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THE HONG KONG SOCIETY OF FINANCIAL ANALYSTS

20th August 2010

Licensing Department
Securities and Futures Commission
8/F Chater House
8 Connaught Road Central
Hong Kong
Submit via e-mail to creditratingagencies@sfc.hk

Re: Consultation Paper Concerning the Regulatory Oversight of Credit Rating Agencies

Dear Madam/Sir,

CFA Institute[1] and The Hong Kong Society of Financial Analysts ("HKSFA")[2] welcome the opportunity to participate in the Securities and Futures Commission's ("SFC") consultation paper regarding regulatory oversight of credit rating agencies ("CRAs") in Hong Kong and we are pleased to forward you our joint comments. The comments are primarily from the perspective of representing investors' interests in the equitable functioning of efficient capital markets.

In our view, CRAs are an integral part of the capital markets, as they provide assessments of default and loss probabilities on a variety of fixed income instruments worldwide. While their processes are unique, their ratings reflect their reviews and analyses of everything from sovereign debt to traditional corporate bonds, asset-backed securities and a host of structured instruments.

In general, CFA Institute and HKSFA recommend the following practices for CRAs:

- CRAs should submit to regulatory authorization;

[1] With headquarters in Charlottesville, VA and regional offices in New York, Hong Kong, and London, CFA Institute, formerly the Association for Investment Management and Research®, is a global, non-profit professional association of more than 100,000 financial analysts, portfolio managers, and other investment professionals in 136 countries of which more than 89,000 are holders of the Chartered Financial Analyst® (CFA®) designation. CFA Institute membership also includes 135 Member Societies and Chapters in 58 countries and territories.

[2] The Hong Kong Society of Financial Analysts Ltd. (HKSFA) is a non-profit organization founded in 1992 to promote the professional and ethical standards of financial analysts and investment practitioners in Hong Kong. As a member society of CFA Institute, the Hong Kong Society assists in the mission of CFA Institute to help investment professionals around the world meet the challenges of global investing.

- CRAs should implement the International Organization of Securities Commissions' Code of Conduct Fundamentals for Credit Rating Agencies ("IOSCO Code") of conduct completely to claim compliance;
- CRAs should have executive-level compliance officers to ensure full implementation and enforcement of the IOSCO Code;
- CRAs should ensure transparency on their rating methodologies, rating assumptions, fee structures, past performance and mechanisms to manage conflicts of interest;
- CRAs should separate fee discussions from rating discussions;
- CRAs should have separate teams handling the assignment of initial ratings and monitoring continuous rating surveillance;
- CRAs should periodically rotate rating teams to prevent possible abuse and to uncover faulty ratings;
- CRAs should not rate a new structure until sufficient statistical data is available to produce a defensible rating;
- CRAs should introduce different rating symbols to distinguish structured products from the traditional debt products; and
- CRAs should not recommend how issuers structure their offerings.

Based on these positions, we state our comments to the specific questions as set out in the Consultation Paper as follows:

Q1.	Is it appropriate for Hong Kong to subject CRAs to a regulatory oversight regime consistent with international development?

We support the proposal for Hong Kong to subject CRAs to a regulatory oversight regime consistent with international development. The best outcomes of such regimes are greater transparency, better managed conflicts of interest, and improved tracking of the performance of prior ratings and methodologies.

Q2.	Should regulatory oversight of CRAs be achieved by extending the existing licensing regime under the Securities and Futures Ordinance ("SFO") to CRAs and those of their staff who perform regulated functions?

CFA Institute and HKSFA believe that CRAs should submit to regulatory authorization, hence, we support the recommendation to license CRAs. However, having qualified staff to perform the "regulated functions" should be a responsibility of CRAs. The "qualification" should not only consist of a specific "certificate", but should provide the relevant experience and continuous training. Therefore, each CRA should have its own specific guideline for continuous training requirements for its staff in the various functional areas.

Q4.	Should the proposed new licensing requirement apply to the rating of Sukuk?

As credit rating is an economic opinion, as oppose to a religious one, and the international CRAs also rate Sukuk, CFA Institute and HKSFA recommend that the new licensing requirements should apply to the rating of Sukuk products.

Q.5.	Should the following activities be excluded from the proposed new licensing requirements:
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)?

Improved ratings coverage can bolster CRA's databases and as a result, may give CRAs further evidence on which to base certain ratings. Therefore, we believe Q5 item (a) preparing credit ratings for an organization's internal purposes, and item (b) preparing private credit ratings, do not need to be excluded from the proposed new licensing requirements.

However, often the private credit ratings, such as the ones mentioned in Q5 item (a) and item (b), are point of time ratings, i.e. not monitored through time, hence there are risks for these private ratings to be misused and misinterpreted. There should be specific terms to regulate how these ratings can be used.

One of the concerns is the risk of private ratings being leaked to the public, which may lead to them being quoted out of context. We agree with the drafted Hong Kong Code of Conduct for Persons Providing Credit Rating Services ("HK CRA Code") Article 19, which requires the leaked ratings, even if they may be private ratings, to be compliant to the provisions of the HK CRA Code.

On the other hand, Q5 item (c) sharing or analyzing consumer or commercial credit data is commonly completed via a different set of methods and criteria, therefore, should be excluded in the proposed new licensing requirement.

Q6.	Further to question 5, do our draft amendments to the SFO effectively exclude these activities from the proposed new licensing requirement?

For the reasons stated above for Q5, we recommend not excluding items (a) and item (b), but excluding item (c) only.

Q8.	Does the HK CRA Code 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?

CFA Institute and HKSFA believe CRAs' should completely adopt the IOSCO Code to claim compliance. The SFC's consultation paper stated that "for the sake of convergence with the regulatory regimes of other jurisdictions, the HK CRA Code reflects the provision of the IOSCO Code – to the extent possible within the Hong Kong context". We welcome this approach.

However, if there are significant differences between the HK CRA Code and the IOSCO Code, we would like to suggest highlighting them to the public so they can understand the reasons behind these differences.

Q9.	Should persons licensed or registered for Type 10 regulated activity be permitted to be licensed or registered for other types of regulated activity?
Q10.	Should persons licensed or registered for Type 10 regulated activity be subjected to a sole business restriction?

To avoid potential conflicts of interest, person licensed or registered for Type 10 regulated activity should not be permitted to be licensed or registered for other types of regulated activity.

According to the IOSCO Code, there are alternative ways to manage potential conflicts of interest. The IOSCO Code requires CRAs to separate their credit rating business from other types of business in which they are involved and which could give rise to conflicts of interest. If this is in place, the licensed persons registered for Type 10 regulated activity may not need to be subject to a sole business restriction.

We have noticed that it is common practice for CRAs to have senior executive compensation linked to financial performance of the operation. While linking compensation with performance is a good corporate governance practice in general, in the context of CRAs, where the same person can sit and vote in rating committees, it possesses high risk of conflicts of interest. We would like to recommend that the HK CRA Code should include a provision to restrict people sitting and voting in a rating committee if their compensation is linked with the performance of the operation.

Furthermore, the positions of CFA Institute in handling conflicts of interest include:

- CRAs should have executive-level compliance officers to ensure full implementation and enforcement of the IOSCO Code. This is a necessary measure to manage perceived and actual conflicts of interest.

- CRAs should have separate teams for initial ratings and for continued rating surveillance. In addition, they should periodically rotate ratings teams to prevent abuse and uncover faulty ratings. These measures should be in place to provide another set of eyes to review the ratings and, hopefully, provide independent judgment.

Concluding Remarks

Since 2006, and through the recent global financial tsunami, CFA Institute has actively engaged in discussions with global CRAs regarding their performance, and has responded to a number of regulatory initiatives in North America and Europe. One of the key proposals we put forward for regulators to consider, which has since been adopted by most of the key regulators, was to use a set rating nomenclature that distinguishes structured products from traditional corporate and commercial paper ratings to help investors recognize the differences. We welcome SFC's proposal to include using different symbols to differentiate the different types of ratings in the HK CRA Code.

We appreciate your consideration of our comments.