

SFAT affirms SFC decision to reprimand and fine Moody's over Red Flags Report

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The Securities and Futures Commission (SFC) has reprimanded Moody's Investors Service Hong Kong Limited (Moody's) and fined it \$11 million for various failures relating to its preparation and publication of the special comment report entitled "Red Flags for Emerging-Market Companies: A Focus on China" published on 11 July 2011 (the Report) (Notes 1, 2 & 3).

The SFC's action against Moody's follows the determination of the Securities and Futures Appeals Tribunal (SFAT) which confirms the SFC's jurisdiction over Moody's in this case (Note 4).

The SFAT has affirmed the SFC's findings that, Moody's, in preparing and publishing the Report which purportedly identified risk factors of Mainland rated issuers:

- failed to provide sufficient explanations for the red flags assigned by it to the rated companies and to set out relevant justifications to the red flags in the Report, and had, as a result, painted an unfair, unclear and misleading picture of the companies;
- chose to list the red flags assigned to each company and to highlight six companies with the largest number of flags in the Report as "negative outliers" to make the Report "actionable" despite the assessment performed by its analysts showed that there was no significant correlation between the number of red flags and the companies' credit risk; and
- failed to ensure the accuracy of the red flags assigned to the companies.

The SFAT found that in the preparation and publication of the Report, Moody's was carrying on its regulated activity of providing credit rating services. The SFAT also found that there were substantive breaches of General Principles 1 and 2 of the Code of Conduct (Notes 5 & 6). The SFAT has determined that Moody's should be subject to a public reprimand and a pecuniary penalty of \$11 million (Note 7).

The SFC's Chief Executive Officer, Mr Ashley Alder, said, "The Code of Conduct sets general principles and standards of conduct that all licensed or registered persons, including credit rating agencies, must follow. The purpose of the Code of Conduct is to maintain high standards of conduct by intermediaries and to ensure intermediaries remain fit and proper."

End

Notes:

1. Moody's is licensed under the Securities and Futures Ordinance to carry on business in Type 10 (providing credit rating services) regulated activity.
2. In the Report, Moody's assessed 49 non-financial Chinese entities against 20 warning signs it called "red flags" to identify possible corporate governance and accounting risks. The Report highlighted and discussed six companies which received the highest number of red flags among the other rated peers, and they were identified as "negative outliers". The Report also displayed the number and type of red flags assigned to each of the 49 companies in various tables.
3. The share prices of more than half of the Hong Kong-listed companies covered in the Report 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 Report suffered the biggest drop in their share prices.
4. Please refer to the [SFAT's Reasons for Determination](#), which is available on its website at www.sfat.gov.hk.
5. General Principle 1 of the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (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.

The SFC's findings under General Principle 1 are limited to Moody's failure to act fairly, in the best interests of its clients, and the integrity of the market. In its Reasons for Determination, the SFAT also made it clear that there are no findings of dishonest conduct or intention to mislead by Moody's.

6. 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.
7. The SFAT reduced the fines imposed by the SFC from \$23 million to \$11 million after rejecting the SFC's findings that:
 - (a) the Report and its accompanying press release created a misleading impression that the red flag methodology had been in use over time and had been relied upon by Moody's in rating Chinese companies and would continuously be applied in the future; and
 - (b) Moody's did not have in place sufficient internal control procedures to ensure that its business activities which were related to and part and parcel of its regulated activities complied with paragraph 4.3 of the Code of Conduct.

With respect to the findings set out at (b) above, the SFAT commented that it is not that Moody's had no internal control procedures in place but that it failed to recognise that the Report should have been subject to the existing internal controls covering the regulated activity of providing credit rating services.