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SFC CEO Mr. Ashley Alder's Remarks at Hedge Fund Standards Board Institutional Investor Roundtable

CEO of the Securities and Futures Commission (**SFC**) and chairman of the International Organization of Securities Commissions (**IOSCO**) Mr. Ashley Alder addressed the Hedge Fund Standards Board (**HFSB**) roundtable on 22 June 2016. In his speech he covered both the positives and negatives facing the financial market today, focusing on the HFSB's aims and objectives to reform the practices which come alongside working in such a market.

As well as praising the HFSB for 'bridging the gap between the old self-regulatory organisation model and conduct regulation by the likes of the SFC' and 'breaking new ground in the way in which industry associations can operate as standard setters', Mr. Alder addressed the issues found in cyber security, conduct, conflicts of interest, insider dealing and outsourcing, as well as the aims the SFC has in developing Hong Kong as an asset management hub and bringing the market back to following its fundamental principles.

Cyber security

Mr. Alder highlighted the growing frequency and sophistication of cyber security incidents in the financial industry, citing the recent Bangladesh Bank incident as a key example showing just how large these attacks can be.

In an attempt to quell the growing number of cyber-security incidents, Mr. Alder identified a range of serious weaknesses in risk assessment, inadequate arrangements for data protection, training and incident management that needed to be seriously addressed. It was also noted that in order to reduce the number of cyber-security attacks effectively, both larger and smaller firms need to better their defences, regardless of the upfront costs of those defences.

Conduct

Conduct, cited as the main area of HFSB interest, was highlighted as having been under scrutiny by the SFC, which has begun a comprehensive review of conduct expectations with a view to strengthening regulations in areas such as the responsibilities of fund managers.

Mr. Alder also brought up the possible need to give guidance to implementing existing principles of the IOSCO, such as the requirement to conduct regular stress tests.

A further point of focus was on leverage within funds, cited as fundamental to the failure of Long-Term Capital Management in 1998 and the collapse of two Bear Stearns hedge funds in 2007. Mr. Alder outlined the aims of developing consistent leverage measurements and collecting leverage data on private funds in order to instil market discipline and enable monitoring by regulators.

Conflicts of interest

The proper regulation of conflicts of interest was identified as an essential basic need in a firm to ensure fair treatment of clients as well as employees. Mr. Alder cited a number of examples showing how conflicts of interest can result in unfairness, such as within broker selection.

Insider dealing and outsourcing

Mr. Alder's concern over insider dealing centres around the evidence suggesting that some firms have yet to implement proper surveillance or transaction monitoring to surface irregular trading patterns, despite inside dealing being an obvious possible point of danger.

Mr. Alder set out a number of ways to ensure firms are properly surveilling possible insider dealings, such as: examining trade patterns and investigating any unusual ones; monitoring trades in relation to specific events such as public announcements, price spikes and significant profits, and tracing the source of information obtained by fund managers and analysts before conducting trades. Mr. Alder also stressed the importance of email and phone log surveillance.

It was also noted that there are control weaknesses seen during inspections when functions are delegated or outsourced. Most of these problems centre on documentation, which may not define the services to be provided, or which involve inconsistencies between internal fund policies and the service contract.

Hong Kong as an asset management hub

On a more positive note, Mr. Alder set out what was being done at the SFC to help develop Hong Kong as a hub for asset management.

This aim included multiple objectives, the first one being to develop Hong Kong as an onshore fund management hub and a domicile for investment funds. The building blocks for this being Stock Connect and Mainland-Hong Kong Mutual Recognition of Funds (**MRF**). The SFC expects that the MRF will be the only real route for foreign-branded public funds to be sold on the Mainland for the time being. There is also the aim to further expand the Connect programme to Shenzhen.

The SFC has also sought to develop Hong Kong into a hub for asset management by making more connections with global centres. This is currently being done through talks about mutual recognition with other markets (i.e. international agreements by which two or more countries agree to recognize one another's conformity assessments), including some in Europe. The aim for these agreements is to, in time, supplant the unilateral arrangements, which in the past have enabled one-way fund sales into Hong Kong.

Since the SFC does not directly regulate private funds as a class, much of this surrounds public funds.

Far from the fundamentals

In the conclusion of his speech, Mr. Alder highlighted the market regulators' concerns surrounding regulation and the markets, described as the sidelining of the fundamental policies that once underpinned the markets.

Mr. Alder noted that this move away from the 'fundamentals' occurred after the financial crisis, when central bank changed policies in order to avoid a depression initially and then tried to jump start economies after years of stagnation. He claimed that, while initially adopted for good reason, this 'loose monetary policy' has not restored growth and inflation close to target. Mr. Alder cited the Eurozone's and Japan's negative interest rates earlier this year as evidence for this.

Mr. Alder went on to highlight that as market regulators, they are concerned with how low or negative interest rates, quantitative easing and related policies have distorted asset prices, affected basic investment decision making and corporate behaviour and led to an overall mispricing of risk.

Another concern involves high equity valuations despite falling corporate earnings, companies hoarding cash, many companies borrowing cheaply to fund buybacks and many cut downs on investment and innovation.

This, according to Mr. Alder, is fundamental to the downgrading of the 'bedrock of investment', where, instead of considering fair value, time premium, risk premium, mean reversion and diversification, companies now second guess the central bank's next move. Mr. Alder went on to argue that the function of the markets have been severely tested since the financial crisis.

These issues were highlighted as of central interest to IOSCO, and according to Mr. Alder, they will be focussed on during the next few years, with the main aim of returning the capital markets back to the role for which they were designed.

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