CHARLTONS
SOLICITORS

Hong Kong **April** 2016

SFAT Reprimands and Fines Moody's HK$11 million over Red Flags Report on Chinese Companies

The Securities and Futures Appeals Tribunal (**SFAT** or the **Tribunal**) has upheld a disciplinary action brought by the Securities and Futures Commission (**SFC**) against Moody's Investors Service Hong Kong Limited (**Moody's**). However, not all the SFC's claims were upheld and the SFAT reduced the fine to HK$11 million from the HK$23 million proposed by the SFC.

A decision was made on the appeal on 31 March 2016, and the 'reasons for determination' were published[1] and shared on the SFC's website[2] on 5 April 2016.

Background

Moody's is a global credit rating agency, and has operated in Hong Kong for many years. Moody's is licensed under the Securities and Futures Ordinance (**SFO**) to carry on business in Type 10 (providing credit rating services) regulated activity.

In July 2011, Moody's published a 25-page report entitled "Red Flags for Emerging-Market Companies: A Focus on China" (the **Red Flags Report**).

The Red Flags Report allegedly devised a framework for identifying governance and accounting risks when investing in emerging market fixed income securities. While academic in nature, as noted by the Tribunal, the Red Flags Report was presented in a highly accessible format and direct language such that the Tribunal concluded it was intended to have an impact on the market, and on consideration of the facts, the SFAT had no qualms that the Red Flags Report did affect the market.

Following the publication of the Red Flags Report, the share prices of more than half of the Hong Kong-listed companies mentioned dropped substantially on the following day, ranging from 5% to as much as 16.8%, compared to their previous closing prices on 8 July 2011. In particular, four of the six companies singled out as "negative outliers" in the Red Flags Report suffered the biggest drop in their share prices.

Due to the impact on the market, in November 2014, the SFC informed Moody's by way of a formal Decision Notice (the **November 2014 Notice**) that pursuant to section 194 of the SFO, Moody's had failed to meet the standards and comply with the practices expected of a licensed corporation. For more information on the Red Flags Report and Moody's appeal, please see Charltons' 2015 newsletter[3].

SFC's determination of Moody's breaches

In the November 2014 Notice, the SFC determined that pursuant to section 194 SFO, Moody's was not fit and proper to remain licensed and was guilty of misconduct. The SFC was of the view that Moody's breached General Principle 1 and General Principle 2 of the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (**Code of Conduct**).

1 http://www.sfat.gov.hk/english/determination/AN-4-2014-Determination.pdf
2 http://www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/doc?refNo=16PR34
3 http://www.charltonslaw.com/newsletters/hong-kong-law/en/2015/272/Moodys-Appeals-SFCs-Disciplinary-Action-Latest-Developments.pdf

General Principle 1 of the Code of Conduct requires that a licensed or registered person should act honestly, fairly, and in the best interest of its clients and the integrity of the market in conducting its business activities.

General Principle 2 of the Code of Conduct requires that a licensed or registered person should act with due skill, care and diligence, in the best interests of its clients and the integrity of the market in conducting its business activities.

The SFC also found Moody's was culpable under paragraph 4.3 of the Code of Conduct, which provides that "a licensed or registered person should have internal control procedures and financial and operational capabilities which can be reasonably expected to protect its operation, its clients and other licensed or registered persons from financial loss arising from theft, fraud, and other dishonest acts, professional misconduct or omission."[4] The SFC reached such a view on the basis that Moody's had minimal procedures and controls to ensure that the Red Flags Report was presented in a "fair, accurate and non-misleading manner"[5].

Pecuniary Damages

The SFC determined that Moody's should be subjected to a public reprimand and a pecuniary penalty of HK$23 million, of which HK$9 million accounted for the breaches of General Principle 1, HK$6 million for breaches of General Principle 2, and HK$8 million for breaches of paragraph 4.3 of the Code of Conduct.

The Appeal

Moody's challenged the findings of culpability made by the SFC and the consequent penalties imposed by way of an application made pursuant to section 217(1) of the SFO.

The Tribunal's decision

1. General Principle 1

As discussed above, the obligation to act honestly, fairly and in the best interest of clients is the paramount principle under General Principle 1.

The SFC had found Moody's to be culpable in three distinct respects under General Principle 1, namely that Moody's:

a) had made inconsistent and misleading statements in the press release and the Red Flags Report regarding the nature and purpose of the Report and had created confusion in the market;

b) had failed to provide sufficient explanations and information for the 'red flags' and to set out relevant justifications in the Red Flags Report and had, as a result, painted an unfair, unclear and misleading picture; and

c) had chosen to list in the Red Flags Report, the 'red flags' for each company and to highlight six companies with the largest number of red flags as 'negative outliers', despite the fact that, by its own analysts' assessment, there was no significant correlation between the number of red flags and credit risk.[6]

On the first point, the Tribunal came to the conclusion that the Red Flags Report, when read in conjunction with the press release, did not give any misleading impressions. On a balance of probabilities, the Tribunal dismissed this aspect of Moody's culpability as insinuated by the SFC.

On the second point, the SFC presented that Moody's failed, with the exception of a limited number of negative outliers, to provide any explanation of how the red flags were assigned to specific companies and what weight should be placed on any given red flags. It is worth noting that Moody's did not dispute the factual basis upon which the SFC came to its finding of culpability.

The Tribunal noted that Moody's did not provide commentary on all of the red flags identified, which made it impossible for readers to assess the significance of the red flags in context. While recognising that Moody's did not wish to overburden the red flag framework with details, it was held that the failure to produce information from which readers could accurately assess the significance of the flags in context constituted a breach of General Principle 1.

On the third point, the Tribunal was of the view that companies designated as negative outliers would have been viewed by the average reader as a company to consider with caution. The description of the term carries negative connotations. While the Tribunal appreciated that from a publishing perspective,

4 Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission, at paragraph 4.3
5 http://www.sfat.gov.hk/english/determination/AN-4-2014-Determination.pdf at paragraph 60
6 http://www.sfat.gov.hk/english/determination/AN-4-2014-Determination.pdf at paragraph 145

such a term may be used to grab readers' attention, it contravenes General Principle 1 of the Code of Conduct as in all circumstances there was no correlation between the number of red flags and the credit risk.

2. General Principle 2

As discussed above, General Principle 2 requires that "in conducting its business activities, a licensed or registered person should act with due skill, care and diligence, in the best interests of its clients and the integrity of the market."

First, it was the SFC's position that the Red Flags Report contained 13 "glaring errors" and Moody's also identified 12 errors. Moody's did not dispute the existence of the errors, but did dispute the impact of such errors on the overall accuracy of the Red Flags Report.

The Tribunal accepted that "there will always be minor errors in a report as substantial as the one under consideration, especially when there are time pressures."[7] However, it concluded that the errors made by Moody's were "errors of consequence"[8].

The Tribunal was of the view that there was an increased need for accuracy due to the nature of Moody's position in the market, as well as the publication's topic. Moody's should have anticipated and appreciated that its publication would be followed closely and carefully, and as such Moody's allocation of red flags could and would have a materially negative effect on the mentioned companies.

Moody's failure to ensure accuracy undermined the interests of Moody's clients, and that of the market, contravening General Principle 2.

3. Paragraph 4.3 of the Code of Conduct

As discussed above, under paragraph 4.3 of the Code of Conduct, "a licensed or registered person should have internal control procedures and financial and operational capabilities which can be reasonably expected to protect its operation, its clients and other licensed or registered persons from financial loss arising from theft, fraud, and other dishonest acts, professional misconduct or omission."

The SFC's determination that Moody's had acted in contravention of the Code of Conduct resulted from their view that Moody's failed to place adequate control procedures concerning the preparation and publication of the Red Flags Report.

Moody's attempted to argue that the publication of the Red Flags Report did not fall within its regulated activities, and therefore was not subject to the Code of Conduct. The Tribunal rejected this submission, on the grounds that even if it had been unintentional, Moody's preparation and publication of the Red Flags Report constituted a credit rating and was thus within the scope of its regulated activities.

The issue to be determined, according to the Tribunal, was whether Moody's had relevant internal control procedures in place to ensure all forms of ratings were subject to formal protection. This is an issue of law.

The Tribunal was of the view that at all material times, Moody's was required to have in place internal control procedures governing its licensed activity, namely preparing credit ratings. The Code of Conduct does not however extend to licensed corporations' unregulated activities, even if they are closely related to their regulated activities.

It was accepted that Moody's had sufficient control procedures in place to regulate its core activity of providing ratings. Its fault lay in not recognising that all forms of rating (such as the Red Flags Report) fell within the definition of its regulated activities. As a result, the Tribunal struck down the SFC's findings of culpability under paragraph 4.3 of the Code of Conduct.

Pecuniary Damages

The SFAT imposed a public reprimand and imposed a pecuniary penalty of HK$11 million, comprising HK$6 million for breaches of General Principle 1 and HK$5 million for breaches of General Principle 2. This was however less than half the HK$23 million fine proposed by the SFC. Moody's was also ordered to pay 60% of the SFC's costs.

7 http://www.sfat.gov.hk/english/determination/AN-4-2014-Determination.pdf at paragraph 194
8 ibid

CHARLTONS

Best Boutique Firm 2015
Asian Legal Business Awards

This newsletter is for information purposes only.

Its contents do not constitute legal advice and it should not be regarded as a substitute for detailed advice in individual cases.

Transmission of this information is not intended to create and receipt does not constitute a lawyer-client relationship between Charltons and the user or browser.

Charltons is not responsible for any third party content which can be accessed through the website.

If you do not wish to receive this newsletter please let us know by emailing us at unsubscribe@charltonslaw.com

---

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