

Importance of capital markets professionalism and the role of regulators

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Introduction

I would first of all like to congratulate the Asia Capital Markets Institute (ACMI), and its managing director Brian Tang in particular, for the successful launch of this summit. You are to be commended for providing an important platform to promote professionalism - that is skillful and conscientious behavior - in the capital markets.

Through organisations like the ACMI, different parts of the capital markets ecosystem – ranging from investors and the buy-side, sponsors, experts, the sell-side, service providers and listed companies – including many of you who are sitting here in this room today are able to work collectively and collaboratively towards ensuring and improving professionalism and market integrity in Hong Kong and beyond.

From a regulatory perspective, the focus on professionalism and capital markets integrity is fundamental to the Securities and Futures Commission's (SFC) overarching mandate as we recognise that the levels of professionalism, conduct and culture of individual stakeholders directly impact the integrity of the market. I have personally come to the view that unless each and every component of the market is acting with integrity you cannot achieve the goal of market integrity.

Accordingly, what regulators around the world are now realising is that the root cause of the financial crisis, and the resulting trust deficit the financial industry has with the public at large, cannot be solved by applying prudential and market-structure regulations alone. Instead we must examine the underlying 'root' causes of conduct and how decisions are made by market participants. An extremely relevant question to ask in this regard is whether the right levels of professionalism are being applied by the industry?

So, it is of no surprise that there has been growing attention paid by global regulators on issues of professionalism, culture and ethics. William Dudley¹, Head of the Federal Reserve Bank of New York, made the sobering conclusion last year that there is still evidence of "deep-seated cultural and ethical failures at many large financial institutions" and that solving "too big to fail" isn't enough without cultural change by market participants. Likewise, Christine Lagarde², Managing Director of the International Monetary Fund, remarked a few weeks ago in a speech that simply adding regulations is not the answer. Madam Lagarde noted that restoring trust in the financial sector will require a shift towards greater integrity

¹ William Dudley, "Ending Too Big To Fail" (Nov 2013).

² Christine Lagarde, "Economic Inclusion and Financial Integrity – an address to the conference on inclusive capitalism." (27 May 2014).



and accountability, paired with a stronger ethical dimension to firms' actions. Mark Carney³, Governor of the Bank of England, has also echoed these sentiments by recently calling for a systematic change amongst firms to see their business as a vocation, "an activity with high ethical standards, which in turn conveys certain responsibilities." Or put in a different way – an industry acting professionally – that is conscientiously and skillfully.

Our old colleague Martin Wheatley, now leading the Financial Conduct Authority in the UK, has also spoken on ethics and culture at firms at great length and weighty organisations like the Financial Stability Board have issued worthy tomes on the subject. Importantly, what is clear is that regulators around the world are now emphasising that culture is an important subject for regulators to focus on when regulating the markets.

A supervisory focus on ethics, culture and behaviors at intermediaries

It is fair to observe that the words 'ethics', 'integrity', and 'professionalism' have been missing from our industry's daily discourse for too long. I see that an important part of my role as a regulator is to bring them back into conversation and back into vogue here in Hong Kong.

In my view, consideration of human factors – that is how did individual and collective decisions and behavioural considerations cause the financial crisis and indeed cause the front page conduct issues since then – has been lacking from the regulatory response post financial crisis.

I want to emphasise an important point I have just alluded to. When we speak of conduct, behaviour and processes at firms we have to take a step back and remember that all these things originate from decisions of individuals within market participants and from decision-making processes by those market participants. Accordingly how decisions are made, what are the incentives and disincentives behind them, what processes apply and whether people actually realise a decision has been made is an important focus point for us as regulators but they should also be a key focus point for the industry itself.

An important component for ensuring that the right decisions are made and the right levels of professionalism exist is the culture of an organisation. Personally I believe that corporate culture is made up of at least three component cultures – including, importantly, (i) an ethical culture, (ii) a leadership culture, and (iii) a culture of professionalism.

From a regulatory perspective, an important reminder of our overarching ethical obligations to the market and to clients is found under the General Principles of the Code of Conduct for Persons Licensed by or Registered with the SFC. General Principles 1 and 2 of the Code of Conduct requires licensees, both individual and corporate, to 'act honestly, fairly and in the best interests of its clients and the integrity of the market'.

Meanwhile, the fundamental requirement of each and every licensee, whether an individual or a corporation, is to be fit and proper and section 129 of the Securities and Futures Ordinance (SFO) has some very important guidance to us on what that means, including the requirements of:

- Competence
- Honesty

³ Mark Carney, "Inclusive capitalism: creating a sense of the systemic." (27 May 2014).



- Fairness
- Reputation
- Character and
- Reliability

These elements are fundamental to the notion that professionalism, ethics and values is imbedded in the regulatory regime that governs our industry.

At the SFC, this all means that we will be broadening our regulatory approach to our licensed entities focus not just on the traditional control systems & procedures framework at firms, but also on the “control culture” – that is, the culture and leadership dimensions of businesses. In essence, more regulatory attention will be paid to the human dimension, the human element, particularly to the drivers of decision making and conduct within licensed entities.

Incentives / Disincentives

One key driver of behaviour and professionalism is incentives and a lot of attention has been paid by regulators and the industry in this regard. Nevertheless, in my observation, there is not enough focus by firms on incentivizing the correct behavior and professionalism and an over reliance on disincentivising bad behaviour. I think the principal way to make people proactively think about issues is the incentives in so doing. What is needed as I have said before then is a combining of the proverbial stick to the carrot, as punishment and deterrence have their limitations. This is where the industry needs to lead the way by enhancing its incentive structures so that professionalism is actively rewarded and encouraged.

In addition to the right incentives is the right work place and corporate environment, not just to encourage professionalism, but to promote and nurture the right decisions, behavior and outcomes. I have come to the view that corporate culture, corporate leadership, corporate professionalism and corporate ethics can, along with the right incentives, be a key driver of good behavior, decision-making and conduct in firms and the efficient functioning of our capital markets.

There is actually a cost-benefit here. One simply has to look at the billions of dollars in fines levied in recent times by global regulators to be convinced that conduct costs are a real threat to financial firms. Regulatory sanctions are expensive in terms of dollars and reputation, and it is in everyone’s interests that issues that would lead to sanctions are avoided at the very root. This means that the entire management structure has to take real responsibility for regulatory matters and avoid overly delegating responsibility to compliance, other control functions, or external advisors.

Leadership structure / Decision-making

That all said culture, values, ethics, professionalism and integrity will not go very far unless there is a ‘delivery and distribution mechanism’ within market participants. This is where the second component of corporate culture – leadership – comes into play. Unless people in authority (note I did not say only ‘the CEO’ or ‘the board’) lead – that is inspire, motivate and cause to follow – on ethics, professionalism and values then they cannot be imbedded into a firm or into our markets”.



Organisational culture and leadership is important since professionalism, ethics and values can only be individually generated up to a certain point. These values cannot be 'effective' unless there is an environment that nurtures and promotes these principles – that is an organisational or corporate culture. That environment is established by people in authority. Firms must not only set the 'tone at the top' but should pay equal attention to how the 'tone in the middle' is working in practice. This is because the vast bulk of the would-be "leaders" and people with daily authority over teams in financial firms operate in this layer.

In my experience it is the senior vice presidents and junior managing directors who are responsible for deal teams that are the crucial conduits in this regard. So it is important that these people in authority have the right ethics, professionalism, values, judgment and supporting culture.

This highlights that every person in authority in a firm has very real responsibilities. Accordingly, an important role of the more senior leaders is to appropriately empower, incentivise, supervise, lead, and reward this 'operational management' strata.

To this end, we will be increasing our direct communication with the senior most leadership and business heads of market participants who, under General Principle 9 of the Code of Conduct, are ultimately responsible for management and control of a firm. This also means that we will not be relying on the exclusive medium of compliance and legal functions, or third party advisors, for dialogue with firms on matters of interest. We will also ask business and operational leaders of firms to engage with us directly and proactively and not wholly delegate communications to their legal or compliance colleagues.

We will also be paying attention to effective decision-making structures of licensed entities and taking a look at whether market participants are properly identifying and delineating their management and leadership structure. This is in light of many market participants in Hong Kong having what is called 'matrix management and operational' structures where decision-making, control, compliance & business processes and critical support functions are often governed in whole or in part by headquarters that sit outside of Hong Kong and are determined at the group-level, and where internal processes and cultures are often imported to the Hong Kong office. In the world of corporate finance, this is often the commitments of a committee who, in my experience, is constituted with a significant number of offshore persons.

Accordingly, we will be focused on ensuring that the governance structures are appropriate for decisions and deals affecting the Hong Kong market and that the right people are the responsible officers of our licensed firms in Hong Kong.

Business ethics, values and principles

Turning to the third aspect I mentioned earlier – good corporate culture can, and should, differ between firms. There is no 'one size fits all' corporate culture. Nevertheless, we all know a good work place when we experience it – and the opposite holds true as well.

That said I hope some of my own observations may be useful on this topic. Firstly, I subscribe to the view that the financial industry, both collectively and individually, has over the years surrendered an ethical standard for a legal one. Worryingly a legal standard is inherently subject to biased interpretations and/or 'opinion shopping'.



What's more, an ethical standard is to be preferred both because it will go a long way to bridge the trust deficit facing the industry as well as provide a 'behavioral buffer' that will protect firms from both legal and reputational risk. If nothing else, applying an ethical standard is the right thing to do.

Accordingly, we will be taking a look at intermediaries' business models to see if there is an alignment of their control priorities and their control culture with their business strategy and decision-making processes. What's more, we will be looking at licensed firms to see whether these principles are, in fact, imbedded in their businesses and operations.

Cross-departmental Initiatives

Apart from the work of our Intermediaries Division on culture and conduct, the SFC's other divisions are also actively engaged in ensuring that higher standards to protect the investing public are being pursued. As many of you already know, starting this year, the SFC has taken on a broader, more proactive oversight of listed companies as a corporate regulator. As a first step, we have set up a Corporate Regulation team under our Corporate Finance Division to review company announcements, circulars and reports, and to conduct periodic in-depth reviews of companies on a risk-based approach. By actively detecting misconduct and following up on suspicious activity, we hope to identify red flags and enhance the SFC's role in maintaining quality markets and high corporate governance standards as well as protecting investors.

Regulatory oversight of listed companies has also come in the form of our new IPO sponsors regime⁴, which came into effect in October of last year, and which aims to enhance the IPO gatekeeping process and the quality of listings.

Creating a virtuous cycle and self-regulation

Returning to the challenges of professionalism, culture and leadership, I have already highlighted the enhanced role of regulators. Nevertheless, only through industry-led initiatives can there be real on-the-ground and in-the-markets change. Ultimately, I am speaking of a market eco-system where there is a self-reinforcing culture of adherence to high ethical standards by market participants. What I have also observed in my 12 months – which is exactly today – at the SFC so far is that market participants do not externally expect high enough standards of each other and of their clients and counterparties. Each firm appears to be reluctant to express, let alone require, the best standards of the people and the entities it does business with.

One practice that the industry should consider using more of, but which has gone out of fashion, is 'cold shouldering' by the industry itself. Indeed, Mark Carney⁵ has forcefully come out to say that "professional ostracism" should be practiced when bad behavior arises. This element of self regulation has been entirely delegated to the regulatory process which is a shame.

Accordingly, it would be worthwhile for organisations like the ACMI to look into ways and means that the industry can create a virtuous cycle of heightened expectations and

⁴ See "Consultation conclusions on the regulation of IPO sponsors" (12 Dec 2012).

⁵ Mark Carney, "Inclusive Capitalism: creating a sense of the systemic." (27 May 2014).



professionalism rather than the current stand-off that is leading to a decline in the standards of integrity and ethics in the market.

The ACMI has the distinct advantage as a newly formed organisation dedicated to improving industry standards to build its reputation around making ethics and integrity a top priority by raising the educational awareness across the entire spectrum of capital market participants on what it means to serve in the best interest of the client and of the public and what it means to act with professionalism in our industry.

Ladies and gentlemen, I will end with a challenge to you all: only by the industry taking up its responsibility to uphold and sustain a virtuous cycle of professional behavior by expecting more of each other, will we begin to restore the industry's trust with the public and ensure the integrity of our markets.

So, by closing, I hope I have helped to set the stage for the next set of speakers in this morning's session, particularly to facilitate this call for heightened expectations of professionalism and ethical conduct that undoubtedly the ACMI will help to play an important role in achieving in the years to come.

Thank you.

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