensity of two-way cooperation between the SFC and CSRC inevitably underwent a very big change with the launch of Shanghai-Hong Kong Stock Connect back in 2014.

Stock Connect basically meant that, for the first time, the CSRC had much the same incentive as we have had to identify and root out cross-border misconduct. The reason for this was quite simple. Stock Connect meant that Mainland and international investors could access the Hong Kong and A-share markets freely and reciprocally without needing to apply for an individual quota – unlike the older QFII¹ schemes. Investors could also trade the Mainland market through Hong Kong brokers, and vice versa.

¹ Qualified Foreign Institutional Investor



This new pathway meant that the CSRC became more focused on the activities of overseas investors in Mainland markets, in much the same way that we have been focused on the activities of overseas and Mainland investors in our own market.

This was very different to the position beforehand when most requests for investigation assistance made to the CSRC were about problems with Mainland businesses listed abroad – to do with suspected accounting fraud and the like. But for obvious reasons, the CSRC had no need to make similar requests of overseas regulators. But with the launch of the Connect programme, this one-way street of cross-border information requests changed into a two-way street of reciprocal assistance.

Not long ago, southbound flows from the Mainland into Hong Kong through the first phase of the Connect programme represented as much as 10% of total turnover, and of course cross-border investor interest in both directions is likely to increase substantially as the scope of the programme widens to include far more stocks in Hong Kong and a new market in Shenzhen.

So cross-border supervision and investigation will become even more essential to contain risks to our respective markets as they experience even larger cross-border flows.

Now the nature of the Stock Connect programme means that the focus of regulatory cooperation has mainly been about market misconduct in the secondary markets. This is because the programme is a gateway for cross-border trading and settlement, and does not concern the listing of companies.

But the fact that Mainland investors now have an increasing exposure to Hong Kong listed companies has meant that many of those investors, as well as the CSRC, are taking a far greater interest in the quality of these companies.

Specifically, we have seen an increasingly vocal cross-section of investors expressing concerns about some features of our listed market – ranging from governance issues to the behaviour of some intermediaries who seem determined to undermine the spirit of some of our market rules. And of course the degree to which the SFC is able to deal effectively with corporate misconduct – whether perpetrated by management alone or aided and abetted by intermediaries – is also dependent on cross border regulatory cooperation when it comes to the many listed businesses which are located in the Mainland. Again, it's a two-way street.

The right regulatory framework

Now as some of you who are based here may know, a fairly intense debate is now underway about joint proposals released by the Exchange and the SFC a few months ago on the structure of listed company regulation in Hong Kong. As the consultation is still underway, I don't propose to rehash the details – the Exchange and the SFC will need to carefully weigh all feedback in the coming months before looking at next steps. However I think that it's worth commenting on a few aspects.

First, I am convinced that we need to make every effort to ensure that our regulatory structure is fit for purpose for 2016 and beyond. And not for 1988, when the basic blueprint for the current regulatory structure in Hong Kong was established following major recommendations for reform known as the Hay Davison Report.



In 1988 our markets were overwhelmingly domestic, a far cry from the international flows which now define Hong Kong as an international financial centre, and which mean, as I have pointed out, that the way in which the SFC works alongside the CSRC is now an indispensable part of the regulatory toolbox.

Responses to the joint consultation proposals range from the supportive, to those who are vehemently opposed to change and those who believe the proposals don't go far enough. Some of those opposed have even claimed that the SFC's role in a new structure will in some way "kill off" the initial public offering (IPO) market.

I have to say that it's very hard for me to imagine why any market regulator would be motivated to pursue policies which could stunt the healthy development of the financial centre for which it's responsible. That certainly doesn't describe the SFC I know.

Sustainable market development

And to illustrate this, I'll describe a recent example of how we are laser focused on sustainable market development. I'm sure that those of you who are on the buy side are aware that in the last few months, we have put a massive effort into the regulation necessary to take Hong Kong to the next level as an international fund management centre, aiming to extend its leading position in Asia and beyond. I previewed some of this at last year's Thomson Reuters event.

Since then we have, among other things, pursued intensive talks with other jurisdictions to strike practical agreements to enable our funds industry to get direct access to large overseas markets, mainly in Europe. It looks like we will be able to announce the first of these very soon. And of course last December, we launched a landmark mutual fund recognition programme with the Mainland to enable Hong Kong funds to access Mainland investors and vice versa.

At the same time, it's essential that our funds industry can market itself as world class. So we are about to consult on changes to our Fund Manager Code of Conduct to ensure that standards of conduct and risk management are properly benchmarked to global norms.

Alongside this, we are in the final stages of adapting our suitability requirement for product sales in the online world, including through automated funds platforms and automated advice. We are also putting in place the final shape of a new corporate structure for funds which will enable firms choosing this way of domiciling in Hong Kong to also take advantage of new market access arrangements. And only last year, the industry welcomed a very significant streamlining of our funds authorisation process, which dramatically reduced the "time to market".

My point here is that without an assurance of quality underpinned by the right regulatory framework, investors in Hong Kong funds would lack the confidence to make significant allocations. Just as important, other countries simply wouldn't allow our funds to be marketed in their territories.

If this combination of our pursuit of overseas market access, new business structures and sound regulation isn't market development I don't really know what is. To be frank, I reject any view that as a regulator, our activities have the net effect of limiting development; on the



contrary our driving purpose is to accelerate Hong Kong's position as an international financial centre while ensuring appropriate investor protection.

Enhancing Hong Kong as a listing venue

And in my view, we should pursue the same philosophy for listing regulation as we have in the asset management space. But in doing so we need to recognise that there is a big difference.

This is that asset management is pretty much solely regulated by the SFC, whereas listing regulation is shared between the SFC and the Exchange, and the Exchange itself has two main decision makers – the full-time Listing Department and the part-time Listing Committee which includes financial services firms as well as lawyers, auditors, investors and listed company representatives. And both the Listing Department and the Listing Committee are largely insulated from the rest of the Exchange to address the conflict between the Exchange's regulatory and commercial functions. So the structure of listing regulation is fairly complex when compared to that for funds and asset managers.

Now as the listing consultation is still underway it's far too early for me to predict the final shape of any reform. And I should say that it's clear to me, regardless of different views, that the SFC, the Exchange and the majority of those who have taken the time to respond to the consultation all share a common goal, which is to ensure that Hong Kong's position as a listing venue is enhanced.

As you would expect some commentators look at Hong Kong's past success and question the need for reform. Others ask whether the SFC has done enough in enforcement to tackle misconduct issues. There is also a concern that the reform would side-line the Listing Committee, reducing the level of market participation in regulatory decision-making. Some worry that the proposed Listing Regulatory Committee – which would decide on the minority of listings which give rise to difficult policy issues – will make the system less efficient and slow down the IPO process. Some also believe that the reforms will give the SFC absolute power over listing matters, which prompts fear of overregulation – although I would point out that regulation of listing by a statutory body is in fact the model pursued in most of the world's leading international financial centres.

Both we and the Exchange will be carefully reviewing all responses so I'll leave most of these questions for another day. But for now I would like to give you some initial thoughts on two really interesting questions raised in the feedback to the proposals.

Addressing the problem

The first is to ask us to be more explicit about any market problems which prompted these proposals in the first place.

The second is to ask why the SFC can't use its existing powers to "fix" any problems in the market without the need for any reform. This second question arises from the fact that the proposals don't actually extend to any of the SFC's statutory gatekeeping and enforcement powers. Instead it mainly alters how some could be deployed alongside the Exchange.

Now before tackling these questions I should say that the proposals are really about three things – efficient decision making, accountable decision making and transparent decision



making, all under a framework whereby, as I have described, listing regulation is shared between the SFC and the Exchange. And this brings me back to the first question about the sort of problems which a better decision-making process could help solve.

Now, by many indications, the Hong Kong listing market is thriving. Hong Kong was the leading centre for IPO equity funds raised in 2015 and most estimates give it the lead once more in 2016. However, although this is a great achievement, it's clear that the sheer number of IPOs or the size of proceeds raised are not definitive measures of a quality market for institutional and other investors.

The fact is that over the past few years there has been a significant rise in complaints against listed companies exhibiting patterns of problematic behaviour. There are enough of these companies for our sometimes colourful local media to coin a nickname for them. We have seen companies on the Main Board with inexplicably high valuations being propelled into major stock indices despite a lack of transparency as to their controllers and their businesses. We have seen many instances of shareholding concentrations which minimise the real public float, or companies where the level of trading interest after the IPO has collapsed.

We know that there are specific problems on the much smaller GEM², ranging from untoward volatility to shell manufacturing and suspect placings of shares. On average, the stock prices of the 34 GEM companies listed in 2015 spiked more than seven times on their debut and halved within one month of peaking. This volatility continues – only last month we saw another three new listings climb more than 10 times, or 1,000%, on their debut.

The overall level of turnover in our markets has remained largely flat – discounting the short-lived spike last year mirroring the run up in the A-share market. And this is despite the record number of new IPOs, although the fact that the average size has been declining is significant.

Now I should be absolutely clear that the types of problems I have described do not affect the majority of our listed companies, especially on the Main Board. Overall our market is healthy. But every market is built on trust and confidence, which can evaporate if it's evident that the regulators aren't quick to identify and deal with problems before they become too widespread.

Enforcement

As I've mentioned, some seem to think that most if not all issues can be dealt with through enforcement. It goes without saying that enforcement is a vital aspect of the SFC's work. Tom Atkinson, who joined us in the summer from Toronto to lead our Enforcement division, will elaborate on this in tomorrow's keynote. All I want to say for now is that the number of SFC inquiries into corporate governance or disclosure issues, insider dealing and market manipulation have more than doubled in the past five years, while the number of formal proceedings commenced have increased by more than 50%.

² Growth Enterprise Market



And you will have seen a series of headlines about some recent enforcement actions we have taken in relation to individual listed companies, including our first action to liquidate a large listed company last year.

Against this background, it was noteworthy that in September Hong Kong received the top ranking for regulatory enforcement across Asia in the independent 2016 CG Watch Survey published by CLSA and the Asian Corporate Governance Association. The report said that the SFC sets the benchmark for the region.

So we are doing a heck of a lot in the listed space from an enforcement angle. But to suggest that enforcement is the silver bullet evidences a lack of insight about the natural limitations of the enforcement tools available to us.

Enforcement normally comes into play only after real harm has been done to investors, requires a lot of time and resources, is subject to testing evidential and other thresholds and can't be relied on to fully compensate victims for their losses.

Separately, if a market becomes known for a large number of enforcement actions this in itself can negatively impact investor confidence and affect its overall reputation. For all these reasons, enforcement is no substitute for effective gatekeeping and regular reviews of rules for the governance of listed companies and the intermediaries who interact with them. And this is why the consultation proposals place an emphasis on the way in which gatekeeping decisions are made, as well as the way in which policy initiatives are pursued. This should enable the Exchange and the SFC to work together to more effectively tackle some of the complex issues I have outlined.

The need for reform

And this brings me to the second question – if the SFC's existing gatekeeping and other powers aren't being increased under the proposals, why can't they be used to deal with any problems without the need for reform? I would say two things in answer to this.

First, as I've explained, the purpose of the proposals is to ensure that all those who currently have IPO gatekeeping and listing policy functions across the SFC and the Exchange work far more closely together within a more efficient, accountable and transparent structure. Whatever the final outcome of the consultation, I firmly believe that the market deserves to have the benefit of these three attributes, including published, reasoned decisions to increase understanding and predictability across all market participants.

Second, it's absolutely correct to point out that the SFC has been given specific gatekeeping powers under the law. Further down the corporate life cycle, we also have the power to suspend trading in a listed company's securities when we think our investor protection mandate justifies this. In fact, the number of these suspensions have increased substantially in the last few months.

And I think it's interesting to see how transparency and procedural fairness operate as part of the suspension process, and also that the position is a bit different when it comes to IPO gatekeeping.

In the case of suspensions, we always ask the company to respond to us directly to address our concerns, we must give reasons for our intention to suspend and we only take action if



the company's explanations are inadequate. The company then has a right of appeal to our Board. And of course the Exchange has an independent non-statutory power to suspend trading.

When a company wants to come to the market for the first time, the Exchange and the SFC each have independent gatekeeping powers which in a way mirror their independent suspension powers – for the Exchange, these powers are contained in its Listing Rules and for the SFC, they are part of the same legislation which gives us an ability to suspend trading.

But despite the fact that the SFC's statutory gatekeeping power has been in place for many years, we have only once formally exercised our legal right to block a listing. Instead we normally discuss any issues that could lead to an objection privately with the Exchange. These discussions usually lead to a voluntary withdrawal of the listing application or a formal refusal of listing by the Exchange.

However, this arrangement, which is based on the idea that, for simplicity, a listing applicant and its advisers should only have to deal with one regulator through the listing process – in this case the Exchange – does come at a cost. Many market participants have remarked that it is unsatisfactory for the SFC to operate opaquely, or “behind the scenes”, particularly when an appeal to an independent tribunal is available if we decide formally to object to a listing.

So in answer to the second question about the use of the SFC's existing powers, I tend to agree that issues about the transparency and accountability of the SFC's own function as a listing gatekeeper merit further consideration – provided that the overall efficiency of the listing process is not impacted.

So far I've spent some time talking about some of the deeper questions that the joint proposals have thrown up, and I've emphasised the importance of the relationship between the SFC and CSRC as we respond to the way in which our markets are experiencing increased cross-border capital flows.

But this is mainly to do with case-by-case regulation, rather than forward-looking listing policy development.

A better decision-making structure

So an important element of the proposals is about how listing policy originates and decided on. And again, without going into the details, this is all about a more efficient, accountable and transparent process. And at this point I want to make my own view absolutely clear. This is that policy responses to emerging risks in our listing market as well as policy formation in the interest of market development needs to be far more agile, rapid and well thought through than it has been in the past.

And nothing illustrates this better than the protracted debate in Hong Kong about weighted voting rights following Alibaba's decision to list in the US. Now for obvious reasons, I can't discuss any particular case. But what I do want to make clear is that – contrary to popular perception – the SFC at no point decided that some form of weighted voting rights is totally impossible for Hong Kong.



In fact, after a lengthy process, the Exchange published consultation conclusions which included a draft proposal for a second stage consultation on this issue. This was in June 2015. But in light of the widespread market interest at the time and the fact that deliberations had already extended over many months, the SFC issued a statement to the effect that it could not support this particular proposal.

And we gave detailed reasons for our stance in order to be absolutely transparent with the public. These included our view that it would be inappropriate for the Exchange to pursue its idea of employing subjective “enhanced suitability criteria” to pick and choose between listed applicants wanting to use weighted voting rights.

But we did not call on the Exchange to stop any further work on this issue, although we understand that in fact little more was done thereafter.

Now this is not to say that weighted voting rights don't involve very difficult policy issues. They certainly do, not least because of the challenges associated with the scope and content of any specific changes to the rule book. In the US, there aren't any specific rules about weighted voting rights and in any event, local market dynamics have resulted in only a small proportion of companies actually adopting differential voting structures. And even then they are usually subject to limitations such as sunset clauses, minimum shareholding limits and the like. But as President Kennedy remarked when kicking off the race to the moon in the early 60's, we sometimes choose to do things not because they are easy, but because they are hard.

Although it is impossible to predict what the final result would have been for such a difficult topic as weighted voting rights, I am absolutely sure that the protracted and ultimately inconclusive process which ended in 2015 would have been handled far more satisfactorily through a better decision-making structure. The joint proposals envisage that representatives of all decision makers, including the SFC, would be expected to discuss the hard issues in real time in the same room, would be expected to try to achieve consensus, would be expected to follow through to a proper conclusion and, importantly, be accountable and fully transparent when finally deciding on a way forward.

And I think you can appreciate why a better decision-making structure would also help us address the sort of issues we see in the GEM as well as problems around long trading suspensions and pockets of low market liquidity.

I'll stop there, in the hope that I've done a little to shed some light on our and the Exchange's proposals on listing regulation. And as I have said, we cannot prejudge the outcome at this stage; our next task is to thoroughly analyse all submissions and responses before making any decisions.