Resilience, right conduct and integrity of the wholesale market

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Good morning. It's an honour to be invited to give this opening keynote for the ASIFMA Compliance Asia Conference 2022.

My address today will focus on two major themes—the resilience of our capital markets and the institutions participating in them, and conduct issues in the wholesale market.

You might ask, shouldn't the behaviour of institutional players in the wholesale market be a matter to be resolved amongst themselves? Why should regulators be concerned?

As an international financial centre, Hong Kong has a huge wholesale financial services industry that is part of an integrated capital market spanning the globe. Risks originating in Hong Kong may reverberate in other financial centres in different time zones. Excessive risk-taking or bad behaviour, even if it is only a small fraction of total activity, could distort prices, strain liquidity and add stress to the financial system.

As regulators, we work to ensure a fair and orderly wholesale market where the prices and liquidity provided are vital to the fundraising and investment plans of countless corporations and individuals.

Maintaining a resilient financial system

Since the COVID-19 pandemic began in March 2020, financial markets have fallen dramatically and then hit new highs, all within a short space of time. As we approach the second half of the year, a number of factors—global and local—have combined to create unprecedented uncertainty and heightened volatility in our markets.

The world continues to battle the COVID-19 pandemic amid greater geopolitical tensions. Global markets have been affected by macro factors such as inflationary pressures, interest rate hikes, supply chain constraints and commodity shocks. These factors were set in train last year and then exacerbated by the Ukraine war. Financial institutions expect sharply reduced profits and revenues for the first half of 2022.

Other factors are specific to the Mainland and Hong Kong, such as the heightened regulatory focus on data-intensive companies and the property and education sectors, strict COVID

Note: This is the text of the speech as drafted, which may differ from the delivered version.

policies and lockdowns and Sino-US tensions. These add to the challenges faced by market participants in maintaining operational efficiency and retaining talent in Hong Kong.

In this context, resilience, not cash, is king. However, our capital markets are only as resilient as the institutions participating in them. When markets reverse, the first participants to go under are typically those with highly leveraged and concentrated positions.

The SFC prioritises financial system resilience above everything. To this end, we are constantly seeking to identify the sources of stress so we can deal with them.

Financial resilience

Securities margin financing (SMF) brokers are particularly exposed to credit risks in times of high volatility. We introduced the SMF guidelines in 2019 to address the deteriorating quality of margin loans and excessive concentration risks—and safeguard financial stability and client interests. The guidelines set out our expectations for SMF brokers to have robust risk management controls over margin loan exposures, securities and client concentrations, margin calls and stress testing.

The guidelines have contributed to the resilience of our SMF brokers during COVID. There are clear indications that the overall quality of margin loans has improved—including higher collateral coverage, a lower ratio of margin shortfall to shareholders' funds and reduced concentrations of both securities and clients.

As part of our ongoing monitoring of SFC-licensed firms, we conduct regular stress tests on their financial soundness. Earlier this year, we revamped the financial return form—submitted regularly by our licensed corporations—to collect richer data to more precisely estimate the potential financial impact of stressed conditions on our firms.

Prime brokers operating in the over-the-counter (OTC) derivatives markets have faced tough challenges to their resilience, as was evident from the Archegos saga last year. Well before that incident, we introduced very timely guidance on risk management measures for prime brokers[1]. The collapse of Archegos prompted us to take a fresh look at the surveillance tools we use to detect concentrated positions in the OTC market. We adjusted our tool kits to use trade repository data to identify and assess potential build-ups. This allows us to follow-up on specific risks at individual firms.

We are now conducting a thematic review of OTC derivatives activities in Hong Kong to assess prevailing market practices. The great majority of OTC instruments traded in this part of the world are booked in London, while the clients are onboarded in Hong Kong. Unless global trading, position monitoring and risk governance structures are well integrated, there may be gaps in oversight. Our thematic review will go beyond prime brokers and probe firms' risk management, assessment and escalation practices. Further guidance will be shared with the industry in due course.

[1] The SFC issued a circular and a report in June 2019 setting out its expected standards of conduct and internal controls for prime brokers

Futures brokers' risk management

Recent shocks in the futures market—most notably crude oil futures trading at negative prices in April 2020 and the suspension and cancellation of nickel contracts by the London Metal Exchange in March 2022—underscored the challenges regulators face in times of market volatility and geopolitical fragility.

When extreme events occur, large position takers who incur severe losses may be subject to huge margin calls. Significant defaults may put futures brokers' own capital at risk, as they will have to satisfy their own obligations with the clearing houses. If futures brokers have inadequate funds to meet them, other clients' funds that are commingled at the clearing houses may be jeopardised. To mitigate these risks, we will soon consult the market on proposed risk management guidelines for futures brokers.

Climate resilience

The urgent need to do something about the threat of climate change is another priority of the SFC. Our new climate-related disclosure requirements for fund managers and funds will make it easier for investors to make informed decisions about green funds. This kind of regulatory support is essential to ensure our market is resilient against climate risks.

From this August, fund managers managing collective investment schemes will be obligated to take climate-related risks into consideration in their investment and risk management processes and to make appropriate disclosures[2] in phases. This will help investors get the information they need and protect them against green washing.

The SFC also plays a leading role in major international initiatives to promote green and sustainable finance. In March, the IFRS Foundation's International Sustainability Standards Board (ISSB) issued its proposed corporate reporting standards for sustainability and climate disclosures. I am co-leading a workstream under the IOSCO Sustainable Finance Task Force to conduct a thorough review of these proposals to help IOSCO decide whether to formally endorse the ISSB standards to its members. IOSCO's endorsement would go a long way to encourage jurisdictions to adopt them.

A laser focus on conduct

Open, fair and orderly markets

Getting back to our focus on conduct in the wholesale market, our job is to maintain open, fair and orderly markets and we take this very seriously. We have zero tolerance for fraud and misrepresentation and will not hesitate to use our disciplinary tools as a deterrent to misconduct. The penalties meted out over the last few years illustrate that. They included huge fines for sponsors' poor due diligence, bond spread overcharges, the 1MDB case and, more recently, mislabelling and misrepresenting facilitation orders as natural orders to clients.

[2] The SFC issued the amendments to the Fund Manager Code of Conduct and a circular in August 2021 setting out its expected standards.

Guidelines for bookbuilding

At the same time, we are keenly aware of the need for financial regulation to evolve and adapt to new developments to remain effective as our markets grow in complexity. Every so often, this may translate into a need to provide additional guidelines to the industry—the new paragraph 21 in the SFC Code of Conduct[3] is a case in point. It clarifies the roles played by intermediaries in equity capital market (ECM) and debt capital market (DCM) transactions in Hong Kong and set out the standards of conduct expected of them in bookbuilding, pricing, allocation and placing activities. The new requirements will take effect on 5 August this year.

The road to developing these new standards was a long and difficult one. While ECM and DCM transactions play a substantial role in our markets, there were no specific regulatory requirements for these activities. The stakeholders involved—issuers as well as buy-side and sell-side market participants—also had vastly different views on what the standards and practices should be. In the end, none of the stakeholders were completely happy with the outcome, which is to say we got it just about right.

While it may appear to some as if the SFC were “intervening” in commercial decisions on matters such as fee arrangements, formation of syndicates and incentive structures, we are adamant that these requirements are necessary to promote higher standards of behaviour among intermediaries, enhance the transparency and effectiveness of price discovery and safeguard the fairness and orderliness of our capital markets.

Market sounding

US regulators’ scrutiny of block-trading practices has been a hot topic in recent news articles. Block-trading has been on our radar for quite some time now and we are looking into how market participants communicate information with potential investors prior to the announcement of a transaction—commonly known as ‘market sounding’.

We will shortly commence a thematic review of market sounding activities with an aim to consider potential conduct standards for market soundings in Hong Kong. As part of the review, we will invite selected firms to participate in a survey later this year.

SupTech to monitor abusive behaviour

While advances in technology may facilitate some forms of misconduct, it can also improve our ability to detect abusive behaviour. A major initiative of the SFC’s SupTech programme was the introduction of the first data standards for order life cycles (DS-OL) in July 2019. These standards prescribe the minimum content and presentation format of trading-related data submitted to the SFC by in-scope brokers—covering about 60% of equities trades in the Hong Kong market. DS-OL came into effect on 30 April 2020. This was a pivotal moment in digitalising our supervisory functions.

We are also developing a data analytics platform driven by big-data and artificial intelligence (AI). Its rule-based algorithms can help us identify potential misconduct in equities trading—such as uncovered short selling, wash trading, spoofing and pricing anomalies in alternative

[3] Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission.

liquidity pools. The platform also supports cross-firm analysis—for example, of trading activities conducted by a single person across different firms.

During the rigorous testing and trial runs we conducted to ensure the proper functioning of the platform, we found some issues related to the interpretation of data standards and data validation. We plan to issue a circular to provide further guidance to the industry and update the DS-OL FAQs in the second half of 2022.

With this project, we see tremendous value in deploying SupTech solutions and strongly encourage you to adopt AI and machine learning to detect misconduct more quickly.

The shift to remote working in many workplaces has heightened misconduct risks. This poses challenges for traditional surveillance models that rely on co-location and "line of sight" which are difficult in the remote working environment. Also, unmonitored messaging applications are being used more often for communicating with clients. In response to these developments, we issued a circular with a report[4] to set out regulatory standards and measures for managing the risks of remote working and responding to operational disruptions.

Conclusion

Ladies and gentlemen, let me circle back to what I said at the beginning—wholesale market operations must be seen to operate in a fair and orderly manner for efficient price and liquidity formation, which is vital for both fundraising and investing. We are laser focused on enhancing the financial resilience and good conduct of firms operating in this space.

It's often said the behaviour of individuals in financial firms is driven by greed and fear, as amply underscored by global financial crises and the spectacular failures of certain firms in the past. We cannot change primal instincts, but the good news is that—as many of you in the audience from compliance will know—egregious behaviour and excessive risk taking can be identified and curbed with a robust compliance framework that provides the necessary checks and balances.

Vigilance on your part, combined with an individual accountability regime alongside regulatory scrutiny and deterrence, can help uphold the resilience and integrity of our wholesale market. Compared to our predecessors, we have big data, RegTech and better tools to detect abusive patterns of behaviour. Our Manager-In-Charge regime also greatly expanded our ability to pursue enforcement action against individuals engaged in financial misconduct.

Firms and individuals should learn from past mistakes, and most of all, they should adopt a culture that aligns with the first General Principle in the SFC's Code of Conduct for licensed persons, which says: "in conducting its business activities, a licensed or registered person should act honestly, fairly, and in the best interests of its clients and the integrity of the market."

Thank you.

[4] The SFC issued a circular in October 2021 on operational resilience and remote working.