Tangled Up in Red Tape

Dealing with a Crisis

Buying Bonanza in Sight

Boards’ first action after the Global Financial Tsunami: The 2009 Board’s “Self Awareness” Assessment

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Like a pendulum swinging back and forth, governments and agencies around the world tend to toughen their regulations following corporate scandals and the collapse of major institutions. After changes to the listing rules on directors' share trading were debated earlier this year, now new regulations are being discussed for Hong Kong as a result of the financial tsunami. **Momentum** asks the authors of a recent review of financial regulation in Hong Kong whether these potential regulations could go too far.

The participants in this discussion are:

- Dr Douglas Arner, Director, Asian Institute of International Financial Law and Associate Professor of the Faculty of Law, University of Hong Kong
- Syren Johnstone, Visiting Fellow, Asian Institute of International Financial Law, University of Hong Kong, former lawyer and investment banker
- Antonio Da Roza, Barrister-at-Law and Research Fellow, Asian Institute of International Financial Law, University of Hong Kong
- Francisco Da Roza, Director of Holly & Associates, former banker and licensed financial advisor

**Momentum**: Can regulations be reformed in a way that they are better, rather than just more of them?

**Francisco Da Roza**: We do have to be very careful when we are talking about reforming regulations. It is governments with their policies that led to market behaviour of excessiveness and then market failure. The focus is too much on regulations because it could politically be an easy way out.

**Antonio Da Roza**: Objectivity is an important component in trying to write smarter rather than more regulations. You need to come at the problems in a very constructive way, and not in a way that attempts to lay the blame at anyone's feet. And it is very difficult to immediately assess whether you have written something smart. Nobody sets out to write stupid regulations. It is only with hindsight that we can say if something was smart.

**Syren Johnstone**: Hong Kong took a step toward smarter regulations with the SFO [Securities and Finance Ordinance in 2003] by giving the regulatory bodies such as the SFC [Securities and Futures Commission] quite a lot of flexibility on how they regulate. In the past few years the government has had the attitude of trying
to liberalise Hong Kong by allowing more investment products to be brought here which gives the investors the opportunities to buy more exotic products. How those products have come into the market is now subject to some criticism. But the problem with issuing more regulations is that you risk swaying the pendulum back too far in the other direction. In Japan, the ability of retail investors to buy interesting financial products was extremely limited. It is a lot better now, but it is a long way behind where we are in Hong Kong. Is this something that should be regarded as a freedom and liberalisation that we should be proud of? Unfortunately, it carries the risk of [investors] getting their fingers burned.

Douglas Arner: In responding to this crisis, we have to be very careful in following the regulation reforms of other jurisdictions. Because even though there have been problems here, the problems we have had are much less severe than in the US and the UK. As a result, we have to be very careful in choosing which path we follow. There will be aspects where there is international agreement on certain things. We are already seeing the impact of that in Hong Kong in the context of sharing tax information and banking secrecy issues. Hong Kong is one of the jurisdictions that have been specifically targeted on this issue. But there is still going to be a lot of latitude in different areas for more restrictive or less restrictive approaches.

SJ: However, we also cannot take advantage of a situation where we encourage regulatory arbitrage. Global markets involve a competition for capital. We cannot go too far out of step with what is being done in major markets like the US and the UK. If we do that, then we risk putting Hong Kong in a situation where it is labeled as an under-regulated jurisdiction, even if it is not true.

DA: The failure of an AIG in any jurisdiction can cause problems in other jurisdictions. As a result, other jurisdictions are going to be taking a much closer look at major financial centres. Consequently, there will not be a great deal of scope for Hong Kong to be less regulated. Had AIG been allowed to fail, that would have been a disaster for the Hong Kong financial system with two million policyholders with no compensation arrangements. One of the greatest dangers in a globalised financial system, is the failure of one of those firms. It is a fact that there is no global mechanism for resolving the insolvency of a failed global financial firm.

Momentum: In what areas does Hong Kong have discretion to diverge from other jurisdictions with its regulations?
DA: It is going to be with the approach we allow financial innovation. A range of jurisdictions are now discussing having extreme, 1930s-style restrictions on financial services. Some jurisdictions are going to begin treating banks as utilities – they won't be taking any risks. But it seems unlikely there are going to be international agreement on going that far. The greatest latitude is for jurisdictions that want to continue to allow a certain level of risk-taking in finance. There is now a very low tolerance for the level of risk that will be accepted in many jurisdictions. But historically, we have been more tolerant of risk in Hong Kong and we haven't had the same pain [as other countries] as a result of this crisis. Restrictiveness will increase, but we have a choice of how much we restrict.

ADR: We have to be very careful about following other jurisdictions because they will be responding to their own political pressures. We need to take a step back and analyse what the problems are rather than what people think they are and what affects them. We must not change regulations for sake of changing them or appearing to improve them. The SFC and HKMA recommended in their reports [made in response to the minibonds issue] to increase the amounts of investor education. However, it is clear the existing system of investor education has not been successful and investors in Hong Kong still carry certain attitudes about making quick, easy money out of stocks without understanding the products they are buying or managing risk.

Momentum: What are your opinions on the SFC and HKMA's recommendations for regulations following the minibonds problems?

ADR: I thought the entire approach to those recommendations was very superficial. It was almost without addressing the root problems.

Momentum: An alternative to the approach to the minibonds affected investors in Hong Kong is to improve investor education. Is there a need for such a measure to prevent similar issues in the future?

ADR: I agree that improving investor education is important. However, it is not enough to solely focus on education. Regulators also need to ensure that financial institutions are held accountable for their actions. This will help prevent similar issues from occurring in the future.
SJ: Both regulators had less than three months to put their reports together. I see them as a starting point. [The issue] is emotional and political and regulators in this context tend to be jujurnauts and may feel the need to defend themselves. I don’t agree with a lot of things in the reports. For example, [the HKMA report’s] requiring point-of-sale recordings [of conversations between banking staff and customers] is impractical and expensive. It may well work against the interests of investors by becoming a shield for the financial institution – showing what has been said under the knowledge of being recorded. The real solution is in developing an appropriate culture within these financial institutions on what is and is not appropriate behaviour. It is partly a job for the regulators but largely a task for the institutions themselves.

DA: The reports are useful because they focused on one specific issue by the regulators. In LegCo’s [the Legislative Council] debates, it is delving beyond what the regulators said in those reports and trying to find out what actually happened. That is the second stage of the process. The third stage is one which has been announced but we have not seen yet. That is a comprehensive review of the performance of the regulatory system in the financial crisis as a whole. Not only in the context of the Lehman Brothers-mini-bonds problem, but looking at general issues. As a result of regulatory changes internationally, there will have to be changes in the legislation and regulations.

Momentum: Does the regulatory system need a shake-up? Should the responsibilities of the two financial regulators, the Securities and Futures Commission and the Hong Kong Monetary Authority, be reallocated or should they be merged?

SJ: The banking and securities industries are staffed by people of rather different personalities, mentalities and approaches. Rather than simply merging regulators, we should look at trying to carve up functionally what it is that needs to be achieved and then staff that need.

DA: Securities regulators tend to be prosecutorial by nature. The problem with that is that if you give them a technical role in capital regulation, it is not very exciting. They want to be in court. In the monetary authority, most of the people there want to be looking at safety and soundness, big-picture financial stability issues. It makes

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已經公佈，但我們尚未看到，也就是全面檢討監管體系在整個金融危機中的表現，不僅是檢討董事局和你價值這個問題，還要研究一般性的問題，在這里修改【監管政策】的背景，怎樣與監管都必須作出改變。

Momentum：監管體系是否需要作大規模革新？證券及期貨事務監察委員會與香港金融管理聯盟兩家金融監管機構的職責是否應重新分配，它們是否合并？

SJ：銀行業與證券業從業員的個性、思維及處事方式往往不相同。我們不應簡單地將二者合并，而是研究如何在職能上劃分所需實現的目標，然後需要什麼人員。

安納德：證券監管機構天性傾向於監控。那麼，問題在於，如果給予他們資本監管的技術角色，他們不會感到欣喜。他們希望上法庭。在金融管理機構，大多數人員希望研究有關安全性與信譽的問題。也就是整體金融穩定性的問題。合理的做法是將目標分解，建立對這些目標擁有共同動機的組織。在香港成立單一監管機構的想法乍看起來具有吸引力。香港是彈丸之地，何不將兩項職能統一起来？問題是，我們目前其實擁有兩個非常成形的監管機構，試圖將它們整合為一個機構將會非常複雜和困難。而在這個過程中，兩家機構都不會在職能上變得更好。我們看到香港的情況是，即使將兩項職能合併之後，也不一定如何順利地運作。在香港，我認為這還是要接受行之有效的現狀，慢慢加以改進。

Momentum：如果以1至10進行評分，10為風險最大，1為風險最小。在今後12個月中，香港的監管政策令投資者擔憂重重的風險有多大？
sense to separate the objectives and build organisations that have a common motivation around those objectives. The single regulator idea in Hong Kong seems initially appealing. We are a small place, why not put everything together? The downsides are we actually have at the moment two rather well-established regulators, and trying to put them together into an organisation is going to be very complicated and messy. And while that process is taking place, neither is likely to do a very good job with their functions. What we saw in the UK is that even when you put everything together, it still does not necessarily work as you would hope. In Hong Kong, my view is you take what you have that is working and build on that.

Momentum: On a rating between one and 10, how much is Hong Kong at risk of having its regulations becoming too great a burden for business during the next 12 months, with 10 being riskiest and one the least risk?

DA: I am going with a five. We could see not a lot of change. We could see some pretty radical changes. It is evenly balanced. In other jurisdictions, particularly in the US and the UK, I give them a 10; they are definitely going to go too far.

SJ: I don’t see a great deal that is going to change fundamentally here. Once things progress further on the minibonds saga and some of the emotional heat goes out of the story, then hopefully people will see that what is happening in the US and the UK is a different order of problem and start looking forward rather than backward. I would give it a five.

ADR: I don’t think we are at a huge risk in Hong Kong of going too far. I can’t think of areas where Hong Kong is overregulated at present. Something the Government is quite careful about is not to overregulate the financial markets. And you have various interest groups that will help to make sure we do not go too far in that respect. You could put me at a three.

FDR: I would go with three, simply because Hong Kong has not been hit badly [by the global downturn], and we always have this culture of valuing our economic freedoms.

This is an edited transcript of a roundtable discussion held at the University of Hong Kong. Further information, including the working paper “The Global Financial Crisis and the Future of Financial Regulation in Hong Kong”, can be found at the Asian Institute of International Financial Law’s website at www.aiiff.com.