



Hong Kong Law

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MOODY'S APPEALS SFC'S DISCIPLINARY ACTION: LATEST DEVELOPMENTS

Moody's Investors Service Hong Kong Limited (**Moody's**) has appealed the Securities and Futures Commission's (**SFC's**) November decision that the agency's July 2011 publication of a report, "Red Flags For Emerging-Market Companies: A Focus on China" (the **Report**), breached the SFC's code of conduct for SFC-regulated entities. Moody's is challenging both the finding of wrongdoing and the nature and extent of the penalties imposed: a HK\$23 million fine and a public reprimand. In the most recent development, the Securities and Futures Appeals Tribunal (the **SFAT**) rejected Moody's request for the appeal proceedings to be held in private. The application for a privacy direction was founded on arguments that publicity arising from the proceedings could undermine Moody's reputation for skilled and balanced analysis and seriously prejudice its operations, in circumstances in which it believes that "the findings reached by the SFC in its Decision Notice are unsubstantiated and should be overturned".¹

Precisely what Moody's did wrong is however still something of a mystery as the SFC has not made public its Decision Notice of 3 November 2014 which imposed the HK\$23 million fine. The 31 December SFAT ruling² on the privacy request simply notes the Decision Notice's conclusion that Moody's publication of the Report breached a number of provisions of the SFC's Code of Conduct for Persons Licensed by or Registered with the SFC.

According to the SFAT ruling, one of Moody's grounds for appeal is its claim that the SFC acted beyond its powers in bringing disciplinary proceedings against it.³ Moody's notice

1 SFAT ruling of 31 December 2014, at paragraph 7
2 SFAT ruling of 31 December 2014 at <http://www.sfat.gov.hk/english/determination/AN-4-2014-Determination.pdf>.
3 Ibid. at paragraph 8.

of application for review asserts that, "As a person licensed with the SFC to undertake Type 10 regulated activity [providing credit rating services], Moody's is required to comply with the Code of Conduct only in so far as it relates to Moody's carrying on the regulated activities for which it is licensed, namely credit rating services, and the Code of Conduct does not apply to any other activities such as publishing commentaries on market-related issues".

In denying Moody's request for a privacy direction, Justice Michael Hartmann emphasized the importance of open administration of justice and noted that "unwanted publicity and possible embarrassment are normal incidences of litigation" and, like professional embarrassment and possible damage to professional reputation, on their own, are not grounds for having litigation conducted in private.

The SFAT will review the SFC's disciplinary decision against Moody's on 10 September 2015.⁴

The Report

Published on 11 July 2011, the Report identified red flags at 61 Chinese non-financial companies. In compiling the Report, Moody's used 20 red flags in five key areas indicative of potential governance or accounting risks:

- possible weaknesses in corporate governance;
- riskier or opaque business models;

4 SFC. "Securities and Futures Appeal Tribunal sets date for Moody's hearing". 8 January 2015.

- fast growth business strategies;
- poor quality earnings or cash flow; and
- concerns over auditors or the quality of financial statements.⁵

The Hang Seng Index fell 698 points the day after publication of the report. The report also caused a sharp drop in the share price and record-high borrowing costs for companies flagged in the report.⁶ For example, West China Cement, which described Moody's allegations against it as misleading, saw a 14% drop in its share price the day after the report's publication.⁷

There have however been comments that the Report was not far off in many respects. Chinese developer, Kaisa Group Holdings (**Kaisa**), which tripped seven red flags in the Report, has been in the press this week following its default on a HK\$400 million loan from HSBC.⁸ On 5 January 2015, Standard & Poor's lowered its credit rating for Kaisa from BB-minus to SD, indicating that the company has defaulted on at least one of its debts, while Moody's downgraded its rating for Kaisa from B3 to Caa3, indicating obligations of poor standing and subject to very high credit risk.⁹

Webb-site Reports found the following changes in stocks' total returns for the five companies with the most red flags in the Report for the period starting the day before the Report's publication (8 July 2011) to the end of 2014¹⁰ :

Company	Red Flags Identified in Report	Change in Total Returns
West China Cement Ltd (2233)	12	down 69.76%
Winsway Enterprises Holdings Ltd (1733)	11	down 92.14%
China Lumena New Materials Corp (0067)	10	down 56.86% (and suspended)

5 Moody's Announcement. "Moody's: Accounting and governance warning signs for emerging market companies" - "Framework is applied to China-based companies". 11 July 2011..

6 Bloomberg. "Moody's Denied Private Hearing on Appeal against Hong Kong Fine". Web. 2 January 2015.

7 Ibid.

8 South China Morning Post. "Two Kaisa Group partners demand refund of 1.2b yuan as problems get worse". 6 January 2015.

9 Ibid.

10 Webb-site Reports, "SFC actions risk chilling critics". 1 January 2015.

Hidili Industry International Development Ltd (1393)	9	down 89.07%
LDK Solar, which was US-listed	9	now bankrupt

Civil Market Misconduct Proceedings against head of US-based Research Company

In a separate development, the SFC started civil proceedings in the Market Misconduct Tribunal against the head of US-based Citron Research, Andrew Left in December 2014, in relation to a research report on Mainland real estate developer, Evergrande Real Estate Group. The SFC alleges that the 2012 report's claims that Evergrande was insolvent and had consistently published fraudulent information were false. Left short-sold 4.1 million Evergrande shares shortly before releasing the report and made a realised profit of approximately HK\$1.7 million. The SFC's proceedings are for the civil market misconduct offence of disclosure of false or misleading information inducing transactions under section 277(1) of the Securities and Futures Ordinance. For further details, please see Charltons newsletter, "SFC Starts Market Misconduct Proceedings over Alleged False Research Report"¹¹ for more information.

11 Charltons. "SFC Starts Market Misconduct Proceedings over Alleged False Research Report" December 2014 at: <http://www.charltonslaw.com/sfc-starts-market-misconduct-proceedings-over-alleged-false-research-report/>.

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Hong Kong Office

Dominion Centre

12th Floor

43-59 Queen's Road East

Hong Kong

Tel: + (852) 2905 7888

Fax: + (852) 2854 9596

www.charltonslaw.com