A red flag for the licensing regime

(a postscript to “A red flag for Hong Kong credit ratings”)

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A red flag for the licensing regime
(a postscript to "A red flag for Hong Kong credit ratings")

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Abstract

In July 2011 Moody's Investors Service Hong Kong issued a report that used a system of red flags to highlight corporate governance and accounting risks in a specified population of listed companies. Although the report is not itself a credit rating, it remains unclear whether Moody’s publication of it should be subject to the disciplinary powers of the Securities and Futures Commission (“SFC”).

At issue is the construction of section 193(1)(d) of the Securities and Futures Ordinance (“SFO”), which provides that an act or omission relating to the carrying on of a regulated activity is liable to be regarded as misconduct subject to the disciplinary powers of the SFC under section 194 SFO. The earlier determination of the Securities and Futures Appeals Tribunal and the judgment of the Court of Appeal both supported a broad, purposive interpretation of relation to find that the SFC’s disciplinary oversight applied.

Moody’s appeal to the Court of Final Appeal is likely to have ramifications that go well beyond the credit rating industry. As the case concerns the interpretation of a disciplinary provision that all regulated persons are subject to, the Court’s ruling will have significant implications on the ambit of the SFC’s disciplinary powers over all companies engaging in regulated activities that require a license from or registration with the SFC.

This article examines the approach taken by the Tribunal and the Court of Appeal and suggests it is flawed and ill suited to the complexities of the business environment surrounding the undertaking of regulated activities. In the absence of an acceptable degree of legal and commercial certainty, there is a risk that regulatory oversight of a wide range of activities other than statutorily defined regulated activities may be introduced via a backdoor opened by the prospect of the SFC’s discipline.

An alternative view of relation is proposed that may assist develop a test of relation that better serves statutory purposes, as well as regulatory and commercial needs.

It is hoped the Court of Final Appeal will take the opportunity to clarify the law in this area in order to facilitate greater certainty as to the extent of the regulatory obligations of licensed corporations as well as the ambit of the SFC’s disciplinary powers.

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1. THE MOODY’S CASE AND ITS IMPLICATIONS

1.1 Red Flag Report and the SFC

In July 2011 Moody’s Investors Service Hong Kong (“Moody’s”), a well known credit rating agency (“CRA”),1 issued a report that used a system of red flags to highlight corporate governance and accounting risks in a specified population of listed companies (the “RF Report”).

The RF Report was issued 42 days after Hong Kong introduced a regulatory regime that provided the Securities and Futures Commission (“SFC”) with oversight of persons engaged in the provision of credit rating services, i.e. Type 10 regulated activity, as defined in the Securities and Futures Ordinance2 (“SFO”). Under this new CRA regime, a person wishing to engage in Type 10 regulated activity would need a license3 issued by the SFC. To obtain a license, it is a statutory requirement that the person is fit and proper, and upon being licensed the SFC requires the licensee to comply with non-statutory codes it has issued pursuant to powers given to it under the SFO (“Codes”).4

Although Moody’s did not consider the report a credit rating subject to the CRA regime, the SFC regarded the issuance of it as part of Moody’s Type 10 regulated activity. As such, Moody’s was held subject to Codes the SFC alleged it had breached when it issued the RF Report. The SFC in its Decision Notice of November 2014 considered Moody’s not to be fit and proper to remain licensed and to be guilty of misconduct and was disciplined by the SFC by way of a monetary fine.

1.2 Moody’s previous appeals

Moody’s appealed the SFC’s decision5 to the Securities and Futures Appeals Tribunal (the “Tribunal”). In Moody’s Investors Service Hong Kong Limited and Securities and Futures Commission,6 the Tribunal determined that the RF Report was either (1) itself a credit rating or, if it was not, (2) its publication was sufficiently related to Moody’s Type 10 regulated activity that it fell within the statutory definition of regulated activity.

Moody’s again appealed, which brought the matter to the Court of Appeal (the “Court”) in Moody’s Investors Service Hong Kong Ltd v. Securities And Futures Commission.7 In "A Red Flag for Hong Kong Credit Ratings",8 which was relied on in the Court,9 the present author had argued that the Tribunal was incorrect in

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1 The term "CRA" in this paper means a firm licensed or registered under the SFO to carry on business in Type 10 regulated activity (providing credit rating services)
2 Cap. 571
3 The SFO refers to both licensing and, for authorized institutions regulated by the HKMA, registration. For convenience, reference in this paper to licensing shall refer to both licensed and registered persons. Moody’s is a licensed corporation.
4 Pursuant to ss. 169(1) or 399 SFO
5 This is a “specified decision” under s. 215 SFO, specifically, Items 51 and 52 of Division 1, Part 2, Schedule 8 SFO
7 [2017] HKCA 232; Cacv 103/2016 (8 June 2017)
9 Court Judgment, para 62
both of the foregoing matters. In its June 2017 judgment, the Court confirmed that the RF Report is not itself capable of constituting a credit rating since, although it is concerned with matters that may pertain to elements of credit risk, it is not primarily concerned with creditworthiness as required by the statutory definition to be a credit rating.\(^\text{10}\)

However, in respect of item (2) above, the Court approved of the Tribunal’s reasoning. It found that the publication of the RF Report was an activity related to the ratings for the purposes of the disciplinary provisions because it constituted “additions and clarifications which were meant to be read together with”\(^\text{11}\) Moody’s published credit ratings. As such, the Court regarded the publication of the RF Report as “part and parcel of the carrying on of the business of credit ratings by Moody’s” (emphasis added).\(^\text{12}\)

### 1.3 The relevant provisions of the SFO

The SFC’s disciplinary powers are established in Division 1, Part IX, SFO. Section 194 SFO provides the SFC with the power to discipline where a regulated person\(^\text{13}\) (1) in the opinion of the SFC ceases to be fit and proper\(^\text{14}\) or (2) is guilty of misconduct.\(^\text{15}\) In both the Tribunal and the Court, significant focus fell on the question of misconduct – the question of fitness and properness was not discussed in the Court’s judgment.

Misconduct is defined in s. 193(1) SFO as comprising any of four categories. The first three, which concern contraventions of relevant laws or certain terms or conditions imposed under the SFO (the “contravention forms of misconduct”),\(^\text{16}\) have not been alleged against Moody’s.

The relevant category of misconduct in the Moody’s case is s. 193(1)(d) SFO (the “Misconduct Provision”). It provides that misconduct means:

> “an act or omission relating to the carrying on of any regulated activity for which a person is licensed or registered which, in the opinion of the Commission, is or is likely to be prejudicial to the interest of the investing public or to the public interest” (emphasis added).

It will be observed that the Misconduct Provision is comprised of two parts. The first is factual: was there an act or omission “relating to the carrying on of” a regulated activity? Other than the decisions of the Tribunal and the Court, the scope of this phrase has not been subject to prior judicial interpretation in Hong Kong.

Second, where an act or omission is found to be related in the relevant statutory sense, it requires the SFC to have formed an opinion that such act or omission is likely to be prejudicial in the relevant regards. However, in forming any such opinion the SFC is required to first have regard to such of its Codes that are “applicable in relation to, the act or omission.”\(^\text{17}\)

Argument in both the Tribunal and the Court significantly turned on the first part

\(^{10}\) Court Judgment, para 43-46 and 59-60; Johnstone, op. cit. section 4.3.2

\(^{11}\) Court Judgment, para 31

\(^{12}\) Court Judgment, para 36

\(^{13}\) The powers apply in relation to any “regulated person” as defined in s. 194(7) SFO

\(^{14}\) ss. 194(1)(b) & (2)(b) SFO

\(^{15}\) ss. 194(1)(a) & (2)(a) SFO

\(^{16}\) ss. 193(1)(a)-(c) SFO

\(^{17}\) s. 193(3) SFO
and what it was for an act or omission to be regarded as related to a regulated activity. While this will be an important focus of the present paper, the relevance of the second part of the Misconduct Provision, as well as the other circumstances giving rise to the SFC’s disciplinary powers will also be relevant to consider.\textsuperscript{18}

1.4 The question of relation

1.4.1 Narrow view

Moody’s argued that, because the “relating to” phrase in the Misconduct Provision refers to activities in the carrying on of a regulated activity, the only activity relevant to fall within the Misconduct Provision are “steps taken in the preparation of the credit ratings”\textsuperscript{19} (the “narrow view”). Given that the statutory definition of Type 10 regulated activity clearly references the preparation of “credit ratings”, a carefully defined term in the SFO, the narrow view appears to be restricted to the performance of a regulated activity.

As such, the narrow view is based on a strict interpretation of the statutory definition of regulated activities and what it is to carry on a regulated activity. Such a construction of the phrase is not without some level of complexity as it nevertheless requires the relevant component steps of preparing a credit rating to be identified, and a mechanism that enables their identification. As discussed further in section 5 below, the undertaking of a regulated activity normally gives rise to a wide variety of other activities having varying degrees of relevance to the regulated activity as strictly defined.

1.4.2 Broad view

The Tribunal observed that the “relating to” phrase merely describes a form of connection between two things, an imprecise phrase capable of bearing a broad or narrow meaning in order to further the legislative purpose.\textsuperscript{20} The Court rejected the narrow view\textsuperscript{21} and approved of the Tribunal’s broad reading of the “relating to” phrase based on a purposive interpretation of legislative intent (the “broad view”). Neither the Tribunal nor the Court clarified what boundaries, if any, such an interpretation should obey other than that which suits the purposes of the legislation.

Both the Tribunal and the Court regarded the RF Report as integral to Moody’s rating activities\textsuperscript{22} and that “the business of credit ratings” encompasses clarifications, additions, and expansions (“ex post adjustments”) of published credit ratings and so should be regarded as related to the carrying on of regulated activity for the purposes of the Misconduct Provision.\textsuperscript{23}

Here it should be noted that there is considerable lack of clarity in both the Tribunal’s and the Court’s use of language as to whether the preparation and publication of ex post adjustments should themselves be regarded as part of Type 10 regulated activity – in which case they appear also be subject to the licensing requirements under Part V SFO - or as activities that do not comprise regulated activities (“non-RA”) but are related to regulated activity for the purposes of

\begin{itemize}
\item \textsuperscript{18} They are discussed in section 2.1.2 and section 4 respectively.
\item \textsuperscript{19} Per Court Judgment, para 32
\item \textsuperscript{20} SFAT Determination, para 106
\item \textsuperscript{21} Court Judgment, para 35
\item \textsuperscript{22} Court Judgment, para 33 referring and approving the Tribunal’s reasoning at SFAT Determination, para 105
\item \textsuperscript{23} SFAT Determination, para 106; Court Judgment, para 33
\end{itemize}
triggering the SFC’s disciplinary powers via the Misconduct Provision. This is discussed further in section 3 below, where it is argued that the language used by the Tribunal and the Court, which departs from statutory language, is itself ambiguous and misleading.

1.5 The present appeal

In February 2018 Moody’s was granted leave by the Court of Final Appeal (“CFA”) to appeal on the following question:24

“Does publication of a report having features such as the features contained in the applicant’s Special Comment Report [i.e. the RF Report] constitute misconduct within the meaning of section 193 of the Securities and Futures Ordinance (Cap 571)?”

The determination of this question will establish whether Moody’s preparation and publication of the RF Report is subject to the disciplinary powers of the SFC.

1.6 Wider implications

To address the specific question before it, the CFA will need to determine the scope of the Misconduct Provision. As the Misconduct Provision is not specific to the CRA regime – it covers all types of regulated activity – the CFA’s approach will likely have a significant bearing on both the ambit and clarity of the SFC’s disciplinary powers, and thus the extent of its regulatory oversight of the general activities of any company that holds a license.

Specifically, the CFA will amongst other things need to consider what acts or omissions are for statutory purposes to be regarded as “relating to” the carrying on of a regulated activity.

Here it must be noted that the CRA regime recognizes that CRAs can and do issue research that amounts to business analysis and, accordingly, does not prohibit a CRA from engaging in ancillary services that are not regulated activities.25 The SFC’s Code of Conduct for Persons Providing Credit Rating Services (“SFC CRA Code”) expressly permits it subject to the requirement that it does not create a conflict of interest for its credit rating services.26 This approach is consistent with the international approach.27

This is also consistent with Hong Kong’s licensing regime generally,28 which permits a company holding a license to engage in multiple business activities, some of which comprise regulated activities conducted pursuant to a license,

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24 Moody’s Investors Service Hong Kong Limited v Securities and Futures Commission [2018] HKCFA 9
25 The SFC, in line with international practice, rejected the concept that CRAs should be subject to a sole business restriction. See SFC’s “Consultation Conclusions Concerning the Regulatory Oversight of Credit Rating Agencies”, 29 October 2010, para 63; Johnstone, op. cit. page 24 and section 1.1
26 SFC CRA Code, para 30
27 For example, EU regulations clarify that ancillary services are not part of credit rating activities. Anex 1, Section B EU Regulation (EC) No 1060/2009. “Credit rating activities” is defined by Article 3, 2 as meaning “data and information analysis and the evaluation, approval, issuing and review of credit ratings”
28 Other than Type 8 regulated activity (securities margin financing), which is subject to a sole business condition (however, there are only a handful of Type 8 license holders)
some of which are non-RA. The Tribunal itself noted that a bright line separates regulated activities from non-RA – it is either regulated or it is not.29

While the SFO provides a clear definition of an act that comprises a regulated activity, many acts undertaken by licensed corporations are in themselves neutral as regards statutory law, and only become relevant to consider for non-statutory purposes, i.e. the Codes, when the act is understood in the context of its performance. For example, the act of time-stamping the record of a conversation may be done for a variety of commercial reasons. However, if it is done because the conversation was between a Type 1 licensed securities dealer and their client, the act comes to be understood as a means by which the licensed person is complying with a relevant non-statutory requirement. That of course does not make the time-stamping act itself a regulated activity (as defined in the SFO), even though undertaking it was contingent on the performance of a regulated activity and was for the purposes of meeting a non-statutory requirement. Nevertheless, there is, at least in layman’s terms, an obvious relationship between the act of time-stamping and undertaking the regulated activity.

It is apparent that where multiple business activities are engaged in, a broad notion of relationship may become problematic in its application, particularly where common resources are used.

The Tribunal and Court decisions do not provide any meaningful guidance to the question: On what basis should an act or omission of a company engaged in multiple businesses be regarded as related to the carrying on of an RA and so be subject to the risk of the SFC’s disciplinary powers?

The absence of clearer guideposts as to how this question is to be answered poses three types of problems. First, senior management and staff of companies engaged in multiple businesses are disadvantaged in the conduct of their business undertaking because of the uncertainty as to what legal and other requirements – including potential liabilities – they and their businesses may be subject to. This potentially includes having regard to the many compliance requirements set out in the SFC’s Codes.

Second, while the foregoing presents special problems for a licensed corporation that is also engaged in non-RA business (such as Moody’s), there remains a risk for any licensed corporation that various of its activities may be subject to ex post assessment. This creates unpredictable commercial risks.

Finally, these problems are inconsistent with an effective regulatory system that conforms to agreed international standards that require a sufficient degree of transparency, fairness and equity.30 While legislative flexibility is both necessary and desirable to cope with changing circumstances, it must be appropriately balanced with sufficient clarity in the law that facilitates commercial undertakings. As the Tribunal succinctly put it, “Licensed corporations are entitled to certainty as to the extent of their obligations.”31

29 SFAT Determination, para 206
30 As required by Principle 6.5 of IOSCO’s “Objectives and principles of securities regulation”, May 2003
31 SFAT Determination, para 206
1.7 Structure of present paper

Sections 2 to 4 explore problematic aspects of the broad view:

section 2 considers the extant problems in that view, including those inherent in its formation and those that arise from its adoption;

section 3 considers the use by the Court of terms not found in statutory language and suggests such terms have served to gloss over important elements of the analysis of the Misconduct Provision that has supported a faulty approach to the provision;

section 4 suggests that the legislative interpretation of the Misconduct Provision undertaken by the Tribunal and the Court suffers from not having taken into account the other sources of the SFC’s disciplinary power and the different purposes they serve.

Section 5 returns to a consideration of the complex series of events that occur in a company undertaking regulated activity. It is suggested that the broad view is not well suited to that complexity and consequently does not best serve the legislative intent. An alternative view of relation is proposed that may assist develop a test of relation that better serves statutory purposes and which promotes commercial certainty and regulatory clarity.

2. EXTANT PROBLEMS WITH THE BROAD VIEW

This section considers the extant problems in the broad view, including those inherent in formation and those that arise from its adoption. It briefly reviews the concerns previously raised by the present author over the Tribunal’s approach to the Misconduct Provision and which remain outstanding following the Court’s judgment. While some of those concerns fell outside the limited scope of appeal to the Court, they potentially do fall within the scope of the appeal made to the CFA. Section 2.1.1 below expands on an argument previously made that faulty reasoning underlies the adoption of the broad view.

2.1 Problems inherent in forming the broad view

2.1.1 Faulty reasoning

The reasoning taken in the Tribunal and approved by the Court:\n
32 SFAT Determination, para 102, 106
33 SFAT Determination, para 105, Court Judgment, para 31
34 The Tribunal appears to have also reasoned that because the “relating to” requirement of the Misconduct Provision is satisfied (SFAT Determination, para 106) Moody’s publication of the RF Report therefore fell within the statutory definition of Type 10 regulated activity (SFAT Determination, para 102 and 107), although it is not clear whether the Court supported that reasoning.

Steps (1) and (2) above are not problematic in terms of the structure of their reasoning, however, they are problematic for other reasons as discussed in section 2.1.3 below.
Step (3) above is problematic because, in the absence of a precise meaning of “relating to”, it comes perilously close to a form of fallacious reasoning Aristotle identified as a *petitio principii*, i.e. to postulate that which is first the question at issue.\(^{35}\) This is because the view of relation is so broad that it is capable of effectively presuming (or itself establishing) a relevant relation between any two things for statutory purposes.\(^ {36}\) This is what the present author has previously described as an almost tautological presumption that the act complained of already falls within some broad scope of an intermediary’s regulated activities, which is precisely the matter in issue.\(^ {37}\)

As such, it is suggested that the approach taken by the Tribunal and approved by the Court implicitly uses “relating to” as a proxy that serves to shift between the specific definition of regulated activity and potentially all other activities of a licensed corporation, including non-RA. As discussed in section 3.4 below, the phrase “relating to” cannot be used in this manner without some abuse of the legislative language of Part IX SFO. This analysis is further supported when one considers the other circumstances that give rise to the SFC’s disciplinary powers, as discussed in section 4 below. This casts doubt on whether the broad view is consistent with the legislative purpose of Part IX.

Finally, steps (4) and (5) above are also problematic. While the Misconduct Provision remains open to interpretation, it is incapable of affecting the interpretation of what is and is not a regulated activity.\(^ {38}\) Rather, its construction is only capable of determining what acts or omissions are subject to the SFC’s disciplinary powers. However, the Tribunal nevertheless appears to have concluded that an act relating to a regulated activity is, on a purposive reading of the relevant statutory provisions, itself a regulated activity.\(^ {39}\) It has previously been suggested that this represents a misuse of the purposive approach in interpreting the legislation - the inversion of reasoning to bring the RF Report within the Misconduct Provision\(^ {40}\) invokes Lord Millet NPJ’s caution that the plain meaning of statutory text should not be distorted to achieve a result considered desirable.\(^ {41}\) The subsequent use by the Court of the non-statutory phrase “business of credit ratings” in the final step of its reasoning is also problematic, and this discussed in section 3.3 below.

### 2.1.2 Section 193(3) SFO

The application of the Misconduct Provision is subject to an additional requirement imposed by s. 193(3) SFO which provides that the SFC may not form any opinion on an act or omission unless it has first had regard to its Codes that “are applicable in relation to” the act or omission.\(^ {42}\)

The SFC asserted that Moody’s had “insufficient internal controls and procedures in place to consider and ensure that its business activities, which were related to

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\(^ {36}\) See SFAT Determination, para 106. See also the discussion in section 5.1 below

\(^ {37}\) See Johnstone, op. cit. page 22

\(^ {38}\) The Tribunal has made a similar observation, at SFAT Determination, para 206

\(^ {39}\) SFAT Determination, para 106-107

\(^ {40}\) Johnstone, op. cit. page 21-22

\(^ {41}\) Town Planning Board v Town Planning appeal Board (Nam Sang Wai Development Company Limited and Kleener Investment Limited) [2009] 5 HKC 231, para. 36 and (2009) 12 HFCFAR 342

\(^ {42}\) Logically, this could mean that where no Codes are applicable the SFC would not need to be concerned with the requirement, although such a logical reading of the requirement appears unwarranted
and [are] part and parcel of the regulated activities for which it is licensed, were in compliance with applicable rules and regulations”. ⁴³

A natural reading of s. 193(3) suggests that applicability of a Code is primarily determined in accordance with its own terms, subject to the overarching enabling provisions of the SFO. ⁴⁴ The SFC’s power to issue Codes is to give guidance on the practices and standards expected in the conduct of a regulated activity ⁴⁵ but, as noted above, Codes are incapable of extending the statutory scope of the SFC’s jurisdiction. As the Tribunal regarded the RF Report as itself a credit rating, ⁴⁶ the applicability of Codes was straightforward to establish.

Given that the Court ruled the RF Report is not a credit rating, the basis on which a Code was applicable to the RF Report (i.e. in itself a non-RA) would need to be established clearly. However, as the Court’s judgment provides no guidance on this, it is unclear how the s. 193(3) requirement has been satisfied. Any suggestion that it is satisfied on the basis that the RF Report is related to the regulated activity would appear to be another example of a *petitio principii*. This is qualitatively different from, say, arguing that a Code applies to the acts of a licensed corporation concerning time-stamping – the Codes expressly address time-stamping. ⁴⁷ The Codes are equally clear that a CRA may engage in ancillary services that are non-RA. If one assumes that the RF Report is related to Moody’s Type 10 regulated activities, this does not prevent it from also being an ancillary service, and so it remains moot as to whether and how the Codes might be applicable to the RF Report beyond the stated concerns of the Codes, namely, the requirement that a CRA when undertaking ancillary services should avoid conflicts of interest with its regulated activities. ⁴⁸

The failure to specifically consider s. 193(3) SFO would seem to be a gap in the Court’s analysis of whether and how the Misconduct Provision is capable of applying to the RF Report, and so the basis on which it might remains to be clearly established. Perhaps the intent is that this covered by the phrases “part and parcel” and “business of credit ratings” but that would be vague. Moreover, it would be unsatisfactory for the reasons discussed in section 3 below.

### 2.1.3 Ex post adjustments

The broad view proceeds on the basis that statements of the sort made in the RF Report are indeed *ex post* adjustments, i.e. are capable of influencing and did in fact influence the meaning of previously published credit ratings. This is step (2) in the Tribunal’s reasoning (see section 2.1.1 above).

A number of concerns have been raised in respect of such an understanding of credit ratings, including:

- it may be inconsistent with industry practices; ⁴⁹
- it may be doubted on the basis that reports such as the RF Report are

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⁴³ SFAT Determination, para 60 & 202
⁴⁴ I.e. ss. 169 & 399 SFO
⁴⁵ s. 169(1) SFO
⁴⁶ SFAT Determination, para 203-209. While the Tribunal stuck down the claim that Moody’s controls were inadequate, it nevertheless accepted that they were relevant to the RF Report.
⁴⁷ Section 3.9(a) of the Code of Conduct for Persons Licensed by or Registered with the SFC
⁴⁸ SFC CRA Code, para 30
⁴⁹ Johnstone op. cit., section 4.2 generally
incapable of affecting the reading of a published rating;\textsuperscript{50}

it is possibly problematic in the context of Hong Kong retaining its standing as an equivalent jurisdiction for the purposes of the European Union;\textsuperscript{51} and

it is open to doubt whether readers of the RF Report did in fact understand the RF Report as an \textit{ex post} adjustment.\textsuperscript{52}

It is unfortunate that the Court has not been able to address those concerns more clearly within the scope of the appeal to it.

For the purposes of the present paper, it is noted that, if the RF Report does not comprise \textit{ex post} adjustments, it is less than clear how one could maintain the view that the RF Report was related to Moody’s credit ratings on the basis suggested by the Tribunal and supported by the Court. The connection suggested as being the relevant one – the power to change published ratings – would no longer exist.

Setting aside the foregoing concerns, it is nevertheless necessary to understand the precise basis of the Court’s view that the “business of credit ratings” encompasses \textit{ex post} adjustments,\textsuperscript{53} and why the RF Report – itself not a credit rating - should be regarded for statutory purposes as relating to the carrying on of Type 10 regulated activity for the purposes of the Misconduct Provision. This is discussed in section 3 below.

\textbf{2.2 Problems consequential on an adoption of the broad view}

It has been suggested that the broad view is not needed to meet the purposes of the legislation and instead gives rise to problematic consequences, as follows.\textsuperscript{54}

\begin{enumerate}
\item \textbf{Uncertain application:} In the absence of clarification or guidelines as to what non-RAs might be regarded as related to a regulated activity, (a) the scope of compliance implications for engaging in a regulated activity become uncertain, particularly where a company engages in more than one business, (b) there is a risk, and attendant commercial uncertainty, of \textit{ex post} assessments of what non-RAs may subsequently be regarded as related to the regulated activity, and (c) there is a risk that such \textit{ex post} assessments of non-RA may be inconsistently determined.

(2) \textbf{Unclear perimeter:} Whether the disciplinary powers of the SFC have been widened in an uncertain and uneven manner such that the issue of a license could in effect become a proxy for the SFC to regulate an unspecified wider range of activities, thus extending the perimeter of the regulatory oversight and disciplinary powers of the SFC in a manner not intended by the legislature.
\end{enumerate}

\textsuperscript{50} \textit{Bathurst Regional Council \textit{v} Local Government Financial Services Pty Ltd (No 5) [2012] FCA 1200} (Federal Court of Australia), as discussed in Johnstone op. cit., page 36

\textsuperscript{51} Equivalence is an important underlying purpose of the introduction of the CRA regime in Hong Kong. See S Johnstone, “Does Hong Kong remain an equivalent jurisdiction for the EU credit rating regime?” \textit{University of Hong Kong Faculty of Law Research Paper No. 2017/005}, available at SSRN: \url{https://ssrn.com/abstract=2949585}

\textsuperscript{52} Johnstone op. cit., page 36

\textsuperscript{53} Court at para 33 referring and approving the Tribunal’s reasoning at SFAT Determination, para 105

\textsuperscript{54} For a more detailed discussion see Johnstone, op. cit. pp 22 to 23 and section 6
(3) Uneven playing field: The creation of an uneven playing field if the regulatory nature of a non-RA is determined by the identity of the person undertaking it. For example, it creates the problem that if an unlicensed person had issued the RF Report the issuer would not be subject to the SFC’s regulatory discipline.\textsuperscript{55} It also means that licensed companies may be subjected to additional burdens that their competitors are not subject to.

(4) Blurring the perimeter: Blurring the tight lines drawn by the SFO around particular types of activity that are regulated in a specific manner in accordance with the SFC’s published Codes. This may challenge the integrity of a central component of Hong Kong’s regulatory framework, namely, the system of licensing as a gateway mechanism and the integrity of the regulatory oversight of conduct.

Items (1) and (2) above have clear, and undesirable, commercial consequences. They could result in an increased cost of compliance as companies, particularly those engaging in multiple businesses, will need to revisit the question of which of their activities are to be regarded as subject to the regulatory oversight of the SFC – and be presented with an unclear landscape. This may also have insurance implications. Licensed companies may elect to reposition activities they regard as non-RA to other group companies that do not hold a license. Taken together, these issues create legal uncertainty that does not facilitate commerce or the objectives of regulatory oversight.

Items (3) and (4) above impact on the integrity and standing of Hong Kong’s regulatory framework. The lack of clarity arguably serves to weaken the SFC’s administrative powers of oversight – such powers should always be clear and unequivocal to be effective in achieving the intent of the legislature when empowering an agency.

Taken together, these issues are problematic because there is a lack of clarity or guidelines as to how a broad view might be applied in practice or, to put it another way, what rules would define the boundaries of a broad approach that would create legal and commercial certainty. This is further discussed in section 5 below. Whether the broad view ultimately serves or hinders the overall policy intent of the legislation remains unclear.

3. USE OF NON-STATUTORY LANGUAGE

This section considers the use by the Court of phrases not found in statutory language. It is suggested that the phrases gloss over important distinctions made in the SFO, serve to compound the problem of ambiguity, and may serve to misguide the analysis of the Misconduct Provision.

3.1 New phrases introduced

The Court described the publication of the RF Report as “part and parcel of the carrying on of the business of credit ratings by Moody’s” (emphasis added).\textsuperscript{56} Neither of these phrases is used in the SFO and their use is problematic insofar as

\textsuperscript{55} This also raises the question as to whether the outcome would be different if an unlicensed subsidiary or associate of Moody’s had issued the RF Report

\textsuperscript{56} Court Judgment, para 36. While the Tribunal uses the “part and parcel” phrase, it does not use the “business of credit ratings” phrase - it uses the phrase “business of publishing the ratings” (SFAT Determination, para 74), which seems a more generic reference
what they mean or imply is less than clear. While it could mean only those activities a CRA undertakes when it is engaged in performing Type 10 regulated activity, this meaning has been ruled out by the Court’s rejection of the narrow view.

The two phrases could be read as little more than a restatement of the specific facts of the Moody’s case, i.e. because the RF Report comprises ex post adjustments, its preparation and publication comprises part of the tasks a CRA engages in when carrying on Type 10 regulated activity.57

However, as the use of these phrases by the Court is based on an adoption of the broad view to establish the scope of the “business of” a regulated activity,58 the two phrases would encompass any non-RA that is under the broad view related to a regulated activity. As discussed further in section 5 below, there may be a number of typical linkages between non-RA and a CRA’s regulated activity of issuing credit ratings – and neither the broad view nor the two phrases assist to identify what kind of relationship between them would be regarded as relevant for statutory purposes. As already noted, this poses a problem for all licensed corporations, particularly those engaging in multiple businesses.

3.2 “Part and parcel”

The term “part and parcel” appears to have been introduced by the SFC,59 and subsequently adopted by the Tribunal and the Court. This phrase does not derive from the SFO and requires disambiguation.

The OED60 describes the phrase as meaning either an integral part of a larger whole, or as an essential part of or inextricably or inescapably linked to some other thing.

The phrase has been used in two different senses in the Moody’s case. The first sense is to refer to the publication of the RF Report as itself a regulated activity because the RF Report comprises a credit rating, and this is the context in which the Tribunal has used the phrase. Given the Court’s ruling that the RF Report is not itself a credit rating, this usage of the phrase is no longer relevant.

The second sense of the phrase is built around the concept that, because the RF Report comprised ex post adjustments, it became “part and parcel of Moody’s ratings themselves”61 or “part and parcel of the carrying on of the business of credit ratings by Moody’s”.62

Section 2.1.3 above has already touched upon the problem of regarding the RF Report as constituting ex post adjustments. Nevertheless, for the purposes of this section 3 let us assume that the RF Report, albeit not itself a credit rating, did serve as an ex post adjustment.

57 SFAT Determination, para 107. However, it is unclear whether the Court’s agreement with the Tribunal’s approach that the RF Report was part and parcel of the carrying on of the business of credit ratings by Moody’s extends to this meaning
58 Court Judgment, para 35
59 The Tribunal refers to the SFC using the phrase (SFAT Determination, para 208). The SFC’s notice of 5 April 2016 refers to both phrases: “its business activities which were related to and part and parcel of its regulated activities” (see Note 7(b)). The SFC’s notice is available at https://www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/enforcement-news/doc?refNo=16PR34
60 Oxford English Dictionary, online version, 2018
61 SFAT Determination, para 102
62 Court Judgment, para 36
In layman’s language, the assessment of credit risk is part of what a CRA does when forming an opinion on creditworthiness and so is also part of the CRA’s overall undertaking. However, the Court accepted that the RF Report is only concerned with elements relating to credit risk, and that elements of credit risk are for statutory purposes quite distinct from any opinion that is expressed on creditworthiness. The statutory definition of Type 10 regulated activity is precise and contemplates neither the discussion of elements of credit risk, nor ex post adjustments. Accordingly, one might query the basis on which the RF Report should for statutory purposes be regarded as part and parcel of Type 10 regulated activity or inextricably linked to it – or is that being overly pedantic and technical?

This quandary is easily resolved once one identifies that the usage of “part and parcel” is semantically different from “relating to”. The former comprises an assertion that the publication of the RF Report is an integral part of Type 10 regulated activity (or, alternatively, an integral part of the “business of credit ratings” – as discussed below), which may have licensing implications under Part V SFO. The “relating to” phrase merely operates to bring acts, such as the publication of the RF Report, within the Misconduct Provision irrespective of Part V SFO.

Given that the CRA regime countenances non-RRA ancillary activities that are not part of the licensing regime, “part and parcel” is therefore best understood either as a tag used to describe something else that has already been established, or as a layman’s description of activities often undertaken by CRAs. Neither help clarify what is required for a relevant relationship for the purpose of the Misconduct Provision to exist, or whether one in facts exists.

Adopting the “part and parcel” tag cum assertion in the context of the “relating to” question is therefore presumptive – similar to the problems of reasoning discussed in section 2.1 above - and prone to mislead. As discussed next, the use of the phrase “business of credit ratings” is an additional complication that is also potentially misleading.

3.3 “Business of”

Although the SFO does not use the phrase “business of credit ratings” it does contain other phrases having a similar semantic structure that refer alternatively to (1) the business of a company generally (which includes all its activities, both regulated activity and non-RRA) (the “inclusive meaning”) and (2) the business of a company when it engages in regulated activity (the “restricted meaning”).

It is instructive to consider the language used in the SFO because, as will be seen, it shifts between using the inclusive meaning and the restricted meaning in order to achieve the purposes of the relevant provision.

3.3.1 Part V SFO (licensing and registration)

Part V SFO uses the restricted meaning to impose a clear boundary around the licensing regime, except where it concerns overarching concerns including fitness and properness or the persons involved in managing the business of the

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63 See the discussion in Johnstone op. cit. section 4.2. The Court acknowledged this at Court Judgment, para 44 to 53

64 But which may nevertheless be subject to the SFC’s disciplinary powers – see the discussion in section 4.1.2 below
company. Of interest to consider is the apparently wide provision of s. 113(1) SFO that “any function performed for” or on behalf of or by arrangement with a person “relating to” a regulated activity carried on as a business is to be regarded as a “regulated function”. Although this could be read quite broadly as regards the scope of matters that may be regarded as being related to a regulated activity (such as non-RAs for the purposes of the disciplinary provisions), a broad reading would be unwarranted: the performance of a regulated function is regarded as carrying on a regulated activity, and persons other than licensed representatives and registered individuals are prohibited from performing “any regulated function in relation to a regulated activity carried on as a business”. A broad reading would imply that a wide range of middle and back-office functions would require licensing, however, it is clear that the SFC does not operate the licensing regime on this basis.

These provisions suggest the activities that are to be regarded as related to the business of a regulated activity – at least for the licensing provisions of the SFO - are only those that would require a license or registration to be obtained. Part V therefore casts acts related to a regulated activity narrowly as those acts comprising regulated functions for which a licence or registration is required. Under this reading, “the business of credit ratings” appears limited to regulated activity of a Type 10 licensee.

3.3.2 Part VIII SFO (supervisions and investigations)

On the other hand, Part VIII uses the inclusive meaning, which provides the SFC (among others) with a range of powers that facilitate investigation into a wide range of activities, both regulated activity and non-RA, including the ability to seek magistrate warrants in relation to business conducted at the relevant premises – this is not qualified by requiring the business to be related to a regulated activity. Part VIII therefore is concerned with all the business activities of an intermediary, not merely those that comprise regulated activity, which reflects the broader purpose of Part VIII being to enable inquiry into possible wrongdoing that may be relevant to an offence under the SFO.

3.3.3 Part IX SFO (discipline)

Returning to the disciplinary provisions of Part IX, persons subject to the SFC’s disciplinary powers under s. 194 include “a person involved in the management of the business of a licensed corporation” ("Management"). This language reflects the inclusive meaning, which provides the SFC with disciplinary powers over Management irrespective of whether the matter concerns regulated activity or non-RA. The SFC’s powers over licensed corporations and responsible officers are

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65 s. 129 and 133 SFO, respectively
66 The section excludes work ordinarily performed by an accountant, clerk or cashier
67 s. 10(a)(i), Part 1, Schedule 1 of the SFO
68 ss. 114(3) & (4) of the SFO
69 This is made more readily apparent by s. 139(9)(b) of the SFO when read together with Schedule 6: only licensed or registered persons can use a specified title. Other activities that may - whether in layman’s language or commercially - be related to the business of a carrying on regulated activity do not comprise a regulated function and otherwise appear to fall outside of the licensing regime
70 For example s. 180 (supervision of intermediaries), refers to the business conducted by the intermediary
71 s. 191 SFO
72 s. 197(7)(d) SFO The other types of regulated persons are licensed persons and responsible officers, who are normally engaging in regulated activity
similarly unrestricted. However, when considering the Misconduct Provision, the inclusive meaning is subject to the additional qualification that the misconduct relates to regulated activity. It is also subject to the requirements of s. 193(3) SFO, which requires that the SFC’s Codes applicable to the act or omission be considered. As these qualifications are not found in the contravention forms of misconduct (or fit and proper) provisions they must, if they are to carry any meaning, have a narrowing effect on the scope of what would otherwise be covered by the inclusive meaning.

Where Management contravenes a provision of the SFO etc, the inclusive meaning applies and it is immaterial whether the relevant act comprised regulated activity, non-RA, or was non-RA related to a regulated activity. On the other hand, where there has been no such contravention, Management could only be liable under the Misconduct Provision if the relevant act (or omission) was related to a regulated activity in the relevant statutory sense and the other requirements of s. 193(3) SFO are satisfied. The nature of the act accordingly determines the ambit of the SFC’s disciplinary powers over Management. *Mutatis mutandis*, the same can be said of other regulated persons, i.e., licensed persons and responsible officers.

### 3.3.4 SFO references to “business” differentiates

The precise language of the SFO as reviewed above indicates that the legislature has differentiated between the inclusive meaning and the restricted meaning with some precision.

As already noted, an important underlying concept of introducing regulatory oversight of CRAs was that a CRA may engage in ancillary services (i.e. non-RA) that are not remote from the specific regulated activity of providing credit rating services yet may nevertheless remain distinct from its regulated activity. The SFO’s use of the inclusive meaning and the restricted meaning is consistent with that and establishes clearly when such non-RA ancillary services are properly subject to the SFO.

In contrast, the Court’s use of the phrase “business of credit ratings” is unclearly defined as to its scope and does not reflect the lexical semantics of the SFO. It does not help with the task of construing “relating to” in a manner that is able to differentiate between non-RA that bears a relevant relation to regulated activity for the purposes of the Misconduct Provision, and non-RA that does not. As such, it is liable to mislead. This is compounded by its usage together with “part and parcel” as discussed above.

### 3.4 Proxy use

Although the foregoing discussion in no way resolves the meaning of relation for the purposes of the Misconduct Provision, some progress has been made. It is clear that the phrase “relating to” cannot within the context of Part IX be used as a tool for shifting between the restricted meaning and the inclusive meaning when considering a company’s business undertakings – doing so would seem to

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73 s. 197(7) definition of “regulated person”  
74 I.e. any of the contraventions under s. 193(1)(a)-(c) SFO  
75 There are a number of other uses of the phrase “business of” used in the SFO that are not reviewed as they are less relevant to the present task  
76 For example, whether or not a non-RA is subject to the licensing regime, it may nevertheless be subject to other statutory safeguards, for example, Part VIII SFO investigations, or exchanges of information under s. 378(3)(e)(i) SFO, as well as other provisions such as under Parts XIII and XIV concerning market misconduct
defeat the specific legislative drafting. However, as discussed in section 2.1.1 above, such a proxy usage appears to implicitly underpin the approach taken in the Tribunal and approved by the Court.

4. OTHER SOURCES OF DISCIPLINARY POWER

This section suggests that the legislative interpretation of the Misconduct Provision suffers from not having taken into account the other sources of disciplinary power and the different purposes they serve.

4.1 Sources of discipline

The discussion of the Misconduct Provision has to some extent been isolated from, and not put in the context of, the other sources of the SFC’s disciplinary powers under ss. 193 and 194 SFO. As argued next, this may be relevant for the purposes of statutory interpretation.

The SFC’s disciplinary powers under s. 194 SFO comprise powers related to licensing and reprimands,77 and a power to impose fines.78 Both sets of powers are exercisable in relation to misconduct79 or where the SFC is of the opinion that a regulated person is not fit and proper.80

4.1.1 Misconduct

Section 1.3 above has already noted that there are four categories of misconduct, of which the Misconduct Provision is one. Unlike the Misconduct Provision, the contravention forms of misconduct are concerned with breaches of certain statutory provisions or terms or conditions imposed pursuant thereto. As discussed in section 3.3.3 above, the contravention forms of misconduct employ the inclusive meaning and, accordingly, it is immaterial whether the relevant act comprised regulated activity, non-RA, or was non-RA related to a regulated activity, it being sufficient that the subject of discipline is a regulated person.81

4.1.2 Ceasing to be fit and proper

Fitness and properness is a prerequisite for being granted a license82 and is required on an ongoing basis. Section 129 SFO sets out a list of matters the SFC shall have regard to (such as financial integrity, competence, reputation and honesty) and provides that the SFC may have regard to any other matter it considers relevant83 and may “take into account such present or past conduct of the regulated person as it considers appropriate in the circumstances of the case.”84

Thus, as with the contravention forms of misconduct, the fit and proper requirement also employs the inclusive meaning, which means that for the purposes of forming an opinion on fitness and properness and exercising the corresponding disciplinary powers, it is immaterial whether an act is a regulated activity, a non-RA, or a non-RA related to a regulated activity. This is confirmed

77 s. 194(1)
78 s. 194(2)
79 ss. 194(1)(a) & (2)(a) SFO. I.e. any of the four types of misconduct under s. 193(1)
80 ss. 194(1)(b) & (2)(b) SFO
81 Section 194(1)(a) & (2)(a) together with s. 193(1)(a), (b) & (c) – but notably not s. 193(1)(d)
82 s. 116(3) SFO
83 s. 129(1) SFO
84 s. 194(3) SFO
by the power of the SFC to have “regard to the state of affairs of any other business which the person carries on or proposes to carry on”.\textsuperscript{85} Of course, the SFC may at its discretion allow its opinion to be influenced by whether a particular act does or does not involve a regulated activity.

4.2 Relevant distinctions

Once the sanctions available to the SFC under s. 194 SFO become exercisable there is no distinction between the types or extent of discipline that can be applied in respect of the Misconduct Provision, the contravention forms of misconduct, or ceasing to be fit and proper. However, there are important distinctions in how the power may become exercisable, and such distinctions in the allocation of power cannot for the purposes of legislative interpretation be ignored.\textsuperscript{86} The next three sections highlight the relevant distinctions.

4.2.1 Fitness and properness

Unlike the Misconduct Provision, when determining fitness and properness the SFC is not required to consider its Codes, nor is it required to consider the interest of the investing public or to the public interest.\textsuperscript{87}

Unlike both the Misconduct Provision and the contravention forms of misconduct, the SFC has an inherent power to determine fitness and properness, subject to the usual legal constraints on the proper exercise of administrative power.

4.2.2 Contravention forms of misconduct

Unlike both the Misconduct Provision and the fitness and properness provision, the contravention forms of misconduct are the only provisions that require a breach of law, or a breach of a term or condition imposed pursuant to law.

4.2.3 Misconduct Provision

Unlike both the contravention forms of misconduct and the fitness and properness provision, the Misconduct Provision only becomes exercisable where the act or omission is related to a regulated activity, and where Codes are applicable to the act or omission (see section 2.1.2 above). Further, the act must in the opinion of the SFC be prejudicial to the interest of the investing public or to the public interest. It is also the only instance where the inclusive meaning is put aside.

4.3 Disciplinary provisions taken as a whole

Each of these provisions clearly have different constraints and, it is suggested, empowers the SFC in different ways with different objectives in respect of a discrete population of regulated persons involved in the securities and futures industry.

Fitness and properness is an assessment of how or whether the operations of a regulated business may be affected by the general conduct of business as undertaken by managers, directors and shareholders. IOSCO\textsuperscript{88} regards powers

\textsuperscript{85} s. 129(2)(d) SFO
\textsuperscript{86} Pacific Sun Advisors Ltd and Another v. Securities and Futures Commission [2015] HKCFA 27
\textsuperscript{87} In the case of fines, the SFC is required to have consideration of the matters set out in s. 199 SFO
\textsuperscript{88} International Organisation of Securities Commissions
covering these matters as being essential to establishing the preconditions for a properly regulated marketplace that is subject to sound supervisory practices. Empowering the SFC in relation to fitness and properness is capable of addressing a wide range of acts undertaken by a regulated person that pertain to such preconditions for market integrity.

The contravention forms of misconduct are specifically concerned with matters arising under the law. Empowering the SFC with administrative powers here enables a more efficient means of discipline than pursuing the same through the courts, subject to appeal mechanisms.

In contrast to the foregoing, the Misconduct Provision is specifically referenced to regulated activities and Codes, and thus is the only provision that has a clear nexus with the licensing regime. As such, it is well suited to addressing regulated persons undertaking regulated activities and the standards expected of them as detailed in the Codes.

The foregoing discussion is not merely a taxonomy of discipline. It highlights that the provisions address different concerns and cover a range of possible acts relevant to the integrity of the regulated marketplace. This leaves it unclear why the broad view is necessary to give effect to the Misconduct Provision, desirable, or warranted by the statutory language. Instead, the broad view of the Misconduct Provision runs a greater risk of extending the ambit of SFC’s standard-setting powers into non-RA that are perhaps more appropriately addressed by the fitness and properness concept.

5. THE CONSTRUCTION OF RELATION

The foregoing sections have reviewed a number of problems with the broad view. It is vague and uncertain in its scope of application, and appears to give rise to more problems than it solves. It does not adequately differentiate between a regulated activity for which a license is required, and something that is done by a company holding a license and as such appears ill suited to the complexities of the business environment surrounding the undertaking of regulated activities. Consequently, it may not best serve the legislative intent.

Does that leave the narrow view as the correct approach? This section suggests that understanding relation along a broad/narrow view dichotomy may be oversimplified and that other approaches to the problem of relation should be considered that would recognize the complexities involved in undertaking a regulated activity, and can be better adapted to statutory purpose. On what basis could the ambiguity inherent in the “relating to” phrase be better resolved, and what is the degree of precision in defining this phrase that best serves the purposes of the SFO?

5.1 Non-RA and regulated activity

In practice, the reality is that certain non-RA are an important component to a licensed corporation’s ability to engage in regulated activities. This is recognized in the Codes, which impose more granular requirements on licensed persons that directly or indirectly regulate the performance of various non-RA. For example, the act of keeping records. That a non-RA is contemplated by the Codes does not render it a regulated activity – they remain activities that facilitate a licensed

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90 Division 2, Part XI SFO
person’s performance of the regulated activity. A rating analyst that is licensed by the SFC may be assisted by staff who collect and prepare the credit history or indebtedness of a corporate issuer, however, such staff are unlikely to be performing a regulated function in relation to Type 10 regulated activity.\(^{91}\)

Such non-RA are not normally subject to any licensing requirement as the SFC regards them as not sufficiently related to the undertaking of the regulated activity.\(^{92}\) Indeed, the SFC regards the maintenance of non-licensed staff as part of a desirable segregation of functions that avoid conflicts of interest when carrying on the regulated activities.\(^{93}\)

Other acts, such as marketing a CRA’s services, business development and negotiating fees, clearly impact on the undertaking of the regulated activity in a commercial sense, but are also not regarded as part of a CRA’s Type 10 regulated activity for regulatory purposes and the persons undertaking such functions are unlikely to be required to hold a license.\(^{94}\) The SFC CRA Code nevertheless is concerned with marketing activities insofar as it prohibits licensed representatives from engaging in the same as this would affect their independence and potentially create a conflict of interest.\(^{95}\)

How acts related to data handling, record keeping and business development are undertaken may cause a licensed person to perform regulated activity well or badly in a commercial and/or regulatory compliance sense. They are equally capable of affecting the integrity of the industry and Hong Kong’s financial markets. In layman’s and commercial terms, they are related to the performance of regulated activity. However, nothing in the licensing regime under Part V SFO or the Codes suggest that a non-RA itself becomes part of a regulated activity because it is somehow involved in undertaking a regulated activity as part of a business.

Once one recognizes that many non-RA are a fundamental component to the integrity of any regulated activity undertaking, one must also ask whether the narrow view of relation would render the regulatory objectives of the SFO difficult to achieve because important determinants of the quality of a regulated activity undertaking might not be subject to disciplinary consequences where they are poorly performed. Such a view would be misguided since, if a poorly performed non-RA led to a shortcoming in the conduct of a regulated activity – such as a breach of a Code - there would be no difficulty in applying discipline to the licensee.\(^{96}\) Moreover, as already discussed, the SFC has effective disciplinary powers that can arise in relation to non-RA where it impacts on fitness and

\(^{91}\) See SFC’s FAQ on CRAs, Q5, available at https://www.sfc.hk/web/EN/faqs/intermediaries/licensing/credit-rating-agencies.html#1 (last accessed 07 July 2018)

\(^{92}\) The SFC’s Licensing Handbook, para 2.4.14 states that staff that do not “perform functions that directly relate to the conduct of the regulated activity for which the corporation is licensed” are not subject to licensing.

\(^{93}\) Ibid., para 2.4.15

\(^{94}\) See SFC’s FAQ on CRAs, Q1, available at https://www.sfc.hk/web/EN/faqs/intermediaries/licensing/credit-rating-agencies.html#1 (last accessed 07 July 2018)

\(^{95}\) para 41 SFC CRA Code

\(^{96}\) On the other hand, where a poorly performed non-RA does not result in a poorly performed RA or any breach of a Code, the SFC has no basis on which to impose discipline on its licensees, although it may issue a compliance advice letter or other letter referring to deficiencies that require improvement. See https://www.sfc.hk/web/doc/EN/speeches/public/enforcement/07/oct_07.pdf (last accessed 07 July 2018)
properness.

The foregoing highlights some of the complexities of non-RA being contemplated by Codes but which nevertheless are not subject to a licensing requirement. Although the licensing regime is a cornerstone of intermediary regulation, it leaves a definition of relation appropriate to the needs of the disciplinary provisions wanting.

Logically, the language of the Misconduct Provision implies there is a limit to the scope of activities of a licensed corporation that are subject to the SFC’s disciplinary powers – it does not imply that all activities of a licensed corporation are subject to the disciplinary powers of the SFC, only those that are related in the relevant statutory sense to the carrying on of a regulated activity are. While many different acts can be conceived of as being somehow related to the carrying on of a regulated activity, the broad view and the narrow view share a similar defect in being unable to define with clarity which acts fall within, and which can in general safely be excluded from, the ambit of the Misconduct Provision – while the broad view errs on the side of over-inclusiveness, the narrow view may err on the side of being under-inclusive.

Neither the broad view nor the narrow view seem capable of giving a satisfactory answer to a natural question: what character must an act or omission possess for it to be sufficiently relevant to a regulated activity that it should give rise to disciplinary oversight? One might alternatively ask: what types of relation are relevant for statutory purposes?

**5.2 The Relevance Horizon**

Although the phrase “relating to” has been described as ambiguous, this is not strictly always the case. For example, when a CRA issues a formal credit rating, it is engaging in regulated activity and the acts “relating to” that clearly must include the primary act of providing or publishing the rating as without it the act of issuance would not have occurred.

One might more precisely state that the phrase is mostly ambiguous and pose the problem as being: How far back in the series of events (i.e. acts) that led to the performance of the regulated activity (the “direct-series” acts) should one go before one can say that the event is no longer related to the regulated activity in a sense relevant for statutory purposes?

This final reach of relevance can be referred to as the “Relevance Horizon”.  

One might further ask: Are acts part of a series of events other than those on the direct-series also capable of crossing the Relevance Horizon (the “other-series” acts)?

Finally, one might also be tempted to ask: Could crossing the Relevance Horizon cause the act to itself be a regulated activity subject to the licensing regime? However, as already noted in section 2.1.1 above, relation as understood in the present context of the Misconduct Provision is incapable of affecting the interpretation of what is and is not a regulated activity.

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97 This is to be distinguished from other forms of relation that are not the concern of the statute, such as commercial relations, and relations based on *de facto* causation or dependence.
5.2.1 Direct-series acts

Acts that are proximate to, and acts that are necessary for, the regulated activity to be performed can be contrasted with those that are not.

The organization and storage of data is central to any knowledge-based business. However, one might expect that the bundle of acts involved in making the final determination of the actual credit rating to be assigned must be related to the regulated activity in a more relevant manner than the act of collecting raw data, which presumably sits beyond the Relevance Horizon. The storage of raw data would surely be more remote from the Relevance Horizon than the organization of raw data for analysis even though both are, in commercial and layman’s terms, related to the performance of the regulated activity. Still other acts are more remote, such as a service agreement with an information provider.

The definition of direct-series acts might also be extended to include acts that arise subsequent to, or are contingent upon, the performance of a regulated activity. This seems a not unreasonable extension to propose as some such acts may be relevant to meeting overarching regulatory objectives. The example of time-stamping discussed earlier, although not itself a regulated activity, is an important means by which the regulator is able to establish whether a securities dealer has engaged in wrongdoing, such as rat trading.98

Although locating the Relevance Horizon on the direct-series is inherently difficult, doing so would appear to be pertinent to establishing an effective disciplinary regime with sufficient certainty of application that facilitates core regulatory objectives.

5.2.2 Other-series acts

There may be a number of understandable commercial linkages between regulated activity and non-RA that may or may not be relevant for the purposes of the SFO. If one considers various of Moody’s publications, such as the RF Report, its published credit ratings, and its Weekly Market Outlook, substantial parts of the underlying data set is likely common to each of these activities, as may be a number of staff, including analysts that operate on the data for different purposes, some of whom may be licensed, others not.

Moody’s, as with any other knowledge based business, may freely choose to direct its core knowledge and expertise to different end purposes, such as marketing to its clients its insight into specific topical issues. The RF Report addressed corporate governance concerns, germane at the time in relation to publicly listed Mainland issuers of rated securities.99 As already noted, the Court acknowledged that the RF Report was concerned with elements relating to credit risk, as opposed to credit rating per se, and Moody’s does engage in non-RA ancillary services for which demonstrating this knowledge would seem relevant. The population of clients of such non-RA ancillary services may of course overlap with the clients of its credit rating services. Publishing the RF Report may also have given rise to additional revenue, separate and distinct from its credit rating revenue stream, as it was a paid for report.100

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98 Rat trading is where a broker takes advantage of knowledge of client trading orders to place orders that benefit themselves (or others) ahead of executing the client orders
99 At the time, publicly listed Mainland Chinese enterprises were under the scrutiny of the US Securities Exchange Commission, investors and the media, for example, see Floyd Norris, “The Audacity of Chinese Frauds” New York Times (26 May 2011)
100 SFAT Determination, para 1
Other-series events could certainly be relevant to regulatory objectives, such as where they might bring about consequences to the performance of a regulated activity. A simple example would be where an other-series event impacts on the financial stability or integrity of the licensed corporation. Another might concern internal controls, for example, concerning the handling of data and the quality of its analysis, the allocation of staff to activities subject to the licensing regime, the decision to publish information into the market and, where relevant, the management of fiduciary issues such as conflicts of interest and confidentiality. However, in each case the touchstone must be overarching regulatory objectives properly formulated.

5.2.3 Common difficulties

The narrow view leaves it unclear where the Relevance Horizon should be located on a series of acts that leads to, or follows from, the performance of a regulated activity. It also excludes all other-series acts. While some other-series acts may be captured elsewhere under the disciplinary regime, such as where they impact on fitness and properness, it is nevertheless reasonable to ask on what basis might it be appropriate for other-series acts be subject to, or excluded from, the Misconduct Provision.

The broad view, being vague and undefined, may capture a wider range of non-RA than appropriate given the basis on which the licensing regime is built. Undertaking a non-RA that requires no license and which sits by side by with, and possibly complements, an intermediary’s regulated activity should not thereby pre-empt a conclusion that the non-RA is related to the regulated activity for the purposes of the Misconduct Provision – such a conclusion would remain moot. Failing to keep this distinction clear also risks diluting a central element of the licensing regime – that licensed corporations are not subject to a single business restriction. As such, the broad view gives rise to a concern that regulatory oversight of a wide range of activities other than statutorily defined regulated activities subject to the licensing regime may be introduced via a backdoor opened by the prospect of the SFC’s discipline.

5.3 Relational theory

Returning for a moment to the term “regulated function”,

a bare reading of the term suggests that many persons would appear to be engaged in a regulated activity. For example, a person undertaking a compliance role (or other back or middle office roles) can certainly be regarded as performing a function by arrangement with the licensed intermediary. However, as discussed in section 3.3.1 above, the statute does not appear to operate in that manner, at least insofar as the way the SFC operates the licensing regime.

Setting aside the statutory language, and the usual practices and expectations in the market, although functions such as the compliance officer role is specific to the licensed context, their role is not, strictly speaking, necessary to the performance of the regulated activity. It is perfectly possible that a regulated activity is undertaken without the involvement of any compliance officer. It may be undertaken in a manner compliant with or in breach of applicable laws and regulations. In practice, of course, licensed corporations engage compliance staff – and a wide range of staff engaged in other functions - to facilitate compliance as well as best business practices, and the SFC expects such arrangements to be in place in order for a license to be regarded as fit and proper.

\[101\] s. 113(1) SFO
In contrast, other acts are essential. For example, for Type 4 regulated activity (advising on securities) to be undertaken there must be an act in which investment advice is provided to a client. Without that act, no regulated activity is undertaken.  

To appreciate the nature of how these different roles are related to regulated activity, it is worth briefly considering how different types of relations are understood within the formal study of philosophy. A generally accepted approach distinguishes between essential relations and predicamental relations. The former requires some causality or necessity, such as between the act of knowing and the object so known, or in the relation between form and matter. These are relations that a thing must possess. By contrast, in a predicamental relation, the essence of the relation is one that exists not in itself but in being referred to another. For example, fatherhood exists not in itself but in another. It is a relation that something may possess but could also lack.  

Returning to the context of licensed corporations, it is plain that there are very few acts that could properly be regarded as bearing an essential relationship to the regulated activity, at least for strict philosophical purposes. The Type 4 example given above is one such case. If one considers the legislative purpose of ss. 168 and 169 SFO to empower the SFC to make or publish specific compliance requirements or guidance that establish minimum acceptable practices and standards, it seems not unreasonable to assert that the acts specified in those requirements or guidance bear a relation to regulated activity that is, when cast in terms of statutory purpose, akin to bearing an essential relation to the undertaking of a regulated activity. In other words, the acts so specified should not be undertaken precariously or accidentally such that the performance of a regulated activity sometimes might possess them and sometimes might not. This reflects the SFC’s expectation of compliance with its Codes.  

Adopting such a view is potentially of some assistance when considering the Relevance Horizon insofar as those acts the SFC have contemplated in the Codes are obvious candidates for falling within the Relevance Horizon. This is because they are expected to bear an intended-essential relation to the performance of a regulated activity.  

This is not to say that all acts not specified in Codes are only capable of being predicamentally related to a regulated activity – it would be unreasonable to place on a regulatory agency the burden of defining the entire universe of all possible acts that may be relevant for regulatory purposes. However, the above approach does reduce the magnitude of the original problem. It also helps to reaffirm that, at least for the purposes of relation in the Misconduct Provision, the relation must be sufficient for statutory purposes, i.e. not merely sufficient for laymen, for commercial purposes or causally related.

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102 Subject to cases where a person is holding themselves out as engaging in a regulated activity, such as where s. 115 SFO might apply


104 The SFC has only exercised its powers under s. 169 SFO. This is a policy approach adopted as a means of preserving regulatory flexibility

105 Of course, acts specified in Codes that are not relevant to a particular regulated activity or circumstance are irrelevant for these purposes
Of the potentially wide range of acts that are not specifically addressed by the Codes (i.e. do not bear an intended-essential relation to the regulated activity), it seems desirable to ask in any given instance, and before resorting to the Misconduct Provision, whether there are statutory mechanisms that are more clearly capable of addressing the act. For example, other-series events that impact on overarching regulatory objectives, such as investor protection, an intermediary’s financial stability, or market integrity, are capable of falling within the fit and proper source of disciplinary power without needing to query the Relevance Horizon under the Misconduct Provision. Reference may also be had to the substantial body of subsidiary legislation to the SFO. The discussion leading to section 4.3 above highlighted that each of the sources of the SFC’s disciplinary powers address different concerns and cover a range of possible acts relevant to the integrity of the regulated marketplace. One might also note the SFO has a number of market abuse provisions that give powers to the SFC.

What remains to be dealt with are direct-series events and other-series events that cannot be treated as related to the regulated activity on an intended-essential basis, nor impact on regulatory objectives, nor are subject to other sanctions provided for in the SFO. An act or omission that falls into this category could be indicative of a flaw in the regulatory net. It is suggested that regulatory agencies and the Courts should be reluctant to turn too quickly to solve such problems via the adoption of excessively flexible and open approaches such as the broad view. Where they are minded to do so, it should be accompanied by due consideration of whether Codes are capable of being revised to resolve the uncertainty, or whether statutory law requires amendment, or whether the courts can adequately advance the law based on the existing statutory provisions. To do otherwise risks damaging the integrity of the disciplinary regime.

5.4 Conclusions

A number of interrelated policy questions potentially linger over the appropriate ambit of the Misconduct Provision following the determination of the Tribunal and the judgment of the Court. How should the concept of regulated activity be understood? How should non-RA acts undertaken as part of a licensed corporation’s business be positioned in the regulatory regime? Is the SFC’s approach to “regulated function” as defined under s. 113(1) SFO correct, or should it encompass other functions performed for the licensed corporation relating to the regulated activity? Could licensing implications possibly arise from the interpretation of the Misconduct Provision?

Nevertheless, there is a fundamental difference, in concept and in practice, between a regulated activity for which a license is required, and something that is done by a company holding a license. For an act or omission to be subject to the SFC’s disciplinary powers under the Misconduct Provision there must be a relevant relationship of sufficient degree between it and a regulated activity such that the application of administrative powers granted to the SFC are properly justified in law.

The importance of not disrupting clarity around an otherwise tightly defined licensing regime is not to be underestimated. It is hoped the CFA will take the opportunity to clarify the law in this area in order to facilitate greater certainty as to the extent of the regulatory obligations of licensed corporations as well as the ambit of the SFC’s disciplinary powers.

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