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

Background brief

Purpose

This paper provides background information on the Securities and Future Ordinance (Amendment of Schedule 5) Notice 2011 (Amendment Notice) and the Securities and Futures (Financial Resources) (Amendment) Rules 2011 (Amendment Rules) which were gazetted on 18 February 2011. The paper also provides a summary of the relevant discussion at the Panel on Financial Affairs (FA Panel) on 19 July 2010.

Background

2. The ratings assigned by credit rating agencies (CRAs) represent their opinion on 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, 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, and Administration briefed the FA Panel 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 the respondents overwhelmingly indicated support for the proposals. A summary of major issues raised by the respondents provided in the consultation conclusions report of SFC is reproduced in the **Appendix**.

The legislative proposals

Amendment Notice

5. The Amendment Notice, which is made by the Financial Secretary under section 142 of the Securities and Futures Ordinance (Cap. 571) (SFO), amends Schedule 5 to the 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 the 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 distributed 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.

Amendment Rules

7. The Amendment Rules are made by SFC under section 145 of the SFO (after consultation with the Financial Secretary) to amend the Securities and Futures (Financial Resources) Rules (Cap. 571 sub. leg. N) (FR Rules) 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 FR Rules 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 FR Rules; and
- (b) a reference to Type 10 regulated activity is added to section 56 of the FR Rules 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.

Discussion at the Panel on Financial Affairs

9. At its meeting on 19 July 2010, the FA Panel discussed the Administration's proposal for establishing a regulatory regime for CRAs operating in Hong Kong. Panel members did not raise objection to the proposal. A member expressed the view that an effective regulatory regime for CRAs should include legislation to hold the CRAs liable for problematic credit ratings. The member doubted the effectiveness of the proposed regulatory regime, given the absence of provisions for class actions and order of compensation.

10. The Administration explained that CRAs would be required to comply with a future CRA Code of Conduct to be drawn up based on the revised Code of Conduct Fundamentals for CRAs issued by the International Organization for Securities Commissions (IOSCO) in May 2008. The IOSCO standards required credit rating activities to be conducted in accordance with the principles of integrity, independence, transparency and confidentiality. Under the proposed regulatory system, SFC would monitor the operation of CRAs, and might take disciplinary actions, including the revocation of licence in a

serious case, against a CRA which had breached the CRA Code of Conduct. The proposed regulatory regime was in fact more rigorous than those in the United Kingdom and the United States, as both CRAs and their rating analysts would need to be licensed. Since any disciplinary actions taken by SFC against a CRA would have profound impact on the reputation of the CRA and its business, CRAs would be cautious not to breach the CRA Code of Conduct and relevant legislation.

11. On a member's concern about the co-operation between Hong Kong and other CRA regulatory bodies in the world, the Administration advised that a global network of CRA regulatory regimes was being formed. After the implementation of the proposed regulatory regime, Hong Kong would sign a Memorandum of Understanding (MOU) with the EU governing the serviceability of CRAs in both Hong Kong and the EU. Under similar MOUs signed between the EU and other jurisdictions, CRAs registered in Hong Kong would be subject to similar regulation in other jurisdictions.

12. As regards the concern about the mechanism to ensure independence and objectivity of CRAs in making sovereign credit ratings, the Administration advised that in accordance with the revised Code of Conduct Fundamentals for CRAs issued by IOSCO, in instances where the government was the rated entity and simultaneously was also the body pursuing the oversight function related to the CRA concerned, the CRA should use different employees to conduct its rating actions than those employees involved in its oversight issues. In Hong Kong, SFC was an independent statutory body responsible for the regulation of the securities market. Like the regulatory bodies in other jurisdiction, SFC would concentrate on monitoring CRAs' conduct in producing credit ratings to ensure that their credit ratings were awarded based on independent, objective and fair assessments.

Relevant papers

13. The relevant papers are available at the following links:

Report by Legal Service Division on subsidiary legislation gazetted on 18 February 2011 and tabled in Council on 23 February 2011 (LC Paper No. LS29/10-11):

<http://www.legco.gov.hk/yr10-11/english/hc/papers/hc0225ls-29-e.pdf>

Legislative Council Brief by the Administration on the "Securities and Future Ordinance (Amendment of Schedule 5) Notice 2011" and the

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

http://www.legco.gov.hk/yr10-11/english/subleg/brief/28_29_brf.pdf

Minutes of Financial Affairs Panel Meeting on 19 July 2010 (paragraphs: 53-63):

<http://www.legco.gov.hk/yr09-10/english/panels/fa/minutes/fa20100719.pdf>

Report of the Securities and Futures Commission on consultation conclusions issued on 29 October 2010:

http://www.sfc.hk/sfc/doc/EN/speeches/public/consult/conclusions_cra_eng.pdf

Administration's paper on "Regulation of credit rating agencies"

<http://www.legco.gov.hk/yr09-10/english/panels/fa/papers/fa0719cb1-2525-4-e.pdf>

Background brief on regulation of credit rating agencies prepared by the Legislative Council Secretariat

<http://www.legco.gov.hk/yr09-10/english/panels/fa/papers/fa0719cb1-2524-e.pdf>

Council Business Division 1
Legislative Council Secretariat
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Summary of major issues raised by the respondents to SFC's public consultation

(extract from the report of SFC on consultation conclusions)

Respondents overwhelmingly welcomed and supported the proposal to establish a regulatory regime for CRAs operating in Hong Kong. Of the reform proposals set out in the Consultation Paper, respondents mainly focused their comments on the following areas:-

- (a) Although there was general support of the proposal to extend the existing SFO regime to include the regulation of CRAs conducting business in Hong Kong, some respondents, principally the CRAs, would prefer to see exemptions from the licensing requirements for individual rating analysts.
- (b) In general, respondents supported the new regulatory regime excluding activities relating to:-
 - Internal credit rating systems;
 - Private credit ratings prepared pursuant to an individual order; and sharing or analyzing consumer or commercial credit data.

However, some respondents commented that the regulatory scope should also cover private credit rating services due to the potential impact of the provision of these services on investment decisions.

- (c) Regarding the possibility of restricting Type 10 licensed or registered persons from carrying on business activities other than credit rating services, respondents generally recognized the need to prevent conflicts of interest which would compromise the objectivity and independence of a credit rating. Some respondents supported the imposition of a sole business restriction under the SFO. More respondents preferred the alternative approach of requiring Type 10 licensed or registered persons to maintain an effective Chinese wall policy to manage potential conflicts of interest.
- (d) Some respondents provided drafting comments concerning the CRA Code.