

## Supervision in a time of change Hong Kong Securities and Investment Institute's Senior Leaders Programme

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Good afternoon, John<sup>1</sup>, Ruth<sup>2</sup>, ladies and gentlemen.

It's my great honour to address the HKSI's Inaugural Senior Leaders Programme today, and to meet with all of you to talk about the SFC's supervisory strategy in a time of change.

### Evolving challenges

The SFC has a mission to promote the integrity and soundness of the securities and futures markets through our licensing and supervisory functions. Our mission doesn't change over time, but the business landscape changes, market players evolve and more innovative technologies emerge. To keep up, we have to adjust our supervisory priorities and our tools and approaches.

One key challenge right now is how best to use our finite regulatory resources to deal with the rapid growth in the number of licensed corporations (LCs). The number of new corporate applications grew more than 50% last year, and as of the end of our fiscal year in March the number of LCs reached almost 2,500. Meanwhile, the operating environment remains tough amid a reduction in market turnover. Last year, the LCs' total operating income decreased by 11% and total net profits fell 51%. Competition is getting tougher as the sector gets more crowded.

Another challenge is coping with the new market entrants we now see. With more financial integration between the Mainland and Hong Kong, more Mainland companies apply to set up subsidiaries or acquire existing brokers here. In fact, the Mainland has overtaken the US as the source of the largest number of shareholder groups controlling our licensed corporations. About 13% of all licensed corporations are controlled by Mainland corporates.

The activities that market players engage in are evolving too. We now have more asset managers than brokerage firms. The number of firms carrying out Type 9 asset management activities is now more than the number carrying out Type 1 regulated activity (dealing in securities). Nearly two-thirds of new firm applications are now for the Type 9 licence.

Next, while we are pleased to see our intermediaries making a profit, they must not do so at the expense of their clients or of the fair and orderly market. In following the money trail, it is not surprising that the worst misconduct is found in the biggest money spinners, such as the cornering of placing shares, price rigging and unrealistic valuation of assets at the low end of

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<sup>1</sup> Mr John Maguire, Chairman of HKSI

<sup>2</sup> Ms Ruth Kung, Chief Executive of HKSI



the listed market. We have to weed out bad behaviour and punish wrongdoers so we can maintain market quality and protect investors.

Technological innovation is transforming financial services, with algorithmic trading and automated advice bringing both new opportunities and risks. In the retail sector, stocks, bonds and funds are increasingly bought online via internet-based trading systems on your computer or even your mobile phone. Our suitability obligations were designed for face-to-face interaction with clients and have to be updated to cater for advice provided on online trading platforms. And internet trading accounts have to be protected against increasingly sophisticated cyberattacks.

In response to this new reality, our regulatory approach now emphasises front-loaded regulation, real-time supervision, thematic reviews and transparency. It also leverages cooperation with other regulators, most importantly the Hong Kong Monetary Authority (HKMA) and the China Securities Regulatory Commission (CSRC). I will explain each of these points in turn.

### **Front-loaded regulation**

The intent of our enforcement and disciplinary actions is to deter bad behaviour. They are a powerful and effective backstop but not the panacea to all regulatory issues. That is why we now strive to front-load our regulation and nip bad behaviour in the bud. When we identify emerging risks in the market, our aim is to take direct intervening actions at an early stage to prevent the problem from spreading. As market problems tend to cut across different sectors and market players, this kind of front-loaded regulation is complemented by a “one SFC” strategy, where we pool all our resources, market intelligence and tool kits from across the SFC to tackle specific risks in a more coordinated way.

One example of this is operation ICE, an acronym that stands for Intermediaries, Corporate and Enforcement, three of our operating divisions at the SFC. The backdrop leading up to ICE’s formation in July last year was the unusual price volatility in many new Growth Enterprise Market (GEM) stock listings. This led to concerns that certain market practices may stand in the way of an orderly, informed and efficient market.

What we saw when we looked closely at these new GEM listings was that many had highly concentrated shareholdings and a small shareholder base. Some places with large allocations repeatedly appeared in otherwise unconnected GEM IPOs. And one or two board lots were placed with just enough people to make up the 100 shareholders needed to meet the Listing Rules requirement. Of the 45 GEM IPOs in 2016, the average first-day price increase was 530%, with the most extreme being an increase of 20 times. Eighty percent of these listings were placing-only, and the great majority of these listings saw prices at least double at the end of the first day of trading, only to be followed by price drops of 50% or more later.

As you may have seen, in January we issued a guideline to sponsors, underwriters and placing agents involved in the listing of GEM stocks which was about how intermediaries should advise on and conduct placing activities to ensure the existence of a fair and open market. We also issued a related statement with the Stock Exchange that sent a clear message that we will not hesitate to take enforcement action if our expectations were ignored. The resulting behavioural change in firms was immediate. IPO share placings became more balanced, some sub-par listing plans were withdrawn and most IPOs started to include a



public offer tranche. From this you can see that our front-loaded regulatory approach is already changing the behaviour of the parties involved in GEM listing applications.

We are increasingly concerned that some listed companies are acquiring assets at unreasonably high prices or selling companies' assets at substantially undervalued prices. As mentioned by our CEO Mr Ashley Alder at a media luncheon a week ago, the SFC is hoping to tackle a long-standing problem of unrealistic valuations used to support suspicious asset disposals or acquisitions by listed companies. It is the duty of all those with a role to play in such corporation transactions to ensure proper valuation to safeguard shareholders' interests.

### **Gatekeeping**

In regulating intermediaries, our front-loaded regulation starts with our Licensing Department's gatekeeping function. The licensing process allows only fit and proper persons to be licensed. In the past, when substantial shareholders and directors of corporate applicants were typically individuals known to the securities industry, it was easier for us to track them and assess whether they are fit and proper. But nowadays an increasing number of individuals, many from the Mainland, with no prior experience in the Hong Kong securities industry, are looking to set up or acquire brokers and asset managers here. This just means we need to conduct a more detailed scrutiny of applications and work closer with other regulators such as the CSRC.

While this is part of the development of the market as the Mainland integrates with the rest of the world, I'd like to mention one recent market phenomenon which disturbs us. Some firms whose businesses are small and dormant are being offered for sale in the market for several million dollars. The price tag comes with two individuals who are paid tens of thousands per month simply for being responsible officers (ROs) in name only without having to report for duty at the office.

The unlicensed individuals who control the company might think that they can manage the firms without having to bear the consequences of their action. This is misguided, as anyone involved in the management of licensed corporations is liable for breaches, and the SFC may exercise its disciplinary powers to sanction them. SFC may revoke the licences of corporations and these ROs for hire who do not genuinely carry on a business of a regulated activity.

For those of you who are genuinely interested in setting up a business in Hong Kong, the process for applying for a new licence is straightforward, and normally takes about 15 weeks. As a new market entrant, whether you set up a new LC or acquire an existing one, we go through the same process of assessing and evaluating the new shareholder. Fitness, properness and financial soundness are key indicators for the assessment. In this connection, I'd like to emphasise that we look beyond the quantitative thresholds and assess each application qualitatively. Getting a licence is a privilege, not an entitlement.

### **Thematic supervision**

Turning now to our ongoing supervision, our number one aim is to drive proper behaviour and a compliance culture. On-site routine inspections are an important supervisory tool for us. These are general checks looking at high risk areas and seeing if the firms have in place systems and controls to manage those risks. After an inspection, we send a letter of deficiencies to set out the areas which require remedial actions. Where there is a serious



breach, we refer the case to our Enforcement Division to decide on whether or not to bring action.

Given the sheer size and the growing complexity of firms' business operations, we now do more thematic reviews to tackle specific and more complex risks in the market. In the past year, we started or completed 45 thematic inspections which ranged from selling practices of Chapter 37 bonds<sup>3</sup> to alternative liquidity pools, best execution and client facilitation, anti-money laundering, placing of GEM IPO stocks and cybersecurity.

While cybersecurity is a recurrent theme in our reviews, a review we began last October following a spate of hacking incidents specifically targeted the resilience of internet brokers to hacking risks. With a view to identify baseline cybersecurity controls, we sent out a questionnaire on the current practices on online trading systems for customer login and notifications. We then selected a number of firms for deep-dive inspections. In tandem, we benchmarked our regulatory requirements and market practices with those overseas and talked to system vendors. After our review, we held industry workshops in January to share our findings and also soft-consulted the industry on proposed baseline requirements on which we aim to issue a consultation paper later this month.

### **Transparency and signalling**

Our on-site inspections are more like a rear-view mirror. They mainly look back and identify what went wrong, why certain controls were not in place and whether remedial action is required.

While random spot checks are necessary and effective, we now place greater emphasis on changing behaviour through signaling to the industry the focuses of our inspections and the proper standards of behaviour. For example, last October, we notified the industry that we would soon conduct a cybersecurity thematic review on brokers' internet or mobile trading systems, and we set out the common deficiencies and vulnerabilities we planned to focus on. In being transparent about our requirements, we give sufficient notice for firms to clean up their act before the inspection begins. This is an example of front-loading our supervision.

Another recent review focused on algorithmic trading. It resulted in a circular we issued in December 2016 where we clarified some concerns and shared good practices. A workshop is being planned later in May where the industry will have a chance to understand more about the findings and best practices.

We reckon that supervision of intermediaries does not just mean conducting inspections and taking regulatory action. It also calls for transparency by providing the industry with necessary guidance and clarification, increasing the industry's awareness and supporting the industry's efforts to comply with regulatory requirements. In the past year, we issued around 40 circulars and hosted or participated in more than 40 workshops on licensing and supervision. The goal is to raise awareness of our supervisory focuses, share our observations on the industry's compliance with regulatory requirements and provide further guidance where needed.

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<sup>3</sup> Bonds listed under Chapter 37 of the Main Board Listing Rules.



## **Real-time supervision**

The SFC has a duty to promote the resilience of our markets and our intermediaries. Our offsite monitoring team closely monitors the adequacy of financial resources and in fact this is done on a real-time basis. Some of you might have the experience of getting our calls on margin books and liquid capital positions when the market becomes choppy. This is one example of our real-time monitoring. The concept behind this real-time supervision is, where possible, to take prompt pre-emptive actions or ameliorate misconduct before it causes further harm to the market.

Let me illustrate this with a recent episode, the plunge in the share price of a heavily pledged stock. We reckon that more than a quarter of the stock's total market capitalisation had been pledged to around 20 margin brokers. In some cases, lending to the substantial shareholder on this single collateral amounted to about 20% to 40% of the broker's total margin loans. The stock's share price plunged more than 80%, even though the total number of shares sold on that day represented just a small percentage of the company's issued shares.

That meant the margin brokers suffered a big discount in the forced liquidation, or were unable to force-liquidate the stock even if they wanted to, due to the subsequent suspension. For those brokers with margin books concentrated on lending collateralised by this stock, the share price drop and subsequent suspension burnt a big hole in their liquid capital. On the day of the plunge and the following week, we asked brokers to replenish with fresh capital.

The above debacle is a sharp reminder of the high risks associated with the lending practices of margin brokers. These have to be improved. Our FRR<sup>4</sup> is designed to be forward-looking and to anticipate the risks of the need for additional liquid capital. We stress-test margin books all the time to make sure brokers are managing them prudently. If we see excessive risks, we immediately follow up and require that risk management be tightened.

We are prepared to intervene at an early stage if we find that a firm's prevalent, risky practices persist without corresponding capital support. We would not wait until there is a breach of the FRR before we intervene. If there is a serious, imminent problem or risky business practice that goes unaddressed, we issue a warning to the broker. If there is no improvement, we would not hesitate to impose licensing conditions or to issue a restriction notice if warranted. Our regulatory regime does not guarantee zero failure but we need to make sure the broker would have sufficient resources to wind down in an orderly way, and that any impact on clients is kept to a minimum.

## **Strengthening supervisory cooperation with regulatory counterparts**

Over the last year, we put a lot of emphasis on strengthening supervisory cooperation with our regulatory counterparts. As I mentioned already, the two regulators with whom we work most closely are the HKMA and the CSRC.

In a powerful alliance, last year the SFC and HKMA joined up to conduct an offsite review of a banking group for the first time ever. The two teams reviewed the same kind of transactions from the separate perspectives of the two contracting parties, namely the bank entity and the securities entities. This revealed conflicts of interest that otherwise would not have been spotted with only one regulator reviewing its own regulated entity. We issued a joint letter on the deficiencies we found, highlighting issues that cut across the different

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<sup>4</sup> Securities and Futures (Financial Resources) Rules.



entities. In another initiative, SFC staff will soon join an exercise with the HKMA inspection team which will allow us to combine and utilise our respective skillsets in reviewing corporate finance practices.

As our markets are increasingly integrated with those on the Mainland, Mainland firms are playing a more significant role in our market. They now account for 70% of our sponsor business, 10% of securities dealing and 40% of margin loans. Recognising their growing role in our markets, we have stepped up our cooperation with the CSRC, which now ranges from licensing and ongoing supervision to training and other issues.

Under a memorandum of understanding (MoU) we have with the CSRC, we share supervisory information and hold regular high-level MoU meetings. We cooperate on reviews of the governance of head offices, oversight of the securities units in Hong Kong and training for head office senior executives. Last November, we jointly organised a seminar in Shanghai to give further guidance to head office senior executives on our areas of concern with their Hong Kong securities units. We have already seen good results from these initiatives.

## **Conclusion**

Ladies and gentlemen, in today's remarks, I outlined our new supervisory approach which is more front-loaded, targeted and real-time. In other words, you can expect our supervisory response will be swift, pre-emptive and proportionate. This is being accompanied by a high degree of transparency and the provision of adequate guidance and training to the industry. But at the end of the day, our supervisory objective cannot be achieved without a culture of cooperation and compliance on the part of market participants.

Since taking up this current portfolio almost a year ago, a question I have explored with my colleagues is, given the finite regulatory resources at our disposal and the challenges of supervising a rapidly growing industry, what is the best way for us to drive proper behaviour and achieve better investor protection? Enforcement actions are an effective backstop but again, they are not the whole solution.

I want to stress that the SFC's regulatory approach is firmly grounded in the tenet that an intermediary is primarily responsible for its own activities and for ensuring that its business complies with the relevant legal and regulatory requirements, in both letter and spirit. We hope that firm managers will take on the responsibility for compliance, and detect breaches and report them to us, instead of relying on detection by our inspection team. Most of all, we hope to see a tone from the top that consistently and as a matter of course places client interests and the integrity of the market at the forefront of business decisions. At the end of the day, this is the real key to success.

At the heart of any firm is a group of individuals at the top who call the shots. If we want to improve conduct and change behaviour, it should start from the top by clarifying who has responsibility for what, and holding them accountable for the conduct and behaviour of the firm. The Manager-in-Charge (MIC) regime we introduced last December aims at providing clarity around the question of who has responsibility for what in a firm, and putting some structure around reporting that information back to the SFC. Two weeks ago, we started to collect information about the MICs of core functions. We see this driving better ex-ante decisions and proper behaviour, starting from the top management and then cascading down through the organisation.



In closing, let me express my sincere gratitude to the support of the HKSI in promoting and developing the professional standards of the Hong Kong securities industry in the past 20 years. The SFC will continue to partner with the HKSI to enhance competence standards in the market.

Thank you.