

Legislative Council Panel on Financial Affairs Regulation of Credit Rating Agencies

Purpose

The Securities and Futures Commission (“SFC”) has prepared a paper at **Annex** to brief Members about the proposed regulation of credit rating agencies (“CRAs”) operating in Hong Kong. This paper sets out the Administration’s views on the SFC’s proposal.

Background

2. An independent and objective credit rating of appropriate quality goes to the heart of investor protection. Following the G20’s consensus on the need to subject CRAs to a regulatory oversight regime, the European Union (“EU”) member states, the United States (“US”), Japan and Australia have announced regulatory measures to strengthen oversight of CRAs.

3. Against the backdrop of global agreement on regulating CRAs, we consider that it would be in the public interest to establish a regulatory oversight regime to enhance investor protection and to enable credit ratings prepared by Hong Kong-based CRAs to continue to be serviceable in other jurisdictions, particularly the EU in the light of her new requirements which will come into effect in June 2011.

SFC’s Proposed Regulatory Regime

4. SFC proposes to amend Schedule 5 of the Securities and Futures Ordinance (“SFO”) to include providing credit rating services as a new regulated activity. Both corporate CRAs and their rating analysts will need to be licensed under the SFO. We consider the proposed legislative approach both sensible and appropriate. Schedule 5 of the SFO can be amended by the Financial Secretary by notice published in the Gazette, subject to the negative vetting of the Legislative Council (“LegCo”).

5. To help ensure that the credit ratings are independent, objective and of appropriate quality, SFC proposes to impose minimum conduct standards for CRAs and their rating analysts by means of a CRA Code of Conduct. The CRA Code of Conduct would be based on the revised Code of Conduct Fundamentals for Credit Rating Agencies issued by the International Organisation for Securities Commissions in May 2008. These standards require credit rating activities to be conducted in accordance with the principles of integrity, independence, transparency and confidentiality. SFC will publish details of the CRA Code of Conduct for public consultation in late July 2010.

Way Forward

6. Following the public consultation in late July 2010, SFC intends to publish the consultation conclusions in late September 2010. Noting SFC's intention to have the regulatory regime in place by end of January 2011, we will work closely with SFC on the legislative amendments and aim to submit the proposed amendments to Schedule 5 of the SFO for negative vetting by LegCo by December 2010. Once the legislative framework is ready, SFC will commence the process of licensing CRAs and their rating analysts with a view to completing it before June 2011 when the EU deadline governing the serviceability in the EU of credit ratings issued by non-EU CRAs comes into force.

Financial Services Branch
Financial Services and the Treasury Bureau
July 2010

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Purpose

This paper discusses recent developments internationally in connection with the regulation of credit rating agencies (“**CRAs**”). It also describes in general terms the proposals that have been formulated by the Securities and Futures Commission (“**SFC**”) for the regulation of CRAs operating in Hong Kong.

Background

2. CRAs play an important role in global financial markets, as investors, borrowers, issuers and governments use their credit ratings for the purpose of making informed investment and financing decisions.

3. Following the credit crisis, a global consensus has emerged as to the desirability of enhanced regulatory oversight of CRAs designed to promote their independence and objectivity and to improve the quality of their ratings. The Declaration on Strengthening the Financial System issued on 2 April 2009 (“**G20 Declaration**”) announced the G20’s agreement that all CRAs whose ratings are used for regulatory purposes should be subject to a regulatory oversight regime consistent with the revised Code of Conduct Fundamentals for Credit Rating Agencies, which was issued by the International Organization for Securities Commissions (“**IOSCO**”) in May 2008 (“**IOSCO Code**”), compliance with which should be enforced by national authorities.

4. In recent months, jurisdictions including the European Union (“**EU**”) member states, the United States (“**US**”), Japan and Australia have announced regulatory measures to strengthen oversight of CRAs. Amongst these measures, the EU’s regime regulating CRAs is of particular importance to Hong Kong. The reason for this is that with effect from 7 June 2011, Regulation (EC) No 1060/2009 of the European Parliament and the Council of 16 September 2009 will prohibit any credit rating issued by a non-EU CRA from being used in the EU for regulatory purposes unless that non-EU CRA operates within a regulatory regime that is equivalent to,

or as stringent as, the EU regime, and cooperation arrangements have been established between the EU and the non-EU jurisdiction in which the CRA operates. In practice, this means that Hong Kong must quickly establish a regulatory regime for CRAs carrying on business in Hong Kong which is generally equivalent to that which will exist in the EU for the regulation of CRAs, and must then ensure that CRAs based in Hong Kong are brought within that regime, and actively regulated, by not later than the 7 June 2011 deadline.

Preparatory Work Concerning the Regulation of CRAs in Hong Kong

5. To the SFC's knowledge, there is no CRA based exclusively in Hong Kong. There are three major global CRAs operating in Hong Kong, namely, Fitch, Moody's and Standard & Poor's, together with three smaller multinational CRAs. Generally, these offices are engaged in the preparation of credit ratings for issue under each CRA's global brand.

6. In the past few months, the SFC has met the senior management of the CRAs which are operating in Hong Kong and, in order to better understand their business activities and operations, has collected relevant information via questionnaires that they agreed to complete. It is clear that these CRAs have accepted, as inevitable, the global move to more rigorously regulate them. They understand that, in order for their Hong Kong operations to remain viable, they will have to be regulated here and they appear content to be subjected to regulatory supervision in Hong Kong which is generally equivalent to that which will exist elsewhere and, more particularly, in the EU.

7. In addition to engaging in discussions with CRAs, the SFC has also entered into ongoing dialogue with IOSCO and with other overseas regulatory bodies, most notably in the EU and the US, for the purpose of ensuring that any proposals that it might formulate for the regulation of CRAs in Hong Kong will be consistent with the approaches that are being put in place in other important jurisdictions. In particular, the SFC is concerned to ensure that the regulatory regime that is created in Hong Kong for the regulation of CRAs is generally equivalent to that which is being put in place in the EU. As part of this process, the SFC also has engaged in ongoing dialogue with the Financial Services and the Treasury Bureau ("**FSTB**"), the Hong Kong Monetary Authority ("**HKMA**"), and the Hong Kong Securities Institute.

Proposed Regulatory Regime Governing CRAs in Hong Kong

Overview of Regulatory Objectives and Proposals

8. The regulation of CRAs does not fall neatly within any existing regulatory regime in Hong Kong, including that created under the Securities and Futures Ordinance, Cap. 571 (“SFO”). However, given the urgency of bringing CRAs within an effective and workable regulatory framework in Hong Kong and the limited time available in which to do so, the SFC considers that the most appropriate option is to create a new type of *regulated activity* under the SFO, namely, “Type 10: providing credit rating services”.

9. By adopting this approach, CRAs providing credit rating services in Hong Kong (together with their rating analysts) would need to be licensed under the SFO, thereby subjecting them to the same wide range of regulatory requirements, including requirements concerning financial resources, competence and record keeping, that apply to licensees conducting other types of *regulated activities* in Hong Kong within the meaning of the SFO.

10. In formulating the scope of this new regime, the SFC has been mindful of the need to exclude certain credit assessment related activities such as banks’ internal credit evaluation systems, private credit ratings and the sharing or analyzing of consumer or commercial credit data. The SFC also recognises the need to incorporate flexibility to excuse persons from an obligation to hold a Type 10 licence in certain cases where their activities would unintentionally fall within the definition of “providing credit rating services” and for whom the requirement to be licensed under the SFO would impose a compliance burden without serving any clear regulatory purpose.

Proposed Legislative and Regulatory Changes

11. The SFC’s proposal to create a new *regulated activity* of providing credit rating services, would require Schedule 5 of the SFO to be amended. Schedule 5 sets out each of the different types of *regulated activity* and defines them. The addition of “Type 10: providing credit rating services” would require this new type of *regulated activity* to be defined in Schedule 5. Because there is potential for there to be overlap between the new definition of “providing credit rating services” and the existing definition of “advising on securities” (Type 4 *regulated activity*) in Schedule 5, it would be necessary for the latter to be amended to ensure

that corporations carrying on the business of advising on securities in the traditional sense of this expression, are not also regarded as carrying on the business of providing credit rating services and thus having an obligation to secure Type 10 licences. Amendments to Schedule 5 can be effected by the Financial Secretary by notice published in the Gazette, subject to the negative vetting procedures of the Legislative Council.

12. The SFC's proposal to regulate CRAs in the manner described would give rise to a need for some consequential amendments to the Securities and Futures (Financial Resources) Rules ("**Financial Resources Rules**") to reflect the creation of the new Type 10 *regulated activity* and to stipulate the paid-up share capital and liquid capital requirements applicable to corporations which are licensed to conduct this type of business. The Financial Resources Rules may be amended by the SFC following consultation with the Financial Secretary, the HKMA and the public, subject to the negative vetting procedures of the Legislative Council.

13. The SFC would impose minimum conduct standards for CRAs by means of a code of conduct for persons providing credit rating services ("**CRA Code of Conduct**"). These minimum standards would include requirements that credit rating activities be conducted in accordance with principles of integrity, independence, transparency, and confidentiality. It is anticipated that this will help ensure that the resulting credit ratings are independent, objective and of appropriate quality.

14. The CRA Code of Conduct would be based on the IOSCO Code, as envisaged by the G20 in April 2009. However, of necessity, it would be formulated within the parameters created by the SFO and would be further refined to achieve consistency between the regulatory regime for CRAs conducting business in Hong Kong and the regulatory regimes existing in other important jurisdictions, especially that which will exist in the EU.

15. Some consequential amendments will also be made to the SFC's Guidelines on Competence to reflect the competence requirements of individuals seeking to be licensed to conduct Type 10 *regulated activity*.

16. The CRA Code of Conduct would be promulgated, and amendments made to the Guidelines on Competence, by the SFC by notice published in the Gazette.

17. The SFC proposes to publish, for the purpose of public consultation, a consultation paper, which will set out the proposed legislative amendments, the proposed CRA Code of Conduct and the proposed amendments to the Guidelines on Competence.

Other Jurisdictions

18. It is difficult to provide a definitive and, therefore, meaningful comparison between the regime that is being proposed by the SFC for the regulation of CRAs conducting business in Hong Kong and the manner in which CRAs are regulated in other jurisdictions. The reason for this is that in all important jurisdictions, the regulation of CRAs is under review and that by 2011, when it is intended that CRAs will become regulated in Hong Kong, the international regulatory landscape will have changed. However, attached to this paper as **Appendix 1**, is a table which summarises the SFC's key proposals for the regulation of CRAs and compares these with the regulatory regimes (actual or anticipated), as currently understood, in five other jurisdictions.

19. As is apparent from Appendix 1, there is general similarity between the approach that has been formulated by the SFC and the approaches adopted, or being developed, elsewhere. This is not surprising because the G20 Declaration requires the regulatory oversight of CRAs internationally to be consistent with the IOSCO Code, which stipulates the minimum standards of conduct that CRAs are expected to meet. The CRA Code of Conduct, which the SFC anticipates issuing, will closely resemble the IOSCO Code. Because other jurisdictions can also be expected to create regulatory regimes for CRAs that revolve around the requirements of the IOSCO Code, the regulatory model that is being proposed by the SFC for Hong Kong can reasonably be expected to closely resemble the regimes that will be created in other important jurisdictions.

20. There will inevitably be some differences because the relevant laws vary from jurisdiction to jurisdiction. For example, the SFO requires both corporations and individuals engaging in *regulated activities* to be licensed. In numerous other jurisdictions, individuals are not licensed. Accordingly, in this particular respect, it is probably fair to say that the regime which is being proposed for the regulation of CRAs in Hong Kong is more rigorous than in other jurisdictions, such as the US and the EU, where individuals are not licensed. These types of differences are not seen by the SFC as being of particular consequence because the

regulation of CRAs will effectively be dictated by the minimum standards of conduct to which they are expected to adhere. Those standards should be relatively consistent from one jurisdiction to another because the G20 Declaration directs that the regulatory oversight of CRAs internationally should be consistent with the requirements of the IOSCO Code.

Proposed Timeframe

21. The SFC proposes to issue its consultation paper in late July 2010 and to publish the results of the consultation exercise in late September 2010. Thereafter, it is intended that the regulatory regime governing CRAs conducting business in Hong Kong will be created by the end of January 2011 so that the SFC can commence the process of licensing CRAs and their rating analysts in February 2011. This process must be completed before 7 June 2011 when the EU deadline governing the serviceability in the EU of credit ratings issued by non-EU CRAs comes into force.

Conclusion

22. The creation in Hong Kong of a regulatory regime for CRAs, which is consistent with similar regimes being created in other important jurisdictions, is essential in order for Hong Kong to be seen as being committed to adherence to international standards of financial regulation and to ensure that Hong Kong remains an attractive jurisdiction in which CRAs will wish to base their Asian operations.

23. The SFC seeks the support of the Legislative Council Panel on Financial Affairs to proceed, in conjunction with FSTB, with its proposals to create a regulatory regime governing the licensing and conduct of CRAs, as more particularly detailed in this paper.

Securities and Futures Commission
July 2010

Summary of Regulation of Credit Rating Agencies (CRAs) in Different Jurisdictions

Appendix 1

	Hong Kong ⁱ	United States (US) ⁱⁱ	European Union (EU)	Australia	Japan	China ⁱⁱⁱ
Regulatory regime for CRAs	Under development	Yes	Yes	Yes	Yes	Yes
Regulatory scope	A person who provides credit rating services by preparing credit ratings for dissemination or by disseminating credit ratings	A person who is engaged in the business of issuing credit ratings on the Internet or through another readily accessible means, for free or a reasonable fee	A person whose occupation includes the issuing of credit ratings on a professional basis	A person who provides a financial product advice	A person whose occupation includes determining credit ratings and either providing them to someone or making them available to the public on a professional basis and registered with Japan Financial Services Agency (JFSA)	A person who provides credit rating services in relation to securities market
Licensee / Registrant	Corporate CRA and their rating analysts, who provide credit rating services, will be required to become licensed or registered persons under the Securities and Futures Ordinance (SFO)	Corporate CRA, whose credit ratings are used for regulatory purposes, must register with Securities and Exchange Commission (SEC) as an “nationally recognized statistical rating organizations”	Corporate CRA, who undertakes credit rating activities in EU, must register with a member state’s designated competent authority	Corporate CRA, who operates in Australia, must be licensed as providers of financial services	Corporate CRA must register with JFSA in order for its credit ratings to be used for regulatory purposes in Japan	Corporate CRA, their senior management and rating staff who provide credit rating services in relation to securities market are required to be registered with the China Securities Regulatory Commission (CSRC)

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Date of implementation of the regulatory regime	Intended to be early 2011	2007	2010	2010	2010	2007
Primary regulator	SFC	SEC	EU's member states' designated competent authorities ^{iv}	Australian Securities and Investments Commission	JFSA	CSRC
Conduct requirements reflecting the following core IOSCO CRA principles <ul style="list-style-type: none"> • Quality and integrity in the rating process • Independence and conflicts of interest • Transparency and timeliness of ratings disclosure • Treatment of confidential information 	Yes To be addressed in the proposed CRA Code of Conduct	Yes Addressed in the Securities and Exchange Act (SEA) and relevant rules issued by the SEC	Yes Addressed in the EU Regulation	Yes Addressed in the Corporations Act (CA)	Yes Addressed in the Financial Instruments and Exchange Act (FIEA)	Yes Addressed in the Temporary Regulation for Securities Market Rating Activities (TRSMRA)

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Enforcement powers	Yes Subject to the same disciplinary actions applicable to the existing licensed corporations or licensed individuals provided under the SFO	Yes Subject to a variety of actions for violating provisions of relevant rules provided under the SEA	Yes Subject to a number of supervisory measures that the EU competent authorities ^{iv} may take in response to violations of requirements governing the activities of CRAs	Yes Subject to the penalties applicable to all Australian Financial Services licensees provided under the CA	Yes Subject to administrative sanctions provided under the FIEA	Yes Subject to the penalties provided under the TRSMRA

ⁱ This column is prepared based upon the regulatory proposals developed by the SFC.

ⁱⁱ Regulatory oversight of CRAs is expected to be revised and tightened in the US as part of the financial reforms being considered there.

ⁱⁱⁱ This column only reflects the regulatory regime for CRAs which provide rating services in Mainland securities market. In fact, CRAs in China may be also subject to other regulatory oversight such as People's Bank of China if it provides rating services to other sectors.

^{iv} On 2 June 2010, European Commission (EC) proposed new measures to improve the existing EU Regulation for CRAs. One of the proposals made by EC is to centralize all regulatory powers over registered CRAs in EU in a new supervisory authority body, European Securities and Markets Authority.