

LEGISLATIVE COUNCIL BRIEF

Securities and Futures Ordinance (Chapter 571)

SECURITIES AND FUTURES ORDINANCE (AMENDMENT OF SCHEDULE 5) NOTICE 2011

SECURITIES AND FUTURES (FINANCIAL RESOURCES) (AMENDMENT) RULES 2011

INTRODUCTION

In order to create a regulatory regime for credit rating agencies (“CRAs”) and their rating analysts –

- (a) the Financial Secretary (“FS”) will publish in the Gazette on 18 February 2011 the Securities and Futures Ordinance (Amendment of Schedule 5) Notice 2011 (“Amendment Notice”, at **Annex A**); and
- (b) the Securities and Futures Commission (“SFC”) has made the Securities and Futures (Financial Resources) (Amendment) Rules 2011 (“Amendment Rules”, at **Annex B**).

JUSTIFICATIONS

2. An independent and objective credit rating of appropriate quality is key to investor protection. 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.

3. Against the backdrop of global agreement on regulating CRAs, we consider that it would be in the public interest to establish such 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, particularly EU in the light of her new requirements which will come into effect in June

2011. Our regime shall meet the expectations laid down by G20 and be generally consistent with the regulatory models that have been adopted (or are in the process of being created) in other jurisdictions. The concern, from a regulatory perspective, is to ensure that those providing credit ratings to which the public has access, are licensed and comply with stipulated regulatory obligations because of the influence that such ratings might have upon public investment sentiment.

4. To this end, we propose introducing a new type of regulated activity – “Type 10: providing credit rating services” – under the existing regulatory regime¹. Type 10 regulated activity is intended to be concerned with the preparation of opinions, expressed using a defined ranking system, primarily regarding the creditworthiness of persons (other than individuals) or financial instruments² being rated. This is intended to be different from Type 4 regulated activity (advising on securities) which essentially involves the provision of advice or guidance concerning the acquisition or disposal of securities. Type 10 regulated activity is not intended to include –

- (a) activities involved in the operation of internal credit rating systems (such as banks’ internal systems for assessing counterparty risks), which do not involve credit ratings being disseminated to the public or distributed by subscription;
- (b) private credit ratings which are prepared pursuant to an individual order and provided exclusively to the person who placed the order and which are not intended for public distribution or distribution by subscription; and
- (c) gathering, collating, disseminating and distributing information about the indebtedness and credit history of any person (such as sharing or analysing of personal consumer credit data through consumer or commercial credit reference agencies).

5. Both corporate CRAs in Hong Kong and their individual rating analysts will need to be licensed and be subject to the general obligations which are common to all persons licensed or registered under the Securities and Futures Ordinance (“SFO”). To help ensure that the credit ratings are independent, objective and of appropriate quality, SFC will impose minimum conduct standards for CRAs in Hong Kong and

¹ Schedule 5 to the Securities and Futures Ordinance provides for the existing nine types of regulated activities, namely, (1) dealing in securities, (2) dealing in futures contracts, (3) leveraged foreign exchange trading, (4) advising on securities, (5) advising on futures contracts, (6) advising on corporate finance, (7) providing automated trading services, (8) securities margin financing and (9) asset management.

² Specifically, debt securities, preferred securities and agreements to provide credit.

their rating analysts by means of a Code of Conduct for Persons Providing Credit Rating Services (“CRA Code of Conduct”)³.

6. Type 10 regulated activity does not necessitate the holding of client assets. Type 10 licensed corporations should be subject to the same capital requirements as applied to corporations carrying on Types 4, 5, 6 and/or 9 regulated activities which do not necessitate the holding of client assets, i.e. a paid-up share capital of HK\$0 and a minimum amount of required liquid capital of HK\$100,000.

THE AMENDMENT NOTICE AND AMENDMENT RULES

7. The Amendment Notice was made by FS under section 142 of SFO⁴. It amends Schedule 5 to SFO (“Schedule 5”) to give effect to the CRA regulatory regime. The main provisions are as follows –

- (a) **Section 3(2)** adds the new Type 10 regulated activity to Schedule 5;
- (b) **Section 3(3)** excludes provision of credit rating services from the existing definition of “advising on securities” in Schedule 5; and
- (c) **Section 3(4)** adds to Schedule 5 four definitions in relation to Type 10 regulated activity.

8. The Amendment Rules were made by SFC, after consultation with FS, under section 145 of SFO⁵. They amend the Securities and Futures (Financial Resources) Rules (Cap. 571 sub. leg. N, “FRR”) to provide for capital requirements for corporations licensed for Type 10 regulatory activity and connected matters. The main provisions are as follows –

- (a) **Section 3** adds a reference to Type 10 regulated activity to the definition of “specified licensing condition”, which prohibits a licensed corporation licensed for certain regulated activities from holding client assets;
- (b) **Sections 4 and 5** add references to Type 10 regulated activity to sections 5(d) and 56 of FRR regarding paid-up share capital requirements and submission of returns to SFC respectively; and

³ The CRA Code of Conduct would be based on the revised Code of Conduct Fundamentals for Credit Rating Agencies issued by the International Organisation of Securities Commissions in May 2008. These standards require credit rating activities to be conducted in accordance with the principles of integrity, independence, transparency and confidentiality.

⁴ Section 142 of SFO provides that FS may, by notice published in the Gazette, amend Schedule 5.

⁵ Section 145(1) of SFO provides that SFC may, after consultation with FS, make rules requiring licensed corporations to maintain such financial resources as are specified in the rules.

- (c) **Section 6** amends Schedule 1 to FRR to provide for the minimum amounts of paid-up share capital and required liquid capital for Type 10 licensed corporations⁶.

LEGISLATIVE TIMETABLE

9. The legislative timetable is as follows –

Publication in the Gazette	18 February 2011
Tabling at the Legislative Council ("LegCo") for negative vetting	23 February 2011
Commencement	1 June 2011

IMPLICATIONS OF THE PROPOSAL

10. The Amendment Notice and Amendment Rules are in conformity with the Basic Law, including the provisions concerning human rights. They do not affect the current binding effect of the existing provisions of SFO and its subsidiary legislation. As SFC will be responsible for performing the proposed regulatory functions, there are no financial and civil service implications to the Government. There are no productivity, environmental or substantial sustainability implications either. On economic implications, the proposal will enhance investor protection and enable credit ratings prepared by Hong Kong-based CRAs to continue to be serviceable in other jurisdictions, though these benefits may come with an increase in regulatory and compliance cost.

PUBLIC CONSULTATION

11. The Financial Services and the Treasury Bureau and SFC consulted and obtained support from the Legislative Council Panel on Financial Affairs on 19 July 2010 on the proposal to establish a CRA regulatory regime. SFC also conducted a public consultation exercise from 19 July to 20 August 2010 and received overwhelming support to the proposal.

⁶ Notwithstanding section 6, CRAs will be subject to the specified licensing condition thus excused from the obligation to maintain any paid-up share capital and subject to the lower liquid capital requirement. This is the same as corporations carrying on Types 4, 5, 6 and/or 9 regulated activities which do not necessitate the holding of client assets.

PUBLICITY

12. A press release will be issued upon gazettal of the Amendment Notice and Amendment Rules on 18 February 2011. A spokesman will be available to handle media enquiries.

ENQUIRIES

13. Enquiries on this brief may be addressed to Miss Mandy Wong, Principal Assistant Secretary for Financial Services and the Treasury (Financial Services), at 2528 9493 or Mr. Wilson Lo, Director of Licensing of SFC, at 2840 9458.

Financial Services Branch
Financial Services and the Treasury Bureau
18 February 2011

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

(Made by the Financial Secretary under section 142 of the Securities and
Futures Ordinance (Cap. 571))

1. Commencement

This Notice comes into operation on 1 June 2011.

2. Securities and Futures Ordinance amended

The Securities and Futures Ordinance (Cap. 571) is amended as set out in section 3.

3. Schedule 5 amended (Regulated activities)

(1) Schedule 5, Part 1—

Repeal

“management.”

Substitute

“management;”.

(2) Schedule 5, Part 1, after entry relating to Type 9—

Add

“Type 10 : providing credit rating services.”.

(3) Schedule 5, Part 2, definition of *advising on securities*, after
““advising on corporate finance”” —

Add

“or *providing credit rating services*”.

(4) Schedule 5, Part 2—

Add in alphabetical order

“*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, non-interest bearing debt securities, and other securities or instruments acknowledging, evidencing or creating indebtedness;

preferred securities (優先證券) means preference shares, preferred shares or preferred stock;

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

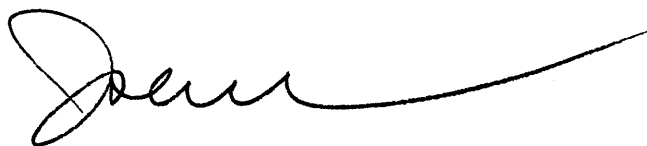
- (a) preparing credit ratings—
 - (i) for dissemination to the public, whether in Hong Kong or elsewhere; or
 - (ii) with a reasonable expectation that they will be so disseminated; or
- (b) preparing credit ratings—
 - (i) for distribution by subscription, whether in Hong Kong or elsewhere; or
 - (ii) with a reasonable expectation that they will be so distributed,

but does not include—

- (c) 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

- (d) gathering, collating, disseminating or distributing information concerning the indebtedness or credit history of any person;”.



Financial Secretary

9 February 2011

Explanatory Note

The purpose of this Notice is to amend Schedule 5 to the Securities and Futures Ordinance (Cap. 571) (*SFO*), which describes the different types of “regulated activity” for the purposes of the SFO, by adding a new type of regulated activity to Part 1 of that Schedule—Type 10: “providing credit rating services”. The objective is to create a licensing regime, and related legal and regulatory obligations, for credit rating agencies (*CRAs*), and their rating analysts, providing credit rating services in Hong Kong. The SFO requires that corporations must be licensed and authorized financial institutions must be registered if they carry on a business in a regulated activity or hold themselves out as doing so in Hong Kong, or actively market whether in Hong Kong or outside Hong Kong to the public any services they provide that would constitute a regulated activity if provided in Hong Kong (see sections 114(1) and (2)(a) and (b) and 115(1) of the SFO). In addition, any individual performing a regulated function in relation to a regulated activity carried on as a business or holding out as doing so, or actively marketing whether in Hong Kong or outside Hong Kong to the public any function the individual performs which would constitute a regulated function if performed in Hong Kong must be a licensed representative accredited to the licensed corporation or an individual whose name is registered by the Monetary Authority as engaged by a registered institution in respect of a regulated activity (see sections 114(3) and (4)(a) and (b) and 115(2) of the SFO). Accordingly, CRAs that are licensed for the new Type 10 regulated activity will be corporations licensed under section 116 or 117 of the SFO or authorized financial institutions registered under section 119(1) of the SFO for the regulated activity (see section 114(2)(a) and (b) of the SFO). The rating analysts who carry on a regulated activity for CRAs will be obliged to be licensed or registered as representatives accredited to these CRAs (see section 114(4)(a) and (b) of the SFO).

2. Section 1 provides for the commencement of this Notice.

3. Section 2 provides for the amendment of Schedule 5 to the SFO.
4. Section 3(1) makes a technical amendment to Part 1 of Schedule 5 to the SFO.
5. Section 3(2) adds the new Type 10 regulated activity to Part 1 of Schedule 5 to the SFO—“providing credit rating services”.
6. Section 3(3) amends the definition of *advising on securities* in relation to the new Type 10 regulated activity and section 3(4) adds 4 related definitions in relation to the new Type 10 regulated activity—*credit ratings, debt securities, preferred securities* and *providing credit rating services*.

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

(Made by the Securities and Futures Commission under section 145 of the Securities and Futures Ordinance (Cap. 571) after consultation with the Financial Secretary)

1. **Commencement**
These Rules come into operation on 1 June 2011.
2. **Securities and Futures (Financial Resources) Rules amended**
The Securities and Futures (Financial Resources) Rules (Cap. 571 sub. leg. N) are amended as set out in sections 3 to 6.
3. **Section 2 amended (Interpretation)**
Section 2(1), definition of *specified licensing condition*—
 - Repeal
“Type 6 or Type 9”
 - Substitute
“Type 6, Type 9 or Type 10”.
4. **Section 5 amended (Paid-up share capital requirement for licensed corporations)**
Section 5(d)—
 - Repeal
“Type 5 or Type 9”
 - Substitute
“Type 5, Type 9 or Type 10”.

5. **Section 56 amended (Licensed corporations to submit returns to Commission)**
 - (1) Section 56(1)(i)—
 - Repeal
“condition,”
 - Substitute
“condition;”.
 - (2) After section 56(1)(i)—
 - Add
“(ia) Type 10 regulated activity, and it is not subject to the specified licensing condition,”.
 - (3) Section 56(3)(d)—
 - Repeal
“activity,”
 - Substitute
“activity;”.
 - (4) After section 56(3)(d)—
 - Add
“(da) Type 10 regulated activity;”.
6. **Schedule 1 amended (Financial resources requirements)**
 - (1) Table 1, after entry relating to Type 9—
 - Add
“Type 10
\$5,000,000”.
 - (2) Table 2, after entry relating to Type 9—
 - Add

- “Type 10—
- | | | |
|-----|--|---------------|
| (a) | in the case where the licensed corporation in question is subject to the specified licensing condition | \$100,000 |
| (b) | in any other case | \$3,000,000”. |



Chief Executive Officer,
Securities and Futures Commission

9 February 2011

Explanatory Note

The purpose of these Rules is to amend the Securities and Futures (Financial Resources) Rules (Cap. 571 sub. leg. N) (*the principal Rules*) to provide for paid-up share capital requirements and liquid capital requirements for licensed corporations licensed for Type 10 regulated activity (providing credit rating services), and connected matters.

2. Section 1 provides for the commencement of these Rules.
3. Section 2 provides for the amendment of the principal Rules.
4. Section 3 amends the definition of *specified licensing condition* in section 2(1) of the principal Rules to add a reference to Type 10 regulated activity.
5. Sections 4 and 5 amend section 5(d) of the principal Rules in respect of paid-up share capital requirements and section 56 of the principal Rules in respect of the submission of returns to the Securities and Futures Commission to add references to Type 10 regulated activity.
6. Section 6 amends Tables 1 and 2 in Schedule 1 to the principal Rules to provide for the minimum amount of paid-up share capital and minimum amount of required liquid capital for licensed corporations licensed for Type 10 regulated activity.