

Licensing Update: Regulation of Credit Rating Agencies

The Securities and Futures Commission has created a new regulated activity to bring credit rating agencies under its licensing and registration framework. Under the revised regulatory regime, credit rating agencies will be subject to capital requirements as well as conduct of business and competency requirements. In this article, we examine the changes to the law.

On February 18, 2011, the Securities and Futures Commission issued the Securities and Futures Ordinance (Amendment of Schedule 5) Notice 2011 and the Securities and Futures (Financial Resources) Amendment Notice 2011 (together “Notices”). The Notices will come into effect on June 1, 2011 and will introduce a new regulated activity under the Securities and Futures Ordinance, namely Type 10 (providing credit rating services).

BACKGROUND

As a result of the financial crisis in 2008, international consensus has emerged that credit rating agencies should be regulated because of the influence ratings produced by such agencies have on public investment sentiment. The introduction of the new Type 10 regulated activity is intended to ensure that Hong Kong adheres to international standards, to enhance investor protection and to enable credit ratings prepared by Hong Kong based credit rating agencies to be serviceable in other jurisdictions.

March 14, 2011

For more information

Timothy Loh,
Principal

tloh@timothyloh.com

Hong Kong: +852 2899.0179

Guy Connell *

gconnell@timothyloh.com

Hong Kong: +852 2899.0140

Founded in 2004, TIMOTHY LOH, SOLICITORS has attained international recognition as a leading Hong Kong and international law firm. We have particular strengths in handling regulatory enforcement actions, complex tax, corporate, commercial and regulatory issues affecting the finance industry and mergers and acquisitions involving private equity or financial institutions. The International Financial Law Review 1000, an independent editorial publication ranking law firms, has recommended us as a leading law firm in banking, investment funds and regulatory matters.

** Not admitted or registered as a lawyer in Hong Kong*

As a result of the Notices, both firms and their staff may be subject to licensing or registration requirements for the provision of credit rating services... “[P]roviding credit rating services” is defined as preparing credit ratings for dissemination to the public, or for distribution by subscription, whether in Hong Kong or elsewhere.

Changes to Law

As a result of the Notices, both firms and their staff may be subject to licensing or registration requirements for the provision of credit rating services. In particular, any person who carries on a business (or holds himself out as carrying a business) of providing credit rating services should be licensed or registered by the Securities and Futures Commission. Similarly, any individual who performs any regulated function in relation to regulated activity of providing credit rating services carried on as a business or holds himself out as performing such a function should be licensed or registered.

Meaning of Type 10

The regulated activity of “providing credit rating services” is defined as preparing credit ratings for dissemination to the public, or for distribution by subscription, whether in Hong Kong or elsewhere.

Credit Ratings

For this purpose, “credit ratings” are opinions, expressed using a defined ranking system, primarily regarding creditworthiness of (a) a person other than an individual, (b) debt securities, (c) preferred securities, or (d) an agreement to provide credit. “Debt securities” means debenture stocks, loan stocks, debentures, bonds, notes, indexed bonds, convertible debt securities, bonds with warrants, non-interest bearing debt securities and other securities or instruments acknowledging, evidencing or creating indebtedness. “Preferred securities” means preference shares, preferred shares or preferred stock.

Dissemination or Distribution

Actual dissemination or distribution is not required. The preparation of credit ratings is sufficient to trigger licensing or registration requirements if it is reasonably expected that credit ratings so prepared will be disseminated or distributed.

Public

However, any distribution or dissemination (or reasonable expectation of distribution or dissemination) must be to the public, whether in Hong Kong or elsewhere. Thus, a person should not be required to be licensed or registered for Type 10 regulated activity if, pursuant to a request made by another person, he prepares a credit rating that is exclusively prepared for, and provided to, the other person and that 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”.

Credit Reports

Persons who gather, collate, disseminate or distribute information concerning the indebtedness or credit history of a person are not within the scope of Type 10 regulated activity.

Advising on Securities

The Notices specifically exempt persons who simply provide credit rating services from Type 4 (advising on securities) regulated activity. The Notices do not, however, specifically introduce a converse exemption so that persons advising on securities are exempt from the scope of Type 10 regulated activity. Nevertheless, a

The Notices do not, however, specifically introduce a converse exemption so that persons advising on securities are exempt from the scope of Type 10 regulated activity. Nevertheless, a person advising on debt securities or preferred securities without a defined ranking system would not fall within the scope of Type 10 regulated activity.

person advising on debt securities or preferred securities without a defined ranking system would not fall within the scope of Type 10 regulated activity.

- independence and avoidance of conflicts of interest;
- responsibilities to the investing public and issuers; and
- disclosure and communication.

Conduct of Business

Any person licensed or registered for Type 10 regulated activity will be subject to conduct of business standards in a new Code of Conduct for Persons Providing Credit Rating Services (“Code”). The Code sets certain requirements in relation to:

Specifically the Code requires that each CRA has and publishes its own code of conduct, and implements compliance and internal monitoring procedures, and along with its representatives, observes certain minimum standards.

- maintaining the quality and integrity of the credit rating process;

© Copyright 2011 Timothy Loh. All rights reserved.

This article provides general guidance only and should not be relied upon as legal advice. You should seek legal advice specific to your individual circumstances. Timothy Loh disclaims liability to any person relying upon this article as legal advice.

To add or remove your name from the distribution list for articles from this firm or to obtain a reprint or soft copies, please send an email to publications@timothyloh.com.

