

“The Business of Securities Regulation”

**The Hong Kong Institute of Directors
2nd Anniversary and Fellowship Dinner
Hang Seng Bank
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Mr Chairman,
Distinguished Guests,
Ladies and gentlemen,

1. I am very honoured to be invited this evening to participate in your Second Anniversary Dinner. When I was first invited to speak, I had to refer to the Pocket Director, written by the eminent Professor Bob Tricker, who used to teach at Hong Kong University. His first words were:
2. “Being a director is one of the most challenging tasks in the modern corporate world. Once it was a sinecure: an occasional meeting with no real responsibility for a fee and maybe a lunch. Today directors are expected to perform. They are exposed to litigation and regulation. The spotlight has swung from management to the board. Managers run the business: directors ensure that is being run effectively and in the right direction.”
3. Lest you kick me out right away for being impolite to try and teach you your job, let me try this evening to say a few words about my job – the business of securities regulation and how our jobs intersect. Speaking to an audience of the calibre of the Institute of Directors has an irresistible challenge about it: one can be entertaining, thought provoking or boringly philosophical. Since I am no good at telling jokes, I shall repeat the only philosophical joke that I know. Confucius was reputed to have said: “Governance and regulation is like frying small fish: it must not be overdone”. Reflecting on this profound thought, it occurred to me that obviously Confucius has never tried frying sharks!
4. And in case you think I am being politically incorrect to the small fry, let me say that in the last two years of the Asian crisis, the regulators and the regulated all shared the same fate – I for one sometimes felt like a hairy crab – bound to be cooked!

5. Let me now get down to the serious part of the evening. As management experts, all of you would have heard the management guru, Peter Drucker's profound question on core competencies: "What business are you really in?"
6. What business is the Securities and Futures Commission really in? Of course, our mission statement says that we are in the business of regulating the securities and futures markets. There are three key objectives:-
7. ***Efficient, Fair and Transparent Markets***
 - Support the continued development of Hong Kong as an international financial centre, ensuring markets are open, fair, efficient, transparent and meet best international standards;
 - Minimize systemic risks by promoting sound risk management and internal controls by market participants and robust financial infrastructure
8. ***Public Confidence and Investor Awareness***
 - Promote confidence in Hong Kong's securities, futures and related financial markets through high quality of market participants, high standards of disclosure and appropriate protection for investors;
 - Advance public understanding of risks, rights and self-responsibility in financial markets
9. ***Sound Regulation***
 - Regulate Hong Kong's securities, futures and related financial markets firmly, fairly and efficiently, in a transparent and accountable manner;
 - Raise standards through effective surveillance and timely investigation of financial market misconduct and crime.
10. We regulate the securities and futures markets and those registered under the Securities Ordinance. Contrary to public perception, we are not the lead regulator of listed companies in Hong Kong – that is the job of the Stock Exchange of Hong Kong, which influences corporate governance through its Listing Rules. We are in fact the second line regulator in the sense that where listed companies clearly breach the Securities Ordinances in areas such as Insider Dealing and market manipulation, we have direct legal responsibility for investigation. Often, where criminal action is suspected, the investigation and prosecution of such offences is referred to the Commercial Crime Bureau of the Police and the Department of Justice.

What business are we really in?

11. Coming back again to Drucker's key question: what business are we really in? Certainly we are in the business of ensuring an appropriate regulatory and governance structure for the market in Hong Kong. We are in the business of helping to establish Hong Kong as a premier international financial centre. I can certainly go on and tell you more about our functions and objectives, except that I have a plane to catch tonight.
12. The answer must be: *securities and futures business is a service business*. And therefore, the regulation of the securities and futures business is also a service business. We do well if the securities business does well. In short, we need to walk the fine line between under-regulation, where the sharks can have a field day and over-regulation, which can inhibit market innovation and ultimately burden the market.
13. As all of us appreciate, globalization, technology and deregulation have brought huge competitive pressures to financial markets. Competition is intensifying in all products, services and markets, leading to consolidation, reform and strategic alliances, including in the exchanges. We are beginning to witness profound changes in the industry, as the traditional lines of finance: banking, asset management, insurance and retirement funds merge and blend. As these businesses become run on functional lines, the traditional regulatory jurisdictional boundaries by institutions have also become much more difficult to define.
14. Thus, just as there are competitive pressures on the financial intermediaries, there is also regulatory competition. No one is immune to market forces. Such competition comes in two forms. First, the regulatory process has to become much more cost efficient. Because financial institutions are pricing their costs more finely, they are also demanding that their regulators should also be more cost efficient, by delivering better regulations at lower costs. A recent survey indicated that the combined staff of the US's top ten federal and self-regulatory agencies amounted to more than 14,400 with an annual budget of US\$2 bn.
15. Market and public pressure means that regulators must engage themselves vigorously and constantly in cost benefit analysis. The IOSCO has begun work on the development of a framework for cost-benefit analysis of regulations¹, and the SFC is part of the Asia-

¹ The Asia Pacific Regional Committee (APRC) of the International Organisation of Securities Commissions (IOSCO) decided in 1997 to undertake a project on competition policy and securities markets regulation. In particular, the project was intended to provide the initial steps to develop a framework for cost-benefit analysis of regulations and regulatory proposals.

Pacific working group to look at the methodology for a meaningful cost-benefit comparative analysis.

16. Secondly, as financial centres increasingly compete with each other for global business, the quality of regulation has also become a factor in competitiveness. Regulatory arbitrage can occur both ways. Business could drift to some centres for regulatory laxity, preferring some offshore centres, for example, for tax and secrecy reasons. Other businesses may drift to those centres where the rule of law is clear and regulations are firmly, fairly and transparently enforced. *The service quality of regulation does count.*
17. As the former bank supervisor turned banker Brian Quinn, remarked recently on London's competitive advantage: "The [London] markets work as well as they do because the authorities are sympathetic, supportive and will step in when necessary – but only when necessary – to solve problems. Market practitioners from other countries like to live and work in London. They learn and, most important, feel valued for their work, partly because of the way they are treated by the supervisors and regulators. Lose those feelings because of a significant change over time in the balance between "regulation" and "supervision" and there is a real risk that other centres which can provide the infrastructure will steadily erode London's position²."
18. These are wise words indeed, applicable to any financial centre. In short, *for Hong Kong as an international financial centre and the leading service economy in the world (85% of GDP in the services area), financial service quality and regulatory service quality matters hugely in our competitiveness.*

Transparency, Accountability & Disclosure-based regulations

19. How do we determine that regulatory service quality? Because technology, financial innovation and globalization have added complexity to the regulatory game, financial regulators find themselves in a perpetual "catch-up" game.
 - First, regulators can never master the risks and rewards of hi-tech innovation that increasingly drive the financial markets.
 - Second, in attempting to give maximum protection to investors, there is a danger not only of moral hazard, but also adding costs to the market, and the cost impact on the regulator itself.
 - Third, the fact of life is that regulation and supervision can try to minimize financial crime and malpractice, but cannot totally

² Brian Quinn, "Will the FSA affect London's competitive advantage?" The Financial Regulator, September, 1999

- eliminate them. Regulatory judgement is no substitute for investors making their own judgements about the risks and rewards of investment decisions.
20. Thus, the international trend of regulation is to ensure investors can make informed decisions in a transparent and fully informed market. A disclosure-based regulatory regime is the wave of the future, and the basic trend in Hong Kong.
 21. Of course, market issuers and participants who have thus far benefited from asymmetric information may grumble about the costs of additional disclosure. As someone put it to me: “when the water is too clear, there is no fish to catch”. I thought the correct analogy should be: “when the water is equally muddy or clear to both the big and small fish, there will be an equal and fair market.”
 22. As the lessons from the Asian crisis proved, when there is investor ignorance about the risks inherent in financial products of companies or countries that they do not understand, they are prone to panic or quick exit, adding volatility to the markets. Increasingly, investors are becoming much more discerning about the quality of the companies and the regulatory framework of the markets that they invest in. They attach increasing importance to the timeliness, relevance, reliability, comparability and understandability of information disclosed by companies and markets.
 23. Transparency helps decision making, by making information about existing conditions, decisions and results more accessible, visible and understandable. Investors can then have sufficient information to identify risks and evaluate the quality of corporate and market governance. This imposes discipline on the decision-makers, including shareholders, management, board of directors and regulators, and makes them more accountable.

Risks, Rewards & Rules of the Game

24. By now, it should be clear that any fair, efficient and transparent market must have fair rules and firmly enforced. These rules must allow for the legal certainty in the exchange and transfer of property rights, and the rules must be enforced in a manner that does not allow one market participant to deprive any other market participant of their rights. In other words, not only must the market be fair, but also the incentive structure – the balance between risk and rewards – must be fair.
25. More important, the application of the rules of the game must be fair, and seen to be fair. This guiding principle determines our service quality. Financial markets was all about confidence – confidence about the integrity of information, intermediaries and market institutions, including the accounting, legal and regulatory

- framework. In short, confidence about the rule of law and the exercise of rule of law. This requires confidence about transparency, accountability and due process.
26. But how do you introduce rules when the nature of market itself, in terms of products, players and processes are in the midst of major changes? The answer is that there is a ladder of legality, escalating from general principles to codes, rules, subsidiary legislation and finally full-fledged law.
 27. When the market is still evolving, such as a new derivative product, it may be inappropriate to try and legislate regulations for such products. To introduce a certain degree of discipline while preserving the market's ability to innovate, the Commission may issue guidelines or statements of principles to provide the market with overall guidance and explain the Commission's regulatory approach to the new trends and developments. The Commission would look at the approaches adopted by leading markets or international bodies. Breaches of such guidelines typically do not carry sanctions. A good example is our Guide to Internet Trading, in which we recognize that the law and regulations to Internet trading is still evolving even in the recognized markets. By adopting general principles of market behaviour, we hope to foster Internet trading growth, without inhibiting innovation.
 28. When the market or product has begun to mature, self-regulatory Codes begin to evolve, such as codes of conduct and the Take-over & Mergers Code. As failure to follow the code provisions may directly impact on the fitness and propriety of a registrant carrying sanctions for non-compliance, the Commission would ensure that those who might be potentially affected are properly consulted and that their views are considered. A code allows for co-operative approaches in dealing with issues that are highly technical, less policy-oriented and requires periodic review.
 29. But neither guidelines nor codes have the force of law. To punish an offender in a manner that is proportionate to the gravity of his or her violations will require the satisfaction of legislation requirements. Rules and regulations with the status of subsidiary legislation would be subject to the necessary vetting by the Legislature, in addition to consultation with the market.
 30. The final level is primary legislation, whereby the provisions may also cast a wider regulatory net over all offenders, and not only persons registered with the Commission. It will require, as the present Composite Bill shows, market consultation, vetting by the Department of Justice and debate and approval by the Legislative Council. At each level, the Commission will be guided by best international standards and practice, suitably adapted for domestic conditions. This, together with market consultation, and an

ascending degree of legislative backing makes the regulation predictable and ensures maximum understanding and clarity, and therefore greater acceptance by the regulated.

Standardize, Educate, Comply and Enforce

31. However, getting the framework of standards, codes and legislation established, promulgated and publicly accepted is only half of the job. Once the rules have been set, they must also be communicated clearly and thoroughly to the market. The market participants must be told what is expected of them under the regulations, and the consequences of breaches, in spirit and in letter. Of course, ignorance of the law is no defence. Thus, the education process is indispensable, and one of the top priorities of the Commission in the forthcoming year, after the promulgation of the Composite Bill, is to educate the public, the investors, intermediaries and in particular, its own staff.
32. But, the best laws are those which the public not only accepts, but understands and supports its fair enforcement. Intermediaries and market participants must develop a culture of compliance, with adherence to best practices of internal audit and controls, stringent risk management and compliance procedures. Even then, genuine mistakes and lapses occur, but those responsible must take due care to ensure that not only the internal checks and balances exist, but the management and staff have proper procedures to prevent mistakes and lapses. Thus, in combination with the self-regulatory organisations, the Commission has a duty to ensure that the market intermediaries and institutions rectify the problems once mistakes have been identified, and install procedures and controls to avoid a repeat of them. A vigilant culture of compliance and continual review ensures that small mistakes do not lead to large losses.
33. But if things really go wrong, when moral suasion and gentle warning is no longer effective, the Commission needs to discharge its enforcement responsibility firmly, and without fear or favour. In the past, as in the future, the Commission will not hesitate to launch enquiries and investigations if there are suspected offences or malpractices, and would take the necessary disciplinary action or prosecution. Where appropriate, suspected fraud and other offences would be referred to the relevant authorities such as the Commercial Crime Bureau.
34. It may be appropriate if I elaborate at this stage our enforcement and disciplinary processes, which have not always been well understood. It is clearly a subject that I should speak on after dinner, rather than before, which will almost certainly spoil your appetite.
35. There is some market concern, coming from the consultation on the Composite Bill that the Securities and Futures Commission is

- becoming far too powerful. I want to reassure everyone that the Commission has no ambition, nor intention, to become investigator, prosecutor, judge and jury, all in one.
36. What the Commission seeks in the Composite Bill are enhancements to our existing investigatory powers to ensure they are adequate to properly investigate improper conduct in our markets. These powers are similar to those available to the SEC in the United States and the ASIC in Australia, and to those proposed for the FSA in the United Kingdom. Investigations are, and will be, subject to secrecy. This is very important as the mere fact an investigation is being conducted can cause reputational damage to a person even if later that person is exonerated.
 37. In the Bill, we will also be asking for the power to impose civil fines on intermediaries for failure to remain “fit and proper” persons. This is really a rounding-out of the disciplinary sanctions that are currently available, so that we can more equitably tailor the sanction to the conduct. Again, civil fines are an essential component of the US regulatory regime. They are also introduced in the UK Financial Services and Markets Bill.
 38. As in the past, and in the future, we will exercise our investigatory and disciplinary powers as fairly, proportionately and judiciously as possible.
 39. Let me tackle directly the perception that civil fines could work harshly. First, let me talk briefly about how we conduct investigations. Investigations are conducted by the Investigation Unit of the Enforcement Division of the Commission, under the supervision of the Senior Director in charge of investigations. There are stringent internal procedures, similar to police procedures, that the investigators must follow to ensure that thresholds are met before an investigation can be commenced. Persons interviewed by the Commission are entitled to counsel.
 40. When the Senior Director determines that there is sufficient evidence for bringing disciplinary proceedings, he will refer the case over to the Disciplinary Unit of the Enforcement Division, separately supervised by another Senior Director. Neither Senior Director gets involved in the work of the other to ensure that there is a clear division of functions between the investigatory and disciplinary processes.
 41. Why do we need civil fines? Civil fines in our mind are the intermediate sanctions between a reprimand (which could be ignored as a slap in the wrist by some) and suspensions or revocations (which are nuclear options that have much larger economic sanction than fines). The purpose of the fines (which go to the General Revenue) is to graduate the sanction to the severity of

the misconduct. They are almost certainly not as damaging as the suspension or revocation of the right to continue business.

42. Sanctions are the outcome of disciplinary proceedings, which are structured to afford due process and natural justice. Before a person is disciplined, he must be told in writing the case against him, the evidence that the Commission relies on and the penalty that the Commission is minded to impose. He is then given ample opportunity to make representations on why a case has not been made out or he should not be disciplined. His representations are considered fully and carefully.
43. A fully reasoned written decision has to be provided. Our internal rules of procedures ensure that in coming to this decision, the officer in charge is impartial and his decision is well based, has taken on board all relevant considerations and is proportionate and consistent.
44. Apart from the internal procedures, there is also a whole spectrum of external checks and balances to ensure that the Commission's actions and decisions are proper, legal, impartial, consistent and proportionate.
45. First, the Commission's decisions to revoke or suspend an intermediary's license are currently fully appellable on the merits to the Securities and Futures Panel. Under the Bill, all disciplinary decisions, including decisions to reprimand (which are currently not appellable) or fine, will be fully appellable on the merits to the Securities and Futures Tribunal, which will be chaired by a full time High Court Judge.
46. Second, all SFC actions and decisions are and will continue to be judicially reviewable. This effectively means that all our actions and decisions are ultimately supervised by, and can be tested as to their legality in the courts.
47. Third, any person aggrieved by our action or the way our staff has handled his case can lodge a complaint with the Ombudsman.
48. Finally, we will add another level of protection alongside the Bill. We will establish a Process Review Panel (PRP) to review our internal processes, to make sure that these processes are proper, that we ourselves fully comply with these processes and that we have followed measures to ensure that our decisions are consistent and impartial.
49. Of course, as a statutory body, we are also subject to other measures that are designed to enhance accountability and transparency. We appear regularly before the LegCo Financial Affairs panel to report on our affairs. Our accounts and annual report are tabled before

LegCo every year. We firmly believe that as we ask for the market to be transparent, we the regulator must ourselves be transparent and accountable, subject only to secrecy provisions.

50. I apologize for giving such a dry subject on regulation and sanctions that has definitely spoiled your appetite tonight. As regulators, one is not in popularity game. No one likes to exercise discipline, but it is a job that must be done. The success of Hong Kong as an international financial centre depends on the vibrancy and creativity of our community. It is not the Commission's mission to stifle or restrict that energy. Rather, we hope that with fair, efficient and transparent markets, the industry will continue to thrive.
51. I began by saying the Commission is in the service business. I would like to conclude by assuring you that the Commission is committed to working with you to ensure that the Hong Kong market is fair, open, transparent and competitive globally.
52. Thank you.

Securities & Futures Commission,
26 October, 1999