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# SFC Consults On Regulatory Oversight Of Credit Rating Agencies

The Securities and Futures Commission (**SFC**) published a consultation paper (the **Consultation Paper**) on 19 July 2010, setting out its proposed regulatory regime to license and supervise the activities of credit rating agencies (**CRAs**) in Hong Kong. The proposed regulation is in line with global regulatory developments and is intended to come into effect by the end of January 2011.

This note provides a summary of the SFC's proposals and the issues discussed in relation to the possible alternatives. The consultation paper is available [on the SFC website](http://www.sfc.hk/sfcConsultation/EN/sfcConsultFileServlet?name=rocra&type=1&docno=1). The SFC is seeking comments on the issues raised in the Consultation Paper, or comments on related matters that may have a significant impact on the issues. The cut-off date for submission of responses is 20 August 2010. Online submissions may be made [here](https://www.sfc.hk/sfcConsultation/EN/sfcConsultMainServlet?name=rocra).

## Background

CRAs have attracted increased regulatory attention globally over the past few years as a result of their role in the global financial crisis. Increased regulatory oversight of CRAs is generally considered necessary in order to increase CRAs' independence and objectivity and to improve the quality of their ratings. IOSCO issued a revised "Code of Conduct Fundamentals for Credit Rating Agencies" (the **IOSCO Code**) in May 2008, which was followed by the G20's "Declaration on Strengthening the Financial System" (the **Declaration**) on 2 April 2009. The Declaration called for all credit rating agencies whose ratings are used for regulatory purposes to be subject to a regulatory oversight regime consistent with the IOSCO Code, and for national authorities to enforce compliance. Since the G20 declaration, jurisdictions such as the European Union, United States, Japan, Australia and India have announced regulatory measures to strengthen the oversight of CRAs.

## Objectives of Regulating CRAs

The SFC considers that the objectives of regulating CRAs in Hong Kong are:

* to ensure Hong Kong's adherence to international regulatory standards;
* to impose minimum standards of conduct on CRAs; and
* to ensure that ratings prepared in Hong Kong continue to be serviceable in other jurisdictions.

## Creation of a New Type 10 Regulated Activity under Hong Kong's Existing Licensing Regime

Under the existing licensing regime in Hong Kong, a corporation must be licensed to conduct any of the regulated activities under the Securities and Futures Ordinance (**SFO**) or to actively market their services to the public. Further, any individual performing a regulated function for a licensed corporation must be a licensed representative accredited to that licensed corporation.

CRAs do not fall directly under any of the existing categories of regulated activities under the SFO. The SFC therefore proposes making "providing credit rating services" a new regulated activity – Type 10. Under the proposed legislation, "providing credit rating services" is defined as:

"preparing credit ratings" for:

(a) dissemination to the public, whether in Hong Kong or elsewhere, or with a reasonable expectation that they will be so disseminated; or

(b) distribution by subscription, whether in Hong Kong or elsewhere, or with a reasonable expectation that they will be so distributed,

but does not include -

(i) preparing, pursuant to an individual order, a credit rating which is exclusively prepared for, and provided to, the person who placed the order and which 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;\*

(ii) gathering, collating, disseminating or distributing information concerning the indebtedness or credit history of commercial enterprises; or

(iii) the preparation, dissemination or distribution of credit rating by any such person or class of persons as [the Commission / the Financial Secretary] may specify by notice published in the Gazette,"

In order to distinguish the activities of CRAs from Type 4 regulated activity (advising on securities), the draft definition of "credit ratings" is:

 "opinions, expressed using a defined ranking system, primarily regarding the creditworthiness of:

(a) a person other than an individual;

(b) debt securities; or

(c) an agreement to provide credit".

To further avoid confusion between Type 4 and Type 10 regulated activities, the SFC proposes to amend the definition of "advising on securities" to clarify that Type 4 regulated activities do not include "providing credit rating services".

The SFC proposes that the rating of sukuk (Shariah-compliant financial instruments, also known as Islamic bonds) will fall within the regulatory regime if the financial instrument being rated constitutes an agreement to provide credit or it acknowledges, evidences or creates indebtedness. This will be a question of fact.

The following activities do not fall within the SFC's licensing regime:

* internal credit rating activities (e.g. banks' internal systems for assessing counterparty risk);
* private credit ratings prepared pursuant to an individual order,
* sharing or analyzing of consumer or commercial credit data (such as through consumer or commercial credit agencies); and
* sharing or analyzing of personal consumer credit data.

## Amendments to Subsidiary Legislation

The SFC proposes to amend Schedule 1 of the Securities and Futures (Financial Resources Rules) (FRR) to specify the paid-up share capital and liquid capital requirements for Type 10 regulated activities:

* Minimum amount of paid-up share capital - HK$0;
* Minimum amount of required liquid capital - HK$100,000.

These are the same as the requirements for Type 4 licensees that do not hold client assets. The SFC considers that the imposition of the same capital requirements on Type 4 and Type 10 regulated activities is consistent and appropriate given that the United States and the European Union do not currently impose any minimum paid-up share capital or liquid capital requirements on CRAs.

## SFC Codes and Guidelines

To determine whether a person is fit or proper to be licensed or registered for a Type 10 regulated activity, the SFC has prepared a draft "Code of Conduct for Persons Providing Credit Rating Services" (**CRA Code**) to be used as a guide for the SFC. The CRA Code reflects the provisions of the IOSCO Code and supplements the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission. The CRA Code of Conduct is attached to the Consultation Paper in Appendix B.

Under the CRA Code and the IOSCO Code, there is a requirement for CRAs to prevent conflicts of interest by separating, operationally and legally, their credit rating business from their other businesses. The SFC is proposing two approaches to address potential conflicts of interest:

1. In the event that a person wishes to be licensed for providing credit rating services as well as other regulated activities, the person would need to demonstrate appropriate segregation of businesses and the maintenance of safeguards against conflicts of interest;
2. Prohibiting CRAs from conducting any business or regulated activity other than that of providing credit rating services - that is, CRAs would be subject to a sole business (or sole regulated activity) restriction.

To assess the competence of an individual to conduct any type of regulated activity, the SFC will be guided by the Guidelines on Competence (the **Guidelines**) published in March 2003. The SFC proposes to include a list of Recognized Industry Qualifications and Regulatory Framework Papers for Type 10 regulated activity in the Guidelines.

## Implementation and Transitional Arrangements

The SFC proposes to finalise and implement the amendments to the existing licensing regime by the end of January 2011. In order to smooth the transition, a "grandfathering" approach is suggested to bring existing CRA analysts into the proposed regulatory regime, provided that a course relating to the regulatory framework for Type 10 regulated activity is completed within six months of receiving licensing approval under the new regime.

After the transition period, all new analysts will have to pass the relevant Local Regulatory Framework Papers to be registered for Type 10 regulated activity.

*The purpose of this Note is to provide a summary only of information included in the Securities and Futures Commission's "Consultation Paper Concerning the Regulatory Oversight of Credit Rating Agencies" (19 July 2010). Its contents do not constitute legal advice and specific advice should be sought in relation to any particular situation.*

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