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# SFC Publishes Consultation Conclusions Concerning The Regulatory Oversight Of Credit Rating Agencies

## Introduction

The Securities and Futures Commission (SFC) has recently released its consultation conclusions regarding the regulatory oversight of credit rating agencies (CRAs). The SFC published a paper on the subject on 19 July 2010 and proposed a number of reforms in the area, with the principal ones being:

1. Legislative amendments to Schedule 5 of the Securities and Futures Ordinance (SFO) with the aim of introducing a new form of regulated activity, Type 10 - providing credit rating services.
2. The drafting of a Code of Conduct for Persons Providing Credit Rating Services (CRA Code) which sets out the factors that should guide CRAs in the conduct of their business and which can be relied upon by the SFC when ascertaining whether a person is fit and proper to be licensed for the new Type 10 regulated activity
3. The creation of a draft list of Recognized Industry Qualifications and Local Regulatory Framework Papers for the new Type 10 regulated activity, to be integrated into the Guidelines on Competence.

The SFC received 21 written submissions from CRAs, industry associations, professional bodies, a listed company and market practitioners.

## International Background

The SFC has made it clear that in formulating a new regulatory regime for CRAs it is attempting to keep pace and maintain consistency with international developments in this area. Over the 2009/2010 period regulatory changes with regard to the oversight of CRAs have been announced in the US, EU, Japan, Australia and India. The International Organization of Securities Commissions (IOSCO) released in 2008 a revised Code of Conduct Fundamentals for Credit Rating Agencies and has recently updated its Objectives and Principles for Securities Regulation to include a new principle for CRAs; "credit rating agencies should be subject to adequate levels of oversight. The regulatory system should ensure that credit rating agencies whose ratings are used for regulatory purposes are subject to registration and ongoing supervision." The G20 declared in April 2009 that all CRA's whose ratings are used for regulatory principles should be monitored by an oversight system which is consistent with the IOSCO Code.

In light of international activity, the SFC has made it a priority to ensure that the oversight regime implemented in Hong Kong is in step with developments around the globe, a position welcomed by the respondents to its consultation paper. A further aim of the proposed reform is to ensure that credit ratings prepared in Hong Kong will be accepted in other jurisdictions. This is particularly important in the case of the EU, as credit ratings issued by CRAs from outside the EU are unlikely to be accepted within the Union from 7 June 2011 onwards, unless the jurisdiction from where they emanate subjects its CRAs to a regulatory apparatus equivalent to that of the EU.

## The Proposed Regime

### The Extension of the SFO Licensing regime

At present, CRAs do not fit tidily into any existing regulatory regime in Hong Kong, including that of the Securities and Futures Ordinance (SFO). The SFC sees the creation of a new form of regulated activity under the SFO, Type 10 "providing credit rating services", as the most efficient way of proceeding. This new regulated activity will be inserted into the SFO Schedule 5 Part 1 and involves the extension of the Hong Kong licensing apparatus to CRAs and those members of their personnel who perform the new regulated activity i.e. the credit rating analysts. This approach to regulation requires the amendment of the SFO, plus some consequential amendments to subsidiary legislation and a number of codes and guidelines published by the SFC.

Nonetheless some respondents were concerned that the extension of the licensing regime to individuals employed by the CRAs could discourage senior analysts, visiting analysts and new recruits to the CRAs from working in Hong Kong. The SFC noted that there is no individual licensing obligation in other major jurisdictions, bar China. However it then stated that the imposition of an individual licensing obligation is an integral part of the regulatory framework of Hong Kong regarding "regulated activities" and that no reason exists to treat CRAs and their analysts differently.

### The Scope of the New "Type 10" Activity

The new Type 10 activity is to be defined under the amended SFO Schedule 5 Part 1 as "providing credit rating services". This is to be distinguished from "advising on securities" (Type 4 regulated activity). The draft definition of "credit ratings", to be set out in Part 2 of Schedule 5 of the SFO, refers to the giving of opinions "primarily regarding the creditworthiness" of the rating target (which can be a person other than an individual, debt securities or an agreement to provide credit). In contrast, "Advising on securities" can include the provision of advice as to a company's creditworthiness, but is primarily concerned with whether or not certain securities should be bought, held or sold. Creditworthiness is but one factor in this equation. Credit ratings do not encompass advice as to whether or not securities should be disposed of or not.

Although the new regime is to apply to the rating of sukuk (Islamic law compliant financial instruments), exemptions from the licensing system are to be included in Part 2 of Schedule 5 of the SFO with regard to the preparation of credit ratings for an organization's internal purposes, the preparation of private credit ratings and the sharing or analyzing of consumer or commercial credit data (e.g. through the work of consumer or commercial credit reference agencies).

These exemptions created a certain amount of debate from the respondents to the consultation, although the majority supported all or some of them. One suggestion was that private ratings should not be excluded as they might be leaked to the public. However the SFC noted that such disclosure would be likely to come within the definition of "providing credit rating services", thereby possibly triggering an obligation to obtain a Type 10 licence. This development would then require the licensee to comply with the provisions of the CRA Code prior to public dissemination. It should be noted that these three categories are also exempt from the regulatory framework applied to CRAs in other jurisdictions, including the EU.

The final exemption from the definition of "providing credit rating services" granted in Part 2 of Schedule 5 refers to "the preparation, dissemination or distribution of credit ratings by any such person or class or persons as the SFC or Financial Secretary may specify by notice published in the Gazette." It was protested by one respondent that the criteria under which such an exemption would be granted are not noted in the amended legislation. However the SFC countered by noting that the power would only be used in exceptional circumstances to ensure that those who had unintentionally placed themselves in the position of "providing credit rating services" could be excused from having to secure a Type 10 Licence. As the exemption is designed to deal with unforeseen circumstances, the SFC stated that detailing the criteria to be taken into account would be impractical. However, should this power of exemption be conferred upon the SFC, it would publish on its website an FAQ section to provide the market with guidance on the factors the SFC would consider when assessing whether to extend the exemption to a person or class or persons.

### The CRA Code of Conduct

The Draft CRA Code of Conduct has been prepared by the SFC to guide CRAs in the conduct of their business and to provide factors which can be relied upon by the SFC when assessing whether a person is fit and proper to be licensed for the new Type 10 regulated activity. The CRA code is intended to be read in conjunction with the Code of Conduct for Persons Licensed by or Registered with the SFC. In keeping with the SFC's aim of ensuring consistency with regulatory standards overseas, the CRA Code is very close in content to that of the IOSCO Code.

The CRA Code requires CRAs to ensure that they do not carry on any form of business which could reasonably be considered to have the potential to give rise to any conflict of interest. It also demands that CRAs have procedures in place to minimize the possibility of conflicts of interest occurring and to identify any conflicts of interest which may arise as a result of the conduct of ancillary businesses. Such ancillary businesses must be defined and the justification for their being reasonably considered to present no potential conflict with the credit rating function of the CRA provided. The CRA Code states that CRAs should not act as consultants or advisors to a rated entity or a related party to a rated entity as regards their corporate/legal structure, assets, liabilities or activities.

In order to reflect the heightened regulation of CRAs in the EU, the CRA Code is stricter than that created by IOSCO. The original draft CRA Code provided in July at the time of the release of the SFC's Consultation Paper has been amended to take into account the submissions of the Committee of European Securities Regulators (CESR) on the matter of CRA regulation. Following these submissions the Code has been amended to:

1. delineate more clearly the respective responsibilities of the CRAs and their licensed representatives;
2. adopt a definition of "structured finance products" more in keeping with that used in the EU and other jurisdictions and dispense with the concept of "structured investment products";
3. introduce some changes to ensure compliance with the CESR's technical advices such as requiring a CRA to create and maintain an effective compliance function to ensure compliance with the CRA Code and the Internal Control Guidelines of the SFC and demanding that a CRA disclose if it or its group receives 5% of its annual revenue from a single source;
4. require a heightened level of disclosure from CRAs with regard to the lead rating analyst and person primarily responsible for approving the credit rating provided, the sources used to produce the credit rating, the level of assessment the CRA has undertaken regarding the due diligence processes performed at the level of underlying financial products and the level of ancillary services provided by a CRA.; and
5. impose the disclosure of an annual description of the internal quality control systems of the CRA, its record keeping policy, its management and rating analyst rotational policy and the outcome of its annual review of its independent compliance function.

### The Guidelines on Competence

When assessing whether an individual is suitably qualified to carry on a regulated activity the SFC is guided by the Guidelines on Competence. These are to be amended under the new regime via the insertion of a list of Recognized Industry Qualifications and Local Regulatory Framework Papers regarding the new Type 10 Regulated Activity. The SFC is currently working in tandem with the Hong Kong Securities Institute (HKSI) on the production of new exam papers for Type 10 responsible officers and on a revision of the existing general exam papers to reflect the development of a new regulated activity.

At present the SFC intends to finalise the amendments to the licensing regime by the end of January 2011 so that the licensing process for the CRAs and their representatives can occur over the four month period subsequent to that date. This tight schedule is being applied to ensure that there is a regulatory regime governing CRAs in place by June 2011, in order to allow credit ratings prepared in Hong Kong to be serviceable within the EU.

However a "grandfathering" regime will be applied to the staff of those CRAs which are "well established" in Hong Kong. Representatives of such CRAs who become licensed during the transitional period will not be required to pass the Local Regulatory Framework Papers and will be assessed on their academic achievements, industry record and through the use of management experience tests applicable to all regulated activities. However they will be required, within six months of securing licensing approval, to complete a course of not less than five hours duration relating to the legal and regulatory framework for Type 10 regulated activity, conducted by a Continuous Professional Training Provider. This will be in addition to fulfilling the normal Continuous Professional Training requirements.

### The Amendment of Subsidiary Legislation

As referred to at the outset of this note, the new regime requires the amendment of subsidiary legislation in the form of Schedule 1 of the Securities and Futures (Financial Resources) Rules (FRR). Schedule 1 is to be amended to specify that CRAs must have a minimum amount of paid up share capital of HK$0 and a minimum amount of required liquid capital of HK$100,000. This is in line with the FRR requirements for Type 4 licensees who advise on securities without retaining client assets. It is also broadly in keeping with the position in the US and EU. Sections 2, 5 and 56 of the FRR are to be amended also, in order to include the new Type 10 regulated activity within their scope.

### The Next Stage of the Process

The SFC will now work side by side with the Hong Kong government in order to ensure the passage of the required legislative amendments. Following the successful completion of this process, the SFC will announce details of matters such as application procedures and timing. Channels of communication will be kept open between the SFC and CRAs in Hong Kong in order to ensure that all concerns will be addressed and the transition to the new regime is as smooth as possible. As the situation internationally is evolving constantly, the SFC will monitor closely developments in other jurisdictions and make any adjustments to the proposed framework required to maintain consistency with international standards, particularly those of the EU.

*This newsletter is intended as a summary only of the SFC's proposals in relation to the regulation of credit rating agencies. Specific advice should be sought in relation to any particular situation.*

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