

## Regulatory Compliance

### Do “Red Flag” Reports Constitute Credit Rating?

#### Introduction

In Hong Kong, credit rating is an activity regulated by the Securities and Futures Commission (the “**SFC**”). Any persons or corporations who wish to carry out such activities are required to apply for the requisite licence and comply with the relevant legal and regulatory requirements. Recently, the Court of Appeal heard an appeal lodged by a credit rating agency against the decision of the Securities and Futures Appeals Tribunal (the “**SFAT**”) where it was found to be in breach of the relevant code of conduct.

#### Background

Back in early 2011, there were only 9 types of regulated activities which required application for licences issued by the SFC. On 1 June 2011, the regulatory regime governing credit rating agencies operating in Hong Kong came into force. Under the new regime, credit rating agencies and their rating analysts who provide credit rating services in Hong Kong are required to apply for Type 10 licence and are subject to supervision by the SFC. In addition to those legal and regulatory requirements that are generally applicable to Types 1 to 9 licensees, Type 10 licensees are required to comply with the Code of Conduct for Persons Providing Credit Rating Services (the “**Code**”). On the same day, the SFC also issued Type 10 licences to 5 credit rating agencies, one of which was Moody’s Investors Service Hong Kong Limited (“**Moody’s**”), part of the global Moody’s credit rating agency network and the subject entity of the following discussion.

Shortly after the obtaining of the Type 10 licence, on 11 July 2011, Moody’s published a 25-page report entitled “*Red Flags for Emerging-Market Companies: A Focus on China*” (the “**Report**”). The Report basically purported to devise a framework of “Red Flags” for identifying governance and accounting risks prevalent when investing in fixed-income securities in the emerging markets. The “Red Flags” were grouped in several categories such as possible weaknesses in corporate governance and poorer quality of earnings or cash flow. Under the Report, more than 60 Chinese companies were examined with different numbers of “Red Flags” tripped in respect of each company.

Following the publication of the Report, the share prices of more than half of the companies red-flagged dropped substantially. This led to investigation by the SFC which later took the view that though the Report was not the sole contributing factor to the drop in the share prices, it was a significant contributor. The SFC further determined that Moody’s had failed

to meet the relevant standards expected of a Type 10 licensee in its publication of the Report. The SFC also found that Moody's had failed to have procedural safeguard in place to ensure integrity of the Report and that the Report was materially misleading, confusing and inaccurate in several respects.

The SFC therefore imposed a penalty of public reprimand and a fine of HK\$23 million against Moody's, which later sought a review of the SFC's decision. The review was heard by the SFAT which largely affirmed the SFC's decision and found that (1) Moody's was carrying on Type 10 activities in the preparation and publication of the Report thus regulated by the Securities and Futures Ordinance (Cap.571) (the "SFO"); (2) there were substantive breaches of the provisions of the Code by Moody's; and (3) Moody's should be subject to a public reprimand together with a pecuniary penalty reduced to HK\$11 million. Moody's subsequently appealed to the Court of Appeal against such decision of the SFAT.

## Issues

In challenging the SFAT's decision, Moody's had advanced several grounds of appeal. The ground on which the court devoted most of its time on is whether the preparation and publication of the Report constituted the carrying on of a Type 10 activity. In essence, Moody's sought to challenge the two alternative bases upon which the SFAT had come to its conclusion that a Type 10 activity was engaged. These two alternative bases are namely:-

1. that the Report itself constituted credit ratings; or
2. that the Report amplified or supplemented Moody's credit ratings, and as such it was part and parcel of the same.

## Discussion

### Whether the Report itself constituted credit rating

In Part 2 of Schedule 5 to the SFO, "credit ratings" is defined as -

*"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;*
- (d) *an agreement to provide credit."* (Emphasis added)

Basically, there are two essential components in the definition, namely the opinions should be primarily regarding the creditworthiness of the specified subjects, and such opinions are expressed using a defined ranking system.

In challenging this first basis, Moody's sought to rely on the fact that the Report only addressed corporate governance and accounting risks, which are only two elements of credit risks. Moody's also relied on the statements in the Report that the correlation between the number of "Red Flags" and creditworthiness is limited. As such, Moody's submitted that the Report did not express opinions primarily on the creditworthiness of the companies concerned.

After hearing Moody's arguments, the Court was persuaded that there is a distinction between assessment of one or two elements of credit risks and the credit rating itself. According to the Court, the crucial question is whether the Report, read as a whole, went beyond the expression of opinions confined to two elements of credit risks only and expressed an opinion primarily regarding creditworthiness.

In answering the question, the Court found that Moody's had made it clear in the Report that the "Red Flags" do not represent a change in Moody's rating methodologies which encompassed other factors, and that the focus of the Report was confined to governance and accounting risks. In particular, the Court had given much weight to the statement in the Report that there is limited correlation between lower ratings and larger numbers of "Red Flags". The Court also noted that Moody's had highlighted that the weighting for those "Red Flags" may vary in respect of the circumstances of each company. In other words, Moody's did not represent in the Report that it had adopted an alternative credit risk assessment approach based on governance and accounting risks alone.

In the circumstances, the Court agreed with Moody's that the Report expressed an opinion primarily on corporate governance and accounting risks which are relevant but far from determinative of creditworthiness. As such, the Report itself did not constitute credit rating.

#### Whether the Report was part and parcel of credit ratings

Moving on to the second basis, Moody's argued that the Report was not part of the process in the preparation of Moody's credit ratings and the "Red Flags" framework was not adopted as part of the methodology in working out such credit ratings. As such, the Report should not be taken as part and parcel of Moody's credit ratings.

The Court, however, rejected Moody's argument and referred to section 193 of the SFO which defines misconducts as including "*an act or omission relating to the carrying on of any regulated activities*" (emphasis added). In this regard, the Court agreed with the SFAT's

reasoning that, even though the “Red Flags” framework was not part of the methodology in arriving at Moody’s credit ratings of a classic kind, the Report did constitute additions and clarifications which were meant to be read together with such classic ratings. As such, the Court held that the publication of the Report was an activity relating to the ratings within the meaning of section 193 of the SFO. The Court therefore affirmed the SFAT’s ruling that misconduct can be established on the basis that the preparation and publication of the Report was part and parcel of the carrying on of the business of credit ratings by Moody’s.

Given that the Court had found the Report was part and parcel of credit ratings, the Court upheld the actual decision of the SFAT although it disagreed with the latter’s conclusion that the Report itself constituted credit rating. Accordingly, Moody’s appeal was dismissed.

## Implications

As at the time of this article being written, Moody’s has already expressed that it is reviewing the Court’s judgment and considering its options. It is therefore possible that we may see further developments of this case. Meanwhile, persons or corporations who are about to make substantive or serious allegations against the credit worthiness of listed companies are advised to obtain legal advice in advance to ascertain whether such activities fall within the realm of credit ratings which are regulated by the SFC.

For enquiries, please contact our Litigation & Dispute Resolution Department:

E: [regcom@onc.hk](mailto:regcom@onc.hk)

T: (852) 2810 1212

W: [www.onc.hk](http://www.onc.hk)

F: (852) 2804 6311

19th Floor, Three Exchange Square, 8 Connaught Place, Central, Hong Kong

**Important:** The law and procedure on this subject are very specialised and complicated. This article is just a very general outline for reference and cannot be relied upon as legal advice in any individual case. If any advice or assistance is needed, please contact our solicitors.

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