CompliancePlus Consulting

Compliance Consulting • Funds Consulting
Regulatory Consulting • Compliance Training

Submission to the SFC Consultation Paper Concerning the Regulatory Oversight of Credit Rating Agencies

August 2010

CompliancePlus Consulting Limited
801, Two Exchange Square, 8 Connaught Place, Central, Hong Kong
Tel: (852) 3667 9099 www.complianceplus.hk

Introduction

We prepare this submission in response to the Securities and Futures Commission's (SFC) Consultation Paper Concerning the Regulatory Oversight of Credit Rating Agencies (CRA) and please find our replies to the questions stated in the Consultation Paper.

Is it appropriate for Hong Kong to subject CRAs to a regulatory oversight regime consistent with international developments?

It is not uncommon for institutions in other countries to make use of the credit ratings issued by Hong Kong credit rating agencies (CRA). Currently, a considerable number of overseas countries are now imposing certain regulatory schemes on their local CRA. In particular, as the SFC has highlighted in the consultation document, the European Union has imposed certain restrictions on its member states in relation to the use of foreign credit ratings.

The relevant restrictions are set out in Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 ("the EU Regulation"). The following articles of the EU Regulations are pertinent to the current SFC proposed legislation.

Firstly, according to Article 4, an EU institution can make use of credit ratings issued by Hong Kong CRA only if, *inter alia*,

> *"(b) the [EU] credit rating agency has verified and is able to demonstrate on an ongoing basis to the competent authority of the home Member State that the conduct of credit rating activities by the third-country [i.e. Hong Kong] credit rating agency resulting in the issuing of the credit rating to be endorsed fulfils requirements which are at least as stringent as the requirements set out in Articles 6 to 12..."*

Alternatively, pursuant to Article 5, an EU institution can make use of credit ratings issued by foreign CRA if that the regulatory scheme in that foreign country is "equivalent" to the scheme imposed by the EU. The foreign scheme is "equivalent" to the EU scheme, if, *inter alia*,

> *"The Commission may adopt an equivalence decision in accordance with the regulatory procedure referred to in Article 38(3), stating that the legal and supervisory framework of a third country ensures that credit rating agencies authorised or registered in that third country comply with legally binding requirements which are equivalent to the requirements resulting from this Regulation and which are subject to effective supervision and enforcement in that third country.*

A third-country legal and supervisory framework may be considered equivalent to this Regulation if that framework fulfils at least the following conditions:

(a) credit rating agencies in that third country are subject to authorisation or registration and are subject to effective supervision and enforcement on an ongoing basis;

(b) credit rating agencies in that third country are subject to legally binding rules which are equivalent to those set out in Articles 6 to 12 and Annex I; and

(c) the regulatory regime in that third country prevents interference by the supervisory authorities and other public authorities of that third country with the content of credit ratings and methodologies."

In light of the EU Regulation and other international development, it is of paramount importance for Hong Kong to adopt a regulatory scheme that is in line with the international standard. Otherwise, it will be increasingly difficult for Hong Kong to maintain its role as an international financial centre.

We agree with the SFC that there is an urgent need to impose such regulatory scheme on Hong Kong CRA. The SFC has to ensure that the proposed legislation can fulfill the requirements set out in the above EU Regulation.

Should regulatory oversight of CRAs be achieved by extending the existing licensing regime under the SFO to CRAs and those of their staff who perform regulated functions?

Extending the SFO seems to be the most convenient and satisfactory solution. It would be unwise to enact a separate legislation to regulate CRA. This is especially so when the SFC intends to impose restrictions on the CRA similar to those imposed on institutions engaging the nine types of regulated activities (such as sole business condition, liquidity requirement, etc).

The existing licensing regime is in line with the registration and authorization requirement of the EU Regulation and is recommended. This also means that for the CRA, there must be at least two Responsible Officers (one of them must be an executive directors), and the officer concerned must be a Licensed Representative. Moreover, all executive directors must apply to be a Responsible Officer.

We believe that this arrangement will be beneficial, since the competence and integrity of the officers concerned can be guaranteed, and there will be greater accountability in the regulatory scheme.

This also enables the market and the institutions concerned to easily familiarize itself with the proposed legislation, since the SFO and its predecessor legislations have been

in force for many years.

Do our draft amendments to the SFO effectively distinguish "providing credit rating services" from "advising on securities"?

In "providing credit rating services", the service providers are primarily giving opinion in relation to the credit worthiness of the instruments in question. They are not advising on whether one should purchase or sell a particular instrument. Thus, if the service provider is merely "providing credit rating services", he is not "advising on securities".

However, "providing credit rating services" may be an integral part of "advising on securities". It seems that the scope of "advising on securities" may be broad enough to cover "providing credit rating services".

For example, in advising whether one should buy or sell an instrument, the adviser may comment on the credit worthiness of that instrument. In this circumstance, a person engaging in regulated activity type 4 may also be engaging in activity type 10. The SFC must clarify whether in this scenario the advisor (who is advising on securities) has to apply for type 10 licence as well.

The following are some possible ways to distinguish these two types of regulated activities:

I. One is "providing credit rating services" if his primary objective is to assess the credit worthiness of an instrument. If that is the case, the fact that he, solely based on his assessment of its creditworthiness, gives opinion as to whether one should buy or sell such instrument does not make him fall into the scope of "advising on securities".
II. One is "advising on securities" if his primary objective is to advise whether one should buy or sell such instrument, and in providing such opinion he considers a number of factors which may or may not include the credit worthiness of the instrument.
III. The scopes of these two types of regulated activities overlap with each other when one advising on securities and the creditworthiness of the instrument is a major but not sole consideration. Nevertheless, this concern may be apparent than real, since in advising on securities, the advisers seldom use a "defined ranking system" to assess the creditworthiness of the instrument concerned.

Should the proposed new licensing requirement apply to the rating of sukuk?

Sukuk means Islamic bonds. Usually, the bond holders lend money to the bond issuers in exchange of the partial ownership of an asset (Susuk Al Ijara) or the right to share

profit of an investment. This is because the payment of interest is prohibited in the Islamic world.

Despite the fact that Islamic bond holders receive no interest, they nonetheless lend money to the bond issuers, and hence Islamic bond is an instrument which creates or denotes indebtedness. Whether the holders receive interest, the ownership of an asset or the right to share profit does not matter.

In addition, from policy perspective, it would be unwise to grant exemption to credit ratings of Islamic Bond merely because its structure is different from traditional bonds. As long as the instrument creates indebtedness, its credit ratings must be regulated. Otherwise, market practitioners will ask for exemptions for all other bonds which carry features similar to that of Islamic Bonds.

Therefore, for the sake of consistency we believe that the proposed requirement should apply to the rating of Islamic bonds. In deciding whether the credit ratings of a particular instrument should be regulated, the SFC should stick to the same test, namely whether the said instrument creates indebtedness.

Should the following activities be excluded from the proposed new licensing requirement:

(a) preparing credit ratings for an organization's internal purposes;
(b) preparing private credit ratings; and
(c) sharing or analyzing consumer or commercial credit data (such as through consumer or commercial credit reference agencies)?

(a) We agree with the proposal. It should however be emphasized that if those internal information is released to the public, the proposed legislation should apply. There may also be a need to define the term "internal purposes" with greater precision.

(b) This treatment is debatable. Before we examine the proposed legislation, we wish to refer to the EU regulation:

Article 2 provides:

> *"This Regulation does not apply to:*
>
> *(a) private credit ratings produced pursuant to an individual order and provided exclusively to the person who placed the order and which are not intended for public disclosure or distribution by subscription..."*

It seems that the proposed treatment is in line with the above EU treatment. In a sense, the proposed treatment is quite reasonable, because private credit ratings can rarely

affect public perception. One of the major purposes of the proposed regulatory scheme is to prevent CRA from using their credit rating function to influence market perception and hence securities' price. Given that private credit ratings may not affect the market significantly, the proposed treatment is understandable.

However, on a closer examination, one would realize that private credit ratings can also play a significant role in the market. For example, the private client seeking such credit rating may be making an influential investment decision. Moreover, from the perspective of market integrity and consumer protection, it seems unwise to draw a distinction between public credit ratings and private credit ratings. This would deprive private customers of their rights and remedies.

In particular, private customers placing credit ratings order must be afforded the same, or even more protection. The credit ratings are supposed to be tailor-made for the specific purposes of the private customers. The private customers would also expect that the CRAs will be observing the relevant code of conduct when they are providing private credit ratings. This is especially so when the CRAs are entrusted with the credit rating tasks to help the private clients to do certain decisions. To borrow the terminology of negligence law, when the CRAs are providing credit ratings to private clients as opposed to the general public, the CRAs and the receivers (i.e. the private clients) are more "proximate" to each other.

In fact, the traditional position of tort law is that the advisors (i.e. the CRAs) does not owe any duty of care to the general public, but may owe a duty to their own clients, i.e. a *Hedley Byrne* duty. By analogy, if the SFO imposes a licensing obligation to CRAs issuing public credit ratings, there must also be an equivalent or more stringent obligation imposed on CRAs issuing private credit ratings.

To impose such requirements on private credit ratings is also a step towards restoring market's confidence in the CRAs after the financial tsunami. We urge the SFC to re-consider the proposed treatment. For example, the CRAs should make sure that if there is a potential conflict of interest (e.g. the private clients request the CRAs to rate the instrument of Company A, and the CRAs have dealing with Company A), the private clients must be informed of the potential conflict.

(c) The SFC proposes that the collection, sharing and distribution of credit data do not fall into the definition of "providing credit rating service". This is a very fine line to draw. It is understandable that the proposed regulatory regime does not apply to pure collection and distribution of credit data. However, an advisor may assess the credit worthiness of an instrument or a company by analyzing the relevant credit data. Very often, the synthesis and analysis of such data is an integral part of the credit worthiness assessment process.

According to the draft legislation, issuing "credit rating" includes assessing the creditworthiness of a company. In doing so the advisors would probably analyze the relevant credit data or history. Therefore, it seems quite contradictory for the SFC to grant an exemption in relation to the sharing or analysis of credit data. In any event, It must be emphasized that the analysis of such data for the purpose of credit ratings may

be covered in the proposed legislation.

Further to question 5, do our draft amendments to the SFO effectively exclude these activities from the proposed new licensing requirement?

Assuming these activities are to be excluded, the next question is whether the draft amendments effectively exclude them.

As regards the assessment of the creditworthiness of a private person, such activity is effectively excluded since the definition of "credit ratings" does not include the assessment of a "person other than an individual".

According to the Interpretation and General Clauses Ordinance (Cap.1), "person" includes

> *"Any public body and any body of persons, corporate or unincorporate, and this definition shall apply notwithstanding that the word "person" occurs in a provision creating or relating to an offence or for the recovery of any fine or compensation."*

In relation to exception (a)(credit ratings for internal purposes), the draft amendment is effective, save that it may be desirable to add that this exception does not apply once those ratings are released to the public.

In relation to exception (b)(credit ratings provided on private order), the amendment may be too narrow. Suppose I pay the CRA to provide a private credit rating exclusively to a third party. It seems that the exemption does not cover this scenario, because the draft amendment merely provides that the exemption apply to the "preparing, pursuant to an individual order, a credit rating which is exclusively prepared for, and provided to, the person who placed the order". In the present case the rating is not provided to "the person who placed the order".

Nevertheless, such worry may be apparent than real, since in the first place "providing credit rating services" means preparing credit ratings "for dissemination to the public" or "distribution by subscription". Private credit ratings would not fall into this definition, since private credit ratings would not be released to the public. Therefore, technically speaking, the exemption contained in the draft amendment may be unnecessary.

With regard to exemption (c) (collection and distribution of credit data of an individual/enterprise), there may be a need to distinguish the mere transmission of raw credit data on one hand and the synthesis and analysis of such data on the other hand. In relation to the distribution of credit data of a private individual, it is effectively excluded since the assessment of an individual is not "credit rating" within the meaning of the proposed legislation.

In light of the above comments, we propose the following draft definition:

"**providing credit rating services**" (提供信貸評級服務) means preparing credit ratings for:

(a) dissemination to the public, whether in Hong Kong or elsewhere, or with a reasonable expectation that they will be so disseminated; or

(b) distribution by subscription, whether in Hong Kong or elsewhere, or with a reasonable expectation that they will be so distributed,

but does not include

(i) preparing, pursuant to an individual order, a credit rating which is exclusively prepared for, and provided to, ~~the~~ a particular person designated by the person who placed the order and which is neither intended for dissemination to the public or distribution by subscription, whether in Hong Kong or elsewhere, nor reasonably expected to be so disseminated or distributed, provided that the said particular person does not constitute the public;

(ii) gathering, collating, disseminating or distributing information concerning the indebtedness or credit history of commercial enterprises, provided that such activities do not amount to the assessment of the creditworthiness of the said commercial enterprises; or

(iii) the preparation, dissemination or distribution of credit ratings by any such person or class of persons as [the Commission / the Financial Secretary] may specify by notice published in the Gazette;

Are the proposed paid-up share capital and liquid capital requirements for Type 10 regulated activity appropriate?

We agree with the proposal. Unlike other regulated activities, giving opinion on the credit worthiness of an instrument does not involve much financial risk. We agree with the SFC that the paid-up share capital and liquid capital requirements should be the same with those imposed on institutions engaging in regulated activity type 4 (advising on securities).

Does the CRA Code of Conduct satisfactorily set out the factors that should guide CRAs in the conduct of their business and which should be relied upon by the SFC in considering whether a person is, or remains, fit and proper to be licensed or registered for Type 10 regulated activity?

We can see that the CRA Code of Conduct was largely following EU Regulation – Regulation (EC) No. 1060/2009 of the European Parliament and of the Council of 16

September 2009 on credit rating agencies. In comparison with this relevant EU regulation, we suggest the following points for SFC consideration to fine tune the draft CRA Code of Conduct:

- requiring the credit rating agencies establishing and maintain a permanent and effective compliance function department (compliance function) which operates independently to monitor and report on compliance of the credit rating agency and its employees with the credit rating agency's obligations (please see Annex 1, section A(5)&(6) of the EU regulation) whilst we note that para. 24 of the draft CRA Code of Conduct already requires that a licensed or registered person should institute policies and procedures that clearly specify a person responsible for compliance. We don't believe that is sufficient. We suggest that the draft SFC Code should emphasis the importance of establishing compliance function as those set out in section A(5)&(6) unless this is impossible given the size of the corporation. Simply requiring the licensed corporation to specify the designated compliance officer is not sufficient from our viewpoint to impose good organization practices and control on credit rating agencies

- Annex 1, Section B(2) of the EU Regulation requires the disclosure of names of the rated entities which the credit rating agencies receive more than 5% of its annual income. The draft code imposes a threshold of 10%. We believe using 5% threshold is more prudent and should clarify that it should be 5% of the total annual income of the group company of the credit rating agencies (where applicable)

- Para. 46 of the draft Code requires that representative involved in the rating process should not buy or sell or engage in relevant securities etc. Ethics about staff dealing in credit rating agencies should be strictly enforced. As such, we suggest that emphasis should be added in the draft Code for licensed representatives to disclose their existing holdings upon joining and regular declaration from them at least annually thereafter (similar to para. 2.1.1 of the Fund Manager Code of Conduct). We are aware that in para. 32 of the draft Code of imposing a general obligation on licensed corporation of adopting written internal procedures to identify and eliminate any actual or potential conflicts of interest. To a certain extent, the SFC defers the licensed corporation to set their own rules on this. Similarly, in the Fund Manager Code of Conduct, SFC also emphasizes that the suggested guidelines are intended to address basic principles and a minimum requirement. Given the importance on this area and the potential of creating real conflicts to the rating analyst with their own investment, we suggest adding the above requirements as minimum requirements to provide pointer to the licensed corporation when setting their own rules.

Should persons licensed or registered for Type 10 regulated activity be permitted to be licensed or registered for other types of regulated activity? Should persons licensed or registered for Type 10 regulated activity be

subject to a sole business restriction?

We understand that persons engaging in more than one type of regulated activity may be facing certain conflict of interest. Yet to impose a sole business restriction is too drastic a solution. Currently, except regulated activity type 8 (securities margin financing), no sole business condition is imposed on persons engaging in other types of regulated activities. Imposing an across-the-board prohibition on the CRA will be unwise and not justifiable.

In fact, currently the SFC allows the licensed person to take part in more than one type of regulated activities. Indeed, the SFC has streamlined the application procedure. For example, a type 1 licensee can also apply for a type 4/6/9 licence. A type 2 licensee may also apply for a type 5/9 licence. The SFC should allow type 10 licensee to involve in other regulated activities too.

The better approach is to provide detail guideline as to how CRA should handle the potential conflict of interest. Possible suggestion includes the adoption of "Chinese wall". Each license application should be considered by the SFC on its merits and circumstance.

Is the draft list of Recognized Industry Qualifications and Local Regulatory Framework Papers for Type 10 regulated activity appropriate?

To simplify the current examination requirement, we tend to suggest not introducing new regulatory paper for Type 10 regulated activity. Given that Type 10 regulated activity has similar feature to that of Type 4 regulated activity, we believe that for candidate applying to become RO of Type 10, they can take LE Paper 2 instead of a new regulatory paper and the SFC can require them to complete a course of not less than 5 hours relating to the Code of Conduct for Persons Providing Credit Rating Services in addition to their normal CPT requirements.

If new regulatory paper is introduced, we are concerned that whether similar revision tools and courses can also be offered to the candidates at the same time. Further, introducing new regulatory paper will further make the existing regulatory paper system even more complicated.

Separately, we would also suggest that for meeting with CPT training requirement going forward, Type 10 regulated activity can be categorized in the same category with Type 1, 4 and 8 competence requirements for CPT compliance purpose given that Type 10 regulated activity carries similar features to that of Type 4 regulated activities.

As such, the table in the SFC Guidelines on Continuous Professional Training under para.4.3 in p.5 should be amended accordingly if this suggestion is adopted.

Are the proposed transitional arrangements appropriate?

We agree with the SFC that the existing staff need not take the Paper. We also agree that the existing staff must take continuous professional training courses of a specified number of hours.

END