Integrity in Financial Markets and SFC's Enhanced Supervisory Approach
HKSI Institute's SFC Executive Director Series

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5 March 2015

Thank you—it is an honour to be here today.

Today, I'd like to follow up on the Institute's very successful Business Ethics Forum in January as I want to keep the momentum up in relation to the ideas generated at that event by sharing a few words with you on how market integrity fits into good business ethics. I also want to speak about how each of you can play a critical role in upholding our market's integrity.

You will be pleased to know that this speech is not intended to go over old ground and cover points that I believe have already been very well made, particularly at the Forum. Instead, what I hope to do in my remarks is adding, to begin with, some further analysis and suggestions in order to move this topic from rhetoric to reality.

I would also like to explore what the SFC is doing to enhance its supervisory approaches to this end.

Market integrity: Underlying principles

To start with, we need to reflect on what we actually mean by *market integrity*. We use this and other very similar terms a great deal without necessarily stopping to reflect on their meaning and their ultimate importance in effecting confidence in our markets. Unless we determine what market integrity means, arguably we are not going to realise it.

According to its definition the noun *integrity* has two meanings or connotations:

- The first is "the quality of being honest and having strong moral principles"—and this was much discussed at the Business Ethics Forum.
- The second is "being whole and undivided".

To me the first limb of *honesty* and *morality* connotes strong *human* elements; whilst the second limb connotes *structural* concepts.

Accordingly the word's flexibility and nuance make it perfect for applying to financial markets. Particularly since the challenge facing us today has both *human* and *structural soundness* elements.

In this respect the flexibility and nuance of the word, when applied to financial markets, means that *each* limb of the definition must apply for *both* to exist. In other words *honesty* *and morality* (including ethical values) and *structural soundness* are mutually dependent. Accordingly I have come to the view that unless each and every component of the market is *acting with integrity*—ie, acting honestly and ethically—you cannot have *structural soundness* nor can you have that all important *confidence* in the markets.

This important, if basic, starting point means that the entire market ecosystem needs to be working to the common goal of market integrity. In financial markets, like a well, it only takes one drop of poison to contaminate them. Accordingly it will take the entire market, and each individual participant, to play its part.

This is where the first of my key observations about the "integrity challenge" is crucial. I have heard all too often from one segment of the financial markets that it's another segment's problem. I have also heard that it is a problem of particular geographies or countries. In Asia Pacific, it has been said that it is a Western Hemisphere problem. I have even heard people in one firm saying that the problem rests in another division of that very same company!

The reality of course is that to a greater or lesser extent it's *everyone's* problem. And unless and until we get this mindset imbedded in each and every component of the financial market, we will be handicapped. This concept has recently gained momentum with the anecdote about focusing on the *barrel* and not just the *bad apples*.

Market integrity: Addressing standards of behaviour and firms' conduct and culture

Having established that the structural integrity of our markets requires *honesty* and *morality*, it is then vital to determine how we can achieve this.

Fortunately a good diagnosis is well-established and well-articulated with many important reports, surveys and speeches concluding that *culture within our industry* is at the heart of the integrity problem—I would actually go a step further and say—*culture is the problem*!

The points and arguments on the necessity of a constructive culture in the financial markets have also been forcefully and, in my view, successfully made – including a *Financial Times* editorial that very recently said:

"Trust in banking goes beyond the actions of a few rogue traders to the very heart of its culture. An industry that is meant to serve the wider economy is regarded as greedy, irresponsible and even criminal.[1]"

Accordingly I do not need to make the case further except to say that there is one statistic that sticks in my mind from the many fine commentaries and that is Martin Wheatley's 2013 observation, in his "Fairness challenge" speech[2], that the *number of rules* actually *increased* during the "breeding ground" of some of the more recent scandals. Martin is correct to observe that rules, sitting in *isolation*, will *not* bring integrity to our markets.

Culture in financial firms

I hope to supplement and support such well-made points by taking another step back and asking the question: *what is the basic concept behind all the cultures that have been talked about, including the "obedience culture", "compliance culture", "risk culture", "ethical culture" and so on*?

[1] *Financial Times*, "How bankers are paid is now everyone's business" (18 November 2014).
[2] Martin Wheatley, "The fairness challenge" (Oct 2013).

To me these are all important variants of one fundamental concept that has been reinforced by other industries, often like ours, after traumatic events—namely the need to imbed a *safety culture*. The financial industry also needs to adopt a safety culture. This does not mean that risk taking should be abandoned—far from it—instead risk taking should be accompanied by detailed and deliberate planning rooted in a culture of safety. One only has to think of the airline industry to realise that a culture of safety is absolutely paramount—it is also a very good business.

A key observation is that while other industries have made considerable progress in embracing a "safety culture", the financial industry has not followed to the same degree. In fact one study[3] by a consulting firm found that the *risk cultures*—a variant of safety culture—in *financial services organisations are five to 10 years behind* the oil and gas and mining sectors.

In the spirit of learning from other industries I also found a study on the milk industry in the book The *Economics of Integrity* fascinating. The author points out that it is remarkable that for a single bottle of milk to safely reach the kitchen table, thousands of people along the production chain—from the farm to the milk processing plant—must act with integrity and trust each other to "do the right thing". Yet it is done every day, not necessarily because of rules, but because of *economic value of integrity* and because it is seen as a *relationship* that provides mutual benefit to each participant. It is also recognised by the dairy industry that the flip-side—a milk tainting scandal—would catastrophically "poison the well" for every market participant.

I have also been influenced by the lessons learned from the NASA Challenger and Columbia disasters and I have been encouraging firms to use these powerful case studies in their efforts to promote cultural change. These case studies illustrate the literally disastrous consequences where "normalisation of deviance"—or normalisation of known flaws—becomes acceptable over time within the culture of an organisation. This normalising influence ultimately caused the catastrophic shuttle disasters that led the official report[4] to conclude that "cultural traits and organisational practices detrimental to safety and reliability were allowed to develop". The report went on to say that economic pressures turned the highly technical culture of NASA into a more process-oriented "culture of production".

Cultural drift

On this point we have to acknowledge that organisations, including financial corporations, are susceptible to *cultural drift*. In fact the International Monetary Fund (IMF) has pointed out in their recent *Global Stability Report*[5] that the *tendency* for corporate culture to drift may be more evident with financial firms since "corporate culture plays an important role in banks because to a much larger extent than other sectors, bank employees often face decisions in situations for which rules are ambiguous or allow for discretion, which may lead to an expectation that bad behaviour will go unpunished and good behaviour unrewarded."

Corporations are *not* static bodies, their cultures and "DNA" evolve. Steven Mandis, in his book[6] about organisational drift in the financial industry, warns of firms incrementally moving

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[3] Oliver Wyman, *Getting to the heart of risk culture within financial services* (2014).
[4] Report of Columbia Accident Investigation Board (2003).
[5] IMF *Global Stability Report* (October 2014).
[6] Steven G. Mandis, *What happened to Goldman Sachs: An insider's story of organizational drift and its unintended consequences* (2013).

away from their intended culture often in destructive ways. He also warns that this slow drift often goes unnoticed unless direct and deliberate control is taken to guide that evolution.

Mandis points out something that I subscribe to and that is that the financial industry, both collectively and individually, has over the years surrendered an *ethical standard* for a legal one. Our industry's needs are better served by applying an *ethical standard* because it will go a long way to bridge the *trust deficit* facing the industry as well as to provide a "behavioural buffer" that will protect firms from both legal and reputational risks.

Why is this important?

In addressing why all of this is important I will again refrain from restating the arguments for getting better outcomes for investors and consumers as well as the need to minimise the conduct scandals that are a blight on our industry. Instead I would like to highlight that ensuring market integrity, and the related challenge of restoring trust in the entire system, is fundamental to both *market stability* and *economic growth*.

The point about market stability is echoed in a European Securities and Markets Authority (ESMA) report[7] last year on risks and vulnerabilities. ESMA highlights that *business conduct directly impacts market integrity* and is *urgently in need of repair to restore public trust in the financial system*. ESMA's view reinforces the notion that unless we address conduct-of-business issues, the financial system as a whole remains at risk and we cannot be confident in the structural soundness of our markets.

Obviously, cultural and behavioural problems are not unique to the financial industry. Nevertheless they can be disproportionately more detrimental to the health of the economy. The London School of Economics has made this quite clear in a research report on risk culture at financial organisations, emphasising that "cultures of organisations in no other sector have the ability to affect the economic health of nations in such a significant way as that of financial services.[8]" This is why a safety culture needs to be adopted by the finance industry.

From a market stability perspective, building an open, global financial system *requires trust*. Trust must be rebuilt at all levels, or using the words of Mark Carney, we must re-establish: "Trust between financial institutions. Trust between regulators. Trust between industry and finance. And most fundamentally, trust between the public and the financial system.[9]"

It is also vital to recognise that despite all the efforts and initiatives we are a long way from where we need to get to. And if I were to diagnose the challenges I would suggest that one symptom of poor market integrity is the lack of confidence in the market and in market participants. The fact that this confidence continues to be eroded means that the problem is actually getting bigger, not smaller, for the financial sector.

[7] ESMA: Joint Committee Report, *Risks and Vulnerability in the EU Financial System*, Chapter 5: Risks from deteriorating conduct of business (March 2014).
[8] London School of Economics, *Risk Culture in Financial Organisations* (2013). p.14.
[9] Mark Carney, Speech at 29th Annual G30 International Banking Seminar, *Regulatory work underway and lessons learned* (12 October 2014).

In turn, deteriorating trust in the financial industry threatens market integrity. Again, benchmarking finance to other industries is instructive and an IMF report[10] recently showed that compared to other non-bank sectors (such as pharmaceuticals, utilities and food production), dissatisfaction with the financial sector is at an all-time high.

What next? Meeting the challenge

As I mentioned earlier we have been aware of the cultural challenge for some time and have applied energies and efforts to address it. The problem as I see it is that we need to turn the *rhetoric into reality*. I also believe we must acknowledge that there is a degree of what I call *regulatory fatigue* setting in and that some within the financial industry are just waiting to return to "business as usual" once regulators and policy makers tire of regulatory interventions.

To this end Daniel Tarullo, a Federal Reserve Governor, framed the issue very well in an aptly titled speech *Good compliance, not mere compliance*, in which he identified a "mere compliance" mentality and a hope by firms that regulators will move on swiftly after applying a "quick fix".

So we have to go deeper. We have to realise that it is not just a job for the board and senior executives and that "tone from the top" is a good start, but not enough. Indeed we have to realise that the task even goes further than recognising the importance of tone in the middle. We also have to realise that this challenge is relevant to each and every employee and requires attention throughout the entire life cycle of employment.

This point really came home to me when I was going over the SFC's mystery shopping programme findings report that we issued last December. It is still very clear that *at point of sale* the message has not yet gotten through to people actually doing the sales and we are a long way from the types of conduct required under the law, let alone by social norms. Sales people are still not demonstrating the qualities that we, and indeed their boards, expect of them. The rhetoric is not becoming a reality.

In particular there is not enough professionalism being exhibited—that is there is not enough of both *skill* and *conscientiousness*—the two qualities that define professionalism. This means that there is still a great fault line in our markets. And if we have a fault line we cannot have the *structural soundness* that, as I mentioned earlier, is a crucial component of integrity.

In the end I have concluded that we need to apply a well-used financial services sales mantra to the financial integrity challenge—namely that it will take *the delivery of the entire firm* to do this properly. This challenge requires an *all of firm* and *all of market* approach. Patches and quick fixes will not be enough. Isolated and imprisoned "tones" will not get us to where we need to be. Only when there is an *entirety* in approach will we see movement in the right direction.

Again, this is where the definition of *integrity* is crucial—the definition requires a state of being *whole and undivided*. Accordingly there must be an undivided and whole awareness and commitment by all to act with integrity.

[10] IMF *Global Stability Report*, Chapter 3: Risk-taking by Banks: The Role of Governance and Executive Pay (October 2014). Figure 3.4.1. p.129.

This will take a renewal in thinking to achieve. For example we all use the expression "tone from the top" and now "tone from the middle", with great frequency. We need to go deeper and articulate exactly what we mean by these expressions. For me it means that business leaders at *all levels* need to take *real ownership* and *real responsibility* for achieving market integrity. It is *not* someone else's responsibility. Neither is it the sole responsibility of the board, or of the risk manager or the compliance teams. It is the responsibility of *each and every person in a position of authority* in a financial firm. And on this point I believe that further work needs to be done by both the industry and the regulator in relation to further articulating what we mean by senior management responsibility.

I know there is a broad spectrum of firms represented here today and I wanted to take the opportunity to emphasise that this is not just a challenge for the larger financial institutions, but also for smaller firms.

Achieving a good corporate culture is arguably both harder and easier in smaller firms that are often characterised by an easily identifiable and very personified leadership structure of a key person or persons. These principals can, and do, influence—if not dominate—the culture and conduct of the firm.

To this end I was struck by an extreme example when watching the PBS documentary, *To Catch a Trader*, to see video excerpts of a deposition given, under oath, by Steven Cohen who was unable to answer, even in basic terms, what was expected under his firm's compliance and code of conduct manual as regards the treatment of material non-public information. This, again extreme, example evidenced to me that if the principal of a very personified firm like SAC could not appropriately understand the "rights and wrongs" around material non-public information, then the rest of the organisation could not be expected to either.

Moreover, his apparent lack of *leadership* and *ownership* of this important topic by the principal of the firm meant that others did not need to *lead* and *own* these important issues. In this sense "tone from the top" is even more important in smaller organisations since there are, by definition, fewer men and women "at the top" and thus their action—or inaction as the case may be—is more *amplified* than in a larger organisation.

Whether we are dealing with a smaller firm or a larger firm ultimately we need to create a *market ecosystem* where there is a self-reinforcing culture of adherence to high ethical standards by *all* market participants. Integrity of the market is an ecosystem-wide challenge —if one organisation does not do it properly, the entire market is unsound—again it only takes one drop to poison a well.

Accordingly the industry has a responsibility of looking for ways and means to create a virtuous cycle of heightened expectations and professionalism rather than the current stand-off that is leading to a decline in trust and standards of integrity in the market.

One practice that the industry should employ more of, but which has gone out of fashion, is "cold shouldering" by market participants *themselves*. Firms should lose their "social licence" and legitimacy, before losing their literal licenses to operate. If a firm knowingly does business with another that is lacking in integrity it is, at best, helping to transmit that lack of integrity throughout the market and, at worst, condoning that behaviour.

A virtuous cycle is crucial to achieving integrity in our markets. I genuinely hope, as Martin Wheatley recently said, that "All around the world, reform of conduct is dominating industry—to the point that we're seeing financial centres actively competing on issues like market integrity and cleanliness.[11]"

Consistency of messaging

On the theme of turning rhetoric into reality—the industry needs to look very carefully at the implicit signals they are sending, especially internally, by their actions, statements and policy positions. Whilst it is important that the industry engage robustly in the policy debates surrounding regulatory reform, it is crucial that they avoid sending "mixed messages" with their responses that, in effect, "arbitrage" or "cleverly avoid" rules. This is another manifestation of a surrender of an ethical standard for a legal one.

An example is this: on the one side, the board of directors can say that they are introducing a tone from the top saying employees need to do the right thing and must abide by both the letter and spirit of the law. But then the very same board institutes a workaround for bonus caps or the extraterritorial application of a regulation. Firms need to be careful: they are sending an implicit but very strong message to their employees that "we can work around the rules, but you can't". If nothing else this undermines their rhetoric and their efforts.

Importance of incentives

Of course the elephant in the room here is compensation and incentives. Too often I have heard from the industry that people need *not* be incentivised to "do the right thing" since that is what is ordinarily expected of them. If that logic were true, then financiers need not be incentivised to perform better and bonuses should be done away with entirely. I am all for a performance culture—but high integrity needs to become a core component of that "performance".

Again, it is worth getting back to basics—*incentive*, in its ordinary meaning, is defined as *encouraging action or effort*. I believe that there is not enough focus on incentivising—that is encouraging—high integrity in markets and an overreliance on disincentivising bad behaviour. Punishment and deterrence only goes so far—the proverbial stick needs to be combined with the carrot.

Accordingly we should consider creative solutions relating to incentives—as Governor Carney recently said "fundamental change is needed[12]" to compensation arrangements. Long-term incentive solutions such as the "performance bond" mentioned by William Dudley or clawing back into fixed pay mentioned by Mark Carney should be evaluated by the industry.

We also need to recognise that our industry is, by definition, a quantitative one. This means that for effective incentives to be put in place we have to have supporting metrics and language. In fact *the language* of the market needs to change. It needs to evolve away from being a language dominated solely by terms such as *P&L*, *comp*, *wallet*, and so on. Instead metrics, and the resulting terminology, that captures high integrity needs to enter the industry's vocabulary.

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[11] Martin Wheatley, *Good Conduct and Market Integrity* (June 2014).

[12] Mark Carney, Speech given at Monetary Authority of Singapore, *The future of financial reform* (17 November 2014).

Language reflects thought and thought reflects values and culture. So the language of finance really needs to evolve to represent a cultural transformation that will evidence improved integrity in our financial markets.

Take for instance the pervasive use of sporting metaphors in our industry - *best athlete*, *home run*, *out of the park*, *own goal*, *foot faults*, *ace* and so on. Competition is healthy but, of course, we need to ask ourselves who firms are competing with. If they are competing with their peers then this is okay. But if they are competing with their clients, or using this language in relation to those clients, then this is a concern.

Importance of diversity

On a related point I want to share with you another observation: when I was reflecting on the latest forex rigging scandal, particularly when I was reading the transcripts of the chatroom conversations, it struck me that this was an all-male group that had very deep-rooted cultural loyalties to each other in the form of quote “the Cartel”. It was very clear that this was a male-dominated culture that directed its loyalty exclusively to its members and not their employers, their clients or indeed the integrity of the market.

I wondered whether the outcome may have been different if there were more women in senior leadership positions on the forex desks of the affected firms…? I then thought of the existing laudable efforts of encouraging diversity and women leadership in finance by firms themselves and by associations in Hong Kong like Women in Finance and the Women’s Foundation.

Perhaps it is worth investigating how we can combine the initiatives that seek greater diversity (and not just in terms of gender) with efforts around cultural renewal so that they intersect to provide for not just better diversity in finance but also better corporate cultures and thus outcomes for investors and the market.

Role of training and industry bodies

Another important realisation is that for industry participants to be professional, to act with integrity and to have an ethical base, they need to be led and guided in this regard. Again this is where the organisational culture and leadership of a firm is fundamental. What is also fundamental are mechanisms that remind and reinforce the expected values and behaviour of industry participants. We cannot just rely, as some people have said to me, on the fact that industry professionals should automatically know what’s right. Moreover, we cannot outsource this entirely to the regulator.

Unfortunately we cannot take the awareness and realisation that everyone in our industry is aware of the basic requirements to act in the best interests of their clients and for the integrity of the market. This point is reinforced by the forex scandal which was still going on, and continued to go on, at the very time the LIBOR scandal was on the front pages of the newspapers. We cannot therefore take it for granted that everyone sees “right and wrong” clearly—often people are wilfully blind, have rationalised their behaviour or are just plain ignorant. Accordingly our combined responses must account for these not uncommon traits of human behaviour.

As I mentioned earlier, the value set of organisations can drift without a deliberate strategy. And a key part of this strategy is training, both formal and informal, to remind and reinforce the values of a firm and to ensure that its culture evolves in the right direction.

Here there is an important role for industry bodies like the HKSI to both set standards and values for market participants and also to deliver knowledge and training, like the Business Ethics Forum, to put those standards into effect.

One idea that was discussed at the Forum that I found of interest, and perhaps the industry should explore further, was the Banking and Finance oath that a number of markets are adopting, including Australia[13]. I also know one leading firm in Hong Kong who asks their employees on an annual basis to review and restate verbally the firm's values. Many professions have an oath—doctors take an oath that has its origins in the Hippocratic Oath (although, interestingly the exact phrase "first do no harm" is no longer included and was in fact not Hippocrates' words, but those of a 19th century surgeon Thomas Inman). Lawyers have an oath and even politicians do[14]. Again, this is something the industry should explore.

Our regulatory response

Turning to what we at the SFC are doing and thinking:

On the issue of integrity, ethics and leadership, we are exploring ways we can further clarify our expectations on industry participants in these important areas. We also need to explore whether the current mandatory CPT regime is meeting the challenges I have just mentioned. And it's worth pausing here to remember what CPT stands for—continuous *professional* training. In other words CPT exists to promote *professionalism*.

As regards our supervisory work, we have broadened our supervisory approach to focus not just on the traditional control systems, but also on the "control culture"—that is, the *culture and leadership dimensions of firms*.

Accordingly we are applying a more *judgment based* and *forward looking* approach to supervision. This means that we will be looking at the "sum of the parts". All too often there is a temptation to explain away individual incidents without seeing, when taken together, what they are saying about an organisation and its control environment and control culture. Firms need to join the dots when they come to reviewing their control environment—we are doing this and so should you.

This means we will examine the "root causes" of decision making, conduct and behaviour at firms—that is, looking beyond the *mere existence* of a compliance or control framework to see if it has a supporting culture. It is no longer enough that firms merely provide the *existence* of a control system, but need to proactively demonstrate that it is *effective* and working in practice. Accordingly, we expect firms to move away from a "tick-box" approach to compliance and controls.

We will look to see what issues and incidents inside firms, collectively and individually, say about the level of *senior management responsibility and decision making processes*. Thus we will pay close attention to the effectiveness of decision-making structures and take a close look at whether market participants are properly defining their management structures including recognising the important role and *responsibilities* of their board of directors.

[13] http://www.thebfo.org/The-Oath/The-Oath

[14] http://www.legislation.gov.hk/blis_ind.nsf/CurEngOrd/FA34A3AD0C3D3AAEC82564800040DD44?OpenDocument

We will also be looking at ways of further clarifying General Principle 9 of the Code of Conduct for Persons Licensed by or Registered with the SFC which squarely places the responsibility for ensuring the maintenance of appropriate standards of conduct and adherence to proper procedures on the senior management of firms. As a consequence, we are stepping up our interactions with Hong Kong-based boards and regional senior management to ensure that they are actively engaged in shaping the firm's culture and behaviours at the regional and Hong Kong levels.

We are also increasingly looking beyond the individual licensed firm in Hong Kong to its broader group to better understand the regional and global picture. The reality that we face when supervising licensed firms in Hong Kong is that many of the key business, risk and compliance decisions are often made outside of our borders.

As a practical measure, we are also asking firms like yours to keep us informed in "real time" of any issues arising from their global activities that may have—or are likely to have—a serious impact on the Hong Kong firm. We are driving home the message to firms that they should "minimise surprises" by proactively reaching out to us, which is also a way for us to gauge their level of regulatory cooperation as well as breaking down the "need to know" culture that exists inside many global firms.

Closing

So in closing, each of you has a vital role in trying to achieve market integrity and professionalism. This can only be achieved by firms, and individuals within those firms, *owning* these challenges and by industry bodies like the HKSI continuing to provide leadership and guidance in ethics, in integrity and in professionalism.

Thank you.