

Addressing Misconduct in Capital Markets

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Good morning. It's an honour to be invited to the 2018 Refinitiv Pan Asian Regulatory Summit to deliver this keynote speech.

We live in a time of great promise and great peril. New technologies are having a profound impact on the sciences as well as businesses and economies. The rapid development of artificial intelligence and machine learning has changed the way financial firms provide customer advice, how trading orders are executed and how regulators conduct surveillance. This is not a gradual evolution — it's a revolution.

In the midst of rapid technological and financial innovation, it's easy to forget that economic development is predicated on fair and efficient capital markets. So I thought this would be an opportune time to reflect on the basic yet essential role that market regulators play in tackling misconduct in capital markets and how that ties in with our current regulatory approach at the Securities and Futures Commission (SFC).

Importance of regulating capital markets

A decade on from the Global Financial Crisis (GFC), it is worthwhile to reflect on how a combination of misconduct and excessive risk taking can destroy trust and prevent markets from functioning properly.

The sub-prime mortgage crisis in the US had its roots in lax underwriting standards and risky lending which fuelled a housing bubble. Banks repackaged poor quality loans via the securitisation process. Flawed credit ratings were assigned to complex products and they were mis-sold to investors as high-credit-quality securities.

When the US housing bubble finally burst, global financial institutions suffered crippling losses on their balance sheets. Confidence deteriorated and interbank lending seized up. The evaporation of public trust led to bank collapses and rescues in the UK and the US.

More recently, failures of peer-to-peer lending platforms in mainland China were triggered by a series of high-profile scams coupled with tightening credit, liquidity and regulatory conditions as authorities reined in excessive lending after years of explosive growth.

Note: This is an expanded version of the speech Ms Leung delivered.



These are stark reminders of the need for regulators to tackle fraud, excessive risk-taking and misconduct in capital markets.

As a regulator in an international financial centre, the SFC is charged with maintaining and promoting the fairness, efficiency, competitiveness, transparency and orderliness of the securities and futures markets. But as both a conduct regulator and a prudential regulator, our objectives are not limited to safeguarding the interests of investors and minimising fraud and market misconduct. Our role also extends to maintaining Hong Kong's financial stability and mitigating systemic risk. I'll now talk about the characteristics of capital markets that give rise to misconduct and how the SFC addresses it.

Characteristics of capital markets that give rise to misconduct

Recently, the FICC¹ Markets Standards Board (FMSB) published a fascinating study of "Misconduct Patterns in Financial Markets." The study examined 390 cases from 26 jurisdictions, spanning 225 years, to identify the causes of misconduct. It found that misconduct has been similar across time, asset classes and jurisdictions. In other words, there is a core set of underlying behaviours which recur over time. These patterns also have a tendency to adapt to both new technologies and market structures.

Twenty-five specific patterns of misconduct were identified and these can be classified into seven broad behavioural categories: price manipulation, wash trading, improper handling of client orders, misleading customers, manipulating reference prices (such as benchmarks), trading on inside information and collusion.

The FMSB report cited a case in US in 1929 when the president of a listed company used dummy accounts he and his associates controlled to conduct wash trades. What is the modern day version like? In Hong Kong, China AU Group Holdings Limited issued convertible bonds in 2009 to finance an acquisition of Mainland property. Its then-CEO and her two associates opened 14 securities trading accounts in various names. The SFC alleged that the former CEO funded these accounts to trade China AU shares to create a false and misleading impression of active trading so that the fundraising exercise would appear more attractive to potential investors. In August, the Market Misconduct Tribunal found the former CEO and her two associates culpable of false trading.

Understanding misconduct and the behavioural patterns behind it helps us design a more robust and effective control framework. It also reinforces the industry's collective memory. New joiners who have no experience of prior failings are made aware of them.

So what are the characteristics of capital markets that enable misconduct to occur in the first place? Well, we've actually touched on some of them already.

First is the age-old problem of conflicts of interest.

When discussing the GFC, I alluded to credit rating agencies which were incentivised to assign higher credit ratings to debt instruments to win more business. In capital markets, there are inherent conflicts of interest in the way firms operate. Whether as market makers or as sole proprietary traders, they may be trading as an agent for clients or as principal. Their

¹ Fixed income, currencies and commodities.



interests in price movements may conflict with those of their clients, opening the way for possible misconduct.

For example, when transacting for clients as agents in opaque markets, they may hide and retain any price differences behind obscure fees and charges. The SFC reprimanded Societe Generale in July 2012 for failing to disclose that it retained the difference between the actual transacted price and what it charged clients for over 3,000 secondary market transactions in over-the-counter (OTC) bonds, options and structured notes. As part of the resolution of this case², Societe Generale, without admitting liability, agreed to reimburse affected customers with interest. It has since taken steps to overhaul its systems and procedures to be fully compliant.

The opacity of OTC trading makes it relatively easy to charge mark-ups or spreads to unsuspecting clients. This opacity and the complexity of some of the financial products traded over the counter impede effective market surveillance by regulators and make it more difficult to detect misconduct such as manipulation, mis-use of information, front running and collusion.

Next, let's mull over the lack of senior management accountability. No doubt we've all seen the prominent news coverage of *firms* being taken to task and fined for misconduct.

But even when charges were brought against individuals, senior management deflected attention from their own failings during the GFC and laid the blame on rogue traders. Very few senior executives were prosecuted. It's not difficult to see why the public and even the individuals concerned have the false impression that senior management or star employees are not personally liable for misconduct.

Finally, as I alluded to earlier, financial innovation, particularly automation and algorithmic trading, heightens misconduct risk by magnifying existing concerns and introducing new ones. By enabling more transactions to be conducted even more quickly, automation makes it even more challenging for regulators to monitor and analyse the huge volume of trading data as well as to ensure that market integrity is maintained.

Questions have been raised over the role of automation and algorithms in flash crashes such as the one in August 2015 when the S&P 500 fell 5% within minutes of opening. Some commentators argued that market volatility was exacerbated by high-frequency trading and market makers holding back liquidity because their computer models malfunctioned or shut down.

The SFC's regulatory approach

But are we doomed to repeat the mistakes of the past? Are market misconduct, excessive risk taking and the cycles of boom and bust going to stay with us? Is the notion of stopping misconduct in capital markets a lost cause?

Of course not. Alice in Wonderland has to keep running just to stay in the same spot in the race with the Red Queen. We regulators have to do better — to keep running a step ahead of the bad actors. We need to adapt to the times and arm ourselves with the appropriate technologies, data and methods to combat misconduct more effectively with the resources at our disposal.

² Under section 201 of the Securities and Futures Ordinance.



Throughout history bad actors have exhibited the same behaviours and recycled the same old tricks. So the SFC aims to drive and mould good conduct to achieve the desired regulatory outcomes. Rather than letting potential issues fester and morph into more serious problems later on and then using our enforcement and disciplinary powers to deal with the fallout, our tactic is to pre-empt them. This means adopting a front-loaded regulatory approach whereby we intervene at an earlier stage with targeted actions designed to achieve a quicker, more impactful outcome.

Before I go into more detail, I want to clarify that enforcement still has an essential role as a regulatory tool for deterring bad behaviour. My colleague Tom Atkinson will speak here tomorrow on the role of enforcement. However, disciplinary action is not *the* panacea, and it takes time. The point is, no single regulatory function can address today's complex misconduct risks.

We need to pool our regulatory expertise and industry knowledge to home in on nascent issues and tackle misconduct in a coordinated, holistic manner. That's why we've adopted the "One SFC approach", so that we can put our heads together to unmask the masterminds, unravel ulterior motives and hidden agendas and expose linkages among the connected parties behind misconduct.

Misconduct in the listed market

Two years ago, we formed a multi-disciplinary project team called ICE after the first letters of our Intermediaries, Corporate Finance and Enforcement divisions. The team's objective was to identify patterns of misconduct that aims to manipulate stock prices, rig shareholders' votes or scam minority shareholders. Even though the so-called "con stock" activities involve a small number of listed companies, the reputation risk for Hong Kong is not small.

The ICE team's strategy has had tangible results. An early success was against price manipulation of GEM shares. There was a pattern: high concentrations of GEM shares were placed with a few shareholders, with 10% or less suspected to be distributed among a number of nominees. On the first day of listing, prices soared multiple times³ only to fall flat later, suggesting a pump-and-dump scheme.

In response, the SFC and Hong Kong Exchanges and Clearing Limited issued a joint statement⁴ in January 2017 which detailed our regulatory concerns⁵. The SFC concurrently issued a guideline⁶ to sponsors, underwriters and placing agents involved in the listing and placing of GEM stocks. Following our intervention, the average first day price change of newly-listed GEM stocks immediately dropped to a more normal level of 20%, where it has since remained.

ICE also took on the dubious market activities associated with shell companies. Our response was clear – better gatekeeping at both the front gate and the back gate. In cases where we suspected that listing applicants reported seriously inflated sales figures, the SFC exercised its

³ The average first day price change of GEM listings was over seven times in 2015 and five times in 2016.

⁴ Joint statement regarding the price volatility of GEM stocks, 20 January 2017.

⁵ We were concerned that these market practices undermined the GEM Listing Rules and prevented an orderly, informed, fair and efficient market in GEM stocks to develop.

⁶ Guideline to sponsors, underwriters and placing agents involved in the listing and placing of GEM stocks, 20 January 2017.



power⁷ to query the listing applications, which were subsequently withdrawn. In cases where vote rigging was suspected, we invoked our power to order suspension of trading in the shares⁸. In 2017, around 40 cases involved the actual or potential use of these powers, compared to only two or three such cases in prior years.

We also put sponsors in the spotlight. We identify sponsors with a history of having their sponsored listings rejected because of substandard work. These sponsors have a higher chance of being inspected by us. If our supervisory inspection identifies poor quality sponsor work⁹, we open an enforcement investigation.

Our recent inspections uncovered a worrying trend of intermediaries concocting convoluted arrangements to either conceal the identities of the beneficial owners of securities or cloak their true intentions, such as to engage in margin lending. Firms should not facilitate market misconduct by making “nominee” or “warehousing” arrangements for their clients. To protect investors and maintain the integrity of the markets, the SFC will not hesitate to take stiff enforcement action against the perpetrators as well as the firms and individuals who participate in such arrangements.

Our intervention tools also include requiring immediate rectification of bad behaviour, imposing licensing conditions or issuing a restriction notice on the intermediary to limit or, in extreme cases, to prohibit some or all of their regulated activities to mitigate and control the risk. We’ve adopted similar approaches to manage the risks posed by persistently loss-making but thinly-capitalised brokers who struggle to meet their minimum liquid capital requirements.

Misconduct in the wholesale market

Let me now shift to the decentralised wholesale market. As discussed earlier, inherent conflicts of interest coupled with a lack of transparency is a recipe for misconduct. That’s why globally, this issue is most taxing to conduct regulators. The SFC Code of Conduct¹⁰ requires intermediaries to disclose material interests or conflicts to the client. The client’s best interest is the overarching principle.

While this seems like a simple rule to follow, firms sometimes conflate their principal roles and their agency roles. We have made this the theme of a joint inspection we conducted with the Hong Kong Monetary Authority (HKMA). The HKMA examined the wealth management unit of a bank that sourced in-house products as agent, and the SFC inspected the books of the securities unit in the same banking group that sold the products as principal. We are able to identify conflicts of interest by examining both ends of the same transaction.

Thematic reviews allow us to deploy our limited regulatory resources to increase our touch points with intermediaries on specific risks identified from our intelligence gathering and monitoring activities. This helps focus our risk-based supervision on imminent, high-impact issues. In the past two years, we completed five thematic reviews on conduct issues in capital markets¹¹.

⁷ Under Section 6 of the Securities and Futures (Stock Market Listing) Rules.

⁸ Section 8 of the SMLR gives the SFC the power to order suspension of trading in the shares of listed companies.

⁹ For example, not following up on obvious due diligence red flags or a lack of professional scepticism.

¹⁰ Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission.

¹¹ These reviews covered algorithmic trading, alternative liquidity pools, best execution, client facilitation, distribution of fixed-income and structured products. Reviews on prime broking and book building are continuing.



Innovation and technology can help the industry improve performance but it can also amplify the risks in capital markets. Quant funds have long employed algorithms to execute large orders to achieve particular statistical benchmarks, such as Value Weighted Average Price. Algorithmic programmes now use a vast number of hidden layers to process large, unstructured data sets to drive investment decisions. These programmes may be too complex and hard for humans to comprehend.

I was once asked this question at a forum — as machines replace humans, what handle do we have over machines to control the risks? The answer is simple. If a computer algorithm goes awry and runs rampant, the SFC can't exactly arrest the computer or bring it in for questioning, as fun as that may sound. Our regulatory handle is over the operator, and to hold senior management responsible for implementing a robust governance structure and appropriate policies and procedures with effective controls to ensure reliability, data protection and security.

This brings us to the final issue of senior management responsibility, which is our response to one of the causes of misconduct discussed earlier. We introduced the Manager-In-Charge regime in 2016 to reinforce the message that senior management are responsible and accountable for fostering good conduct and behaviour. Let there be no doubt — we will vigorously pursue individuals culpable for misconduct.

Before I conclude, I want to go back to what I said about the SFC leveraging technology to enrich our market surveillance and intelligence. To improve the effectiveness of our gatekeeping function, the SFC has embarked on a strategic effort to more closely track bad apples involved in misconduct and to keep bad actors out of the market altogether. New initiatives help us collect and analyse data as well as to more easily identify and visualise the relationships between firms, listed companies and individuals. To enhance our market surveillance, we also use big data processing techniques to analyse trading information. Those who exploit technology should be aware that the SFC is also leveraging technology to make sure that they have no place to hide.

Conclusion

Ladies and gentlemen, 10 years on, it's more important than ever to remember the lessons from the GFC. While misconduct appears throughout the ages in various forms and guises, the behavioural patterns always remain the same. In this rapidly changing world, on the cusp of revolutionary breakthroughs in financial technology, it seems the adage "the more things change the more they stay the same", still rings true today.

But one thing that has not changed is the SFC's steadfast determination to keep our capital markets clean. The bad actors are on our radar and we will do whatever it takes to prevent them from harming our markets. Hong Kong is open for business, but not at any cost. That's why the SFC has shifted to a front-loaded regulatory approach. The examples I cited today demonstrate the positive impact that this new approach has had, as well as the SFC's resolve to tackle misconduct.

Thank you.