

Speech at HKSI Institute Roundtable Luncheon

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Thank you Craig and to the Hong Kong Securities and Investment Institute (HKSI) for inviting me to speak again at your lunch series.

At this event last year, I spent most of the time talking about what many had seen as a massive loss of trust between the public and the financial industry – as well as between regulators and firms. This was a global concern, but was felt particularly strongly in the US and Europe because they were at the centre of the global financial crisis.

And despite a slew of G20 statements over the past year about an apparent end to regulatory reform and the start of a new growth agenda, concerns about financial industry conduct (or more bluntly, misconduct) refuse to go away. Few can have missed the multi-billion dollar fines paid by some large banks for forex trading violations the week before last, as well as the resulting criticism heaped on banks in the foreign media.

This story alone has some way to run.

Meanwhile, the leaders of global firms continue to pursue elaborate, expensive programmes to force changes in the way in which they do business – all reaching for a new internal culture. The aim is to claw back some of the loss of trust, to avoid repeating incidents leading to more fines or worse, and to avoid even more regulation.

Many now think this cultural transformation will take years, and in the meantime regulators are still putting in place structural fixes such as the separation of retail banking from the riskier sort, restrictions on pay and greater personal accountability for senior executives.

Now before Shanghai-Hong Kong Stock Connect launched last week, I was intending to say a lot more today about the Commission's recent work relevant to conduct in financial institutions. But I think it would be very odd if I don't talk about the trading link in some detail given its deep significance and the widespread media coverage over last week.

But before getting to that, I just want to pursue last year's conduct theme a little further with a few remarks about our evolving approach to the supervision of firms as well as enforcement.

"Supervision" is simply a handy term for the way in which we oversee the firms falling under our wing as well as our licensing work. The major development since last year has been a decision to reset the way in which we supervise firms to better match how they – as well as the markets they trade in – have changed enormously over the past few years.

This involves restructuring ourselves into specialised teams with more experts, as well as redoing the way in which we make risk assessments. All of this is to ensure that we are



better aligned with the vastly different activities of the largest global players down to the very small retail firms.

We also know that we need to get ahead of markets which are now almost wholly dependent on technology, are more complex than ever before and which carry new special risks. This also implies greater specialisation as well as better identification and analysis of a vast array of risk data.

In some recent speeches we have gone into some of the detail on this, especially about the new way in which we are approaching the supervision of the Hong Kong activities of the larger global firms, all of which provide important services and liquidity in our local market.

In simple terms this is about having a really clear overview of all local, regional and global firm operations which are relevant to Hong Kong. But at the same time we need to ensure that big firms still have the flexibility to operate their cross-border businesses efficiently, and in line with Hong Kong's position as an open international financial centre and large-scale importer of financial services.

Getting the balance right here is really important. Since the crisis some international financial markets have fragmented into local silos. We think that if this is matched by too much localisation of financial services in Asia the result would be unfortunate for the development of our capital markets.

One way of achieving this balance is to conclude new bilateral supervisory arrangements between the SFC and so-called "home" regulators of these big firms. We are now working on legislative fixes in Hong Kong to enable this to happen, and discussions with foreign regulators are already underway.

And we will definitely ensure that the industry is involved in this process because the outcome will undoubtedly affect the way in which the SFC will interact with firms across multiple business lines.

I should also say that this push to better oversight and specialisation should be a welcome development for both large and small firms. That's because a regulator which is more sensitive to the way in which you actually conduct your business reduces risks of misunderstandings whilst at the same time strengthening our ability to protect investors.

As for enforcement, many of you will have seen that we continue to match punitive action – fines and the like – with a pursuit of strategies which aim to redirect the proceeds of misconduct back to investors who have been harmed.

Last year's Court of Final Appeal decision in the Tiger Asia case was an important anchor for this strategy, though I should say that, because Hong Kong is an open, international market, investor remediation can't be achieved in every single case. But we'll continue to push hard in this direction, which quite often means that enforcement actions have to be taken very quickly to preserve assets within Hong Kong.

I should also say we think that this type of restorative justice, especially in a place where class actions are yet to develop, is far better than leaving investors high and dry even when misconduct has been proved and punished. And you will have seen that although there have been multi-billion dollar fines in overseas markets in recent years, little of this cash has



ended up with investors who may have suffered loss. So I think there is a lot to be said for doing things differently here.

Stock Connect

I should now get on to Stock Connect – after all its launch was only announced two weeks ago, the launch actually happened just last Monday and there has been lots and lots of media coverage about the first week of trading.

So I first want to deal with some of this coverage, especially about initial trading volumes on the southbound and northbound legs, as well as the longer-term outlook.

Then, wearing a market regulator hat, I want to tell you why the design of this trading link is totally unique – a world first – and why for us and the Mainland regulators this design gave rise to major challenges for market surveillance and enforcement.

Now the media story so far pretty much boils down to one topic. This is that the trading volumes after the first day were disappointing, and there seems to be lacklustre interest on the part of Mainland investors in Hong Kong stocks.

Of course everyone knows that the news cycle is incredibly short.

But in this case I think some perspective is necessary.

First, it's next to impossible to judge the success of a "world first" trading link based on the first few days of trading, especially as the two markets are very different and in the past have been entirely independent of each other.

Even before trading started wiser heads had forecast that it would take two years or more for the full impact of the link to become apparent. Some had estimated that inflows through the northbound leg by 2020 would reach US\$600 million or so, boosting international investors' overall stake in A shares to 7% from 2% now – but that this would take time to build.

Now as with all long-term guesses these ones are likely to miss the mark. But the point is that trading is expected to continue to be a slow burn in the initial phase, and I should say that the last thing we wanted was a rush of speculative money leading to possible market instability.

I also think that there are two additional very important factors at work – one is about market sentiment and investor familiarity, and the other is structural.

The first point is pretty simple. The A-share market had run up by about 15% in anticipation of the trading link since our initial joint announcement with the China Securities Regulatory Commission (CSRC) in April, but still trades below its 2007 peak. The intelligence we have is that initial northbound trading was dominated by hedge funds looking at A-H share arbitrage opportunities, and that Mainland investors sold into this demand.

But the real area of future interest on the northbound leg must lie with mutual funds and other providers of long term, patient capital. By definition they have no need to join an unseemly rush. But in our discussions with buy-side managers – as well as the sell-side banks and brokers who service them – a few things have become clear.



First, there is huge interest in the overall significance of Stock Connect among large allocators of global funds. The reason for this is blindingly obvious – anaemic growth prospects elsewhere, especially Europe, set alongside higher growth in mainland China.

Although mainland China's growth rates have slowed, Stock Connect will enable foreign capital to target the drivers of future prosperity with far greater precision – which pretty much lie with the private sector as well as with reformed state-owned enterprises.

Market insiders have also pointed to under-valuations in the A-share market – which has a PE ratio of about 10x – making exposure to high growth sectors even more attractive. And of course any future inclusion of A shares in the MSCI or other global indexes will make a huge difference to fund allocations.

So why the relatively slow start?

The funds industry has pointed to the need for “familiarisation”. After all the final announcement and start of trading didn't give fund managers much time. But in our view that didn't matter much for the simple reason that this is a multi-year project.

We know and expect that managers will need time to assess the legal, regulatory and operational environment and to sort out things like client agreements as well as approvals from the home regulators of foreign funds. This is especially the case for Undertakings for Collective Investment in Transferable Securities (UCITS) funds based in Luxembourg and Ireland.

We also know that many funds are also working on internal approvals to get going early next year. On top of that there is a need for far more research coverage of the universe of A shares that are now investable through the link.

So all of this takes time, but all is resolvable.

By the same token retail investors who may be interested in A shares, as well as Mainland investors looking at the Hong Kong markets, will all be feeling their way – and again that is to be expected.

As to the southbound leg, it's well known that retail investors in the A-share market are about 80% of the total, and the numbers show that southbound trading last week reflected this 80/20 mix.

As with northbound investors it's to be expected that they will take a cautious approach when entering an unfamiliar market, particularly as Hong Kong trading is not itself retail-dominated.

Add to that the stock price run up in the weeks prior to the launch, as well as evidence that short-term views may be affected by expectations of continued renminbi appreciation, forex risks and Mainland interest rates – although it's been interesting to see what effect Friday's rate cut has had on today's trading.

In short, investors on both sides of the border need time to get familiar with each market, long-only institutional investors need time to sort out the operational side, and short-term sentiment is bound to play a part.

So what about structural roadblocks?



For Mainland investors there is only one big one – the RMB500,000 portfolio requirement. There has been some speculation that Mainland investors passing this test may already be invested in Hong Kong. I need only say here that this was introduced as a deliberate speed bump for the pilot programme.

International investors have also referred to a number of structural issues. The biggest was Mainland capital gains tax – which was removed the Friday before trading started. The others are technical, but still important.

One is about the additional counterparty risk to do with the need to deposit shares with selling brokers before a trade is done and before payment is made. This doesn't match the usual setup for delivery versus payment.

Others are to do with the way in which legal title in A shares is held by the clearing house, leading to some concerns about the clarity of beneficial ownership. All of these differences have implications for how the buy-side deals with brokers and custodians, as well as their home regulators.

Without going into arcane detail I can say that we think that these issues can be worked through over the next few months. I should also say that we are fully committed to partnering with industry associations such as the Asia Securities Industry & Financial Markets Association and the Hong Kong Investment Funds Association to resolve teething problems.

One thing is certain – the momentum is there to move forward. One very large global fund manager has remarked that the trading link will undoubtedly consolidate the regional positions of Hong Kong and Shanghai as financial centres.

I don't think that conclusion is very hard to reach. But I also believe that the northbound leg will also ensure that Hong Kong will definitely cement its position as the world's base for funds and brokerages to participate in mainland China's drive to open its financial markets. And that should be good news for everyone here.

Enforcement and surveillance

Finally I just want to touch on important agreements reached with the CSRC and Shanghai Stock Exchange in the run up to last week – all of which were absolutely essential for us to launch the trading link with confidence.

In fact I've no hesitation in saying that without these the trading link could not have moved forward.

The big challenge was to make sure that, despite the unique design of the link itself, both we and the CSRC could still police each of our markets in much the same way as we do now.

And I should say that this design challenge was a fairly hard nut to crack.

Now why was this an issue in the first place?

To answer that it's important to understand that our regulatory system is based on the assumption that all brokers dealing in our market are located in Hong Kong and licensed by us. This gives us a window onto much of what we need to know for investor protection. This



ranges from supervision of brokers themselves through to market surveillance, investigations and enforcement against market crimes – the whole process.

But under Stock Connect this assumption is turned on its head.

That's because when a Mainland investor wants to trade through the link he has to use a Mainland broker – which doesn't also need to be in Hong Kong. As a result we don't have any locally-based broker to go to when investigating specific southbound trades and when we want to find out more about clients as part of our surveillance work.

The fact is that we no longer have a normal situation where we can get client-level trading information as we did in the past. In a sense we no longer have a "line of sight" view of what's going on with the market. This is also the case for the Mainland regulators because the design of the trading link is a mirror image on both sides of the border.

The reality was that for ourselves and the CSRC there was a possibility that market activity happening through the trading link would go dark – or at least dark grey – unless we worked out a new design for cross-border surveillance to fit the design of the link itself.

I'm glad to say that after lots of discussion by late October we had agreed a new mechanism for the flow of client, trade and order data between the SFC, The Stock Exchange of Hong Kong (SEHK), CSRC and the Shanghai Stock Exchange.

And because reciprocity is the basic principle underlying the relationship between the CSRC and the SFC, all Hong Kong brokers participating in Stock Connect have to agree under the Exchange rules to enable client trading information to be provided to the Mainland authorities for northbound trades. By the same token, we can get fast access to client-level information about southbound trades.

This agreement was essential for both of us to police our markets properly and to ensure investment patterns and behaviour remain brightly lit.

It also means that both regulators are now mutually dependent on one another to do their jobs properly.

We also agreed to collaborate very closely on enforcement, including in areas where firms and individuals in one jurisdiction are engaged in misconduct in another.

This includes commitments about fast responses to information requests made during investigations as well as coordinated action aimed at financial redress for Mainland and international investors harmed by misconduct.

So all in all it would be a mistake to think that the level of market surveillance and credible enforcement might be impaired under Stock Connect.

In fact the design of Stock Connect has forced a solution where the degree of oversight of cross-border transactions is better than ever, meaning that there are fewer places to hide for those intent on causing harm in our markets.

Relevance for firms

Firms might ask what all of this has to do with them?



First of all, it goes without saying that the new Exchange rules for Stock Connect have to be taken seriously by all sell-side firms who are routing northbound orders.

And as part of this firms must be prepared to respond very quickly to requests about client dealings originating from the Mainland authorities. For this reason they also need to maintain specific client and dealing records, and keep them for at least 20 years.

This is important because it's vital that reciprocity happens properly – in other words that our legitimate expectation for fast information from the Mainland to do our surveillance work on southbound trades is quite rightly shared by the CSRC's expectation for northbound trades.

I should also say that brokers should get familiar with all the other new Exchange rules as well as the trading and clearing mechanisms for the link. Have a good look at the information and FAQs now on the Exchange website if you haven't yet done so – which should also help with the drafting of client agreements.

Conclusion

For me the interesting thing that links all the topics I've tried to cover today is the need for ever closer collaboration between regulators – whether to properly supervise large global firms operating in Hong Kong, or to police cross-border trading under Stock Connect.

And I'm glad that the agreements we have now reached with the CSRC are in many ways a model for other markets to emulate.

I will stop here and possibly take one or two questions.