

Beyond Compliance: Prudence and other Challenges 2nd Annual Compliance Summit Asia

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Thank you for inviting me to address you this morning.

It is a pleasure to be back here amongst you again. I would like to commend the organisers for putting together such a useful and practical programme.

I would like to talk about compliance challenges from a number of different perspectives: firstly, the challenge set by regulators and the need for prudent compliance; secondly, the challenges of an increasingly complex set of laws in multi-jurisdictional businesses; and thirdly, the need for, but also the limits of, governance systems and controls in fostering a compliant environment.

I also want to say something about our litigation practice because the need for precedent and case law is an essential aid to all of these challenges. And our litigation practice is also always topical if not controversial.

Beyond Compliance: Prudence

Hong Kong, as a global financial centre, has a constant and ready supply of capital and capital markets expertise.

But what about confidence and integrity in our market? Where does that come from?

The SFC's overall objective, in general, is to raise and maintain highest standards of conduct within our market.

The challenge for us as regulators and for financial services participants and compliance professionals in particular is whether that objective is a shared one or not. This is, in essence, the first part of the challenge set by regulators.

The second part relates to the content of that challenge.

For example, the Hong Kong style avoids overly prescriptive rules. Our rule book prescribes broad standards of conduct that assume intelligent, prudent behaviour.

Nonetheless, we have experts in their field who continue to lobby us saying "We want more prescriptive rules. Tell us exactly what you want us to do and we will do it. It is too hard for us to work out how and what it is we should be doing." In other words, a map.



But life is full of situation in which you know where you want to end up but you don't necessarily know straight away how to get there. This is where expertise, experience, judgment, the ingredients of fitness and properness, perhaps summed up by that most Roman of virtues, prudence needs to be applied.

It is hard to sympathise with the argument that prescriptive rules are required so that expert professionals will know what to do when the argument is put forward by those same highly trained professionals and experts who are meant to possess the requisite expertise and judgment.

The notion of prudence is a useful one here. It is now commonly used to refer to thoughtful cautiousness before action. But in Roman times, it had a more formal and pointed meaning: the ability to govern and discipline oneself with practical wisdom and good sense. In other words, the ability to act in a situation you may not have faced before.

An expert doesn't necessarily have a map or guide for every situation. If there was such a map, arguably there would be no need for regulated persons at all, certainly no need for them to have qualities of expertise and experience as well as fitness and properness. All that would be needed would be a big book we could consult that would tell us exactly what to do in any situation.

Prudence also imports the action, not just expertise. It is sometimes said the prudent person is someone who not only knows or senses what is right and what should be done but is also compelled to do it. There is no doubt a moral core at the heart of prudent action and, prudent compliance.

Prudence: Recent Examples

We have seen some examples of the right thing being perceived and acted upon recently.

On 1 January 2014, our new standards on electronic trading will come into effect. They introduce profound change in this important and growing field. The new standards deal with:

- measures that make it clearer how existing trading requirements apply to electronic trading;
- introduce new standards for the design, development, testing and use of algorithms;
- indicate what kinds of control over in-use software is required; define what is meant by pre-trade and post-trade controls; and
- define the extent to which Direct Market Access (DMA) devices can be delegated and sub-delegated.

The challenges set by these new standards are real ones.

And the reaction, I am glad to say from most market participants, has been prudent in the true Roman sense.

The Electronic Trading Information Template that was developed by a number of industry associations, including my fellow panelist this morning, Mark Austen's ASIFMA (Asian Securities Industry and Financial Markets Association), is an example of proactive prudence and is a notable case in point. The template is a tool that will help firms develop compliant



practices in a relatively new and uncharted area of regulation. It is not meant or intended to be any kind of guarantee of compliance but I think it is a sensible, mature and relevant starting point. That is its virtue. I commend ASIFMA and the other industry bodies involved in developing the template.

The challenge for compliance professionals and expert advisers is that they will help financial services firms not only comply with the bottom line but they will add qualitative value to the prudential culture of the organisation, adding some of that Roman virtue of prudence to the business operations of their firms and, in turn, the market.

The Challenge of Multi-lateral Compliance

Another challenge arises from the longer arms of many regulators, especially those in global markets, including the SFC's, extending well beyond territorial boundaries.

We are used to the notion of parallel systems in Hong Kong through "one country, two systems". But for many financial services firms operating here, it is more complicated than that: one firm: multiple, or perhaps multi-lateral, systems.

The SFC too must operate in a multi-lateral legal environment.

The SFC has recently taken successful insider dealing proceedings against a Fidelity fund manager based in Boston who traded in Hong Kong on behalf of his employer as well as proceedings against a number of Mainland traders for market misconduct here in Hong Kong. More recently we have initiated market misconduct proceedings against New York-based hedge fund Tiger Asia for trading in Hong Kong; we have ongoing proceedings before the Court of First Instance against two Hong Kong solicitors whom we allege committed securities contraventions in relation to trading in both Hong Kong and Taiwan using confidential information from within the law firms that employed them; and insider dealing proceedings against a Singaporean in relation to trading in shares of Titan Petrochemicals Group Ltd. There are many other examples where proceedings are on foot or investigations are in train.

Our Hontex litigation last year involved proceedings in Hong Kong against a company that was incorporated in the Cayman Islands with no operative presence in Hong Kong, a business in Fujian province and directors residing in Taiwan. In obtaining remediation orders of over \$1 billion for investors who were mostly in Hong Kong but also scattered around the world, the solution too had to be multi-jurisdictional and multi-legal.

We all know ignorance of the law is no excuse. The maxim pre-supposes we are only referring to the law of this jurisdiction but the challenge is far greater and no-one can afford to be ignorant of any law of any jurisdiction that may apply from time to time.

Cross-border enforcement action is likely to be a permanent and growing phenomenon especially in global markets like Hong Kong's if the increasing volume of incoming requests to the SFC from foreign regulators seeking assistance is a guide.

There are several challenges in this space for regulators too, including how regulators should determine priority and precedence of enforcement action when conduct violates laws in multiple jurisdictions.

Regulators too need the Roman virtue close to hand. This is a subject for another day.



Compliant Systems

A third compliance challenge is, in a sense, a paradox.

One of the important achievements of modern financial markets is the attention paid now to systems and controls in governing conduct within financial services firms.

The paradox is that while systems and controls are necessary, their existence can lull senior management into a false sense of comfort. The assumption underlying any system is that it works. But testing whether a system works, i.e. fit for purpose, is inherently difficult. The question of whether it is in fact fit for purpose only arises when it fails. And by then it is too late.

Fraudsters, for example, love systems because senior management focuses on what the system delivers which means the eye is rarely trained on the gaps or ways in which the system can be evaded or exploited.

For example, the investment banker who is placed on a deal team but knows the timing gap between the team being assembled and the control room being notified of the relevant addition to the restricted trading lists which gives rise to a trading opportunity. (Prudence might indicate that the team be assembled after rather than before the Control Room notifications were in place.)

There is no solution to this paradox other than the administration of any control system needs counter-intuitive auditing from a risk perspective. How would a fraudster view this system? What are the key safety measures that need to be in place? How do we test and measure the reliability of the system? What data are we not capturing in this system? What are the gaps?

These are all prudent questions that ought to be asked of every control system on a regular basis.

Compliance Benefits from Litigation

This brings me to the other challenge for compliance: when the regulator takes enforcement action.

This is an opportunity to restate our commitment to litigation as a means of tackling problems that arise in our market.

Litigation achieves highly valuable and desirable outcomes that cannot be achieved by any other means. First, it is self-evidently important that public controversies caused by misconduct are resolved through a public and judicial process. Public judgments aid future decision-making by market participants. Their absence creates greater uncertainty for compliance professionals and advisers in guiding the behaviour of market participants and fosters inconsistent or perverse outcomes.

This is one of the reasons the SFC is keen to litigate in courts of record so that a public decision with reasons is available to the wider community of market participants and professionals.



This is a necessary development in our market that will improve the quality of advice and decision-making by all market participants which in turn helps to foster confidence and integrity in our market.

Current SFC Litigation

As at the end of last month:

- we have caused to be issued and served over 70 charges with over two-thirds of the charges dealing with insider dealing or market misconduct. This represents an increase of 17% on the same time last year;
- we have initiated civil proceedings seeking remedial orders against 64 people representing an increase of 23% on the same time last year; and
- we have issued 32 decision notices in disciplinary proceedings under Part IX of the Securities and Futures Ordinance, representing an increase of 100% on the same time last year.

All of these cases have been commenced on the basis that we believe their prospects are strong based on competent and experienced legal advice.

We will not win all of these cases (although our track record is that we win over 90% of our cases) and this is a profoundly healthy reality.

Of course that doesn't give us a licence to bring cases on flimsy or suspect grounds or where there is insufficient legal merit to the case. It simply means that in a two-horse race, it is unrealistic to think we will or ought to win every race. At the same time, the fear or anxiety of losing a case should never trump the inherent merits of a case that ought to be prosecuted.

Recently, there have been some sectoral voices seeking to challenge the SFC's litigation practice, complaining about a perceived absence of check or balance on the SFC's litigation decisions. The best check and balance on the SFC's litigation practice is the court room: it is the ultimate test of whether we are making reliable decisions. And, of course, the best check and balance on sectoral interests is an independent regulator like the SFC.

On that note, I will close. Thank you for the opportunity to address you again.