THE LAW SOCIETY OF HONG KONG 香港律師會

SECURITIES AND FUTURES COMMISSION
Concerning the Regulatory Oversight of Credit Rating Agencies

The Law Society generally welcomes the proposal to regulate Credit Rating Agencies (CRAs). The Council has consulted its Securities Law Committee on the Consultation Paper and has the following response to the questions therein:

Part I Consultation on Regulatory Oversight of Credit Rating Agencies

Questions 1
Is it appropriate for Hong Kong to subject CRAs to a regulatory oversight regime consistent with international developments?

Law Society's response
Yes

Question 2
Should regulatory oversight of CRAs be achieved by extending the existing licensing regime under the SFO to CRAs and those of their staff who perform regulated functions?

Law Society's response
Yes

Question 3
Do our draft amendments to the SFO effectively distinguish "providing credit rating services" from "advising on securities"?

Law Society's response
We have no comments on the draft amendments.

Question 4
Should the proposed new licensing requirement apply to the rating of sukuk?

Law Society's response
We express no particular views on the rating of sukuk specifically, but agree that a purposive approach should be taken to determine whether a given security is, in

substance, in the nature of products which are regulated under the new laws and regulations.

Question 5
Should the following activities be excluded from the proposed new licensing requirement:

(a) preparing credit ratings for an organisation's internal purposes;

Law Society's response
We agree with this exclusion.

(b) preparing private credit ratings;

Law Society's response
We agree with applying the exclusion to the initial commissioning of a private credit rating. However, where any private credit rating is subsequently distributed or presented to third parties (whether the public in general or to persons who were not parties to the contract whereby the credit rating was commissioned) for a commercial purpose, there is no reason in principle for the exclusion not to apply from an market protection perspective.

If the intention of the new rules is to subject credit rating professionals to certain basic standards of conduct and indirectly to maintain an orderly financial market, we believe private credit ratings should not be excluded on a one-off basis, but should be regulated in circumstances where they could potentially be used to benefit a certain person (e.g. the entity being rated, or the person commissioning the rating) to the detriment of third parties, or the financial markets in general.

In this connection, we note Paragraph 19 of the draft Code of Conduct which apply the Code requirements to any private ratings, even if there is no intention to disseminate such ratings subsequently. This suggests that under the general spirit of the proposed regulatory regime, a rating does not fall outside the ambit of regulation simply because of its "private" nature. We believe this is the correct approach to take.

We therefore suggest that some limits should be put on the definition of "private credit ratings" which would take certain business activities outside the ambit of licensing and continuing conduct requirements. For example, the SFC may consider excluding ratings that are initially commissioned on a private contractual basis, but are subsequently distributed, in a commercial context, to the public or to unconnected third parties within a certain period (e.g. 6 months) of the drawing up of the rating.

(c) sharing or analyzing consumer or commercial credit data (such as through consumer or commercial credit reference agencies)?

Law Society's response
We agree with this.

Question 6
Further to question 5, do our draft amendments to the SFO effectively exclude these activities from the proposed new licensing requirement?

Law Society's response
We have no comments on the draft amendments.

Question 7
Are the proposed paid-up share capital and liquid capital requirements for Type 10 regulated activity appropriate?

Law Society response
We have no comment on the proposed financial resource requirements

Question 8
Does the CRA Code of conduct satisfactorily set out the factors that should guide CRAs in the conduct of their business and which should be relied upon by the SFC in considering whether a person is, or remains, fit and proper to be licensed or registered for Type 10 regulated activity?

Law Society response
We have examined the CRA Code of Conduct in light of the IOSCO Code of Conduct Fundamentals for CRAs and found them generally consistent. We have some detailed comments as set out in Part II below.

Question 9
Should persons licensed or registered for Type 10 regulated activity be permitted to be licensed or registered for other types of regulated activity?

Law Society's response
No. We propose that any person licensed or registered for Type 10 regulated activity should not be permitted to be licensed or registered for other types of regulated activity.

Question 10
Should persons licensed or registered for Type 10 regulated activity be subject to a sole business restriction?

Law Society's response
Yes, we agree that a rating agency should be subject to a sole business restriction.

Question 11
Is the draft list of Recognised Industry Qualifications and Local Regulatory Framework Papers for Type 10 regulated activity appropriate?

Law Society's response
We have no comments on the draft list.

Question 12
Are the proposed transitional arrangements appropriate?

Law Society's response
We have no comments on the draft list.

Part II Comments on the Draft Code of Conduct

General – We propose that a licensed CRA should be a sole-business concern (see Q10 above). We therefore do not agree with some of the proposed provisions in the Code of Conduct which assume a multi-service business (e.g. Paragraphs 23 and 30). We will not discuss each of these provisions in this part.

Paragraph 14 – We propose removing the second sentence in this provision, as staffing issues and rotations should be left to the discretion of the organisation in question, as long as it adheres to the principle of continuity and impartiality as stated in the first sentence in this paragraph.

Paragraph 17 – We believe this paragraph is superfluous given the general expertise requirements in the "Quality of the Rating Process" section.

Paragraph 30 – The last sentence in this paragraph requires the licensed or registered person to define what it considers and does not consider to be an "ancillary business" and why. We believe this is superfluous given the previous sentence which already assumes that that thinking process to have been carried out. Specifying such process in too much detail may lead to undesirable micromanagement by the regulators.

Paragraphs 38-40 – We agree with the spirit behind these requirements, but believe its proposed drafting is unnecessarily strict (e.g. requiring information to be stored specifically by way of a password-protected website). Organisations should be given some discretion to organise and segregate sensitive information as long as the broad principles (e.g. effective keeping and retrieving of records, avoidance of conflicts of interest, freely accessible mode of storage, etc.) are complied with.

The Law Society of Hong Kong
Securities Law Committee
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