

Hong Kong Securities Laws Violations: SFC's Case Against Moody's – Part 3

On June 8, 2017, the Hong Kong Court of Appeal ("Court") handed down a judgment ("Judgment") dismissing an appeal brought by Moody's Investors Service Hong Kong Ltd ("Moody's") challenging a determination ("Determination") by the Securities and Futures Appeals Tribunal ("Tribunal").¹ This article examines the reasons for the Judgment to uphold the Determination and thus the disciplinary action by the SFC against Moody's.

Background

In July 2011, Moody's published a special comment report entitled "*Red Flags for Emerging-Market Companies: A Focus on China*" (the "**Report**") which was distributed to subscribers and available for purchase by the general public on Moody's website. The Report contained traditional credit ratings in respect of a number of Chinese companies accompanied by a "red flag" framework which scrutinized certain weaknesses.

The Report received extensive local and international media attention and had a material impact on the market. One day after its publication, the share prices and bond prices of more than half of the "red-flagged" Chinese companies in the Report experienced substantial falls.

On March 31, 2016, the Tribunal in the Determination upheld the disciplinary action of the SFC against Moody's, finding that:

- a) in the preparation and publication of the Report, Moody's was carrying on Type 10 activities, thus regulated under the Securities and Futures Ordinance (the "**SFO**");
- b) there were substantive breaches of General Principles 1 and 2 of the Code of Conduct; and
- c) Moody's should be subject to a public reprimand together with a pecuniary penalty of

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\$11 million.

The bulk of the discussion in the Judgment focused on whether Tribunal was wrong in law in holding that the preparation and publication of the Report constituted the carrying on of Type 10 activity under the SFO. Although Moody's was successful in persuading the Court that the Report itself did not constitute a credit rating, the Court ultimately agreed with the Tribunal that it amplified or supplemented Moody's credit ratings such that it engaged in Type 10 activity.

For a more detailed analysis of the Report and the SFC's position prior to the appeal decision, see our eUpdate entitled "Hong Kong Securities Laws Violations: SFC's Case Against Moody's" – Part I and for a detailed analysis of the Tribunal's determination, see Part II.

In this Part III of the SFC's Case Against Moody's, we look at the findings of the Court concerning Moody's appeal against the Determination.

Grounds of Appeal

Pursuant to section 229 of the SFO, the Court can only entertain an appeal from the Tribunal on a point of law. In the Notice of Appeal, Moody's advanced three grounds of appeal:²

- a) the Tribunal was wrong in law in holding that the preparation and publication of the Report constituted the carrying on of Type 10 activity;
- b) the Tribunal was wrong in law in affirming that the SFC had jurisdiction to exercise its disciplinary powers under section 194 of the SFO; and
- c) the Tribunal erred by determining the jurisdiction issue by reference to whether the Report would have been likely to convey to the readership the message that it contained "credit ratings" rather than by reference to an objective evaluation of whether the Report did actually contain 'credit ratings' as defined in the Ordinance.

The Court examined each of the above grounds in reverse order, and quickly dismissed Ground (c) holding that it is obviously without merit. It stated that the Tribunal carefully analysed the statutory scheme in the SFO and explained why the preparation and publication of the Report constituted Type 10 activity by reference to the contents of the Report and the press release issued by Moody's introducing the Report.³

The Court then turned its attention to Ground (b), which was also dismissed. The dismissal of Ground (b) was premised on the basis that the Tribunal is entitled to conduct a full merits review. The Court held that the way in which the SFC originally proceeded against Moody's is irrelevant except to the extent that Moody's suffered any procedural prejudice leading to injustice. Since there was no alleged unfairness, the Court held that

the SFC's reasoning cannot be germane to the determination of Ground (b).⁴

Ground (a): Did the Tribunal err in law in finding that the preparation and publication of the Report constituted the carrying on of Type 10 activity?

The Court examined the two bases on which the Tribunal concluded that Moody is engaged in Type 10 activity, being that: (i) the Report itself constituted credit ratings; and (ii) the Report amplified or supplemented Moody's credit ratings, and as such it was part and parcel of the same.

Did the Report amplify or supplement Moody's credit rating such that it was part and parcel of the same?

In examining this question first, the Court set out the permissible scope of appellate intervention in an appeal on questions of law as set out in *Edwards v Bairstow*⁵. However, the Court noted that no submission was made to the effect that the Tribunal fell into any of the *Edwards v Bairstow* errors in concluding that the Report was intended to be read as amplifying and supplementing Moody's ratings, as being so intimately attendant upon them that it constituted more than mere comment and became part and parcel of Moody's ratings themselves.⁶

The core proposition in Moody's submission was that as the Report was not part of the process in the preparation of Moody's credit ratings and the red flag framework was not adopted as part of the methodology in working out such credit ratings, the Report should not be taken as part and parcel of the credit ratings. The Court did not accept that proposition. It held that when reading the relevant paragraph of the Determination together, the Tribunal was clearly entitled to hold that even though the red flag 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 and as such the publication of the Report was an activity relating to the ratings within the meaning of section 193.⁷

Counsel for Moody's submitted that it is not enough for the purpose of section 193 that an activity is found to be related to or connected with credit ratings. It was submitted that as the phrase "*relating to*" refers to activities in the carrying on of the business of credit ratings, only steps taken in the preparation of the credit ratings could fall within the scope of that section. The Court did not accept the narrow construction of that phrase, and instead agreed with the Tribunal's construction stating that it is consistent with the purposive interpretation of the statute and the proportionate interference with the freedom of expression.⁸

Therefore the Court agreed with the Tribunal 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.

Did the Report itself constitute credit ratings?

In examining this question, the Court honed in on the definition of “*credit ratings*” in Part 2 of Schedule 5 of the SFO, and in particular the first component that it comprise “*opinions primarily regarding the credit worthiness of the specified subjects*”.

The Court noted that the Report only addressed corporate governance and accounting risks, which are only two elements of credit risk. Moody’s counsel stressed that the two aspects discussed in the Report form but an extremely limited subset of a whole basket of factors in the consideration of credit worthiness. And those two aspects cannot be determinative of creditworthiness. Accordingly, it was submitted that the Report therefore did not express any opinion primarily on the credit worthiness of the companies concerned. The Court accepted this proposition, concluding that the Report was not presented as an expression of opinions primarily regarding creditworthiness, but instead only presented as a discussion limited to two elements without expressing any opinion on the overall assessment of the creditworthiness.⁹

The Court highlighted the distinction between assessment of some (but not all) elements of credit risk and assessment of creditworthiness. The Court concluded that the Tribunal failed to have regard to such distinction when it elided the assessment of strengths and weaknesses in terms of governance and accounting risks into overall assessment of creditworthiness.¹⁰

In other words, the Report expressed an opinion primarily on corporate governance and accounting risks which are relevant, but far from determinative of creditworthiness.

Conclusion

Whilst the Court upheld the actual decision of the Tribunal, it disagreed with its conclusion that the Report itself constituted credit rating. This decision helps provide some clarity as to what constitutes Type 10 activity. If a report tends to give an opinion as to the overall assessment of creditworthiness, then it is likely to fall within Type 10 activity for the purpose of the SFO. Furthermore, if a report amplifies or supplements an earlier, then that latter report will also be subject to regulation.

Given the stakes and public scrutiny this case has generated, this case may well be headed for an appeal to the Final Court of Appeal, so watch this space.

¹ *Moody’s Investor Service Hong Kong Limited v Securities and Futures Commission* [2017] HKCA 232; CACV 103/2016.

² Judgment, para 11.

³ Judgment, para 12.

⁴ Judgment, para 18.

⁵ [1955] UKHL 3; [1956] AC 14.

⁶ Judgment, para 29.

⁷ Judgment, para 31.

⁸ Judgment, para 33.

⁹ Judgment, para 48.

¹⁰ Judgment, para 53.