Keynote Regulatory Address at Trade Tech Asia 2009

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19 November 2009

Introduction

Good afternoon ladies and gentlemen. Thank you for inviting me to speak at this annual trading conference. I understand that this is the 6th year of this industry event and I congratulate the organisers for yet another successful conference.

You have spent two days listening to the insights and views of industry experts on their respective areas of specialisation in the trading space. I believe they have covered everything there is to be said about trading, in breadth as well as in depth, from the perspective of the industry. There is nothing more I want to add to what they have said. Instead I will share with you my thoughts on the regulatory initiatives that are being hotly debated globally and also changes to the regulatory landscape in various parts of the world.

Apparently, there is a view out there that post-crisis, the regulatory environment is as volatile as the market and in the face of this, firms are uncertain of the way forward, in particular how their business would be affected. Although I do not agree that the regulatory environment is “volatile”, I believe some of the more seasoned players in the market will advise that post-crisis, firms should watch the type of enforcement actions that are taken and what type of conduct is sanctioned to get an indication of what the regulators have in store for the firms.

Regulatory reforms

It has been very succinctly stated at the G-20 (Group of Twenty) Leaders Summit earlier this year, that the way to battle the financial crisis is to do it on three fronts: firstly, stabilising and ensuring the continued functioning of financial markets; secondly, stimulating the economy to counter the recession and thirdly (which is where we are at now), fixing the regulation of the financial system.

“Fixing” the regulation does not mean over-regulation or overzealous regulation. While too little regulation is not necessarily a good thing, nor is too much regulation. The operative words are “sensible regulation”. That is and has always been my view, before, during and after the crisis. The voice of dissent in the face of new regulations has always been about increased compliance burden, in terms of costs, time and resources and hence, stifling business innovations.

I personally think such a view is too short-sighted. Any firm which is structurally sound, and with enough foresight, will remember that history tends to repeat itself. The economy is cyclical and the waves of financial turbulence, although having ebbed, I dare say, will come in again in future. When that happens, if we have a robust regulatory regime in place

globally, the disruptions to the financial markets would be kept to a minimum and the firms will be less affected.

As for stifling business, that is an argument which is not sustainable at the best of times. What most people fail to realise is that regulations are often enablers rather than show-stoppers. More often than not, regulations "legitimise" conduct or business models which are otherwise traversing grey areas or uncharted territories, and basically operating under a web of uncertainty or a cloak of darkness. And we know that the compliance and risk management folks in firms hate uncertainty, more so now than before. Any form of uncertainty spells risk to them and they will throw out a risky business proposition even before you get started.

There is always a psychological barrier and inertia to change. Therefore, getting the stakeholders' buy-in from the outset is crucial to the successful implementation of any new regulatory initiatives. If the teething issues are properly managed, I have no doubt that fresh business opportunities can be identified and created in an environment where the regulatory structure is sensible and transparent.

At the G-20 Summit in Pittsburgh (held on 24-25 September 2009), the world leaders promised harmonisation of standards to ensure a level playing field and avoid fragmentation of markets and regulatory arbitrage. Is regulatory harmonisation something that regulators should work towards in all areas of regulation? Is it practical and/or desirable?

I would like to talk more about what regulators are doing in terms of "fixing" the regulation of the financial system and also share with you my views on cross-border harmonisation of regulations. I will be talking in the context of three areas which, not only have significant implications for the Asian markets but are also currently in the full glare of international floodlights: the regulation of dark pools and short selling. I will then talk about the G-20 developments before concluding.

Dark pools

I was very pleased to learn that during the course of the conference several speakers[1] have already spoken about this topic and it was also put up as a debate topic during the break-out sessions. Although I have not had the benefit of those sessions, I am sure a starting point of the discussions would have been that dark pools (despite the alarming sounding name) are really nothing new. Whatever term is used to describe them, be it dark pools or alternative trading venues, they are really just facilities that allow dealing activities outside traditional exchanges without prices being disclosed publicly.

Statistics

The proliferation of dark pools has been phenomenal during the last few years but the pace of development varies across the regions. According to the U.S. Securities Exchange Commission ("**SEC**"), the number of active dark pools transacting in stocks that are traded

[1](a) **John Lowrey, CEO of Chi-X Global** *(Trading The New Global Liquidity Landscape in 2009)*
(b) **Lee Porter, Managing Director of Liquidnet** *(One Year On : Re-evaluating the Trading Proposition in Asia of Alternative Trading Venues/Dark Pools in Light of Lower Trading Volumes and Regulation)*
(c) **Tony Brooker, Head of Electronic Trading at Mizuho Securities, TK Yap, Executive Director of OCBC and Kyle Stewart, Head of Asian Institutional Equities at Knight Capital** (panel members on *The Big Debate That The Full Service Broker Business Model Will Be Increasingly Replaced By The Rise of Agency Only and Dark Pool Service Offerings)*

on major U.S. stock markets has increased from approximately 10 in 2002 to approximately 29 in 2009.

Across the Atlantic, the Markets in Financial Instruments Directive ("**MiFID**"), which came into effect in late 2007 brought a new type of trading venues to the European market, commonly known as "multilateral trading facilities" ("**MTFs**"), which include dark pools. It has been reported that at the moment there are at least 15 MTFs operating in Europe.

In Asia, dark pools are still at an infancy stage. While they are already making their presence felt in the Asian markets, it is hardly close to the domination of their counterparts in the U.S. and Europe. Some of the more prominent American and European firms have explored the prospects of setting up similar operations in the major markets in Asia, including Hong Kong. In Hong Kong, we have seen the number of dark pools, mainly brokers' internalisation pools, increased from just a handful several years ago to more than 10 currently.

Concerns with dark pools and reactions from regulators

As regulators, we acknowledge the benefits dark pools have brought to the market over the years (anonymity, speed etc). But all that glitters is not gold. We are mindful of the implications that dark pools may have on the market if they are not properly regulated.

Firstly, there have been discussions about the implication of dark pools for the integrity of the market. The main issue being debated is that a lack of transparency in dark pool operations deprives the public of fair access to information about the best available prices to some market participants and thus results in a two-tiered market. As we all know, the dark pool is an institutional market. Regulators should carefully study the pros and cons of integrating this institutional trading venue and the trading venue offered by stock exchanges before making any policy changes. I think the primary focus here should be whether the two-tiered market has created difficulties for regulators to conduct market surveillance. If the presence of dark pools has affected the ability of regulators to supervise the market, regulators should work together with the industry to identify ways to address this.

Another unintended consequence of dark pools is the fragmentation of pricing data, thus making it difficult for investors to know where they are likely to get the best price for their orders. In some markets, there are rules requiring an exchange to route an order to another exchange or liquidity pool if there is a better price. But such order routing usually incurs costs to investors. The growth of dark pools calls for a review of the best execution policy.

Thirdly, price discovery, as we know, is a major function of an exchange market and the efficiency with which it is carried out depends on whether orders from a diverse set of participants are properly integrated so as to achieve reasonably accurate price discovery and reasonably complete quantity discovery. Most of the dark pools determine execution prices with reference to exchange produced prices. If dark pools continue to grow and account for a significant portion of market share, it will affect the price discovery function currently performed by the exchange market. How can we obtain or access information about fair market prices if most transactions are executed on non-displayed markets?

While regulators do not have comprehensive answers to the above issues currently, regulatory reforms have been initiated. In Europe, the Committee of European Securities Regulators ("**CESR**") is due to commence a review of the operation of the MiFID at the end of this year. Given that there appears to have been a significant migration of liquidity from

the traditional exchanges to the MTFs, including dark pools, this gives rise to questions as to whether there are unfair commercial advantages for the operators of this new type of trading venues and whether the trend undermines price discovery, market integrity and efficiency for the market as a whole. The MiFID review will address these issues. Earlier this year, the UK Financial Services Authority has launched a study of the way the UK equity markets are being used, including how alternative trading platform and dark pools function. I understand that the study is still on-going.

To bring about greater market transparency and fairness, the U.S. SEC has recently mooted three changes to enhance the transparency of dark pools:-

(a) dark pools in the U.S. are currently required to publicly display stock quotes if their trading volume exceeds 5% of the volume of a particular stock. But the new plan would reduce the threshold to 0.25%;

(b) the second change would require actionable indications of interests ("**IOI**") to be displayed in the public quotation system; and

(c) the third proposal requires real time reporting from dark pools for their executed trades, making the dark pools' identity visible to the public.

The SEC is still awaiting feedback from the public on these proposals. However, as you will agree with me, the changes proposed by the U.S. SEC are dramatic and will basically require dark pools to operate like lit pools. In my view, these proposals have far-reaching implications and require careful study and thorough discussions with the industry before they are finalised.

Harmonising the regulation of dark pools?

In view of the proliferation of dark pools, International Organization of Securities Commission ("**IOSCO**") has also commenced a new project to examine potential regulatory issues. These issues include price discovery, market fragmentation, fair access, leaking of information about orders that are placed as dark, etc. The SFC is a member of this project team.

Do I expect IOSCO to roll out a regime that will harmonise the regulation of dark pools? It may be premature to comment at this stage. What I can say for certain is that regulators worldwide appear to be ratcheting upwards the scale and level of dark pools regulations and I cannot foresee any jurisdiction bucking this trend. But my guess is it would not be done using a cookie-cutter to achieve harmonisation across the regions.

This is mainly because despite its allure, dark pools seem to have a different appeal to different jurisdictions. And if this is the starting point, naturally the corresponding regulatory regime will be quite different. As to why the appeal of dark pools varies amongst the jurisdictions, this is due to a multitude of reasons. In Asia, the growth of dark pools appears to be slower due to resistance from various fronts. In particular, unlike in the U.S. and in Europe, Asian exchanges are generally considered as national interests. Hence, it should not come as a surprise that there are domestic forces at play and these exchanges tend to be accorded an almost exclusive franchise to operate a stock market domestically. This has impeded the growth of dark pools in this region.

Nonetheless, it is possible to make out a case for dark pools to operate in jurisdictions which consider their domestic exchanges to be national interests. The argument is founded on the fact that dark pools are really not exchanges. They are two very different creatures. We are basically going back to the basics of marketing theory i.e. product differentiation. Dark pools can offer something exchanges cannot, e.g. a wide range of order types including algorithmic trading tools. Thus, it is arguable that dark pools are not competing with the exchanges, they are in fact offering a different type of service or servicing a different segment of the market. I always believe that the pie is big enough for everyone to have a slice, the question is how big is the slice you get. In fact, dark pools and exchanges have complementary roles and together they may actually increase the size of the pie.

In Hong Kong, off-exchange transactions[2] reported to the exchange account for only about 3% of total market turnover on most trading days. This figure has already included transactions conducted on the dark pools operated by brokers. However, on days when there is an index rebalancing exercise, we estimate that on average off-exchange transactions could exceed 10% of total market turnover but we have seen it go up to as high as 24% of total market turnover. We understand that this is mainly because it is easier for market participants to execute transactions off-exchange at the closing price for the purpose of rebalancing the index portfolios. This further illustrates that dark pools and other alternative trading pools can offer something to market participants which may not be offered by traditional exchanges. In any event, as some of you in the audience may be aware, we are currently studying the market structure and dark liquidity, including dark pools and internalisation systems. We have engaged with major firms which have dark pool operations in Hong Kong and note that the volume of trades currently executed via these dark pools is relatively small[3]. Our study will help us identify the appropriate ways for alternative trading venues to develop in Hong Kong.

Direct Market Access

Any discussion on dark pools will not be complete without talking about direct market access ("**DMA**"). So I will touch on DMA briefly before I move on to discuss short selling.

Along with the emergence of dark pools or alternative trading pools, we have also seen a rapid development of advanced trading tools, in particular algorithmic trading or DMA in general. As most of you are very familiar with these, I will go straight into a discussion of the regulatory challenges that DMA presents.

DMA allows institutional investors to trade faster and to have direct control of their order execution. The increase in trading speed can amplify any unintentional errors in the execution process. DMA also enables institutional investors to send a large amount of order flow to the market within a very short period of time, which may have a systemic impact on the market. For example, the use of DMA facilitates the automatic generation of time-sensitive orders based on the changing market conditions. In the past, we have seen a number of occasions when DMA users sent large orders to the exchanges merely based on the pre-set algorithmic formula without giving sufficient consideration to the prevailing liquidity level in the market. As a result, the stock prices fluctuated wildly triggered by the

[2]Off-exchange transactions include share placements and cross trades for client facilitation or other trading facilities such as dark pools, cross-trading platforms or crossing engines. These trades are supposed to be reported back to the HKEx.

[3]It is estimated that the crossed trades in general is less than 5% of the firm's turnover.

arrival of these large orders. It is therefore important that brokers who provide DMA services ensure that there is sufficient pre-trade monitoring and control of orders using DMA.

However, broker-sponsored access has raised more challenges for us to monitor DMA orders. As we know, some brokers have offered their institutional clients direct access to the market without going through the brokers' trading systems. This kind of DMA provides market participants unfiltered access to the market and makes it difficult for brokers to conduct any meaningful pre-trade monitoring. The term "naked access", which was coined by some market participants, can better describe this type of trading activity. Some regulators have been looking into this issue. I expect that some jurisdictions may be looking at establishing more specific rules to deal with the risks arising from sponsored DMA.

In Asia, electronic trading is still developing and evolving and so we do not yet have specific regulations on the use of DMA or algorithmic trading. It is however an area that we are closely monitoring.

Short Selling

And moving on to the next topic: short selling. One main effect of short selling is that it depresses stock prices down to the level that is consistent with its fair or fundamental value. While this may be viewed as the normal cause and effect of a particular type of a trading activity when the economy is functioning normally, in the midst of a loss in market confidence, short selling in conjunction with other trading strategies will cause the market to tailspin.

This was what happened in September 2008. Short selling was viewed as that "diabolically evil" activity responsible for the stock market carnage. However, there is no empirical evidence to show that short selling was the culprit in sending global markets on a downward tailspin as there were many other factors at play during that critical period. Nevertheless, the role of short selling in exacerbating the rapid decline of the market remains.

Towards the end of 2008, global regulators were forced to take proactive actions to prevent any further precipitous fall in the markets. Regulators in Australia, the U.S., the UK and some Asian markets including Japan and Korea imposed temporary measures to ban or restrict short selling. Temporary measures were also introduced to enhance transparency of short sales/positions which would give investors more information (on over-pricing) as well as provide information to regulators so that they can act more effectively and appropriately during times of financial disruption.

In any event, as the markets regained some stability, the temporary measures were either allowed to lapse or extended (with variations), depending on domestic market conditions. In some jurisdictions, the temporary measures were replaced with permanent rules. But to be fair to all the regulators which had reacted in the heat of the meltdown in 2008, it is easy for the pundits to criticise the regulators' actions when the dust has settled. Like they say, there is no better sight like hindsight.

As you are all probably aware, Hong Kong did not take any similar drastic measures in banning or restricting short selling activities back when market volatilities and uncertainties were surging. This was partly because Hong Kong already had a very robust short selling regime in place, including the tick rule and other pre-borrowing requirements. We already tightened the nuts and bolts of short selling when the Asian financial crisis (in 1997-1998) exposed the regulatory deficiencies in our short selling regulations at that time and as it

turned out our improved short selling regime was sturdy enough to withstand the financial crisis last year.

Harmonising the regulation of short selling?

Although short selling did not cause the financial crisis, it did become evident during the crisis that there were weaknesses or insufficiencies in the regulation of short selling in many jurisdictions. Another issue which the crisis highlighted was that the regulation of short selling varied substantially across markets in different jurisdictions. The Technical Committee of IOSCO saw merits in having a more common approach to the regulation of short selling which would help to simplify the compliance process for market participants that operate in different markets and to minimise any potential regulatory arbitrage.

The Technical Committee of IOSCO believes that short selling plays an important role in the market for a variety of reasons, such as providing more efficient price discovery, mitigating market bubbles, increasing market liquidity, facilitating hedging and other risk management activities. The Task Force on Short Selling that I chair was tasked to develop high-level principles for the effective regulation of short selling to foster a more consistent international regulatory approach toward short selling. The Task Force recommended four high-level principles in this regard. The first three principles relate to the importance of having a strict settlement discipline; the merits of enhancing transparency on short selling and the significance of having an effective compliance and enforcement system. The fourth principle is that short selling regulation should not stifle certain types of market activities that are critical for efficient market functioning and development.

The general consensus is that now we need to have something closer to a global standard and that is something we are working on within IOSCO, trying to establish a model that will work across all major markets in the world. As IOSCO is not a rule-making body, it merely requires the member jurisdictions to agree on a consensus and each individual jurisdiction can work out how to adopt each standard.

A recent survey shows that by and large, among the Task Force members that consist of 14 different jurisdictions, these four principles either have been implemented or implementation is still work-in-progress. For example, in Europe, the CESR is also consulting on its pan-European short selling disclosures regime. In the U.S., the SEC has also held a roundtable to discuss securities lending and short sale issues.

On the domestic front, the SFC has just recently completed its public consultation on increasing short position transparency. I would like to take this opportunity to talk a bit more about the consultation. I would like to make two points. Firstly, we find that the information the SFC currently has on short selling is not sufficient at times of high market volatility. We only have data on short sale turnover (on a daily basis) and this does not reveal the outstanding short positions in the market. The lesson learned last year was that in times of crisis when snap decisions have to be made, it is helpful to have a holistic picture of the short selling market including both turnover and outstanding positions. Secondly, any reporting made to the SFC will obviously be on a confidential basis. We have received pages and pages of literature in response to our consultation paper opposing the public disclosure of clients' short positions. If we do decide to publish the data we receive, please be assured that we will be doing it on an aggregated, no-name and delayed basis.

Having an insight on short positions would help the SFC in making more informed decisions in times of market disruptions. In fact, the knee jerk reactions from some of the regulators

last year were triggered by the lack of information on short selling in their domestic markets. Very often, in the absence of information, the safest route to take is to pull the plug so that everything grinds to a halt to allow ourselves time to reflect on things.

G-20 Developments

Moving on to the final area before I conclude: G-20 developments. I have mentioned at the outset that keeping abreast of regulatory reforms is crucial for a firm in determining the way forward for its business. You will probably ask who sets the scene for regulators? On occasions, regulators take reactionary measures but by and large we try to be proactive. As a result of this financial crisis, the world leaders have taken a lead in the regulatory reforms. As such, we should all keep our ears close to the ground insofar as the G-20 developments and commitments are concerned.

At the Pittsburgh Summit in September, the message that came through was that the leaders recognised that the process of recovery and repair was still underway and they pledged to sustain strong policy responses until a durable recovery was secured.

At this forum, I shall focus only on one of the policies the G-20 leaders agreed upon at the Pittsburgh Summit i.e. to ensure that the regulatory system for banks and financial firms rein in the excesses that had led to the crisis and in particular, the areas the SFC (together with the other regulators in Hong Kong) is working on.

Reforming compensation practices to support financial stability

It is recognised that an inappropriate remuneration system creates an incentive for excessive risk-taking which is damaging for firms, their shareholders and also the stability of the financial market as a whole. The banking regulator in Hong Kong, the Hong Kong Monetary Authority (HKMA), has issued a consultation paper on its proposed "Guideline on a Sound Remuneration System" at the end of last month on this matter. The proposals in HKMA's paper are essentially along the lines of linking bonus of bankers to the creation of long term value. The final Guideline is expected to be issued by the end of 2009 and banks in Hong Kong are expected to take prompt action to implement the Guideline. The SFC is also closely monitoring developments in reforming compensation practices.

Improving OTC derivatives markets

The G-20 leaders agreed that the OTC derivatives market should be improved according to the following principles:-

(a) all standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by the end of 2012 at the latest ;

(b) OTC derivative contracts should be reported to trade repositories;

(c) and non-centrally cleared contracts should be subject to higher capital requirements.

Suffice to say that the regulation of OTC derivatives is a big topic and may re-shape the current market structure. Hong Kong is monitoring the global developments and we are prepared to listen to suggestions and to engage with the industry to achieve win-win solutions on the way forward.

*Regulation and registration of credit rating agencies ("**CRAs**")*

The G-20 leaders also recommended that all CRAs whose ratings are used for regulatory purposes should be subject to a regulatory oversight regime that includes registration by the end of 2009. This recommendation attempts to enhance integrity of credit ratings which was found to be one of the factors contributing to the financial turmoil.

In tandem with the G-20 leaders' recommendation to introduce more effective oversight of CRAs, the SFC will continue to monitor international initiatives on the regulation of CRAs and participate in the relevant discussions.

Conclusion

If there is only one message that you take away with you from this, that message should be that regulatory changes are on their way (and I mean a LOT of changes). The regulators are putting the final touches to what they have in store for the market and you will see things happening soon. You have read in the papers about what the regulators are doing or going to do, they are not only for international posturing, they will actually happen.

Some people find changes challenging. I do not think that they have to be if the changes are properly managed. The SFC has a practice of consulting extensively on all our proposals. Market participants are briefed time and again and rule changes are properly articulated. We try to give ample notice before changes are rolled out.

It is advisable for you to look at your resources and infrastructure to manage the imminent regulatory reforms to see whether they are nimble enough to respond to the changing environment, especially if the changes have to be executed globally. Understandably, there may be cost implications especially if your firm operates across different jurisdictions. I will not argue with that. Suffice to say that sometimes it is worthwhile to endure short term pain for long term gain.

Thank you.