

Speech at 6th Pan-Asian Regulatory Summit

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I spoke at this conference last year, which was just a few days before the launch of Shanghai-Hong Kong Stock Connect. As many of you know, this was the first time the Shanghai A-share market was linked directly to a foreign exchange.

So 12 months on I would like to share some thoughts on where we are now and then end with some of the themes the SFC is pursuing to further develop Hong Kong's role as China's international financial centre.

Now to begin with I want to spend some time on an important issue which lies at the heart of how the SFC views its role as the Mainland and Hong Kong markets continue to integrate.

Last October we had just signed what I then called at this conference a "ground-breaking" agreement with the China Securities Regulatory Commission (CSRC). Essentially this enabled us to intensify our ability to assist each other when dealing with misconduct in the Hong Kong and Shanghai markets.

We also agreed on how we would share surveillance data about trading in each other's markets.

Both of these agreements were essential for the launch of Stock Connect.

Now in recent months some have voiced concerns about the wisdom of cross-border cooperation between regulators. This gained some attention in the media over the summer when the Mainland authorities intervened in the A-share market.

Some have even raised doubts about whether we should be sharing and exchanging information with the Mainland or other overseas regulators at all.

So I want to make our position absolutely clear on this. And that is that without close cooperation and information sharing Hong Kong's markets – and the individuals and institutions who invest through them – would be exposed to unacceptable levels of risk. This in turn would threaten Hong Kong's reputation as a place where international and local investors can operate with confidence.

Why is this so? I think it deserves some explanation, and we can look at Stock Connect itself as a concrete example.

The starting point is that as regulators both we and the CSRC want to make sure that our existing ability to detect and enforce against market misconduct – which may range from price manipulation to insider dealing – remains unaffected under the Stock Connect scheme.



The catch is that the basic design of Stock Connect means that this is not assured. Under this design, Mainland investors can trade in our market by placing orders with a broker in the Mainland. Similarly an international investor can trade in the A-share market by placing an order with a broker in Hong Kong.

This means that there is a big difference between our ability to detect misconduct when trading takes place outside Stock Connect when compared to trading through Stock Connect itself.

For normal trading our surveillance team uses some fairly sophisticated desktop systems to detect patterns which indicate potential market abuse. Our next step is usually to require the broker who handled the trades to tell us more, including who was behind the trades, and this in turn can lead to a broader investigation.

Many of you working at Hong Kong brokerages will be familiar with this procedure – called “S181 notices” in the compliance jargon.

The problem is that this process can’t work as it’s supposed to in the Stock Connect world.

We can certainly conduct our desktop surveillance operations in much the same way. But crucially we can’t then take the next step by going directly to brokers to get more information on clients and their trades. This is because the brokers placing orders in our market are located in the Mainland, not in Hong Kong.

And the CSRC is in exactly the same position when it comes to the A-share market.

Trades in the A-share market through Stock Connect are placed through brokers in Hong Kong and not through brokers in the Mainland. This means that if the CSRC wants to investigate the origin of suspicious trades it cannot go to a broker in the Mainland to find out.

So both we and the CSRC are in the same boat: unless we intensify information sharing and cooperate in investigations we lose our ability to properly track and deal with suspected misconduct.

And because we are in the same boat each of us have the same incentives to cooperate.

Now I should make it clear that this balance of incentives to cooperate wasn’t the same before Stock Connect. The fact is that for many years the Mainland authorities were on the receiving end of many more information requests from overseas regulators than they made themselves to overseas regulators. And the reason for this was obvious. Most enquiries made by overseas regulators were about China businesses listed abroad, not only here but also in the US. The fact that the Mainland-listed markets were purely domestic meant that this information flow was largely a one-way street.

Stock Connect changed this so far as secondary market trading is concerned. And I can confirm that since the programme was launched both we and the CSRC have had a very good experience under our new cooperative arrangements.

First, whilst for obvious reasons the details have to remain confidential, I can say that we have experienced consistently rapid responses from the Mainland to our requests for surveillance information about dealings in our market.



These ranged from enquires about potential insider dealing to market manipulation and unexplained movements in prices or turnover.

On top of this both we and the CSRC have initiated new investigations under the enhanced enforcement agreements signed last year. These involve investigations in relation to companies which are listed only in the Hong Kong market or in the Mainland market where we need evidence from the other jurisdiction to make progress.

Now of course trading under Stock Connect represents only a fraction of overall turnover in the Hong Kong and Shanghai markets. For a while it was roughly 2% for Shanghai and about 5% for Hong Kong. And since the events over the summer in the A-share market this has declined to about 0.6% in Shanghai and 1% in Hong Kong.

So you might well think that enhanced cooperation really can't be very important given that so far Stock Connect trading represents a small minority of total market activity.

From my perspective this completely misreads the situation. It is true that the proportion of trading represented by Stock Connect has been fairly small. But the significance for us is far greater because it has kick-started a new era for broader reciprocal engagement between ourselves and the CSRC.

This is all about being able to detect, investigate and deal with those who are determined to harm our markets despite the fact that they operate outside our individual jurisdictions and are therefore largely beyond our reach.

The fact is that as the SFC and CSRC gain experience in reciprocal assistance under Stock Connect, this leads to closer cooperation in other areas, including misconduct perpetrated by insiders or controllers of Mainland businesses listed in Hong Kong.

I for one am optimistic that we will continue to forge an even deeper relationship with the Mainland authorities to ensure that further market integration – which is undoubtedly on the cards – is founded on sound supervision and enforcement.

I should also mention that on another front we are progressing discussions with the CSRC about coordinated supervision of Mainland-headquartered financial firms who have subsidiaries in Hong Kong licensed by us. Information sharing here can give us a far better picture of how these firms function and how they manage risks across the markets in which they operate.

And to those who have expressed concerns about all of this my answer is pretty straightforward.

The fact is that if a market chooses to establish closer ties with another market to offer greater opportunities to investors, brokers and other participants, it is essential that the regulators also establish closer information-sharing and assistance arrangements. You can't have one without the other and it would be naive to think otherwise.

I should of course point out that all information sharing is subject to specific safeguards under Hong Kong law to ensure that the public interest, confidentiality and individual rights are safeguarded. So, for example, when we are asked by any overseas regulator to use our powers to investigate we must always ensure that the right to claim privilege against self-incrimination is fully respected.



In this respect we partner with the Mainland in the same way as we do with regulators in other international financial centres in the West.

Our ties with the Mainland market have been close for many years – largely because of the growth in the number of Mainland companies listed here. From small beginnings, the H-share market has been an outstanding success. But the degree of integration has accelerated over the last five years with initiatives such as the Renminbi Qualified Foreign Institutional Investors (RQFII) scheme, then Stock Connect last year and now our Mutual Recognition of Funds (MRF) initiative this year.

On top of this Mainland brokers and asset managers have taken a far larger market share in Hong Kong than before and Mainland investors trade through brokers here as well as through Stock Connect.

So you can see why we thought that it was vital to conclude new cooperative agreements before Stock Connect was launched. And you can also see that expanding avenues for mutual assistance is an essential condition to further market integration.

By the way, you may have seen that some other countries have indicated that they want to connect their markets with the Mainland markets.

Now from our perspective there is nothing wrong with this; we think that Hong Kong will continue to thrive as the main point of connection between global capital and the Mainland for many years to come.

Greater connectivity with other time zones will simply increase the size of the cake for all. In fact, that is what we aim to achieve alongside the CSRC in the next stage of the MRF scheme.

Nevertheless I do wonder whether these countries have reflected seriously about the need to underpin these arrangements with the sort of regulatory understandings with the Mainland authorities that both we and they view as essential.

One final point on this subject of cooperation between regulators. This is that although we can negotiate and sign formal regulatory memoranda of understanding and the like, much still depends on establishing deep, informal connections between the authorities involved.

This is for the simple reason that formal arrangements can't work without a good level of insight, understanding and even empathy at a personal level. This is especially important when the systems involved are as different as those in the Mainland and Hong Kong.

To that end we place a lot of importance on our secondment arrangements with the CSRC as well as other contacts across all levels of seniority.

It was also with this in mind that earlier this year we established a dedicated Mainland Affairs Unit within the SFC. This is headed by a very experienced former CSRC Deputy Director General, who most recently worked as Deputy General Manager at the Dalian Commodity Exchange.

Only through this kind of broad-based approach can we be confident when taking on the challenge of working effectively across such very different markets.



Now, I said at the beginning that I would touch on some of our plans for the future. And here I should say that no regulator can operate in a vacuum, ignoring changes in economic conditions which alter the risks we deal with. I need hardly point out that the world is a profoundly different place to this time last year.

Global equity markets have had their worst quarter since 2011. Capital is departing from emerging markets, commodity prices have plummeted and many commentators see China, not long ago the reliable engine of the world economy, as its greatest vulnerability. This is hardly surprising as China represents 16% of world output and 30% of expected growth. And quite remarkably China featured in the US Fed's recent decision to leave interest rates unchanged.

On top of that, Bank of International Settlements data indicates that private non-financial debt in China has surpassed the levels reached in the US and the UK in 2007. Lower growth raises questions about the sustainability of this debt.

Basically this amounts to high anxiety in places like the International Monetary Fund, and this in turn leads to mixed reactions to events such as China's changes to its exchange-rate policy in August.

Despite all of the new risks that people now worry about the fact is that growth rates in China still outstrip those elsewhere, even at the lower end of estimates. And it's undeniable that the heavily telegraphed shift from construction and heavy machinery investments towards consumption and services is now under way.

And this is why Hong Kong will play an even more important role in the longer term to enable Mainland savers to access the world and international investors to access China.

Much of this is linked to the confidence investors have in the high standards of regulation in Hong Kong's markets. Many have remarked on the way in which Hong Kong weathered events over the summer by ensuring that trading could continue safely and continuously despite a big increase in volatility.

Against this background I believe that it's up to the SFC to leave no one in doubt about our unwavering commitment to high market standards and credible deterrence against misconduct.

And I would put the statement we made earlier this year disagreeing with some Stock Exchange proposals for Weighted Voting Rights as an example of our commitment to maintaining standards in the long term, notwithstanding opposition from some who may prioritise short-term business and deal flow.

And although events over the summer understandably led to something of a temporary hiatus for some projects such as the further expansion of Stock Connect, I expect things to get back on track fairly soon.

Of particular importance to the SFC is the MRF project I mentioned earlier, which we and the CSRC announced in May.

This programme allows Mainland funds to be sold to international investors through Hong Kong, and for Mainland investors to access international investments via Hong Kong funds.



We think that MRF is as important for Hong Kong and the Mainland as Stock Connect. As with Stock Connect, we expect that initial business volume will be fairly small as products and distribution channels will take time to develop. But in the longer term we expect business to become very significant. And the programme works because it is completely aligned with the Mainland's own opening-up policies.

Now to finish I'll touch on some themes we are working on which should see the light of day in the coming months.

Because time is short I'm afraid that I can only give you some highlights. But I hope you can see that all of it is anchored in the issues I have dealt with so far – especially making sure that market development rests on a sound regulatory basis to instil confidence.

First, we'll continue to work on extending Hong Kong's lead as an Asian asset management centre.

This is a key project for us, and although MRF is an important part of it, there is a lot more to it than that.

Last Friday we announced a new streamlined process for funds approval to reduce the time to market without compromising investor protection. This followed very helpful discussions with the funds industry.

We are now working on enhancing our Fund Manager Code of Conduct looking at topics such as commissions and independent advice.

And I should say here that although we will look at developments overseas in this area we will not adopt them in Hong Kong without careful thought. One size fits all is rarely the right approach.

Just to take one example, although unbundling of research from broker commissions charged to asset managers is now a big theme in Europe, different considerations may apply in Asia where many markets, including China, are in fact under-researched.

Second, we will seek to promote alternative distribution channels for retail mutual funds.

Right now the narrow bank-dominated distribution channel makes funds too expensive and limits choice for investors. Different types of distribution platforms, some of which may be automated, will probably mean that we will need to issue more guidance on our approach to suitability and Know Your Clients requirements.

This is really part of the so-called "fintech" revolution, which is starting to occupy governments and regulators globally.

We are now in the early stages of discussion with the Hong Kong Exchanges and Clearing Limited about the possibility of an exchange-based platform aimed at fund distribution through brokers and we'll pursue other ideas for similar platforms with the funds industry.

Third, we will look to change the way in which we conduct surveillance of our public markets.



This is because these markets are far larger and more complex than they used to be. Specifically we'll see whether it would be feasible for us to identify market orders directly at a client level rather than at a broker level to better detect potential misconduct.

This is a longer-term project, but it would mean that we would have a much better overview of market-wide trading patterns, and also reduce the number of times we would need to bother brokers for client-level information.

Fourth, we will continue to work with the Stock Exchange on listing regulation.

We are very conscious of issues to do with small public floats ripe for manipulation, problems with backdoor listings as well as other instances of corporate misconduct. Whilst serious problems are confined to a minority of companies, we know that a few bad apples can have a big reputational impact.

Fifth, we are working with the Hong Kong Monetary Authority on a number of joint projects, including ways in which we can enhance our oversight of wholesale securities markets activity carried on by banks.

Finally, we will continue to be unrelenting in the pursuit of remedial outcomes in our enforcement work wherever we can.

Our track record in isolating and then restoring illicit gains back to investors who have been harmed is now well established and fully supported by the Hong Kong Courts.

So to close I just want to reiterate my main point.

It is clear that Hong Kong will remain at the vanguard of mainland China's financial market engagement with the world, and this fact sets us apart from other international financial centres.

This means that we need to deal with a very different range of challenges and opportunities to most other regulators. The ride won't be smooth – as events over the summer demonstrated.

We will nevertheless do everything we can to ensure that high standards of regulation – including under our agreements with the CSRC – properly supports the development of our markets for the long term.

Thank you.