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

The Administration's Response to Issues Raised at the Subcommittee Meeting Held on 8 March 2011

INTRODUCTION

This paper presents the Administration's responses to issues raised by Members of the Subcommittee at its meeting held on 8 March 2011.

REGULATORY OBJECTIVES AND FRAMEWORK

2. We seek to establish in Hong Kong a regulatory regime for credit rating agencies ("CRAs") for two purposes:

(a) **To enhance investor protection** – Our 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 fulfil 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 are not regulated here. 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.

3. Introduction of a new type of regulated activity – "Type 10: providing credit rating services" – means subjecting both corporate CRAs in Hong Kong and their individual rating analysts to the licensing regime under the Securities and Futures Ordinance ("SFO", Cap. 571), and hence all general licensing obligations. This will also enable the Securities and Futures Commission ("SFC") to publish a Code of Conduct for Persons Providing Credit Rating Services ("CRA Code").

RESPONSES TO SPECIFIC ISSUES RAISED

4. The ensuing paragraphs provide information requested by Members of the Subcommittee, following the order in the letter dated 9 March 2011 from the Clerk to Subcommittee.

I. To provide details of the proposed regulatory regime for CRAs, including but not limited to -
- **(a) eligibility criteria for licensing CRA firms and individuals;**
- **(b) sanctions for breach of relevant legislative requirements or code of conduct;**
- **(c) criminal and/or civil liabilities for problematic credit ratings; and**
- **(d) measures to prevent/avoid conflict of interests.**

Eligibility criteria for licensing CRAs and rating analysts

5. 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 to carry on 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 are published on SFC's website (http://www.sfc.hk).

Sanctions, civil and/or criminal liabilities

6. SFC is empowered by 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 -

- Revocation of a licence;
- Suspension of a licence;
- Public or private reprimand;
- Ban from the industry permanently or for a stated period; and/or
- 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.

7. Licensed CRAs and analysts will be required to comply with all applicable rules, codes and guidelines administered by SFC, including the CRA Code to be promulgated. 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. If a licensed CRA or rating analyst is found to be guilty of misconduct or not fit and proper, SFC may invoke its disciplinary powers as described in paragraph 6 above.

8. Our regime will not include 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 they will be treated in the same manner as other persons licensed under SFO and will generally be subject to the same criminal or civil liability. It follows that in the same way as 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, it is not intended that similar liability should be specifically created for CRAs. This, of course, does not mean that our regime lacks regulatory "teeth".

9. First, 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 might be tempted to depart from the minimum obligations that apply to them under the CRA Code.

10. Secondly, both might 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 might 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 might 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.

11. 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 might 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 might 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.

Preventing/Avoiding conflict of interests

12. Part 2 of the CRA Code imposes extensive obligations on CRAs and their analysts to maintain independence and avoid conflicts of interest. It provides the general principles by which CRAs and their analysts should operate, the procedures and policies that CRAs should have in place to avoid conflict of interest, and additional requirements relating to individual representatives. For example -

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

Financial resources requirements

13. The essential purpose of the revised Code of Conduct Fundamentals for Credit Rating Agencies issued by the International Organisation of Securities Commissions in May 2008 ("IOSCO Code") is to promote investor protection by safeguarding the integrity of the rating process. Since the issue of capital requirements has been raised by the Subcommittee, it is worthy of note that the IOSCO Code does not introduce any minimum capital requirements for CRAs. This approach is

generally accepted on a global basis and the United States, the European Union and Australia impose no capital requirements on CRAs.

14. The situation is different in Hong Kong because section 129(1)(a) of SFO requires SFC to have regard to financial status or solvency 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 Securities and Futures (Financial Resources) Rules (Cap.571N) ("FRR").

15. SFC considers 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 the latter lacks justifications at the current state of play.

16. In the case of CRAs, SFC believes that increasing their capital obligations 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 interests 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.

17. Actually, the purpose of maintaining the FRR requirements 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.

II. To provide the latest version of the draft "Code of Conduct for Persons Providing Credit Rating Services", with remarks on any substantive deviations from the Code of Code of Conduct Fundamentals for Credit Rating Agencies issued by the International Organisation of Securities Commissions.

18. The CRA Code will impose minimum conduct standards for CRAs carrying on business in Hong Kong and for their rating analysts. SFC consulted the public concerning an initial draft Code during the consultation exercise last year, following which some refinements to it were introduced.

19. The CRA Code is primarily based on the IOSCO Code, but has also incorporated additional requirements that are dictated by the regulatory differences that exist in Hong Kong (e.g. the obligation imposed on individuals to be licensed in Hong Kong, whilst generally speaking individuals are not licensed elsewhere) and some additional requirements that have been introduced in other jurisdictions, particularly in the European Union. Importantly, however, the IOSCO Code, the measures put in place in other jurisdictions such as the European Union, the United States, Japan and Australia, and in Hong Kong in the CRA Code, all revolve around the principles of integrity, independence, transparency and confidentiality.

20. Generally speaking, the CRA Code does not substantially deviate from the IOSCO Code. At **Annex** is a copy of the CRA Code, which is marked up to reflect the key differences between it and the IOSCO Code.

III. To consider requiring CRAs to take out indemnity insurance as an investor protection measure, and provide information on any comparable arrangements in overseas major financial markets.

21. SFC views this matter as giving rise to similar issues to those discussed above in relation to the matter of imposing increased capital obligations on CRAs.

22. According to the advice provided to SFC, there is no general professional indemnity insurance requirement for CRAs in any other principal jurisdiction. This is so in the United States, the European Union 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.

23. SFC believes that Hong Kong would be placed at a competitive disadvantage in relation to other principal jurisdictions were Hong Kong CRAs to be compelled to take professional indemnity insurance cover. SFC considers that similar concerns arise in this connection as arise in relation to any proposal to increase the capital obligations of CRAs (as detailed in paragraph 16 above). It also believes 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.

24. Although SFC does not favour the imposition of a compulsory professional indemnity insurance obligation for CRAs, this does not mean that licensed corporations (including CRAs) are not expected to take 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) ("Internal Control Guidelines"), 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 fidelity and replacement insurance.

IV. 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 hiding the (previous) unfavourable credit ratings.

25. SFC agrees with the proposal of requiring CRAs or their clients to disclose all credit ratings that have been made on a financial product or issuer under certain circumstances, and has made appropriate provision to this effect in the CRA Code. As a consequence, it is not anticipated that issuers will easily be able to conceal unfavourable ratings when the new regulatory regime comes into force. If a rating is discontinued, paragraph 18 of the 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. Paragraph 47 of the CRA Code requires CRAs to ensure that all of their ratings and updates are publicly disclosed in a timely manner. In addition, paragraph 52 of the CRA 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.

V. In relation to the definition of "providing credit rating services", to review whether the present construction of the definition, particularly the phrase "with a reasonable expectation that they will be so distributed", may create a loophole.

26. Paragraphs (a)(ii) and (b)(ii) of the definition of "providing credit rating services" [1] 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

[1] "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; or
but does not include…

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. It might be argued that this would give rise to a situation in relation to which, in the absence of paragraphs (a)(ii) and (b)(ii), neither the CRA nor the client would be required to hold a Type 10 licence.

27. For "private rating" business of CRAs, it is the practice of CRAs to incorporate into their client agreements a provision which prohibits their clients, to whom ratings will be provided for their exclusive use, from publicly disseminating any such rating. Where it is subsequently wished to publicly disseminate a "private rating" of this type, paragraph 19 of the CRA Code requires the CRA that prepared it to first ensure that the rating has been prepared in compliance with the provisions of the CRA Code.

VI. To review whether Type 4 regulated activity is actually distinct from the proposed Type 10 regulated activity, and whether the respective (proposed) scopes of the two regulated activities would create loophole or overlap in the regulatory regime under SFO.

28. There is no overlap between Type 4 regulated activity (advising on securities) and Type 10 regulated activity (providing credit rating services). The former 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 is quite different and involves 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. The expression of an opinion as to creditworthiness clearly involves an expression of opinion (not advice) as to whether credit, which might be extended to the corporate body or on the security of the instrument that is rated, is likely to be realised.

29. For the avoidance of doubt, the definition of "advising on securities" contained in Schedule 5 to SFO is to be amended 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 the SFO will not be permitted to carry on the business of providing credit rating services unless it also holds a Type 10 licence.

VII. To advise the Subcommittee of (a) any financial product that is regulated by credit rating requirements before such product is offered to the public; and (b) any regulatory requirement regarding the standard of credit rating applicable to regulated financial products.

30. For funds, unlisted structured investment products or debt securities offered to the public, there is no requirement under SFO, the Companies Ordinance (Cap. 32) or applicable SFC product codes and guidelines, that these products be rated.

31. The Code on Unit Trusts and Mutual Funds contains a requirement for the credit rating(s) of a guarantor to be disclosed, where applicable, in the case of a guaranteed fund (paragraph 8.5(c)(iii)), and a requirement that the credit ratings of collateral be disclosed in offering documents (Appendix C – C2A(g)) and in annual reports (Appendix E – Holdings of collateral).

32. The Code on Unlisted Structured Investment Products requires a product issuer (or where appropriate, the guarantor) of a non-collateralised structured investment product to meet certain eligibility criteria. One of the criteria is that the product issuer (or the guarantor) has a top three investment grade credit rating issued by a rating agency of international standing and reputation acceptable to the SFC (Appendix A – paragraph 1(b)(ii)). This requirement is in line with the requirements applicable to listed derivative warrants and callable bull/bear contracts under Chapter 15A of the Main Board Listing Rules. In addition, where a structured investment product is supported by collateral, one of the eligibility requirements for the collateral is that it likewise has to have a top three investment grade credit rating.

Financial Services Branch / Financial Services and the Treasury Bureau
Securities and Futures Commission
16 March 2011

Annex

SECURITIES AND FUTURES COMMISSION
證券及期貨事務監察委員會

SFC
證監會

Code of Conduct for Persons Providing Credit Rating Services

[Date]

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Introduction

1. This Code applies to persons licensed by, or registered with, the Securities and Futures Commission ("**SFC**") for Type 10 regulated activity (providing credit rating services), including, as appropriate, representatives (as defined in section 167 of the Securities and Futures Ordinance (Cap. 571) ("**SFO**")). The SFC recognizes that compliance with some requirements of this Code might not necessarily be within the control of a particular representative. In considering the conduct of representatives under this Code, the SFC will take into account their levels of responsibility within their firms, any supervisory duties they may perform, and the levels of control or knowledge they may have concerning any failure by their firms, or by individuals under their supervision, to observe this Code.

2. The SFC will be guided by this Code in considering whether a licensed or registered person satisfies the requirement that it/he is fit and proper to be or to remain licensed or registered. This Code, which is based on the revised Code of Conduct Fundamentals for Credit Rating Agencies issued by the International Organization of Securities Commissions in May 2008 ("**IOSCO Code**")[1], does not have the force of law and does not replace any legislative provisions, or any other codes or guidelines issued by the SFC. In particular, it supplements, and should be read in conjunction with, the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission ("General Code of Conduct").

3. For the purposes of this Code:

   (a) "**CRA**" means a "licensed corporation" or "registered institution" (as defined in Part 1 of Schedule 1 of the SFO), which is licensed or registered to carry on business in Type 10 regulated activity;

   (b) "**ratings**" has the same meaning as "credit ratings" (as defined in Schedule 5 of the SFO);

   (c) "**rating target**" means the subject of a credit rating and may be a person (other than an individual), debt securities, preferred securities or an agreement to provide credit;

   (d) "**rated entity**" means the rating target or, in the case of a rating target that is debt securities, preferred securities or an agreement to provide credit, the issuer of the debt securities or preferred securities or the person (other than an individual) agreeing to provide credit; and

   (e) "**structured finance products**" means securities or a money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction.

[1] http://www.iosco.org/library/pubdocs/pdf/IOSCOPD271.pdf

Part 1 – Quality And Integrity Of The Rating Process

Quality of the Rating Process

4. A CRA should adopt, implement and enforce written procedures to (a) document reporting lines and allocate functions and responsibilities, and (b) ensure that the credit ratings it prepares are based on a thorough analysis of all information known to the CRA that is relevant to its analysis according to the CRA's published rating methodologies.

   [Remark: This paragraph is based on IOSCO Code paragraph 1.1, and the underlined part sets out an additional regulatory requirement.]

5. A CRA should use rating methodologies that are rigorous, systematic, and, where possible, which result in ratings that can be subjected to some form of objective validation based on historical experience, including back-testing.

6. A CRA should keep records properly and in line with all applicable statutory requirements, including the provisions of the Securities and Futures (Keeping of Records) Rules (Cap. 571O). Proper record keeping includes maintaining records to support credit ratings prepared by a CRA. A CRA should keep such records for not less than seven years, in writing in the Chinese or English language, or in such a manner as to enable the records to be readily accessible and readily convertible into written form in the Chinese or English language.

   [Remark: This paragraph is based on IOSCO Code paragraph 1.5. The underlined sentences reflect the existing record keeping requirements, including the record retention period, under the Securities and Futures (Keeping of Records) Rules.]

7. A CRA should use representatives who, individually or collectively (particularly where rating committees are used), have appropriate knowledge and experience in developing a credit rating of the type being prepared. Representatives should apply a given methodology in a consistent manner, as determined by the CRA.

8. A CRA should ensure that the credit ratings it prepares are assigned by the CRA (or its affiliates) and not by any individual representative.

9. A CRA and its representatives should take steps to avoid issuing any credit ratings that contain misrepresentations or are otherwise misleading as to the general creditworthiness of the rating target.

10. A CRA should ensure that it has, and devotes, sufficient resources to carry out high-quality credit assessments of all its rating targets. When deciding whether to rate or continue rating a rating target, it should assess whether it is able to devote sufficient personnel with sufficient skill sets to make a proper rating assessment, and whether its personnel likely will have access to sufficient information needed in order to make such an assessment. A CRA should adopt reasonable measures so that the information it uses in assigning a rating is of sufficient quality to support a credible rating. A CRA should refrain from assigning a rating, and should ensure that any existing rating is withdrawn, if the CRA does not have sufficient quality information to support a credible rating. If the rating involves a type of financial product presenting limited historical data (such as an innovative financial

vehicle), the CRA should make clear, in a prominent place within the rating report, the limitations of the rating.

[Remark: This paragraph is replicated from IOSCO Code paragraph 1.7, and the underlined sentence sets out an additional regulatory requirement.]

11. A CRA should establish a formal review function made up of one or more senior staff members with appropriate experience to review the feasibility of providing a credit rating for a financial product that is materially different from the financial products the CRA currently rates.

12. A CRA should establish and implement a rigorous and formal review function responsible for periodically (and at least annually) reviewing (a) the methodologies and models, and significant changes to the methodologies and models, it uses, and (b) the adequacy and effectiveness of its systems and internal control mechanisms. This function should be independent of the business lines that are principally responsible for rating various classes of rating targets. The findings of any such review should be comprehensively recorded in a written report, a copy of which should be provided to the SFC forthwith upon its completion. A CRA should take appropriate measures to address any deficiencies identified during the course of any such review.

[Remark: This paragraph is based on IOSCO Code paragraph 1.7-2. The additional requirement can provide more information for the SFC to assess systems and controls of a CRA.]

13. A CRA should assess whether existing methodologies and models for determining credit ratings of structured finance products are appropriate when the risk characteristics of the assets underlying a structured finance product change materially. In cases where the complexity or structure of a new type of structured finance product or the lack of robust data about the assets underlying the structured finance product raise serious questions as to whether a CRA can determine a credible credit rating for it, the CRA should refrain from issuing a credit rating.

14. A CRA should structure its rating teams to promote continuity and avoid bias in the rating process. Where practicable, in view of a CRA's staffing resources, representatives who are involved in the rating process should be subject to an appropriate rotation mechanism which should provide for gradual change in rating teams.

[Remark: This paragraph is based on IOSCO Code paragraph 1.8. The additional requirement is to require a CRA to arrange an appropriate rotation mechanism for its rating teams on a gradual basis.]

Monitoring and Updating

15. A CRA should ensure that adequate personnel and financial resources are allocated to monitoring and updating its ratings. Except for ratings that clearly indicate they do not entail ongoing surveillance, once a rating is published the CRA should monitor, on an ongoing basis, and update the rating by:

    (a) Reviewing, at least annually, the rating target's creditworthiness;

[Remark: This subparagraph is based on IOSCO Code paragraph 1.9(a), and the additional requirement is to specify the minimum review frequency.]

(b) Initiating a review of the status of the rating, which is consistent with the applicable rating methodology, upon becoming aware of any information that might reasonably be expected to result in the rating requiring revision or termination; and

(c) Updating the rating on a timely basis, as appropriate, based on the results of such review.

16. Subsequent monitoring should incorporate all cumulative experience obtained. Changes in methodologies, models or key assumptions used in preparing credit ratings should be applied where appropriate to both initial ratings and subsequent ratings. A CRA should review affected credit ratings as soon as possible and not later than six months after the change, and should in the meantime place those ratings under observation.

[Remark: This paragraph is based on the concluding paragraph of IOSCO Code paragraph 1.9. The underlined sentence is to require a CRA to review the impact of its change in methodologies, models or key assumptions on the affected ratings within a specified period of time.]

17. If a CRA uses separate analytical teams for determining initial ratings and for subsequent monitoring of ratings, each team should have the requisite level of expertise and resources to perform their respective functions in a timely manner.

18. Where a rating is made available to the public, the CRA should in a timely manner publicly announce (or ensure that its affiliate publicly announces) if the rating is discontinued and include full reasons for such discontinuation. Where a rating is provided only to subscribers, the CRA should in a timely manner announce (or ensure that its affiliate announces) to such subscribers if the rating is discontinued and include full reasons for such discontinuation. In both cases, the CRA should ensure that continuing publications of the discontinued rating indicate the date the rating was last updated, the fact that the rating is no longer being updated and include full reasons for its discontinuation.

[Remark: This paragraph is based on IOSCO Code paragraph 1.10, and the additional requirement is to emphasize the timeliness of announcement and to provide reasons for the discontinuation.]

19. A CRA should ensure that any "private rating" (prepared by the CRA pursuant to a request made by a person 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), is only subsequently disseminated to the public or distributed by subscription, whether in Hong Kong or elsewhere, if such rating has been prepared in compliance with the provisions of this Code.

[Remark: There is no such requirement under IOSCO Code. The purpose of this requirement is to address the situation when a private rating subsequently becomes public.]

Integrity of the Rating Process

20. A CRA and its representatives should deal fairly and honestly with issuers, investors, other market participants, and the public.

21. Representatives of a CRA should maintain high standards of integrity, and a CRA should not employ individuals with demonstrably compromised integrity.

22. A CRA and its representatives and employees should not, either implicitly or explicitly, give any assurance or guarantee of a particular rating prior to the rating assessment. This does not preclude a CRA from developing prospective assessments used in structured finance products and similar transactions.

23. A CRA should prohibit its representatives who are involved in the rating process from making proposals or recommendations regarding the design of structured finance products that the CRA rates.

24. A CRA should institute policies and procedures that clearly specify a person responsible for compliance by the CRA and its employees with the provisions of its code of conduct (as further described under paragraph 68 of this Code) and with any law, rules, regulations, codes or other requirements which apply to the CRA and are issued, administered or enforced by the SFC or any other regulatory authority or agency. This person's reporting lines and compensation should be independent of the CRA's rating operations.

25. A CRA should institute policies and procedures requiring its representatives and employees, upon becoming aware that another representative, employee or entity under common control with the CRA is engaging, or has engaged, in conduct that is illegal, unethical or contrary to the CRA's code of conduct (as further described under paragraph 68 of this Code), to report such information immediately to the individual in charge of compliance ("**compliance officer**") or a responsible officer of the CRA, as appropriate, so that proper and appropriate action may be taken. A CRA's representatives and employees are not necessarily expected to be experts in the law. Nonetheless, they are expected to report such activities as a reasonable person in their position would question or be concerned over. A CRA should ensure that its compliance officer or responsible officer, who receives such a report from a representative or employee, is obligated to take appropriate action, including such action as is required by any law, rules, regulations, codes or other requirements which apply to the CRA and are issued, administered or enforced by the SFC or any other regulatory authority or agency, and by the CRA's own rules, guidelines or codes. A CRA should not retaliate, and should prohibit retaliation by its other representatives or employees, against any representative or employee who, in good faith, makes such a report.

Part 2 – Independence And Avoidance Of Conflicts Of Interest

General

26. A CRA should neither forbear nor refrain from preparing or revising any rating based on the potential effect (economic, political, or otherwise) on the CRA, a rated entity, an investor, or other market participant.

27. A CRA and its representatives should use care and professional judgment to maintain both the substance and appearance of independence and objectivity.

28. The determination of a credit rating should be influenced only by factors relevant to the credit assessment.

29. The credit rating a CRA assigns to a rating target should not be affected by the existence of, or potential for, a business relationship between the CRA (or its affiliates) and the rated entity (or its affiliates), or any other party, or by the non-existence of such a relationship.

30. A CRA should not carry on any business which can reasonably be considered to have the potential to give rise to any conflict of interest in relation to its business of providing credit rating services. A CRA should have in place procedures and mechanisms designed to minimize the likelihood of conflicts of interest arising, and to identify any conflict of interest should it arise, in relation to the conduct by it of any ancillary business. A CRA should also define what it considers to be an ancillary business and why it cannot reasonably be considered to have the potential to give rise to any conflict of interest with the CRA's credit rating business. For the avoidance of doubt, a CRA should not provide consultancy or advisory services to a rated entity, or a related party of a rated entity, regarding the corporate or legal structure, assets, liabilities or activities of that rated entity or related party.

    [Remark: This paragraph is based on IOSCO Code paragraph 2.5 with amendments to expressly restrict a CRA from carrying on certain types of consultancy or advisory services. In addition, this paragraph also requires a CRA to have in place procedures and mechanisms to minimize and identify any potential conflict of interest that may arise from its ancillary business.]

31. A CRA should not enter into any contingent fee arrangement for providing credit rating services. Contingent fees are fees calculated on a predetermined basis relating to the outcome of a transaction or the result of the services performed by the CRA. For the purposes of this paragraph, a fee is not regarded as being contingent if established by a court or other public authority.

    [Remark: This paragraph is an additional requirement, and there is no such requirement under IOSCO Code.]

Procedures and Policies

32. A CRA should adopt written internal procedures and mechanisms to (a) identify, and (b) eliminate, or manage and disclose, as appropriate, any actual or potential conflicts of

interest that may influence (i) the ratings the CRA makes, or (ii) the judgment and analyses of the representatives who are involved in the preparation of ratings. A CRA's code of conduct (as further described under paragraph 68 of this Code) should also state that the CRA will disclose such conflict avoidance and management measures.

33. A CRA's disclosures of actual or potential conflicts of interest should be complete, clear, concise, specific and prominent, and should be made in a timely manner. A CRA should also make full public disclosure of its ancillary services and update such disclosure in a timely manner.

[Remark: This paragraph is based on IOSCO Code paragraph 2.7, and the underlined sentence requires additional disclosure of ancillary services provided by a CRA.]

34. A CRA should publicly disclose the general nature of its compensation arrangements with rated entities, including:

(a) Where a CRA or any affiliate of the CRA that is a credit rating agency, receives from a rated entity compensation unrelated to its ratings service, the CRA should disclose the proportion that all such compensation constitutes against the total fees that the CRA, or its affiliate, receives from such rated entity for the provision of ratings services; and

(b) Where 5% or more of –
(i) the CRA's total annual revenue; or
(ii) the combined annual revenue of the CRA and any affiliate of the CRA that carries out credit rating activities,
is received from a single issuer, originator, arranger, client or subscriber and/or any affiliate of such issuer, originator, arranger, client or subscriber, the CRA should disclose the party or parties from which such revenue is received.

[Remark: This paragraph is originally based on IOSCO Code paragraph 2.8. The underlined additional requirements relate to certain public disclosures to better illustrate potential conflicts of interest. In addition, the disclosure threshold in subparagraph (b) has been reduced to 5% from 10% as required by IOSCO Code.]

35. CRAs should encourage issuers and originators of structured finance products to publicly disclose all relevant information regarding these products so that investors and other CRAs can conduct their own analyses independently of the CRA contracted by the issuers or originators to provide a rating. CRAs should ensure that rating announcements include disclosure as to whether the issuer of a structured finance product has informed the CRA that it is publicly disclosing all relevant information about the product being rated or whether the information remains non-public.

36. A CRA should ensure that it and its representatives and employees do not engage in any securities or derivatives trading giving rise to conflicts of interest with the CRA's rating activities, or which might reasonably be expected to give rise to such conflicts of interest.

37. In instances where rated entities (e.g. governments) have, or are simultaneously pursuing, oversight functions related to a CRA, the CRA should use representatives to prepare and revise its ratings who are not the same individuals involved in its oversight issues.

Representatives' Independence

38. Reporting lines for representatives, and their compensation arrangements, should be structured to eliminate, or effectively manage, actual or potential conflicts of interest.

39. A CRA's code of conduct (as further described under paragraph 68 of this Code) should state that a representative will not be compensated or evaluated on the basis of the amount of revenue that the CRA derives from rated entities that the representative rates or with which the representative regularly interacts.

40. A CRA (or its affiliates) should conduct formal and periodic reviews of compensation policies and practices for its representatives and employees who participate in, or who might otherwise have an effect on, the rating process to ensure that these policies and practices do not compromise the objectivity of its rating process.

    [Remark: This requirement is based on IOSCO Code paragraph 2.11(b), and the underlined part extends the original requirement to other group companies of a CRA.]

41. Representatives who are directly involved in the rating process should not initiate, or participate in, discussions regarding fees or payments with any entity they rate.

42. No representative or employee of a CRA should prepare (or participate in or otherwise influence the determination of) a rating of any particular rating target if the representative or employee of the CRA:

    (a) Owns securities or derivatives of the rated entity, other than holdings in collective investment schemes;

    (b) Owns securities or derivatives of any entity related to a rated entity, the ownership of which may cause, or may be perceived as causing, a conflict of interest, other than holdings in collective investment schemes;

    (c) Has had a recent employment or other significant business relationship with the rated entity that may cause, or may be perceived as causing, a conflict of interest;

    (d) Has an immediate relation (i.e. a spouse, partner, parent, child, or sibling) who currently works for the rated entity; or

    (e) Has, or had, any other relationship with the rated entity or any related party thereof, that may cause, or may be perceived as causing, a conflict of interest.

43. A representative involved in the rating process (or his/her spouse, partner, minor children or any account controlled by the representative in which the representative has a beneficial interest) should not buy or sell, or engage in any transaction involving, any securities or derivative based on securities issued, guaranteed, or otherwise supported by any entity within such representative's area of primary analytical responsibility, other than holdings in collective investment schemes.

    [Remark: This paragraph is replicated from IOSCO Code paragraph 2.14, and the underlined part extends the original scope that may potentially give rise to conflicts of interest.]

44. Without prejudice to paragraph 2.4 of the General Code of Conduct, representatives and employees of a CRA should be prohibited from soliciting money, gifts or favours from anyone with whom the CRA does business and should be prohibited from accepting gifts offered in the form of cash or any gifts exceeding a minimal monetary value.

[Remark: This paragraph is based on IOSCO Code paragraph 2.15. The underlined part is to make reference to the similar general conduct requirement set out in the General Code of Conduct.

45. Any representative of a CRA, who becomes involved in any personal relationship that creates the potential for any real or potential conflict of interest (including, for example, any personal relationship with an employee of a rated entity or agent of such entity within his or her area of analytic responsibility), should be required to disclose such relationship to the compliance officer or responsible officer of the CRA who is designated for such purpose by the CRA's compliance policies.

46. A CRA should establish policies and procedures for reviewing the past work of representatives who leave the employ of the CRA and join an rated entity the representative has been involved in rating, or a financial firm with which the representative has had significant dealings as part of his or her duties as a representative or employee of the CRA.

Part 3 – Responsibilities To The Investing Public and Rated Entities

Transparency and Timeliness of Ratings Disclosure

47. A CRA should, in a timely manner, publicly disclose all ratings and updates of such ratings (or ensure that its affiliate does so), provided that this obligation shall not apply to "private ratings" within the meaning of paragraph 19 of this Code or to ratings that the CRA (or its affiliate) provides only to subscribers. In the case of ratings that are only provided to subscribers, a CRA should, in a timely manner, disclose all such ratings and updates of such ratings to such subscribers (or ensure that its affiliate does so).

    [Remark: The underlined part includes the requirements set out in IOSCO Code paragraphs 3.1 and 3.4.]

48. A CRA should ensure that the policies for distributing its ratings and updates are publicly disclosed.

49. A CRA should ensure that each of its ratings includes (a) a clear indication of when it was last updated, and (b) a clear and prominent statement identifying the name and job title of the lead rating analyst who is responsible for the rating and the name and the position of the person primarily responsible for approving the rating. Ratings of debt securities or preferred securities should include information on whether the credit ratings concern newly issued debt securities or preferred securities and whether the CRA is rating such securities for the first time. Each rating announcement should also indicate the principal methodology or methodology version that was used in determining the rating and where a description of that methodology can be found. Where the rating is based on more than one methodology, or where a review of only the principal methodology might cause investors to overlook other important aspects of the rating, the CRA should ensure that this fact is explained in the ratings announcement. Such explanation should include a discussion of how the different methodologies and other important aspects were factored into the rating decision.

    [Remark: This paragraph is based on IOSCO Code paragraph 3.3, and the underlined parts set out additional disclosure requirements.]

50. A CRA should ensure that sufficient clear and easily comprehensible information is published about its procedures, methodologies and assumptions (including financial statement adjustments that deviate materially from those contained in the rating target's published financial statements and a description of the rating committee process, if applicable) to enable other parties to understand how a rating was determined. This information should include (but not be limited to) the meaning of each rating category and the definition of default or recovery, and the time horizon the CRA used when making a rating decision. A CRA should also ensure that all material sources, including the rated entity and, where appropriate, a related party of the rated entity, which were used to prepare the credit rating, are identified. An indication should also be given as to whether the credit rating has been disclosed to the rated entity or to its related party and, following such disclosure, whether the credit rating has been amended before being issued.

    [Remark: This paragraph is based on IOSCO Code paragraph 3.5, and the underlined parts set out additional disclosure requirements.]

51. A CRA should disclose to what extent it has examined the quality of information used in the rating process and whether it is satisfied with the quality of information it bases its rating on.

[Remark: This paragraph is an additional disclosure requirement, and there is no such requirement under IOSCO Code.]

52. Where a CRA rates a structured finance product, it should ensure that the public (in the case of a rating which is made available to the public) or subscribers (in the case of a rating which is made available only to subscribers) are provided with sufficient information about its loss and cash-flow analysis, and an indication of any expected change in the credit rating, so that an investor with an interest in investing in the product can understand the basis for the rating. A CRA should also ensure disclosure of the degree to which it analyzes how sensitive a rating of a structured finance product is to changes in the CRA's underlying rating assumptions. A CRA should disclose, on a timely and ongoing basis, information concerning all structured finance products submitted to it for its initial review or for a preliminary rating. Such disclosure should be made irrespective of whether the issuer of such a product engages the CRA to provide a final rating. A CRA should state the level of assessment it has performed concerning the due diligence processes conducted in relation to the underlying finance products, or other assets, of structured finance products. The CRA should disclose whether it has undertaken any assessment of such due diligence processes or whether it has relied on a third-party assessment, indicating how the outcome of such assessment influences the credit rating.

[Remark: This paragraph is based on IOSCO Code paragraph 3.5(a), and the underlined parts set out additional disclosure requirements in relation to structured finance products.]

53. A CRA should differentiate ratings of structured finance products from traditional corporate bond ratings, preferably through a different rating symbology or by using an additional symbol which differentiates them from rating categories used for other rating targets. A CRA should also disclose how this differentiation functions. A CRA should clearly define a given rating symbol and apply it in a consistent manner for all types of debt securities and preferred securities to which that symbol is assigned.

[Remark: This paragraph is replicated from IOSCO Code paragraph 3.5(b), and the underlined part is an alternative requirement in relation to structured finance products.]

54. A CRA should assist investors in developing a greater understanding of what a credit rating is, and the limits to which credit ratings can be put to use vis-à-vis a particular type of financial product that the CRA rates. A CRA should clearly indicate the attributes and limitations of each credit rating, and the limits to which the CRA verifies information provided to it by the rated entity.

55. When issuing or revising a credit rating, the CRA should explain in its press releases and reports the key elements underlying the rating.

56. Where feasible and appropriate, prior to issuing or revising a rating, the CRA should inform the rated entity of the critical information and principal considerations upon which a rating will be based and afford the rated entity an opportunity to clarify any likely factual misperceptions or other matters that the CRA would wish to be made aware of in order to produce an accurate rating. A CRA will duly evaluate the response. Where, in particular circumstances, the CRA has not informed the rated entity prior to issuing or revising a

rating, the CRA should inform the rated entity as soon as practical thereafter and, generally, should explain the reason for the delay.

57. In order to promote transparency and to enable the market to best judge the performance of its ratings, a CRA should, where sufficient historical data exists, publish information about the historical default rates of rating categories and about ratings transition frequency. In addition, a CRA should disclose whether the default rates of rating categories have changed over time. The information should be sufficient to help interested parties understand the historical performance of each category, as well as whether rating categories have changed and, if so, how. It should also help interested parties draw quality comparisons among ratings given by different CRAs. If the nature of a rating, or other circumstances, make an historical default rate inappropriate, statistically invalid, or otherwise likely to mislead the users of the rating, the CRA should explain this. This information should include verifiable and quantifiable historical information about the performance of its rating opinions, organized and structured, and, where possible, standardized, in such a way as to assist investors in drawing performance comparisons between different providers of credit rating services.

[Remark: This paragraph is replicated from IOSCO Code paragraph 3.8, and the underlined part sets out an additional disclosure requirement.]

58. A CRA should state prominently in each credit rating whether or not the rated entity, or any related party of the rated entity, participated in the credit rating process, and (for an unsolicited rating) whether the CRA had access to the accounts and other relevant internal documents of the rated entity or its related party. A CRA should also disclose its policies and procedures regarding unsolicited ratings.

[Remark: This paragraph is based on IOSCO Code paragraph 3.9, and the underlined parts set out additional disclosure requirements.]

59. Because users of credit ratings rely on an existing awareness of a CRA's methodologies, practices, procedures and processes, a CRA should fully and publicly disclose any material modification to its methodologies and significant practices, procedures, and processes. Where feasible and appropriate, disclosure of such material modifications should be made prior to their going into effect. A CRA should carefully consider the various uses of credit ratings before modifying its methodologies, practices, procedures and processes. When methodologies, models or key rating assumptions used in preparing any of its credit ratings are changed, a CRA should immediately disclose the likely scope of credit ratings to be affected by using the same means of communication as was used for the distribution of the affected credit ratings.

[Remark: This paragraph is replicated from IOSCO Code paragraph 3.10, and the underlined sentence sets out an additional disclosure requirement.]

The Treatment of Confidential Information

60. A CRA should adopt procedures and mechanisms to protect the confidential nature of information shared with it by a rated entity where this occurs under the terms of a confidentiality agreement or otherwise under a mutual understanding that the information is shared confidentially. Unless otherwise permitted by the confidentiality agreement and consistent with applicable laws or regulations, a CRA and its representatives and

employees should not disclose confidential information in press releases, through research conferences, to future employers, or in conversations with investors, other issuers or other persons, or otherwise.

61. A CRA should use confidential information only for purposes related to its rating activities or in accordance with any confidentiality agreements with the rated entity.

62. A CRA should take all reasonable measures to protect all property and records belonging to it, or in its possession, from fraud, theft or misuse.

63. A CRA should prohibit its representatives and employees from engaging in transactions in securities when they possess confidential information concerning the issuer of such securities. A representative (or his/her spouse, partner, minor children or any account controlled by the representative in which the representative has a beneficial interest) should not engage in transactions in securities when the representative possesses confidential information concerning the issuer of such securities.

64. In preservation of confidential information, representatives and employees of CRAs should familiarize themselves with the internal securities trading policies maintained by the CRA, and periodically certify their compliance as required by such policies.

65. A CRA should ensure that its representatives and employees do not selectively disclose any non-public information about ratings, or the possible future issue or revision of ratings of the CRA, except to the rated entity or its designated agents.

66. A CRA should ensure that it and its representatives and employees do not share confidential information entrusted to it with its affiliates that are not credit rating agencies, or with the employees of such affiliates. A CRA and its representatives and employees should not share confidential information within the CRA, or with its affiliates that are credit rating agencies (including the representatives and employees of such affiliates), except on an "as needed" basis and as permitted under any relevant confidentiality agreement.

    [Remark: This paragraph is based on IOSCO Code paragraph 3.17, and the underlined parts extend the original requirement to other group companies of a CRA.]

67. A CRA should ensure that its representatives and employees do not use or share confidential information for the purpose of trading securities, or for any other purpose except carrying on Type 10 regulated activity.

Part 4 – Disclosure Of The Code Of Conduct And Communication With Market Participants

68. A CRA should have its own code of conduct and should disclose it to the public and describe how its provisions fully implement the provisions of this Code. A CRA should also describe generally how it intends to enforce its code of conduct and should disclose, on a timely basis, any changes to its code of conduct and how it is implemented and enforced.

[Remark: This paragraph tightens the requirement set out in IOSCO Code paragraph 4.1 as a CRA's own code of conduct is not allowed to deviate from this CRA Code.]

69. A CRA should establish a function within its organization (or that of its affiliates) charged with communicating with market participants and the public about any questions, concerns or complaints that the CRA may receive. The objective of this function should be to help ensure that the officers and management of the CRA are informed of those issues that they would want to be made aware of when setting the organization's policies.

70. A CRA should publish in a prominent position on its home webpage links to: (a) the CRA's code of conduct; (b) a description of the methodologies it uses; and (c) information about the CRA's historic ratings performance data, or that of any of its affiliate that carries out credit rating activities.

[Remark: This requirement is based on IOSCO Code paragraph 4.3, and the underlined part extends the original requirement to other group companies of a CRA.]

71. A CRA should ensure that details of the following information are available to the public on an annual basis:

    (a) Its internal control mechanisms designed to ensure the quality of its credit rating activities;

    (b) Its record-keeping policy; and

    (c) Its management and rating analyst rotation policy.

[Remark: There is no such requirement under IOSCO Code. The purpose of this paragraph is to assist the public to better understand the control systems of a CRA.]