Regulatory responses to the financial crisis: The view from Hong Kong

Keynote Address

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5 July 2010

Introduction

Good morning. It's a pleasure to be here with you today.

I've been asked to provide some thoughts on regulatory responses to the financial crisis and the various measures we have taken or are taking in Hong Kong.

Having an externally-oriented economy and open securities and futures markets, Hong Kong has not escaped unscathed, although it has not been as hard hit as some markets. Despite the economic downturn, our financial sector has largely withstood the strains placed upon it. None of our banks has had to be bailed out. Neither has any of our brokers failed. During the height of the financial meltdown, when other major markets imposed bans or restrictions on short selling in their securities markets, we were able to stay our course. Still, Hong Kong has faced several of the same issues as other markets as a result of the crisis. Short-term emergency measures were taken to address frozen credit markets, provide liquidity and increase the protection provided for bank deposits. The crisis has highlighted several areas in which our regulatory regime needed to be strengthened. In addition to this, we, along with regulators around the world, continue to work to identify steps which should be taken to prevent or minimise the likelihood of future crises.

What I'd like to do today is look at some of the current regulatory matters relating to the securities and futures markets that have been identified at a global level and give you a Hong Kong perspective on these. These are, of course, my personal views and not necessarily those of the Securities and Futures Commission (SFC).

First, though, for those of you who aren't very familiar with Hong Kong, perhaps I can provide a bit of general background.

Hong Kong - context

Hong Kong is a large banking and asset management centre. It also has a mature, open and active equity market. We are both part of China and its offshore financial centre, in short, an international, developed market within an emerging market. Hong Kong has traditionally been the "gateway" for many Mainland Chinese enterprises seeking to access the international capital markets. In recent times, it has also played an increasing role in the evolution of the renminbi (RMB) into an international currency. Our banks have accepted RMB deposits since 2004. Since 2009, international trade settlements in RMB have been

able to be transacted between Hong Kong and designated Chinese cities on the Mainland. In recent years there have been a good number of RMB bond issuances in Hong Kong, including a sovereign bond issuance last year. As Hong Kong continues to increase its capacity for RMB financial transactions and applies its considerable expertise to expanding the range of RMB-denominated investment products (such as RMB-denominated, traded and settled equity products), and in light of China's overall strong growth prospects and the opportunities that the internationalisation of the RMB would bring about, Hong Kong has enjoyed strong incoming fund flows. The potential for RMB financial and investment products is enormous and will have major ramifications not only for Hong Kong but for all of us, as will the increasing number of Chinese investors, financial professionals and enterprises seeking investment and trade opportunities and financial services outside the Mainland of China. I note here that South Africa, of course, has increasing economic and diplomatic relations with China.

Global financial market reforms

While economists would point to 2007 as the time when the cracks perforated the fabric of calm in the world financial markets, it was the collapse of Lehman Brothers in September 2008 that brought immediate meltdown. While pumping massive amounts of public money into their banking and financial systems, governments around the world had to examine how and why existing regulation had failed and, with that, to put in train reforms to address the inability of national regulatory regimes to supervise financial markets and players that operate globally, but which impose a burden on national governments and taxpayers when they fail, and to resolve cross-border crises. These international efforts have been spearheaded by G20 leaders and co-ordinated by the Financial Stability Board (FSB), drawing on support from international standards-setters (such as the International Organization of Securities Commissions, the IOSCO) and the international financial institutions (such as the International Monetary Fund, the IMF). The focus is on systemic risks, macro-prudential regulation and international co-operation. The aim is to seek global solutions to minimise the recurrence of the problems. Having experienced first hand how inter-connected and correlated the world markets have become, world leaders understand that they have to create global tools which should be applied across markets and countries where necessary.

Concurrently with the global initiatives, individual countries are working on national laws to deal with their problems. In the US, market discipline and self-regulation, the brainchild of the 80's and 90's, has been so badly discredited that the pendulum has swung from de-regulation to re-regulation. The Dodd–Frank Wall Street Reform and Consumer Protection Act, anticipated to be signed into law in the near future, will usher in a new paradigm of more intrusive regulation. Since the US is home to the largest number of systemically important global financial institutions and since these institutions are also present and operating in markets around the world, not just in Europe but also in Asia and Africa, the US legislation will influence the final shape of global reforms.

The EU is another major driver of financial reforms. The debt crisis has raised questions about EU solidarity in dealing with the problems, the sustainability of the Euro and even the longer term viability of the union. That individual member states are taking their own ad hoc measures to deal with the current debt crisis, such as bans on naked short selling, is not helping, as this raises the question of whether future actions will be co-ordinated. Meanwhile, some of the reforms proposed at the EU level have raised concerns about market entry

barriers. The Alternative Investment Fund Managers Directive (AIFMD), for instance, has been criticised in some circles as creating “Fortress Europe”, or even “Prison Europe”.

Not every country has the same imperative for financial reform, or the exact same set of issues. However, because of the importance attached to global adherence to international standards, the pressure is on for all markets to comply or risk being marginalised. It is therefore vital that the standards that are set are reasonable, and don’t represent knee-jerk reactions to particular issues.

Being an international financial centre with open securities and futures markets, Hong Kong will ensure that its regulation and standards meet international requirements.

Within the global theatre of action, a number of areas are of particular relevance to the Hong Kong securities market. They include the regulation of credit rating agencies (CRAs) and of hedge fund managers, and investor protection. I will focus on these areas today.

Short selling restrictions, transparency

First, let me talk a little bit about the regulation of short selling as this issue took centre stage during the meltdown.

Hong Kong was one of the few developed markets that did not impose emergency short selling regulations during September and the last quarter of 2008.

We have had an “uptick” rule since 1998; essentially, a short sale cannot be made below the best current ask price. Naked short selling is generally prohibited and covered short selling in Hong Kong may be executed only on the stock exchange’s trading system in designated securities.

Our uptick rule was introduced in the wake of the Asian financial crisis. As some of you may recall, in 1998 the Hong Kong Government intervened heavily in the stock market in response to speculative pressure on Hong Kong’s currency and abusive short selling of Hong Kong stocks. The short selling rules that were introduced in the wake of these events were quite controversial at the time, not least because a breach of the rules attracted criminal sanctions in addition to any penalties for failed settlements. The regime that we put in place was intended to endure for some time. In subsequent years there was a push in the market for us to relax the rules, but we did not do so, and events in September 2008 reaffirmed for us that the uptick rule should remain in place. In fact, events since September 2008 have vindicated the efforts we put in in 1998.

The financial crisis exposed the weaknesses and insufficiencies in the regulation of short selling in many jurisdictions. The IOSCO Technical Committee saw merits in having a common approach to the regulation of short selling across different markets – to reduce multiple compliance costs and to minimise any potential for regulatory arbitrage. One of the drivers was to require more reporting and disclosure. In Hong Kong, we conducted a public consultation on proposals to introduce a position reporting requirement. The obligation will be triggered once a short position reaches 0.02% of the issued share capital of the relevant issuer, or the value of the short position amounts to or exceeds HK$30 million (about ZAR29.6 million, or about US$3.85 million), whichever is lower. In setting the threshold we were mindful that substantial positions needed to be captured, but that the limit should not be

set so low as to impose undue compliance burdens. We looked at thresholds in other markets, and also had regard to the characteristics of the local market (for example, we noted that ratio of short selling to turnover in Hong Kong appeared to be much lower than in London and New York, and that the ratio of short exposure to market capitalisation in Hong Kong is much lower than in New York). We took a risk-based approach in proposing an initial list of shares to be covered by the reporting regime, since our underlying objective in imposing these requirements was to facilitate identification of positions with the potential to affect market stability. We will retain the discretion to require more frequent reporting, to lower the applicable thresholds or require reporting of positions in additional shares should contingencies arise. We propose to publish the data collected, aggregated per stock and without identifying the short sellers, on a delayed basis.

I'd note here that we continue of course to monitor the short selling measures being considered and adopted in other parts of the world.

Credit rating agencies

Let me now turn to the regulation of credit rating agencies.

Credit rating agencies are not currently required to be registered or licensed in Hong Kong, and we do not specifically regulate the conditions for the issue of credit ratings. However, in light of the recommendations by the G20 and the Financial Stability Board, the IOSCO Principles and regulatory developments in other parts of the world, the Hong Kong Government has stated its intention to regulate this area.

The issuance of credit ratings is, of course, a global business. Issuers, ratings firms and analysts, and the end-users of ratings could all be based in different places. Thus, the regulatory approach in this area needs to reflect this, and it's important that the measures adopted in different markets are harmonised as much as possible.

Taking the EU as an example, under new regulations, credit ratings issued in third countries can be used in the EU for regulatory purposes only if they comply with regulatory requirements which are as stringent as those imposed in the EU. Credit rating agencies established in the EU may endorse credit ratings issued in third countries where conditions can be satisfied and where the activities resulting in the issuance of the credit ratings are undertaken in whole or in part by the endorsing agency or members of the same group. Alternatively, credit ratings issued by third parties without a presence or affiliation in the EU may be certified in certain circumstances. In these scenarios, there is a requirement that the relevant legal and supervisory framework in the third country is equivalent to or as stringent as that in the EU and that there be suitable co-operation arrangements in place between the relevant supervisory authorities.

These measures will affect credit rating agencies issuing ratings in Hong Kong to the extent that they are used in the EU for regulatory purposes. The transitional timeline for these third-country requirements is very tight; provisions in this regard will apply from mid-2011.

For our part, we are working together with the Hong Kong Government on proposals for licensing and supervision of credit rating agencies issuing credit ratings in Hong Kong. The objective is to put in place a regime that meets international standards. Our proposals are

largely based upon the Code of Conduct Fundamentals for Credit Rating Agencies issued by the IOSCO. Once finalised, they will be released for public consultation.

Hedge funds and hedge fund managers

Another, very important, area of focus globally is the asset management industry.

The regulation of collective investment schemes and fund managers in other parts of the world is something that has significant effects in Hong Kong. I mentioned before that Hong Kong is a large asset management centre. A large proportion of the funds managed by Hong Kong-based asset management professionals are not domiciled in Hong Kong. But asset managers carrying on business in Hong Kong are required to be licensed by us. In addition, if a fund is to be distributed to the public in Hong Kong, it must be authorized by us.

One of the current considerations in this area at the international level is regulation of certain alternative investment funds and/or the managers of these funds, both in terms of requirements for registration and operations and in terms of reporting and other transparency measures. Some of the measures being proposed target hedge funds in particular.

Hedge fund managers carrying on business in Hong Kong are subject to our regulatory regime and are required to be licensed. Once licensed, they are subject to our supervision. To improve the transparency of Hong Kong's hedge fund industry, we have conducted surveys of Hong Kong-licensed hedge fund managers in recent years, and have published reports on the results. Together with other IOSCO members, we are also participating in the collection of information from hedge funds pursuant to the framework developed by the IOSCO to facilitate assessment of systemic risk. We have been carrying out joint inspections with the Securities and Exchange Commission (SEC) in the US and in Hong Kong of hedge fund managers who are both licensed in Hong Kong and registered with the SEC. Thus, while other jurisdictions are putting in place a licensing and supervision regime covering hedge fund managers, we already have regulatory supervision over those hedge fund managers who operate in Hong Kong. One of the areas of focus of the G20 and Financial Stability Board is on systemically important non-banks. We will follow the global regulatory developments in this area closely to ensure that our regime continues to meet international standards.

Developments in Europe and in the US relating to regulation of hedge funds and other alternative investment funds and their managers have huge implications for the international asset management industry and related sectors. Of particular concern are the proposed provisions in the AIFMD relating to the marketing in the EU, or sale to EU investors, of funds managed by non-EU managers or located in non-EU countries. Much has already been said about this aspect of the draft Directive, and its terms are still being debated, but it has the potential to restrict substantially the universe of these types of funds available to EU investors. In my view at least, this could be detrimental not just to the managers and funds concerned but also to the EU investor base.

International co-operation

All of this leads me to a point which has been raised many times recently – the importance of international co-ordination in considering and implementing regulatory measures. In calling for convergence or for consistency, however, we also need to set standards that are

reasonable and that achieve the underlying objectives without imposing unduly high burdens or having unnecessary adverse effects.

Large, regulated firms are internationally active, operating through affiliates in many countries, and financial markets themselves are increasingly linked. We need to ensure that we minimise scope for arbitrage between different regulatory requirements and that data is able to be analysed at the appropriate level when assessing matters such as systemic risk.

The challenges here, of course, are numerous. Once regulatory "gaps" or imbalances are identified and measures are being considered to address them, we need to weigh up the "cost" or regulatory burden against the benefit sought, and determine the best way to achieve the main objective. We need to take into account not just universal but local and/or regional needs or market characteristics, and also the time-sensitivity of a given matter at issue. And obviously there will be issues and measures that have implications at a global level and others that by their nature have a more localised effect.

To deal with these challenges, I believe that it's important for us to continue our efforts to identify the matters that have the potential to have widespread repercussions and develop sensible, effective and timely regulatory, supervisory and other financial sector policies within international forums.

Investor protection issues

I would like to spend some time talking about some investor protection issues that have arisen in Hong Kong. Investor protection is, of course, one of the general objectives underpinning the Principles of Regulation developed by the IOSCO, and we're not the only jurisdiction considering these sorts of matters.

For many investors in Hong Kong, the collapse of Lehman Brothers directly affected investments they had made in structured products linked to Lehman group entities, or where Lehman group entities were counterparties to transactions underpinning the products. We received tens of thousands of complaints from investors in respect of the sale of these products, and devoted huge amounts of time and resources to investigating them. The SFC has the power to revoke or suspend the licence or registration of an intermediary, or to impose a fine of up to HK$10 million per instance of misconduct, but we do not have power to compel an intermediary to pay compensation to a third party. In determining whether and what disciplinary action to take against a regulated person, however, we may take into account any actions that person has taken voluntarily to remedy or mitigate misconduct. Using these tools, we were able to reach agreement with various of the intermediaries who sold these products. The intermediaries made voluntary repurchase offers to qualifying investors and agreed to take steps to address complaints and enhance their systems and processes. So far, more than HK$5.6 billion has been paid to about 30,000 investors in Lehman-related products.

We conducted an extensive public consultation in 2009 on measures to strengthen investor protection. The proposals that were the subject of this consultation were broad-ranging, and many were aimed at addressing issues we had identified as a result of the complaints we had received. At the same time, we were mindful that any regulatory response needed to be measured. We sought to balance appropriate safeguards for investors with the need to avoid unduly stifling the market.

The “investor protection” proposals covered requirements both for the authorization of investment products for public sale in Hong Kong and in respect of the conduct of intermediaries.

On the product side, we set out additional requirements, particularly in the area of structured products. These covered things like eligibility of key product parties, minimum requirements for collateral and guarantees, specific measures addressing conflicts of interest and the need for functional independence between certain key parties (for example, a fund manager and a swap counterparty), and mandatory market-making for some products. In addition to a generally-applicable disclosure standard and detailed product-specific disclosure items, we introduced the requirement for a summary document setting out key features and risks for investors, as has been done in many other jurisdictions. The objective is to make it easier for investors to understand and compare different products. We added on-going disclosure obligations throughout the life of certain products. And in light of their illiquid and longer-term nature, we proposed that, in the case of structured products with certain minimum scheduled tenors, issuers and intermediaries would be required to provide investors with a cooling-off or unwind period, or in other words an opportunity to cancel or unwind the transaction within the first few days after making a decision to invest in the product.

On the conduct side, we proposed enhancements to the “know-your-client” process for intermediaries. We revisited the obligation to assess a client’s knowledge, expertise and investment experience, in light of the fact that an investor’s net worth is not necessarily an indication of his or her experience or sophistication in financial matters. For example, where investment products have embedded derivatives, intermediaries selling the products to clients must assess their clients’ experience in investing in those types of products, and may only sell on an advised basis if the client does not have the requisite experience. Our proposals also covered disclosure of commission and a prohibition on the use of gifts.

Another, vital part of this equation is investor education and investor responsibility. To build and maintain a vibrant and orderly market , we need three parties to work together: the market players and intermediaries, who must put their clients’ interests first, the regulator, who must set clear and fair rules and vigorously enforce them, and informed and financially literate investors, who understand their rights and obligations and look after their own interests. To underscore the importance of this work, the Hong Kong Government has separately consulted on proposals for the establishment of an Investor Education Council to take up the role of investor education across different sectors of the financial industry and markets.

Concluding remarks

I’ll wrap up here, as we have covered quite a bit of ground. I hope that this has provided some insight into some of Hong Kong’s considerations in this area. And, since the actions of any of us can affect the others, I hope that it serves to highlight the importance of co-operation and consistency between countries and regions and the importance of measured responses as we work to address imbalances and improve the regulatory framework.