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Paper for the House Committee

Report of the Subcommittee on Securities and Futures Ordinance (Amendment of Schedule 5) Notice 2011 and Securities and Futures (Financial Resources) (Amendment) Rules 2011

Purpose

This paper reports on the deliberations of the Subcommittee on Securities and Futures Ordinance (Amendment of Schedule 5) Notice 2011 and Securities and Futures (Financial Resources) (Amendment) Rules 2011 ("the Subcommittee").

Background

2. The ratings assigned by credit rating agencies ("CRAs") represent their opinions on the creditworthiness of an instrument involving indebtedness or the ability of the borrower or issuer to meet its financial obligations. Credit rating is thus a key reference for investors to assess the safety of an investment. Since the onset of the global financial crisis in 2007, concerns have been expressed by the market about the failure of CRAs to sufficiently consider the risks inherent in more complicated financial instruments and, as market conditions were worsening, to reflect this promptly in their ratings. Specifically, users of ratings are concerned about the business practices and business models adopted by CRAs that may affect their impartiality and independence.

3. Following G20's consensus on the need to subject CRAs to a regulatory oversight regime, the European Union ("EU"), the United States ("US"), Japan and Australia have announced regulatory measures to strengthen oversight of CRAs. Against this backdrop of global agreement on regulating CRAs, the Government considers that it would be in the public interest to establish a regulatory oversight regime in Hong Kong to enhance investor protection and to enable credit ratings prepared by Hong Kong-based CRAs to continue to be serviceable in other jurisdictions.

4. The Securities and Futures Commission ("SFC") conducted a public consultation exercise from 19 July 2010 to 20 August 2010 on the relevant proposals, following the Administration's briefing for the Panel on Financial Affairs on the proposals on 19 July 2010. SFC released the consultation conclusions on 29 October 2010, reporting that a total of 21 written submissions had been received and there was general support of the proposal to extend the existing regulatory regime of the Securities and Futures Ordinance (Cap. 571) ("SFO") to include the regulation of CRAs conducting business in Hong Kong.

Securities and Futures Ordinance (Amendment of Schedule 5) Notice 2011 and Securities and Futures (Financial Resources) (Amendment) Rules 2011

Securities and Futures Ordinance (Amendment of Schedule 5) Notice 2011 ("Amendment Notice")

5. The Amendment Notice, which is made by the Financial Secretary under section 142 of the SFO, amends Schedule 5 to SFO by adding a new type of regulated activity to Part 1 of the Schedule- "Type 10 : providing credit rating services". The effect of this amendment is that the existing regulatory regime under SFO will apply to corporations, authorized financial institutions and individuals providing credit rating services in Hong Kong.

6. Under the Amendment Notice, Type 10 regulated activity relates to the preparation of opinions, expressed using a defined ranking system, primarily regarding the creditworthiness of a person other than an individual, debt securities, preferred securities or an agreement to provide credit. It does not include the following activities:

(a) preparing, pursuant to a request made by a person, a credit rating which is exclusively prepared for, and provided to, the person and that 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; or

(b) gathering, collating, disseminating or distributing information concerning the indebtedness or credit history of any person.

Securities and Futures (Financial Resources) (Amendment) Rules 2011 ("Amendment Rules")

7. The Amendment Rules are made by SFC under section 145 of SFO (after

consultation with the Financial Secretary) to amend the Securities and Futures (Financial Resources) Rules (Cap. 571 sub. leg. N) ("FRR") to provide for paid-up share capital requirements and liquid capital requirements for corporations licensed for Type 10 regulated activity and connected matters. The major amendments are as follows:

(a) a reference to Type 10 regulated activity is added to section 5 of and Schedule 1 to the FRR so as to impose a duty on corporations licensed for Type 10 regulated activity to maintain a minimum paid-up share capital and required liquid capital as prescribed in Schedule 1 to the FRR; and

(b) a reference to Type 10 regulated activity is added to section 56 of the FRR so as to impose a duty on corporations licensed for Type 10 regulated activity to submit periodic returns to SFC.

8. The Amendment Notice and the Amendment Rules will come into operation on 1 June 2011.

The Subcommittee

9. At the House Committee meeting held on 25 February 2011, Members agreed to form a subcommittee to study the Amendment Notice and the Amendment Rules. Under the chairmanship of Hon James TO Kun-sun, the Subcommittee has held four meetings to discuss the legislative amendments with the Administration. The membership list of the Subcommittee is in the **Appendix**.

Deliberations of the Subcommittee

Regulatory objectives

10. The Subcommittee has sought explication on the policy objectives of establishing a regulatory regime in Hong Kong for CRAs. The Administration has advised that the proposed regulatory regime is to serve the following two purposes –

(a) **To enhance investor protection** – The regulatory regime should help ensure that the credit ratings, to which the public has access, are independent, objective and of appropriate quality so that rating users will make informed investment decisions.

(b) **To fulfill international obligations of regulating CRAs and to enable credit ratings prepared by CRAs in Hong Kong to continue to be serviceable in other jurisdictions** – A number of CRAs have already established presence in Hong Kong but their credit rating activities in Hong Kong are not subject to regulation at present. Hong Kong is expected to meet the requirements laid down by G20 and to create a regulatory regime for CRAs which is generally consistent with the regulatory models that have been adopted (or are in the process of being created) in other jurisdictions.

Regulatory framework

11. The Subcommittee notes that introduction of the Type 10 regulated activity (providing credit rating services) means subjecting both corporate CRAs in Hong Kong and their individual rating analysts to the licensing regime under the SFO, and hence all general licensing obligations. This will also enable SFC to publish a Code of Conduct for Persons Providing Credit Rating Services ("CRA Code")[1].

12. The Subcommittee has sought details of the proposed CRA regulatory regime, including the following-

(a) eligibility criteria for licensing CRAs and rating analysts;

(b) sanctions for breach of relevant legislative requirements or other regulatory obligations;

(c) criminal and/or civil liabilities for problematic credit ratings; and

(d) measures to prevent/avoid conflicts of interests so as to ensure the integrity of the rating process.

Eligibility criteria for licensing CRAs and rating analysts

13. The Administration and SFC have advised that for CRAs and their analysts to be eligible for a licence, they must satisfy SFC as to their fitness and properness. In determining this, SFC may take into account such matters as it considers relevant and, in addition, must have regard to the matters stipulated in section 129(1) of SFO. These matters include their financial status or solvency, their educational or other qualifications and experience, their ability

[1] Section 399 of the SFO confers SFC the power to publish codes and guidelines for providing guidance for the furtherance of any of its regulatory objective, or in relation to its functions or the operation of any provision in the SFO.

to carry on the regulated activity competently, honestly and fairly, and their reputation, character, reliability and financial integrity. The above criteria are detailed in the Fit and Proper Guidelines and Guidelines on Competence, which have been published by SFC.

Sanctions, civil and/or criminal liabilities

14. With regard to the sanctions applicable to CRAs under the proposed regulatory regime, the Administration and SFC have advised that SFC is empowered under section 194 of SFO to take disciplinary actions against a regulated person (including a licensed CRA, its licensed representatives and responsible officers, and management staff) if that person is found to be guilty of misconduct or not fit and proper to remain a regulated person. Such disciplinary powers include –

(a) revocation of a licence;

(b) suspension of a licence;

(c) public or private reprimand;

(d) ban from the industry permanently or for a stated period; and/or

(e) imposition of a fine of the greater of $10 million or three times any profit gained or loss avoided as a result of any misconduct.

Licensed CRAs and rating analysts will be required to comply with all applicable rules, codes and guidelines administered by SFC, including the CRA Code to be promulgated by SFC. In general, SFC will be guided by the CRA Code in considering whether a licensed CRA or rating analyst satisfies its/his regulatory obligations and remains fit and proper to be licensed.

15. At the request of the Subcommittee, the Administration and SFC have provided the updated version of the draft CRA Code[2] to the Subcommittee, with explanations on the key differences between the draft CRA Code and the Code of Conduct Fundamentals for Credit Rating Agencies issued by the International Organization of Securities Commissions in May 2008 ("IOSCO Code"). According to the Administration and SFC, the draft CRA Code is primarily based on the IOSCO Code, but has incorporated additional requirements that are dictated by the regulatory difference that exist in Hong Kong, and some additional requirement that have been introduced in other jurisdictions, particularly in EU. The IOSCO Code and the measures put in

[2] Annex to LC Paper No. CB(1)1613/10-11(01)

place in Hong Kong (by way of the CRA Code) and in other comparable jurisdictions all revolve around the principles of integrity, independence, transparency and confidentiality.

16. The Administration and SFC have also advised that under the proposed regulatory regime, there are no specific provisions under which CRAs or their rating analysts may face criminal or civil liability as a consequence of the performance of the regulated activity of providing credit rating services. The intention is that licensed CRAs or their rating analysts will be treated in the same manner as other persons licensed under SFO. At present, a person licensed to advise on securities, futures contracts or corporate finance does not face potential criminal or civil liability that is specifically designed around deficiencies in the provision of such advice. Therefore, it is not intended that similar liability should be specifically created for CRAs.

17. The Administration and SFC have stressed that the proposed regulatory regime does not lack regulatory "teeth". They have explained that firstly, the threat of revocation or suspension of the licence of a CRA or a rating analyst, or subjecting them to a very substantial fine, are powerful disincentives to a CRA or a rating analyst who may be tempted to depart from the minimum obligations that apply to them under the CRA Code. Secondly, both may face potential civil liability at common law, for example, by negligently issuing a credit rating that is false or misleading, thereby breaching a duty of care owed to persons relying on the rating. Alternatively, they may face civil liability under section 108 of SFO if they issue a rating report containing any fraudulent, reckless or negligent misrepresentation which induces others to enter into transactions involving securities, regulated investment agreements or collective investment schemes. In addition, they may face civil liability under section 391 of SFO where a rating report is publicly issued which contains false or misleading information concerning securities or futures contracts. Thirdly, the criminal provisions of SFO are capable of applying to CRAs and their rating analysts in the same way as they are capable of applying to other persons licensed under SFO. Accordingly, a rating analyst who issues a rating report knowing it to be capable of influencing the market may well, by way of example, commit the offence of insider dealing (section 291 of SFO) if he buys or sells securities in anticipation of the influence that his rating will have on the market, or the offence of disclosing false or misleading information inducing transactions (section 298 of SFO) if his report contains false or misleading information. Alternatively, CRAs and their rating analysts may well face criminal liability under section 107 of SFO if they issue rating reports containing fraudulent or reckless misrepresentations for the purpose of inducing other persons to enter into transactions concerning securities, regulated investment agreements or collective investment schemes.

Disciplinary actions

18. Noting that SFC may take disciplinary actions against a regulated person if that person is found to be guilty of misconduct or not fit and proper to remain a regulated person, the Subcommittee has examined the following issues –

(a) whether the term "misconduct" is defined in SFO or illustrated in any rule/code/guideline of SFO regulatory regime;

(b) on what ground(s) SFC would decide to take a disciplinary action against a regulated person for misconduct or being not fit and proper to remain a regulated person, and what rules or guidelines SFC would follow in making determinations in disciplinary proceedings; and

(c) whether the scope of misconduct only covers acts or omissions that are related to the regulated activity of providing credit rating services.

19. According to the Administration and SFC, the term "misconduct" is defined in section 193(1) of the SFO, to mean –

(a) a contravention of any of the relevant provisions as defined in Part 1 of Schedule 1 to SFO;

(b) a contravention of any of the terms and conditions of any licence or registration under SFO;

(c) a contravention of any other condition imposed under or pursuant to any provision of SFO, or of any condition attached or amended under section 71C(2)(b) or (9) or 71E(3) of the Banking Ordinance (Cap. 155); or

(d) an act or omission relating to the carrying on of any regulated activity for which a person is licensed or registered which, in the opinion of SFC, is or is likely to be prejudicial to the interest of the investing public or to the public interest.

SFC shall not form any opinion under (d) above on the nature of the act or omission in the context of interest of the investing public or the public interest unless it has had regard to such provisions in any code of conduct made or code or guideline published under SFO.

20. As regards the definition of "fit and proper", the Administration and SFC have advised that sections 116(3), 117(2)(e), 120(3) and 121(2)(e) of SFO compel SFC to refuse to grant a licence to carry on a regulated activity unless the applicant satisfies SFC that it/he is a "fit and proper" person to be licensed for the regulated activity. Section 129(1) of SFO provides that SFC may take into account such matter as it considers relevant in determining whether a person is fit and proper to be licensed, and must have regard to the matters stipulated in that sub-section[3]. In addition, section 129(2) of SFO permits SFC to take into account any decision made by other regulatory bodies in respect of the applicant when considering its/his fitness and properness. The Fit and Proper Guidelines published by SFC outline a number of matters that SFC will normally consider in determining whether a person is fit and proper and provide examples of when SFC is not likely to be satisfied as to a person's fitness and properness.

21. As advised by the Administration and SFC, in exercising its powers to instigate disciplinary proceedings, SFC is required to follow the procedural requirements stipulated in section 198 of SFO. SFC has developed various guidelines to enhance fairness and certainty of the disciplinary proceedings, including the SFC Disciplinary Fining Guidelines published in 2003 and a pamphlet entitled "Disciplinary Proceedings at a Glance" in 2005 to provide a brief overview of the disciplinary process. Under Part XI of SFO, a person who is aggrieved by a decision of SFC may apply to the Securities and Futures Appeal Tribunal ("SFAT") for a review of the decision. SFAT is an appellate body with the ability to consider cases on their merits, which is independent of SFC and chaired by a High Court judge. If a person is dissatisfied with SFAT's decision, an appeal can be made to the Court of Appeal.

22. As regards the scope of misconduct that may be subject to SFC's disciplinary actions, the Administration and SFC have advised that the term "misconduct" is not confined to the actions of licensed or registered persons arising out of their conducting of the business for which they are licensed or registered. Accordingly, misconduct on the part of a CRA or one of its analysts might well be unrelated to its/his credit rating activities (see paragraph 17 above). It is neither practical nor appropriate to stipulate each and every type of conduct which would result in SFC concluding that a person is not fit and proper to be, or to remain, licensed, or that it/he has been guilty of misconduct. It is also impracticable and inappropriate for there to be a comprehensive list of the actions that SFC will take in each and every situation. These determinations are to be made by SFC by exercising its discretion in each case, within the statutory restrictions that are imposed on it and subject to the checks and balances inherent in the system of review which has been

[3] These matters are mentioned in paragraph 13 above.

created under SFAT. Conferring such discretion on a financial regulatory body is a universally recognized model. It enables SFC to formulate a fair and appropriate response to particular circumstances, without having its hands tied in a manner that might result in unfair consequences in some cases. Furthermore, the decisions of SFC and SFAT create a body of jurisprudence which effectively influences future decisions of SFC and leads to consistency.

23. At the Subcommittee's request, SFC has provided a list[4] of the most significant disciplinary actions, which was included in SFC's 2009-2010 Annual Report, for the purpose of illustrating the types of disciplinary actions that were taken by SFC in 2009-2010 and the circumstances in which such disciplinary actions were taken.

Sanctions against breach/non-compliance under the regulatory regimes of other comparable jurisdictions

24. Noting that there are no specific provisions under which CRAs or their rating analysts may face criminal or civil liability as a consequence of the performance of the regulated activity, the Subcommittee has sought information on the relevant arrangements under the CRA regulatory regimes of other comparable jurisdictions.

25. According to the Administration and SFC, Part C of Chapter 4 of the Consultation Report – Regulatory Implementation of the Statement of Principles Regarding the Activities of Credit Rating Agencies issued by the International Organization of Securities Commissions in May 2010 ("the IOSCO Report") summarizes the regulatory powers to sanction CRAs for violating requirements governing their credit rating activities in various overseas jurisdictions including the US, EU, Australia and Japan. The IOSCO Report does not indicate that there are any specific criminal offences in these jurisdictions to sanction CRAs for their acts arising out of their rating business. However, these overseas regulatory bodies have disciplinary powers similar to those conferred on SFC, such as revocation of licence or registration, suspension of licence or registration, monetary penalties, and reprimand or censure. The Report also states that in addition to the above disciplinary powers, many of these regulatory bodies can also refer matters for criminal prosecution for general offences. SFC believes that the regulatory regime that is proposed for CRAs in Hong Kong is similar to those prevailing, or being proposed, in other major jurisdictions.

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[4] Annex D to LC Paper No. CB(1)1676/10-11(01)

Preventing/Avoiding conflict of interests

26. With respect to the issue of conflicts of interests, the Administration and SFC have advised that Part 2 of the draft CRA Code imposes extensive obligations on CRAs and their analysts to maintain independence and avoid conflicts of interests. The relevant provisions include the following –

(a) A CRA is not allowed to provide consultancy or advisory services to a rated entity, or its related party, regarding the corporate or legal structure, assets, liabilities or activities of that rated entity or related party (paragraph 30 of the draft CRA Code).

(b) A CRA is required to disclose when it and any of its rating agency affiliates receive more than 5% of their combined annual revenue from a single issuer (paragraph 34(b) of the draft CRA Code).

(c) Representatives are not allowed to initiate, or participate in, discussions regarding fees or payments with any entity they rate (paragraph 41 of the draft CRA Code).

<u>Existing regulatory requirements regarding credit ratings of financial products</u>

27. The Subcommittee has examined how the proposed regulatory regime for CRAs relates to the existing regulatory requirements in respect of financial products. In this regard, the Subcommittee has sought information on the following –

(a) whether there is any financial product which is subject to credit rating requirements before the product is offered to the public; and

(b) whether there is any specified standards of credit rating applicable to regulated financial products.

28. The Administration and SFC have advised that for funds, unlisted structured investment products or debt securities offered to the public, there is no requirement under SFO, the Companies Ordinance (Cap. 32) ("CO") or applicable SFC product codes and guidelines, that these products be rated. There are however certain disclosure requirements where such financial products are rated. Under the prospectus regime of CO, a document containing a public offer of shares or debentures (including plain vanilla bonds) is required to be authorized by SFC for registration as a prospectus under CO unless an exemption applies. There is no requirement under CO for bonds or issuer of the bonds to be rated. If credit ratings are disclosed voluntarily in a prospectus, SFC would expect the issuer to provide sufficient particulars and information on such credit ratings to enable prospective investors to make

informed investment decisions. For funds and unlisted structured investment products, where an issuer voluntarily discloses any credit rating, SFC's codes including the Code on Unit Trusts and Mutual Funds ("UT Code") and the Code on Unlisted Structured Investment Products ("SIP Code") impose requirements to disclose the breakdown or meaning of the credit rating, and where appropriate, warning statements shall be inserted. In the case of unlisted structured investment products, the issuers/guarantors/other counterparties and (if applicable) the collateral are subject to eligibility requirements, and credit ratings are one of the many criteria in considering the eligibility.[5]

Proposed definitions of "providing credit rating services", "credit ratings" and "debt securities"

29. The Subcommittee has examined whether the proposed definition of "providing credit rating services"[6] for inclusion in Schedule 5 to SFO is clear and precise enough to reflect the intended scope of the Type 10 regulated activity (providing credit rating services) and to avoid giving rise to any loophole in the regulatory regime. The Subcommittee is particularly concerned whether the phrase "with a reasonable expectation that they (i.e. credit ratings) will be so disseminated/distributed" in paragraphs (a)(ii) and (b)(ii) of the definition, may create a loophole.

30. The Administration and SFC have advised that the paragraphs (a)(ii) and (b)(ii) of the definition of "providing credit rating services" are actually designed to close a potential loophole, instead of creating one. These paragraphs make it clear that CRAs will be regarded as providing credit rating services notwithstanding that they might conveniently turn a blind eye to the probability that a client might intend to publicly disseminate a rating that they have prepared for its private use. Accordingly, these paragraphs are intended to catch an extreme and unlikely situation of a less than reputable CRA establishing a rating business and seeking to avoid a licensing obligation under SFO on the basis of an understanding with its clients that it will prepare ratings ostensibly for their use only, but under a tacit understanding between them that the clients will publicly disseminate them.

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[5] A summary of the detailed requirements for credit ratings set out in the UT Code and the SIP Code is given in Annex F to LC Paper No. CB(1)1676/10-11(01).

[6] As specified in the Amendment Notice, -

"providing credit rating services" (提供信貸評級服務) means-

(a) preparing credit ratings-

(i) for dissemination to the public, whether in Hong Kong or elsewhere; or

(ii) with a reasonable expectation that they will be so disseminated; or

(b) preparing credit ratings-

(i) for distribution by subscription, whether in Hong Kong or elsewhere; or

(ii) with a reasonable expectation that they will be so distributed; but does not include…

31. The Subcommittee is also concerned about the appropriateness of using the term "reasonable expectation" in the proposed definition of "providing credit rating services", as the term might involve a subjective element and give rise to possible disputes. In this regard, the Subcommittee has requested the Administration to -

(a) clarify whether the court is expected to apply an objective test in determining whether the person in question has had "a reasonable expectation";

(b) review whether there is any judicial authority on the interpretation of the term "reasonable expectation" in Hong Kong or other common law jurisdictions; and

(c) consider whether the term "reasonable anticipation" ("合理預期") would be more appropriate than and thus can replace the term "reasonable expectation" ("合理期望") in the context of the proposed definition.

32. The Administration and SFC have responded that after detailed consideration from the drafting and operational perspectives, they have come to a view that the phrase "reasonable expectation" could remain unchanged. Firstly, the phrase "reasonable expectation" is also used in a definition in relation to Type 7 regulated activity - "automated trading services" contained in Schedule 5 to SFO. Adopting the same phrase in the definition of "providing credit rating services", the new Type 10 regulated activity, will bring consistency. Secondly, in the unlikely event of a firm/individual conducting credit rating activities without being licensed, the court will determine whether, in the particular circumstances, a reasonable man in the same position as the firm/individual would expect that the credit ratings it/he was preparing would be disseminated to the public.

33. The Administration and SFC have further advised that their research reveals that there are a number of judicial cases[7] suggesting that the phrase "reasonable expectation / reasonably be expected" provides an objective test. In fact, the phrases "reasonable expectation", "reasonably expected", "reasonably expect" and "reasonably be expected" are widely used in Hong Kong statutes, but the phrase "reasonable anticipation" is not found in the statutes. The phrase "reasonably anticipated" does appear once in the Table

[7] As advised by the Administration, these judicial cases include -
(a) *Leung Chi Keung v Market Misconduct Tribunal* [2010] HKEC 1768;
(b) *HKSAR v Gurung Krishna* [2010] HKEC 1150; and
(c) *Wong Chan Oi Ying v Wong Yiu Cho* [2007] HKEC 442 and *R v S* [2010] HKEC 1365.

under Schedule 5 to the Air Navigation (Hong Kong) Order 1995 (Cap. 448 sub. leg. C), but is used in the technical context concerning aircraft equipment. The Order does not have a Chinese version. With the above, the Administration and SFC are of the view that the phrase "reasonable expectation" in the definition of "providing credit rating services" should remain unchanged.

34. As regards the Chinese rendition of the phrase "reasonable expectation", the Administration and SFC have advised that both "合理預期" and "合理期望" are used in Hong Kong's legislation. Since the question will be ultimately determined by an objective test, the Chinese rendition of "合理期望" in the definition of "providing credit rating services" is very unlikely to alter the effect of such an objective test to be adopted by the court. Given the aforesaid and the fact that "合理期望" has been used in the Chinese text of the SFO in connection to Type 7 regulated activity (i.e. automated trading services), it is considered that the Chinese term "合理期望" can remain unchanged for the sake of consistency.

35. The Subcommittee has also examined whether the proposed definitions of "credit ratings" (信貸評級) and "debt securities" (債務證券)[8] are sufficiently wide and clear to reflect the intended scope of entities and financial products, whose credit ratings are to be covered by the proposed regulatory regime. In this regard, the Chairman has suggested that consideration be given to adding a catch-all phrase to the proposed definition of "credit ratings" to cater for novel financial products in future.

36. In this regard, the Administration and SFC have highlighted that the proposals that have been prepared for the establishment of a regulatory regime for CRAs in Hong Kong have taken into account international reforms in this area. Consistent with those reforms and the direction of the G20, Hong Kong's proposals are modelled on the IOSCO Code. Under the IOSCO Code, a credit rating is defined as an opinion regarding the creditworthiness of an entity, a credit commitment, a debt or debt-like security or an issuer of such obligations, expressed using an established and defined ranking system. In addition, the IOSCO Code clearly indicates that credit ratings are not

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[8] As specified in the Amendment Notice, -

credit ratings (信貸評級) means opinions, expressed using a defined ranking system, primarily regarding the creditworthiness of—

(a) a person other than an individual;
(b) debt securities;
(c) preferred securities; or
(d) an agreement to provide credit;

debt securities (債務證券) means debenture stocks, loan stocks, debentures, bonds, notes, indexed bonds, convertible debt securities, bonds with warrants, noninterest bearing debt securities, and other securities or instruments acknowledging, evidencing or creating indebtedness.

recommendations to purchase, sell or hold any security. The proposed definitions of "credit ratings" and "debt securities" cover a broad range of rating targets, including –

(a) a wide range of public bodies and other incorporated or unincorporated bodies, by virtue of the definition of "person" contained in section 3 of the Interpretation and General Clauses Ordinance (Cap. 1);

(b) securities and other instruments acknowledging, evidencing or creating indebtedness. The term "securities" is widely defined in Part 1 of Schedule 1 to SFO to include a wide range of financial products including stocks, bonds, and options; and

(c) an agreement to provide credit which covers any other financial instrument which creates a credit commitment.

It follows that if a financial instrument conveys an obligation to pay a pre-determined amount of money, it is clear that this would create "indebtedness" within its ordinary meaning. Thus, for licensing purposes, preparing credit ratings of such instruments will almost certainly constitute "providing credit rating services".

37. The Administration and SFC have pointed out that in consulting the public on the proposed CRA regulatory regime, SFC had included in its consultation document the proposed legislative amendments, including the draft definitions of "credit ratings" and "debt securities". The written comments from existing CRAs, rating users, industry and professional associations and market practitioners expressed no concerns as to the scope of the proposed definitions of "credit ratings" and "debt securities" or that they might not capture existing and future financial products. The proposed definitions have also been subjected to international review, particularly by EU.

38. On account of the above reasons, the Administration and SFC believe that the proposed definitions of "credit ratings" and "debt securities" are wide and clear enough to meet the policy intention that gave rise to the proposal to create a regulatory regime for CRAs in Hong Kong. The introduction of a catch-all clause, which may extend the scope of the definition of "credit ratings", could cause concerns on regulatory certainty.

Distinction between Type 4 regulated activity and the proposed Type 10 regulated activity

39. Noting from the Administration that the proposed Type 10 regulated activity (providing credit rating services) is intended to be different from Type 4 regulated activity (advising on securities), the Subcommittee has requested the Administration/SFC to review whether the two types of activities

are actually distinct from each other, and whether their respective (proposed) scopes as specified in Schedule 5 to the SFO would create any loophole or overlap in the SFO regulatory regime.

40. The Administration and SFC have affirmed that there will be no overlap between the two types of regulated activities. Type 4 regulated activity (advising on securities) is defined in Schedule 5 to SFO to capture the giving of advice to a client concerning the acquisition or disposal of particular securities by that client. Type 10 regulated activity (providing credit rating services) will be different and involve the provision of opinions, expressed using a defined ranking system, regarding the creditworthiness of a corporate body or an instrument of the types stipulated in the definition of "credit ratings". Credit ratings do not constitute advice to a client concerning the acquisition or disposal of securities by that client. For the avoidance of doubt, the definition of "advising on securities" contained in Schedule 5 to SFO is amended by the Amendment Notice to specifically provide that "advising on securities" does not include "providing credit rating services". It necessarily follows that a firm which holds a Type 4 licence under SFO will not be permitted to carry on the business of providing credit rating services unless it also holds a Type 10 licence.

Transparency and timeliness of ratings disclosure

41. In consideration of the need to safeguard the interests of the investing public, the Subcommittee has requested the Administration/SFC to consider requiring CRAs or their clients to disclose all credit ratings that have been made on a financial product or issuer under certain circumstances so as to prevent the product issuers from hiding the (previous) unfavourable credit ratings.

42. SFC has advised that it agrees with the Subcommittee's proposal and has actually included appropriate provisions to this effect in the draft CRA Code. Firstly, if a rating is discontinued, paragraph 18 of the draft CRA Code requires CRAs to make timely public disclosure of this fact and the reasons for such discontinuation. Accordingly, if an issuer is dissatisfied with a rating and instructs the CRA to discontinue the rating, the CRA will be obliged to publicly disclose these facts. Secondly, paragraph 47 of the draft Code requires CRAs to ensure that all of their ratings and updates are publicly disclosed in a timely manner. Furthermore, paragraph 52 of the draft Code contains a specific requirement in relation to structured finance products, under which CRAs should disclose, on a timely and ongoing basis, information concerning all structured finance products submitted to them for initial review or for a preliminary rating. Such disclosure should be made irrespective of whether the issuer engages the CRA to provide a final rating concerning the product in question. With the above safeguarding measures in place, it is not anticipated

that issuers will easily be able to conceal unfavourable ratings when the new regulatory regime comes into force.

Private ratings

43. Noting that the proposed CRA regulatory regime is not intended to regulate the activity of providing private ratings, the Subcommittee has examined whether this unregulated realm of activity is susceptible to abuse. Since the clients of CRAs are not subject to regulation under the proposed regulatory regime, the Subcommittee has requested the Administration/SFC to put in place appropriate measure to address this possible loophole, such as requiring CRAs to include in the relevant service agreement a provision to prohibit their clients from disseminating the private ratings and related information to the public.

44. The Administration and SFC have responded that while they do not think it appropriate to require firms conducting private rating to be licensed under SFO, they agree with the proposal to require CRAs to incorporate into their client agreements provisions prohibiting their clients from disseminating private ratings. Accordingly, SFC has revised paragraph 19 of the CRA Code to this effect[9].

Financial resources requirements

45. The Subcommittee notes that under the Amendment Rules, Type 10 licensed corporations are subject to the capital requirement of a paid-up share capital of HK$0 and a minimum amount of required liquid capital of HK$100,000. The Chairman has expressed concern that the capital requirement is minimal and disproportionate to the risks that investors of relevant financial products are exposed to. He considers that the credit ratings given by CRAs may affect large amounts of investments and hence there should be proper risk management in this regard. In this connection, he has requested the Administration to consider raising the capital requirement and/or requiring CRAs to take out professional indemnity insurance as an investor protection measure, and provide information on the relevant arrangements in other major financial markets.

46. The Administration and SFC have explained that the essential purpose of the IOSCO Code is to promote investor protection by safeguarding the integrity of the rating process. The IOSCO Code does not introduce any minimum capital requirements for CRAs. This approach is generally accepted on a global basis and in the US, EU and Australia, no capital requirements are imposed on CRAs. The situation is different in Hong Kong because section 129(1)(a) of SFO requires SFC to have regard to financial status or solvency

[9] The revision is shown in Annex E to LC Paper No. CB(1)1676/10-11(01).

when reaching a determination as to the fitness and properness of an applicant to be licensed. SFC is also obliged, by section 116(3)(b) of SFO, to refuse to grant a licence to an applicant if it fails to satisfy SFC that it will be able, if licensed, to comply with the FRR.

47. SFC has stressed that consistency is an essential part of sound regulation. Bearing in mind that Type 10 licensees will not hold client assets, the same capital requirements should be imposed on CRAs as are imposed on these other types of licensed corporations (i.e. Type 4 (advising on securities), Type 5 (advising on futures contracts), Type 6 (advising on corporate finance) and Type 9 (asset management) licensed corporations) carrying on regulated activities without holding any client assets. SFC considers that there is no legitimate basis upon which CRAs should be singled out for special treatment in relation to their capital requirements. SFC also considers that for the sake of consistency, an increase in capital requirements would have to be done across the board, but such arrangement lacks justifications at the current state of play.

48. SFC also considers that increasing the capital obligations of CRAs might well cause them to relocate to another Asian jurisdiction that part of their business which would give rise to an obligation to be licensed under SFO. This might well result in CRAs reducing the scope of their Hong Kong operations to the conduct of research or information gathering (which would not require them to be licensed), with research material being communicated to associated companies outside Hong Kong where the preparation of ratings would take place. This is not in the best interest of Hong Kong because it would mean that the rating of Hong Kong rating targets would occur outside Hong Kong. Furthermore, there would, in that event, be no redress in Hong Kong in the case of unacceptable conduct during the preparation of a rating report because there would be no entity licensed in Hong Kong in relation to which SFC might wish to take action.

49. The Administration has further advised that the purpose of the financial resource requirements under the FRR is to ensure a licensed corporation has sufficient financial resources to carry on its regulated activity. The amount of liquid capital that is maintained by a licensed corporation is not intended to constitute a pool of funds from which clients might potentially be compensated. To provide for all potential claims, the liquid capital requirements of CRAs, and all other licensed corporations, would have to be so high that many would not be able to sustain viable businesses. Furthermore, SFC sees no direct correlation between higher capital obligations for CRAs and higher rating standards.

50. With regard to the Chairman's suggestion of requiring CRAs to take out professional indemnity insurance, SFC has advised that there is no general professional indemnity insurance requirement for CRAs in other principal

jurisdictions including the US, EU and Japan. In Australia, corporations which are licensed as financial product advisers, are required to obtain professional indemnity insurance if they serve retail clients. Because CRAs are licensed in Australia as financial product advisers, they must therefore obtain professional indemnity insurance if they serve retail clients. In response to this requirement, CRAs operating in Australia have limited the scope of their business operations by not serving retail clients. The implication of this is that they do not incur this insurance obligation.

51. SFC considers that similar concerns arise in this connection as arise in relation to any proposal to increase the capital obligations of CRAs. In addition, SFC also takes the view that the imposition on CRAs of an obligation to take professional indemnity insurance would give rise to the same issue of consistency of approach and would logically give rise to a need to impose similar obligations on other corporations which are licensed under SFO.

52. SFC has however advised that while it does not favour the imposition of a compulsory professional indemnity insurance obligation for CRAs, licensed corporations (including CRAs) are expected to take out insurance cover. Under paragraph 37 of Part B of the Appendix to the Management, Supervision and Internal Control Guidelines for Persons Licensed by or Registered with the Securities and Futures Commission (April 2003), a licensed or registered corporation is expected to have adequate insurance to protect it from operational risk. Accordingly, CRAs will be required to have insurance cover for different types of business exposures, including but not limited to professional negligence, fidelity and replacement insurance.

Recommendation

53. The Subcommittee supports the Amendment Notice and the Amendment Rules. The Administration and the Subcommittee have not proposed amendments to the subsidiary legislation.

Advice sought

54. Members are invited to note the deliberations and recommendation of the Subcommittee.

Council Business Division 1
Legislative Council Secretariat
6 April 2011

Appendix

Subcommittee on Securities and Futures Ordinance (Amendment of Schedule 5) Notice 2011 and Securities and Futures (Financial Resources) (Amendment) Rules 2011

Membership list

Chairman	Hon James TO Kun-sun
Members	Hon CHAN Kam-lam, SBS, JP Hon Audrey EU Yuet-mee, SC, JP Hon WONG Ting-kwong, BBS, JP Hon CHIM Pui-chung (Total： 5 members)
Clerk	Ms Anita SIT
Legal Adviser	Mr YICK Wing-kin
Date	8 March 2011