Keynote remarks at Hedge Fund Standards Board Institutional Investor Roundtable

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Today I will touch on some of the SFC's work which may be of interest to the Hedge Fund Standards Board (HFSB) community. But before doing that, I would like to recognise the fact that in its short existence, the HFSB has, in my view, broken new ground in the way in which industry associations can operate as standard setters.

The HFSB is one of the first of a new brand of industry associations which bridges the gap between the old self-regulatory organisation model and conduct regulation by the likes of the SFC. It is significant that the HFSB was the model for the FICC Markets Standards Board set up in the UK last year as a result of the Fair and Effective Markets Review recommendations.

And when the industry evolves its own robust conduct standards, particularly through an organisation like the HFSB where funds and investors come together, the chances are that the laws and rules we enforce are less likely to be breached. This is of obvious value to members as well as the regulators.

At the same time, we are not normally in a position to formally endorse industry standards as part of our formal framework of regulation. For one thing, we cannot do so when rules have not gone through the usual legislative or consultative process. But more importantly, we should not fetter or formalise the HFSB's own freedom to develop its standards without too much interference from us.

Cybersecurity

I also want to support the HFSB's efforts on cybersecurity.

Cybersecurity incidents are now frequent across the financial industry, and many institutions have been targeted for disruption by attacks which are now far more sophisticated. There is no doubt that cybersecurity threats are now the top risk for banks and the broader financial system. The recent Bangladesh bank incident caught a lot of attention, not least because of the SWIFT payments system involvement, but also the fact that two central banks in Asia and the US were targeted.

But the risk extends to all markets, investors and intermediaries, as well as consumers of all kinds of financial services. In Hong Kong, we have even seen recent incidents involving unauthorised access to client internet stock trading accounts.

In March, we issued a circular to all firms about our expectations for cybersecurity controls. Cyber risk management will also remain a major focus of our firm inspections.

As you might expect, we have identified a number of serious weaknesses in risk assessment as well as inadequate arrangements for data protection, training and incident management.

On the whole, smaller firms find it more difficult to understand the nature of the threat and potential liability issues. Some may not want to incur the upfront costs of better defences. So there is a lot more to be done in this area where regulators must partner closely with the industry.

Hong Kong as an asset management hub

Next, I want to talk about what we are doing at the SFC to help develop Hong Kong as a hub for asset management. Because the SFC does not directly regulate private funds as a class, much of this is about public funds.

The first objective is to develop Hong Kong as an onshore fund management hub and a domicile for investment funds.

Stock Connect and Mainland-Hong Kong Mutual Recognition of Funds (MRF) are building blocks for this. Both programmes are based on Hong Kong's historic strength as a connector between the Mainland and the rest of the world. We expect that, for the time being, MRF will be the only real route for foreign-branded public funds to be sold on the Mainland.

As you may have seen from media reports, a further expansion of the Connect programme to Shenzhen is next up.

The other side of the coin is to ensure that Hong Kong makes more connections with other global centres. Thus, we are now in talks about mutual recognition with other markets, including some in Europe. These places are starting to recognise the growing significance of Hong Kong's asset management industry and understand that this calls for new reciprocal recognition arrangements. In time, these may come to supplant the unilateral arrangements which in the past have enabled one-way fund sales into Hong Kong. In the private fund space, our relationship with Europe is built on the Alternative Investment Fund Managers Directive (AIFMD) where we have signed the AIFMD memorandum of understanding (MoU) with 30 authorities in Europe to allow Hong Kong alternative investment fund managers to access EU investors.

Conduct

Coming back to the main area of HFSB interest – conduct – I should say that our asset management strategy for Hong Kong is also focussed on how to enhance industry standards.

We have begun a comprehensive review of conduct expectations with a view to strengthening regulations in areas such as the responsibilities of fund managers. This takes in disclosure of commissions as well as independent advice.

Another area is liquidity risk management, where we are considering the need to give guidance to implement existing principles of the International Organization of Securities Commissions (IOSCO), including the requirement to conduct regular stress tests.

At the global level, IOSCO and the Financial Stability Board are also looking at leverage within funds – especially hedge funds – and will issue a consultation covering this topic very shortly.

Traditional balance sheet leverage is frequently used by funds to boost investment returns. Leverage was, however, central to the failure of Long-Term Capital Management in 1998 and the collapse of two Bear Stearns hedge funds in 2007. These failures showed that leveraged funds not only affect their largely non-retail investors, but also have systemic risk implications.

For hedge funds, while there is generally no cap on leverage, the focus is on reporting and disclosure of leverage to enable monitoring by regulators and to instil market discipline. Attention is now on the use of derivatives to create synthetic leverage and the absence of consistent standards for measuring leverage, both within and across jurisdictions.

In Hong Kong, although we do not directly regulate private funds, we do regulate private fund managers carrying out the regulated activity of asset management. So developing consistent leverage measurements in light of this international work and collecting leverage data on private funds are areas we will pursue, and I would urge the industry to actively participate and contribute.

A public consultation on all of these issues is planned for the second half of this year, and we have already started engaging private fund managers on this.

Conflicts of interest

Now let me touch on a few more conduct issues which may be of interest to the HFSB and its members.

First, conflicts of interest. It is basic that firms need to identify all material conflicts and have a compliance programme to address them. This is essential to ensure fair treatment of clients.

Earlier this month, we reprimanded and fined a large fund manager after we found that it had failed to ensure that interest received on cash balances in its fund – actually zero – were at the prevailing commercial rates, which were above zero. It turns out that the manager did not check the rate of interest offered by other banks when depositing cash in its own group bank. And this had gone on for more than four and a half years.

During our asset manager inspections, we have also seen conflicts of interest issues in broker selection. In one firm's broker review, the CEO's votes were concentrated on brokers that offered soft commissions, even though the CEO did not interact with the brokers on a regular basis. The CEO was also allocated 30% of the votes, exceeding those allocated to CIO and other investment professionals, who each had 10% to 20% of the votes. The CEO actually voted for two brokers who did not get many votes from the investment professionals. And those two brokers were among the top three brokers selected.

There were also instances at other asset managers where the allocation of trades to brokers was not in line with broker review results.

Insider dealing and outsourcing

Another area is insider dealing. There has been a lot of publicity about insider dealing cases overseas and in Hong Kong. But we still see that some firms have yet to implement proper surveillance or transaction monitoring to surface irregular trading patterns.

For example, we saw that funds at one firm started to build positions in a stock in the two weeks leading up to an announcement which led to a trading suspension. When trading resumed, the stock price surged 55%, and all positions were sold on the same day. These were blindingly obvious red flags which should have led to closer scrutiny, but the firm did not have any controls in place to identify them.

So we are urging firms to make sure they have proper insider dealing surveillance in place. This may include examining trading patterns and investigating any unusual ones; monitoring trades in relation to specific events such as public announcements, price spikes and significant profits, and tracing the source of information obtained by fund managers and analysts before conducting trades. Email and phone log surveillance is important here.

Finally, we continue to see control weaknesses during our inspections, for example, when functions are delegated or outsourced.

Most of the problems we see with outsourcing centre on documentation, which may not define the services to be provided, or which involve inconsistencies between internal fund policies and the service contract. In some cases, there is no documentation to evidence any monitoring or review of the outsourced functions or any due diligence.

Far from the fundamentals

To finish up, I will recap on a theme about regulation and the markets which I continue to worry about. This is that after years of "unconventional" central bank policy, we are all having to navigate markets in an environment where the fundamentals have been sidelined. And although market regulators and the financial industry are often seen to be on opposite sides of the fence, this disconnect from fundamentals means that we are pretty much in the same boat.

Basically, we are in unchartered waters due to central bank policy and regulation following the financial crisis. And although the Fed is moving very slowly towards normalisation, the global picture is that loose monetary policy has not restored growth and inflation close to target. And the political resolve to pull fiscal and other levers to help the situation is weak. This means that we are stuck with this world of policy-dependent markets for a while.

And the fact that interest rates went negative earlier this year in the Eurozone and Japan speaks for itself.

We are of course aware that monetary measures were first introduced to avoid a depression and then try to jump start economies after years of stagnation.

But as market regulators, we are concerned about how low or negative interest rates, quantitative easing and related policies have distorted asset prices, affected basic investment decision making and corporate behaviour and led to an overall mis-pricing of risk.

A commonly heard opinion is that central banks have used fixed income as a policy tool to such an extent that the market is no longer a true measure of market expectations. In this world view, central bank policy is overwhelming valuations, and prices do not really reflect investor views of the underlying economy or of corporate equity or debt.

A recent article in the *Financial Times* pointed out that "stock market valuations imply a future of rosy profits and economic optimism," but "at the same time, sovereign bonds are priced for a stagnant world of diminished opportunity and minimal inflation."

And, just as concerning, equity valuations are reaching highs even when corporate earnings continue to fall, companies hoard cash, many companies borrow cheaply to fund buybacks and many cut down on investment and innovation. Some listed businesses are shying away from corporate investment and underlying growth and instead use financial engineering to boost short-term share-price performance with buybacks, outsourcing, tax optimisation and creative accounting.

This means that the bedrock of investing – fair value, time premium, risk premium, mean reversion and diversification – has been downgraded. Instead much of investing is now about second-guessing the central banks' next move.

The point is that our capital markets are meant to function as places that can transform savings into productive investment by individual businesses, and in the vast majority of markets, the purpose of regulation is to support this core purpose through efficient, reliable disclosure, pricing and settlement mechanisms. Unfortunately, this assumption has been tested severely since the financial crisis.

Now it is evident that none of this is ideal. So we are all essentially trying to make sense of a world where fundamentals are marginalised and the traditional role of markets helping to allocate savings efficiently and price risks properly is compromised.

This is doubly important because, as banks retreat under the weight of regulation, litigation charges and structural reform, market-based finance is supposed to pick up the slack to fund real economies.

Now these issues are of central interest to IOSCO, of which I became Chairman earlier this year.

In particular, there is much discussion about the trade-offs between the desirability of renewed growth, the need to ensure that systemic risks are contained and the larger role for capital markets in Asia as well as in Western markets.

These are the issues on which IOSCO will be focussed during the next few years, with the overall objective of ensuring that capital markets can play the important role for which they were designed.

Thank you.