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Application No. 4 of 2014

IN THE SECURITIES AND FUTURES APPEALS TRIBUNAL

IN THE MATTER OF a Decision made by the Securities and Futures Commission under section 194 of the Securities and Futures Ordinance, Cap. 571

AND IN THE MATTER OF section 217 of the Securities and Futures Ordinance, Cap. 571

BETWEEN

MOODY'S INVESTORS SERVICE HONG KONG LIMITED Applicant

and

SECURITIES AND FUTURES COMMISSION Respondent

Tribunal: The Hon Mr. Justice Hartmann, NPJ, Chairman

Dr Billy Mak Sui-choi, Member

Ms Ding Chen, Member

Date of hearing: 10 to 12 September 2015

Date of determination: 31 March 2016

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REASONS FOR DETERMINATION

Introduction

1. On 11 July 2011, the applicant in this matter, Moody's Investors Service Hong Kong Limited ('Moody's') published a 25-page report, described by Moody's as a 'special comment', which bore the heading: *Red Flags for Emerging-Market Companies: A Focus on China* ('the Report'). The Report was distributed to paid subscribers and was available for purchase by the general public on Moody's website.

2. Moody's is part of a global credit rating agency – reported to be one of the three largest in the world – made up of Moody's Investors Services Inc. and its many affiliates. Moody's has operated in Hong Kong for many years.

3. The Report (or special comment) was not an esoteric work, essentially academic in nature, intended for philosophical debate among a limited audience. In its accessible format and direct language it was clearly intended for the market. It was intended to have an impact and, on a consideration of all the evidence, it clearly did so.

4. In the wake of that impact, the respondent in this matter, the Securities and Futures Commission ('the SFC') commenced an enquiry. Some three years later, the enquiry culminated in a formal Decision Notice (dated 3 November 2014) in terms of which the SFC informed

Moody's that, pursuant to s.194 of the Securities and Futures Ordinance, Cap 571 ('the Ordinance'), it had determined that, in its preparation and publication of the Report, Moody's had failed to meet the standards and comply with the practices expected of a licensed corporation. By way of a broad description, the SFC found that that Moody's had failed to have the required procedural safeguards in place to ensure the integrity of the Report and that the Report itself was in a number of material respects misleading, confusing and inaccurate to the extent that the publication was, or was likely to be, prejudicial to the interests of the investing public, including Moody's own clients, and prejudicial also to the integrity of the market.

5. After Moody's had been given an opportunity to make representations, the SFC determined that it should be subject to a public reprimand and to a pecuniary penalty of HK$23 million.

6. Moody's now seeks, by way of its application for review made pursuant to section 217(1) of the Ordinance, to challenge the findings of culpability made by the SFC and the consequent penalties imposed.

7. In determining the application, the Tribunal is required to make a full merits review, conducting the review as if it is the original decision maker.

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The introduction of a licensing regime

8. As the Tribunal has already indicated, Moody's is one of the world's leading credit rating agencies.

9. Having some understanding of the fundamental nature of 'credit ratings' is essential in determining this review. 'Credit ratings' have been described as 'opinions about relative credit risk' and 'credit risk' itself has been described as 'the potential for loss due to failure of a borrower to meet its contractual obligation to repay a debt in accordance with the agreed terms'[1].

10. Moody's own code of professional conduct describes credit ratings as being 'probabilistic opinions about future credit worthiness'.

11. Credit ratings, therefore, are not guarantees of present credit quality or future credit risk: they are 'opinions'.

12. Coming from rating agencies of global reach and established reputation, credit ratings are important because they enable market participants to employ these opinions as screening devices to match the relative credit risk of issuers of debt instruments with their own risk tolerance. As such, they assist government bodies and corporations to raise funds in the world's capital markets.

13. In June 2011, recognising the depth of influence that credit rating agencies – such as Moody's – have on the operation of the world's

[1] These definitions have been taken from the Global Association of Risk Professionals ('GARP'), a leading United States risk management association.

capital markets, a statutory licensing regime was introduced in Hong Kong. This was apparently in line with the increased oversight of credit rating agencies in other jurisdictions.

14. The new licensing regime provided for an additional type of 'regulated activity' to Part 1 of Schedule 5 to the Ordinance, namely, Type 10 regulated activity, this activity being described as 'providing credit rating services'.

15. 'Credit ratings' themselves are defined in the Ordinance as meaning –

> "… opinions, expressed using a defined rankings system, primarily regarding the credit worthiness of –
>
> a) a person other than an individual;
> b) debt securities;
> c) preferred securities; or
> d) an agreement to provide credit."

16. 'Providing credit rating services' includes in the Ordinance "preparing credit ratings for dissemination to the public, whether in Hong Kong or elsewhere", and further includes "preparing such ratings for distribution by subscription".

17. On 1 June 2011, at the inception of the new regulatory regime, Moody's became licensed under the Ordinance to carry on Type 10 regulated activity. It was close to six weeks later, on 11 July 2011, that Moody's published the Report.

Looking to the Report

18. The Report was published at a time of considerable concern in the market as to accounting and corporate governance standards in place in a number of Mainland corporations that issued debt securities and that had been rated: in short, as to their credit risk. More will be said later in this judgment of the fact that the publication of the Report came shortly after the New York Times had published an article – *The Audacity of Chinese Frauds* - and there had been at least one high-profile scandal as to the discovery of fraud in a Mainland company that issued debt securities.

19. As to the nature and purpose of Moody's 'special comment' – *Red Flags for Emerging-Market Companies: A Focus on China* - a press release issued on the day of publication said the following:

> "Moody's Investors Service highlights, in a new report, governance and accounting risks prevalent when investing in fixed-income securities in the emerging markets.
>
> Through a framework of 'red flags', the report focuses on transparency concerns and the general complexities associated with rapidly developing markets."

20. The central focus of the Report was therefore the red flag framework, that framework being applied to 'Chinese non-financial corporates'. The press release said that the red flag framework –

> "… adds consistency in approach to challenging and often non-transparent situations that are part of the credit decision-making process in new markets."

21. The press release explained that the red flag framework was "supplemental to" Moody's methodological approach to rating non-financial corporations in emerging markets, the purpose being to highlight "discreet risks that may warrant further investigation".

22. The press release went on to say that the Report highlighted companies with an unusually large number of "red flags triggered relative to their rated peers" – in the Report these companies were called 'negative outliers' – and examined the causes.

23. The Report emphasised, however, that the allocation of red flags was not to be taken as a change to Moody's analytical approach –

> "Our ratings already account for the inherent challenges in assessing these Chinese companies: their short history of operations, their diverse industries with limited peers for comparison, their concentrated family ownership structures and their high-growth environments…"

24. The red flags were instead used as "an interesting screen" to identify "potential areas of concern for follow up and closer scrutiny." As to the manner in which the red flag framework was to be used, the Report's front page overview said –

> "In rapidly developing emerging markets, the use of frameworks to assess elements of credit risk provides consistency in identifying relative strengths and weaknesses across a growing pool of rated issuers. In this report, we look at 20 red flags, grouped into *five categories*, that highlight issues meriting scrutiny to identify possible governance or accounting risks for non-financial corporate issuers in emerging markets." [emphasis added]

25. The five categories were described as follows –

i. Weaknesses in corporate governance: short track record of operations and listing history, murky

shareholders' background, large and frequent related-party transactions;

ii. Riskier more opaque business models: unusually high margins compared to peers, concentration of customers, complicated business structures;

iii. Fast-growing-business strategies: very rapid expansion, big capital investments resulting in large negative free cash flow and intangible assets;

iv. Poorer quality of earnings or cash flow: discrepancy between cash flows and accounting profits, disjointed relationship between growth in assets and revenues, large swings in working capital, insufficient tax paid compared to reported profits;

v. Concerns over auditors and quality of financial statements: a switch in auditing firm or legal jurisdiction of auditor's office, delay in reporting, or adverse comment from auditors.

26. The Report examined each of these five categories, detailing the red flags used in each and showing the number of times the chosen companies 'tripped' or 'triggered' red flags.

27. In addition to the five categories of red flags, the Report also examined various market indicators that may constitute timely warnings of impending difficulties. For example –

> "…a sharp drop in an issuer's share price, the build-up of a large position of investors shorting the company's stock, and an upward spike in the cost of buying credit-default swaps to insure against the company's default."

28. In the Report, the red flag framework was applied to a total of 61 Chinese issuers of fixed-income securities that it had rated including 49 'high yield' (non-investment grade) issuers.

29. The Tribunal is satisfied that the Report clearly intended to give the message that the greater the number of red flags, that is, the greater the number of warning signs, the greater the need on the part of market participants for scrutiny. The framework was not overly complex. It was 'accessible'. It may be explained as follows. Each red flag represented an element of potential credit risk. A total of 20 red flags were designed, those 20 being divided into five categories. Although different factors can have a different impact on credit risk, in the framework each red flag carried the same weight. What was created therefore was a structure that contained a 20-point scale. Hence, a company allocated 20 red flags represented, on any ordinary reading, the maximum potential credit risk; a company allocated none at all represented the minimum potential credit risk.

30. To emphasise this hierarchy of potential credit risk, the Report laid emphasis on those companies that had been allocated the greatest number of red flags – the 'negative outliers'. The Report listed six such negative outliers, five in the non-property sector and one in the property sector. The six negative outliers were: West China Cement Limited (West China Cement) with 12 red flags; Winsway Coking Coal Holdings Limited (Winsway Coking Coal) with 11 red flags; China Lumena New Materials Corporation (China Lumena) with 10 red flags; Hidili Industry International Development Limited (Hidili Industry) with 9 red flags; LDK Solar Company (LDK Solar) with 9 red flags, and Longfor Properties Company Limited (Longfor Properties) with 7 red flags. Of the six, four were Hong Kong listed companies: West China Cement, Winsway Coking Coal, China Lumena and Hidili Industry. The

reason why each of these negative outliers had triggered a relatively high number of red flags was examined and explained[2].

31. Although, as noted, on any ordinary reading the red flag framework operated on the basis that the greater the number of flags triggered the greater the potential credit risk, this was subject to a qualification; namely –

> "An issuer's tripping of many red flags does not represent an immediate rating concern because our ratings already reflect many of the issues highlighted by the relevant red flags, and the ratings also incorporate more than just the potential concerns that the flags capture. Moreover, as indicated, there is only limited correlation between lower ratings and a higher number of red flags tripped."

32. Moody's accepted, therefore, that, although there was a link – the red flags incorporating many of the elements contained in its credit ratings (of the classic kind) – there was only a "limited correlation" between lower ratings and higher numbers of red flags. From that it follows – there being no exact correlation - that the red flag system had to be something more than a mere illustration of Moody's existing ratings. As the press release announced, the red flags were "supplemental" to Moody's existing ratings: adding to them and/or amplifying them.

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[2] By way of illustration, the following was said in respect of Winsway Coking Coal, a company rated by Moody's as 'Ba3stable', which triggered 11 flags: "Our ratings for Winsway, a coking-coal logistics business, take into account the company's short track record and plan for rapid expansion. By quintupling its procurement of Mongolian coal from 1.3 million tonnes in 2008 to 6.5 million tonnes in 2010, the company triggered several red flags in its build-out of needed infrastructure, which put pressure on working capital and resulted in negative free cash flow, along with a faster rise in revenue. The ratings also reflect a red flag for related-party transactions because the company's chairman has both majority ownership of Winsway and external, commodities-trading businesses, which facilitated the debut and growth of Winsway's operations. Nevertheless, reported related-party transactions have been immaterial, and the chairman has a non-compete agreement with Winsway."

33. When published on 11 July 2011, the Report received extensive local and international media attention, a not unexpected reaction bearing in mind Moody's international standing and influence and the fact that its categorisation of certain rated Mainland corporations as 'negative outliers' carried with it, on any ordinary reading, an implication, at its mildest, of potential concern, at its more robust, of clear risk.

34. What was to be made of the Report? One publication, Market Watch, commented in its edition of 12 July 2011:

> "Moody's was careful to draw a line between the report and its credit ratings, saying that the ratings are done separately and that the 'tripping of many red flags does not represent an immediate rating concern'.
>
> Cantor Fitzgerald analysts picked up on this theme, saying in a note Tuesday that the warnings were short of credit downgrades."

35. However, according to the publication, the analysts had not simply taken the Report as some form of 'interest piece' requiring no form of response. To the contrary, the publication went on to say:

> "But Cantor Fitzgerald added that markets should demand higher credit premium and lower stock valuation for companies receiving such 'red flags' in compensation for these risks."

36. As indicated earlier in this judgment, the Report had a material impact on the market. A number of media outlets reported that the Report had triggered a panic sell-off in the shares of those issuers that had been the subject of red flags[3]. By way of illustration, on 12 July 2011, the *Apple Daily* published a report saying:

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[3] In this regard, see paragraph 13 of appendix 1 of the SFC Decision Notice dated 3 November 2014.

> "Riding on the waves of China's 'Western Development Strategy', West China Cement [2233] has seen a surge in profits in recent years, enjoying an over 40% (up) in earnings before interest, taxes, amortisation and depreciation margin [EBITDA margin]. However, the company was 'awarded' the most number of 'red flags' by Moody's, implying that, in the eyes of Moody's, this cement enterprise which has changed its auditors twice in two years, was most likely to see its 'myth' punctured.
>
> According to Moody's, West China Cement was the riskiest on the list given its lack of a well-developed internal control system before listing, successive change in the CEO and CFO in less than a year after listing, coupled with its higher-than-peer EBITDA margin (and) a highly-concentrated shareholding…"

37. As to the extent of the impact, the SFC noted that on the day after publication the share price of more than half of the issuers red-flagged in the Report had experienced substantial falls. Four of the six issuers identified in the Report as negative outliers suffered the biggest drops: on the face of it, an indication that they were now seen by the market – whatever the qualifications given by Moody's in the Report - as carrying risks that could not be ignored. By way of illustration, by the close of trading on 12 July 2011, the shares of West China Cement (the issuer given the highest number of red flags, a total of 12) had fallen by 16.78%. The three other negative outliers most badly hit were China Lumena, its shares falling by 13.56%; Longfor Properties, its shares falling by 10.84%, and Winsway Coking Coal, its shares falling by 10.71%.

38. West China Cement and Winsway Coking Coal, at the request of the Stock Exchange, published statements acknowledging the increase in trading volume and decrease in price of the companies' shares,

stating that – save for the Report – their Boards were not aware of any reasons why this should have taken place[4].

39. Relevant bond prices were also affected. By way of illustration, and again referring to West China Cement, in an article published by *Bloomberg* on 12 July 2011, bearing the headline – *Moody's Sparks West China Cement rout on 'Red Flags' Report* – it was said:

> "Yields on West China Cement's $400 million of 7.5% bonds due January 2016, jumped 85 basis points to 9.434 percent as of 9:48 AM in Hong Kong. That's the biggest jump since June 8 and set for the highest level since June 27…"

40. As Moody's pointed out to the SFC, there were, of course, other factors influencing the market at the relevant time, more especially the fact that the share prices of the issuers made the subject of the Report had been trading in a downward trend in the six months prior to publication and after publication, in respect of a number of the issuers, that long-term slide had persisted.

41. The Tribunal has taken note of the fact that market volatility may often have varied and complex causes. In the present instance, however, on the evidence placed before it, the Tribunal is satisfied on the probabilities that the negative impact felt by those Mainland issuers that had been allocated numbers of red flags was - immediately after

[4] By way of illustration, the published announcement by West China Cement read as follows: "Save for the Report, the Board is not aware of any reasons for such decrease and/or increase. Save as disclosed above, the Company also confirms that there are no negotiations or agreements relating to intended acquisitions or realisations which are disclosable under Rule 13.23 of the Listing Rules, nor is the Company aware of any matter disclosable under the general obligation imposed by Rule 13.09 of the Listing Rules, which is or may be of a price-sensitive nature."

publication of the Report - principally occasioned by the contents of the Report itself and not by other unrelated factors.

42. Did Moody's anticipate such a reaction or ought it to reasonably have done so? The Report, as indicated earlier in this judgment, was published at a time of considerable concern in the market as to the accounting and corporate governance standards in place in a number of rated Mainland issuers of debt securities. Its publication came just a month after the *New York Times* had published an article: *The Audacity of Chinese Frauds* and there had been at least one high-profile scandal as to the discovery of fraud in a Mainland company. On the evidence, it is apparent that Moody's issued the Report in major part because of the concerns in the market. The employment of the red flag framework was patently intended to catch the attention of readers. In the judgment of the Tribunal, Moody's must have appreciated in such circumstances that in all probability the Report would have a material impact on the market, that is, an impact of consequence.

43. The fact that Moody's identified concerns in the market and sought to produce a research publication that was relevant cannot in any way be criticised. According to the SFC, however, the Report not only attracted the attention of the market, it attracted the criticism of investment analysists and others. By way of example, in a note prepared by Macquarie Equities Research dated 13 July 2011 and entitled *Overly Moody*, it was commented that "the risk-assessment framework of the 'red flag' report in question appears debatable in many cases…" while the Wall Street Journal, in its edition of 24 July 2011 in an article headed *Rating Firms Barking up Equity Tree*, commented that "[it] isn't unheard of for credit-rating firms to affect stock prices by highlighting specific

problems at the companies whose debt they assess. But the July 11 Moody's report stood out by touching on broad issues affecting scores of companies, while not offering up any specific rating action…"

44. The accuracy of the Report was also called into question. By way of example, one of the companies under consideration, China Glass Holdings Limited, was given a red flag for family ownership of over 30% when this was factually incorrect.

45. In light of these matters, the SFC commenced an enquiry which was later transferred into a formal investigation. In its Notice of Proposed Disciplinary Action dated 14 February 2013, the SFC informed Moody's that it was of the preliminary view that the Report (and its related press release) contained misleading, inaccurate and unfair statements and that Moody's had failed to put in place proper internal controls and procedures to manage its work.

46. Having considered extensive submissions filed on behalf of Moody's, the SFC came to its final determination in its Decision Notice dated 3 November 2014. In that notice it determined that, pursuant to s.194 of the Ordinance, it considered Moody's not to be fit and proper to remain licensed and to be guilty of misconduct.

47. S.193 of the Ordinance defines 'misconduct' as including:

> "… 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 [the SFC], is or is likely to be prejudicial to the interest of the investing public or to the public interest."

48. The SFC found that Moody's disciplinary culpability lay in its failure to comply with certain provisions of the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission ('the Code of Conduct').

49. S.169(1) of the Ordinance gives the SFC the power to publish codes of conduct, such codes providing guidance to licensed institutions (such as Moody's) as to expected standards of conduct in the discharge of regulated activities. In this regard, s.169(1) provides that:

> "Without prejudice to the power of the Commission [the SFC] to make rules under section 168, the Commission may publish, in the Gazette and in any other manner it considers appropriate, codes of conduct for the purpose of giving guidance relating to the practices and standards with which intermediaries[5] and their representatives are ordinarily expected to comply in carrying on the regulated activities for which the intermediaries are licensed or registered."

50. The SFC found that Moody's had breached General Principle 1 of the Code of Conduct which - under the heading, *Honesty and Fairness* - provides that:

> "In conducting its business activities, a licensed or registered person should act honestly, fairly, and in the best interests of its clients and the integrity of the market."

51. In its Decision Notice, the SFC found that Moody's was culpable under General Principle 1 in three respects which may be summarised as follows:

[5] An 'intermediary' is defined in Part 1 of Schedule 1 to the Ordinance as meaning 'a licensed corporation or a registered institution'. At all times relevant to this determination Moody's was a licensed corporation.

a) misleading statements had been made in both the press release and the Report, the impression being created that the red flag framework was a part of Moody's established methodology, having been relied upon in the past, and was not a "new screen" methodology that had not previously been used and may not necessarily be used in the future;

b) there had been a failure to sufficiently explain and justify the red flag framework, the Report, thereby presenting an unfair and misleading picture to the market; and

c) the red flag framework had been used to rank companies with the largest number of red flags being allocated to 'negative outliers' despite the fact that, on its own analysis, there was no significant correlation between the number of red flags and credit risk.

52. In its Decision Notice, concerning its assessment of penalties, the SFC said that it had taken into account the following two factors which may broadly be described as going to the gravity of the various breaches: first, their serious nature and, second, their impact on the market. The SFC said that it had also taken into account two factors which may be described as being mitigatory: first, that the preparation and publication of the Report constituted a unique set of circumstances which were unlikely to be repeated and, second, that an extended period of time had been taken by the SFC to come to a final determination.

53. For its breaches of General Principle 1, the SFC determined that a pecuniary penalty of $9 million was appropriate. This was a

reduction of $1 million on the amount assessed in the Notice of Proposed Disciplinary Action.

54. The SFC further found that Moody's had - on a separate and distinct basis from the breaches under General Principle 1 - breached General Principle 2 of the Code of Conduct which - under the heading, *Diligence* - provides that:

> "In conducting its business activities, 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."

55. In respect of General Principle 2, the SFC found there to be a total of 12 errors within the published Report relating directly to the apportionment of red flags and a further error concerning one of the companies under review, Winsway Coking Coal.

56. The errors themselves were not disputed by Moody's although it was contended that, in all the circumstances, they were of little or no consequence.

57. The SFC did not agree. As the red flags constituted warning signals, they were, therefore, in the view of the SFC, capable of having an impact on the share price of the companies that had been made subject to the red flag framework. For that reason, accuracy in the allocation (or non-allocation) of red flags was of utmost importance in the interests not only of the companies themselves but in the interests of the market as a whole.

58. For its breaches of General Principle 2, the SFC determined that a pecuniary penalty of $6 million was appropriate. This was a

reduction of $4 million on the amount assessed in the Notice of Proposed Disciplinary Action.

59. The SFC also found that Moody's was culpable under paragraph 4.3 of the Code of Conduct which – under the heading, *Internal Control, Financial and Operational Resources* – provides that:

> "A licensed or registered person should have internal control procedures and financial and operational capabilities which can be reasonably expected to protect its operation, its clients and other licensed or registered persons from financial loss arising from theft, fraud, and other dishonest acts, professional misconduct or omission."

60. In respect of paragraph 4.3, the SFC found that Moody's had "minimal procedures and controls in place to ensure that the Report, a publication related to its credit rating business, was presented in a fair, accurate and non-misleading manner". These minimal procedures and controls, it was said in the Decision Notice, had proved themselves to be insufficient to ensure compliance with applicable rules and regulations and to ensure the interests not only of Moody's clients but also of the market.

61. For its breach of paragraph 4.3 of the Code of Conduct, the SFC determined that a pecuniary penalty of $8 million was appropriate. This was a reduction of $2 million on the amount assessed in the Notice of Proposed Disciplinary Action.

62. As to the general question of penalty, the SFC rejected any suggestion that in reality the breaches which it had determined under General Principles 1 and 2 and paragraph 4.3 were no more than separate particulars in support of a single allegation of misconduct and/or of unfitness to remain licensed. The SFC maintained its view that Moody's

had committed three separate breaches, each properly subject to its own penalty. In the result, as stated at the beginning of this judgment, having considered the representations made on behalf of Moody's, the SFC determined that Moody's should be publicly reprimanded and fined $23 million. This penalty was $7 million less than the penalty assessed in the Notice of Proposed Disciplinary Action.

A summary of Moody's grounds of review

63. Moody's principal ground of review is one of jurisdiction. In this regard, it has been submitted that the preparation and publication of the Report was not a regulated activity in respect of which Moody's was licensed; it was not part of Moody's credit rating services. This being the case, the preparation and publication of the Report was not an activity to which the Code of Conduct applied.

64. In respect of this challenge to jurisdiction, Moody's does not dispute that, in carrying on the regulated activities for which it is licensed (i.e. the provision of credit rating services), it is subject to the provisions of the Code of Conduct published pursuant s.169(1) of the Ordinance and, if found to be in breach of the Code, that it may be found guilty of misconduct or not to be a fit and proper person and therefore liable to penalty pursuant to s.194 of the Ordinance. Moody's rejects the contention, however, that it is subject to the Code of Conduct when carrying on related activities.

65. The Report, it is said, being a commentary on market-related issues, may have borne some relationship to the provision of credit rating

services but its preparation and publication nevertheless constituted an activity distinct from the provision of credit rating services and, as such, an activity that is not regulated and therefore not subject to the statutory oversight of the SFC. In this regard, it was submitted that –

> "It is not sufficient for the SFC to say that the preparation and publication of the Report was 'proximate to', 'connected to' or 'related to' the provision of credit rating services. In preparing and publishing the Report, Moody's was either 'carrying on the regulated activities for which it was licensed' (and therefore is required to comply with the Code of Conduct) or it was not. It was not."

66. In seeking to rebut the assertion that it has acted beyond its statutory powers, it has been submitted on behalf of the SFC that the provisions of s.169(1) and s.194 of the Ordinance are to be viewed purposefully, the statutory language being construed in the light of its context and purpose. In the present case, it is submitted that the nature and purpose of the Report was so closely allied to and so immediately consequent upon Moody's Type 10 regulated activities that, if not found actually to constitute such activities in terms of the Ordinance, it was nevertheless closely attendant upon them and, as such, must be subject to the disciplinary jurisdiction of the SFC.

67. The primary issue, therefore, that falls for determination in this judgement is the issue of jurisdiction. Only if it is determined that the SFC acted within its powers will the merits of the findings that Moody's acted in breach of the Code of Conduct call for consideration.

68. Should the challenge to jurisdiction fail –

a) Moody's seeks to challenge the substantive findings made by the SFC in respect of General Principle 1 and paragraph 4.3 of the Code of Conduct.

b) As indicated earlier, Moody's did not challenge the findings of the SFC under General Principle 2 that the Report contained a number of factual inaccuracies. As the Tribunal understood it, Moody's answer is that, taken in context, the inaccuracies simply do not warrant disciplinary action and in consequence no penalty is warranted.

c) In respect of the penalties that were imposed by the SFC, to cite from the written opening submissions of Moody's leading Counsel, Mr. Huggins, the challenge is based on the assertion that the three separate fines of $9 million, $6 million and $8 million were 'ultra vires, and/or arbitrary, and/or excessive and wrong in principle.'

The issue of jurisdiction

69. In determining the question of jurisdiction, the issue that falls for consideration is whether the relevant statutory provisions in the Ordinance extend to Moody's publication of the Report. The issue is therefore one of statutory interpretation, that is, of seeking the true meaning of the relevant words chosen by the Legislature. It is therefore primarily an issue of law.

70. As to this task, the Tribunal is to follow the guidance given by the Court of Final Appeal in *HKSAR v Cheung Kwun Yin*[6], namely, that –

> "… statutory language is construed, having regard to its context and purpose. Words are given their natural and ordinary meaning unless the context or purpose points to a different meaning. Context and purpose are considered when interpreting the words used and not only when an ambiguity may be thought to arise."

71. In Hong Kong, this is today the established approach, namely, that statutory provisions must be given a purposive interpretation. However, as emphasised by Mr. Huggins, on behalf of Moody's, the use of this approach should not be taken as judicial licence to ignore or refuse to give effect to the words which the Legislature has chosen to use. In this regard, the following observations of Lord Millett NPJ in *China Field Ltd v Appeal Tribunal (Buildings) (No.2)*[7] are apposite:

> "There can be no quarrel with the principle that statutory provisions should be given a purposive interpretation, but there has been a distressing development by the courts which allows them to distort or even ignore the plain meaning of the text and construe the statute in whatever manner achieves a result which they consider desirable. It cannot be said too often that this is not permissible. Purposive construction means only that statutory provisions are to be interpreted to give effect to the intention of the Legislature, and that intention must be ascertained by a proper application of the interpretative process. This does not permit the court to attribute to a statutory provision, a meaning which the language of the statute, understood in the light of its context and statutory purpose, is incapable of bearing…"

72. Mr. Huggins accepted that one of the main statutory purposes of the SFC's disciplinary powers under the Ordinance is to regulate the activities and conduct of persons and bodies in the securities

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[6] (2009) 12 HKCFAR 568

[7] [2009] 5 HKC 231, para. 36 and (2009) 12 HFCFAR 342

and futures industry in order to protect investors, a purpose, that cannot be subject to criticism. This, however, he submitted, did not give to the SFC some general mandate. The only activities and conduct which may be regulated are those for which the particular person or body is 'licensed or registered'. That phrase, he submitted, defines the parameters of what falls for regulation by way of codes of conduct published under the Ordinance. Those parameters, he said, cannot be widened by implying additional words – as the SFC had done in its Decision Notice – that suggest that activities that are merely 'proximate to' or 'connected with' regulated activities are somehow pulled into the interpretative net.

73. Mr. Huggins submitted that, in so far as this may constitute a 'strict', as opposed to 'liberal' interpretation of the relevant statutory provisions[8], such an interpretation was obligated by two factors: first, the impact on Moody's constitutionally protected freedom of expression and, second, what was described as the principle that a penal statute must be construed strictly. The Tribunal will return to these two factors later in this judgment.

74. Whatever the basis upon which the SFC found that the preparation and publication of the Report constituted regulated activity, Mr. Yu advanced the jurisdiction argument on two bases. First, that the red flag framework, whatever the qualifications, constituted *of itself* a rating exercise. Second, that Moody's made it plain that the methodology encompassed by the red flag framework was part and parcel of the process of explaining how its ratings worked and part and parcel of

[8] As the Tribunal understood the approach adopted by Mr. Huggins, a strict construction narrows the operation and effect of the statutory provisions under consideration. If the statutory provisions are coercive, a strict construction reduces the extent of the coercive effect: see *Bennion on Statutory Interpretation*, 6th Ed., s.182, page 482.

keeping them up to date and as such was so closely attendant upon the business of publishing the ratings themselves that it fell within the statutory definition of regulated activities.

75. In determining the issue, of jurisdiction, the Tribunal is satisfied that the first and fundamental approach must be to consider the actual words employed by the Legislature, giving those words a purposive interpretation.

76. On the basis that the SFC has sought to discipline Moody's for breaches of the Code of Conduct, what is first required, therefore, is an examination of s.169(1), the section that gives to the SFC the power to draw up and publish codes of conduct for the specific purpose of –

> "… giving guidance relating to the practices and standards with which intermediaries [i.e. licensed corporations such as Moody's]… are ordinarily expected to comply in carrying on the regulated activities for which the intermediaries are licensed… "

77. Accordingly, codes of conduct published pursuant to s.169(1) may only be used as a basis by the SFC to discipline licensed corporations to the extent that they govern the carrying on of 'the regulated activities' in respect of which such corporations are licensed.

78. As cited earlier in this judgment, 'misconduct' itself must apply to 'regulated activity' and not activity generally. In this regard, see s.193, which provides that 'misconduct' includes –

> "… 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]

79. At all material times, the 'regulated activity' for which Moody's was licensed was to provide 'credit rating services'. Again, as cited earlier in this judgment, 'credit ratings' are defined as meaning –

> "… opinions, expressed using a defined rankings system, primarily regarding the credit worthiness of –
>
> a) a person other than an individual;
> b) debt securities;
> c) preferred securities; or
> d) an agreement to provide credit."

80. The first question that arises, therefore, in determining jurisdiction may be articulated as follows: "in terms of the relevant statutory provisions, did the publication of the Report (of itself) constitute the provision of credit rating services?"

81. In determining this issue it is important to note that the phrase 'credit ratings' is broadly defined. The Legislature has not condescended to specific accountancy directives or mathematical formulae. No doubt there are at this time globally accepted systems – systems of the classic kind – that are employed by rating agencies such as Moody's to rate debt securities. The statutory definition, however, is not limited to these ratings. It allows for different forms of credit ratings in respect of a range of subject matters. This is no surprise. Invariably, legislation of this kind is broadly drafted so as to meet the exigencies of changing circumstances. Commercial and financial markets are dynamic. Corporations that issue debt security must struggle with the uncertainties of those markets; their fortunes fluctuate. As markets develop, so the nature and complexity of debt securities evolve and such evolution, in its turn, demands changed approaches to rating.

82. Moody's own code of professional conduct describes credit ratings as being "probabilistic opinions about future credit worthiness": credit rating, therefore, is not merely an exercise of collating historical fact, it must deal with current and future uncertainties. Moody's code of professional conduct further states that its "credit ratings are forward-looking opinions that seek to measure relative credit loss." As such, having regard to changing market conditions, such forward-looking opinions may have to be on-going in the sense that they require to be clarified, supplemented or made subject to change.

83. Understandably, therefore, the Ordinance defines 'credit ratings' as 'opinions', that is, as views, judgments or beliefs, without any limitation to their form other than that they are 'expressed' using a 'defined rankings system', namely, a system that divides its subject matter into ranks or classes that are clearly specified.

84. The format of such 'a defined rankings system' is not itself specifically defined, for example, as constituting any particular integration of mathematical and accounting data. It follows, therefore, that such a system, providing it sets out defined rankings, may come in many forms; it may be self-contained or it may be complementary to an existing system.

85. In the view of the Tribunal, it is significant that the statutory definition does not limit the subject of 'credit ratings' to debt securities issued by corporate bodies but extends to the corporate bodies themselves.

86. If the phrase 'credit worthiness' may be said to be the expression of an assessment of current and future ability to honour debt obligations, it is also significant that the statutory definition does not limit the factors that may be taken into account in any such assessment. It is for the provider to determine what factors are to be incorporated and the weight to be given to them.

87. The Report is focused on, and gives opinions regarding, the credit worthiness of the corporate issuers of fixed securities that are listed in it, a total of '61 rated Chinese entities'. The opening sentence of the Report - under the heading *Red Flags as a Screen* - states:

> "In rapidly developing emerging markets, the use of frameworks to assess elements of credit risk provides consistency in identifying relative strengths and weaknesses across a growing pool of rated issuers."

88. On any objective assessment, it is clear that the red flag framework constitutes a system, one that is based on the use of flags that are grouped into five separate categories, each category aimed at identifying "possible governance or accounting risks". These categories are defined and explained in considerable detail. Each of them defines areas of possible concern[9].

89. The ranking within the system is based on the tripping or triggering of the red flags. The higher the number of red flags that are tripped or triggered in respect of each of the five categories, the higher the number of warning signs as to governance and/or accounting risks. In

[9] As stated earlier in this judgment, the categories are as follows: (1) possible weaknesses in corporate governance, (2) riskier or more opaque business models, (3) fast-growing-business strategies, (4) poorer quality of earnings or cash flow, and (5) concerns over auditors and quality of financial statements.

this regard, the corporations found to have tripped or triggered the highest number of red flags are ranked as 'negative outliers', such negative outliers attracting 'greater scrutiny'[10], that is, being deserving (in terms of the red flag framework) of the closest scrutiny in respect of possible or potential governance or accounting risks.

90. What must also be noted is that, within the Report itself, Moody's expressed confidence that the red flag framework – a 'method' for identifying relative strengths and weaknesses among rated issuers of debt securities - could be applied more generally to rated issuers in developing markets; in short, that it had a degree of general applicability. In this regard, the Report (page 2) states:

> "The methods we use and present here are applicable to all HY companies in developing markets, not just China. Although we summarise our findings for China, we plan to follow up soon with a report for other HY issuers in the Asian region."

91. Whether this broader applicability was always to be supplementary to Moody's ratings of the classic kind does not detract from the fact that Moody's itself recognised that it had put together a system for assessing potential credit risk, a system that its engineers believed could be used more broadly than in respect of a limited number of Mainland issuers.

92. In broad summary:

i. Each of the 20 flags in the red flag framework constituted a warning sign of potential credit risk (credit risk being the potential for loss due to failure

[10] See the sub-heading on page 4 of the Report: *Negative Outliers Attract Greater Scrutiny*.

of a borrower to meet its contractual obligation to repay a debt in accordance with the agreed terms).

ii. Each of the 20 red flags was grouped into five categories, those categories outlining elements of potential credit risk.

iii. Each company under scrutiny was made subject to the allocation to it of red flags, the greater the number of flags allocated the higher the potential credit risk. As was said earlier in this judgment: with no red flags allocated, there was, within the scope of the framework, no credit risk element; with 20 red flags allocated, there was, within the scope of the framework, a maximum number of credit risk elements.

iv. The red flag framework, it was said, was applicable not only within one limited set of circumstances but was applicable to high yield companies in developing markets.

93. On a straightforward, purposive construction, therefore, taking into account the matters referred to hereafter, the Tribunal has had no difficulty in coming to the determination that, whether it was intended by Moody's or not, the red flag framework constituted a well-defined system or mechanism for judging levels of credit risk and, as such, constituted a credit rating. The preparation and publication of the Report was therefore a regulated activity.

94. In coming to its determination, the Tribunal has not ignored the fact that qualifications were contained in the Report suggesting that, while the red flag framework could help to identify areas to investigate, it could not serve to rank credit risk. In this regard, on the front page of the Report it was said:

> "These findings show that screens for governance or accounting risks can help identify areas to investigate but cannot serve as mechanisms to rank order credit risk."

95. Mr. Huggins, for Moody's, submitted that the most that could be said was that the Report involved an exercise "which was preparatory to a possible review of existing credit ratings".

96. In the judgment of the Tribunal, the problem with the qualifications is that, when the Report is taken as a whole, they cannot alter the very clear structure of the red flag framework, a framework, no matter how blunt and/or unsophisticated, that seeks – on any ordinary and reasonable reading - to suggest that the greater the accumulation of red flags, the greater the relative weakness of a company made subject to review. Why else describe the companies that have accumulated the highest number of red flags as 'negative outliers'? Elsewhere in this judgment, the Tribunal has made reference to the fact that during the preparation of the Report by the Moody's team concern was expressed that the red flag framework may send out "wrong signals", indeed, that it should be scrapped as it had been scrapped in the past. The decision was made to keep the red flag framework, clearly a system that assessed elements of credit risk by a form of ranking, and whatever the qualifications placed in the Report, those qualifications were not capable of altering the true nature of the framework. The Tribunal would go so far as to say that the qualifications in fact added confusion, building into the Report a fundamental contradiction. Nuanced arguments can of course be made but the Tribunal, on the basis detailed later in this judgment, must look to the Report as a whole: what was the message it conveyed?

97. The Tribunal has also taken into account the qualifications contained in the Report as to the fact that there was only limited correlation between lower ratings and higher numbers of red flags. The Tribunal is satisfied, however, that this does not go to the issue of whether a credit rating system, in the form of the red flag framework, was presented in the Report, it goes rather to the nature of that system, particularly its limitations.

98. In overseeing the preparation of the Report, Brian Cahill, one of Moody's senior executives, suggested on more than one occasion that it be "actionable". For example, he said: "Give summary level detail of average number of rating flags by rating category. Name the outliers [make the report, actionable as opposed to generic]."

99. On an ordinary reading, 'actionable' means capable of giving rise to some form of action while 'generic' means characteristic of a class. On this basis, it would appear that Brian Cahill was recommending that the contents of the Report, certainly in respect of negative outliers, should be capable of being acted upon as opposed to being read simply as going to the characteristics of certain rated Chinese corporations.

100. On behalf of Moody's, it was submitted that this was an incorrect interpretation and that the word 'actionable', in the context of publishing, was intended to suggest no more than that what was published should be interesting, thought-provoking and the like[11].

[11] Trevor Pijper, one of Moody's accounting experts, does not appear to have understood the word 'actionable' in exactly this way. In his email of 27 June 2011, he spoke of an apparent intention to produce something 'actionable' in the sense that it would highlight prominently a number of negative outliers and that readers [naturally enough] would regard those negative outliers as being

101. The Tribunal has had difficulty accepting that submission. There was no expert evidence as to what the word 'actionable' means in a publishing context and it must surely, almost invariably, be the intention of a publisher (who must compete in the market) to publish material that is interesting and thought-provoking. Although it is not in any way decisive in the Tribunal's determination of the issue of jurisdiction, on the probabilities the Tribunal is satisfied that the word 'actionable' as used by Brian Cahill was intended to have its ordinary meaning as described above.

102. If the Tribunal is wrong in concluding that the red flag framework (which was the central focus of the Report and its rationale) *of itself* constituted a form of credit rating within the ambit of the Ordinance, it is persuaded by Mr. Yu's submission that the red flag framework was more than a mere illustration of Moody's ratings of the classic kind, some form of explanation that provided no basis upon which it itself could be acted upon. To the contrary, at the very least, it is evident that it 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. As such, the Tribunal is satisfied that the preparation and publication of the red flag framework fell within the statutory definition of regulated activities[12].

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companies presenting the greatest credit risk. If they did so - and it appears that a substantial portion of the market did - it appears to be Mr. Pijper's implication that it may result in action being taken by way of divestment.

[12] The SFC in its exchange of correspondence with Moody's may have used phrases such as 'proximate to' or 'connected to'. This Tribunal, however, is required to make a full merits review, conducting the review on the basis that it is the original decision-maker.

103. In this latter regard, the Report said the following (on page 1) to make it clear that it was to be read in conjunction with and/or as being supplementary to ratings already made:

> "Our ratings already factor in the inherent challenges of analysing young, fast growing Chinese companies with few peers, concentrated family ownership, and sometimes poor transparency. As an illustration, although we rate China's sovereign credit at Aa3 with a positive outlook, 80% of rated companies with predominantly Chinese operations fall below investment grade. In fact, we rate 76% of non-financial HY [high yield] issuers at Ba3 and below. *The red flags provide further clarity and detail, but do not represent a change in our rating methodologies*. [emphasis added]

104. To put the matter beyond doubt, the Report continued (on page 2) by saying:

> "To address investors' concerns *and provide transparency on our approach to ratings*, this report identifies warning signs – so-called 'red flags' for our rated, high-yield, non-financial Chinese companies." [emphasis added]

105. On the basis that credit ratings are "probabilistic opinions about future credit worthiness", it must be integral to Moody's rating activities that, in times of concern, it should seek to assist the market by adding to or clarifying ratings (of the 'classic kind') earlier made. Certainly, a reading of the Report shows that the 'red flag' warning signs are to be read in conjunction with existing ratings. By way of illustration, Appendix 3 to the Report, which tabulates the number of red flags tripped, first, by Chinese high-yield non-property and, second, Chinese high-yield property issuers, does so by contrasting existing ratings with the number of red flags triggered. The following is an example -

"**List of Chinese HY Non-Property Issuers – By Rating**

Issuer Name	**Corporate Family Rating/Bond Rating Outlook**	**Red Flags Tripped**	**Industry**
China Oriental Group Co	Ba1/Negative	7	Steel
Parkson Retail Group Ltd	Ba1/Stable	3	Retail
Citic Pacific Ltd	Ba1/Stable	7	Conglomerate

"

106. Returning for a moment to the provisions of the Ordinance, the Tribunal notes that the term 'misconduct', as defined in s.193, includes "an act or omission *relating to* the carrying on of any regulated activity". In ordinary parlance, the phrase 'relating to' describes a form of connection, that is, a description of the way one thing stands in connection with another. It is not a precise phrase, the Tribunal recognises that, and, as such, for purposes of statutory construction, it is capable of bearing a broad or narrow meaning in order to further the legislative purpose. In the opinion of the Tribunal, at the very least, the red flag framework contained in the Report, so clearly clarified and/or expanded upon the ratings of a classic kind already made by Moody's in respect of the companies under review in the Report that, in giving a purposive construction to the relevant statutory provisions, the act of publication must be held to be an act *relating to* those earlier ratings.

107. For the reasons given, therefore, on a purposive reading of the relevant statutory provisions, taking into account all matters relevant to context and purpose – and before looking to whether a more strict interpretation should be applied and, if so, whether that would bring a

different result - the Tribunal has had no difficulty in coming to the conclusion that in the preparation and publication of this Report [13] Moody's was carrying on its regulated activity of providing credit rating services.

108. As to the employment of a more strict interpretation, Mr. Huggins, for Moody's, submitted that this was obligated by two factors, the first of which was the fact that in issue was Moody's constitutionally protected right to freedom of expression, the second of which is the asserted principle that a penal statute must be construed strictly.

109. Looking first to the issue of freedom of expression, the Tribunal is prepared to accept that, in determining the jurisdiction issue, Moody's constitutionally protected freedom of expression is engaged. It is further prepared to accept that the relevant statutory provisions – in respect of the preparation and publication of the Report – have placed restrictions on that freedom. In order to come to a determination on the true interpretation of the statutory provisions, having regard to their context and purpose, these are matters which have throughout its interpretation process been taken into account by the Tribunal. That said, however, assuming, for purposes of the exercise, that Mr. Huggins is correct and that, instead of it being simply a factor to be taken into account in a purposive interpretation, it should result in a more narrow interpretation of the relevant statutory provisions [14], the Tribunal is satisfied that such an approach does not alter its preliminary interpretation.

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[13] For the avoidance of any confusion, what has fallen for determination in this judgement is the limited issue of whether the Report in question constituted an integral part of Moody's regulated activities.

[14] During the course of submissions, Mr. Yu, for the SFC, argued that a statutory provision should be construed by giving it a purposive interpretation and it is only after the true meaning of the statutory

110. It is Article 16 of the Hong Kong Bill of Rights that enshrines freedom of expression[15]. The freedom, however, is not absolute. The exercise of the freedom carries with it 'special duties and responsibilities' and may therefore be 'subject to certain restrictions' as are provided by law and are necessary in order to respect the rights or reputation of others or for the protection of national security, public order (*ordre public*) or public health or morals.

111. The authorities put before the Tribunal by Mr. Yu, leading counsel for the SFC, make clear that the meaning of *ordre public* is wider than the English expression 'public order' which may be limited to matters of law and order. *Ordre public* is a principle allowing the organs of state to ensure the common welfare by satisfying collective needs. These needs may include such matters as economic order[16].

112. In the view of the Tribunal, having regard to the vital importance of the securities and futures industry in all its forms to the sustainability and economic prosperity of Hong Kong, the principle of *ordre public* must extend to measures that are necessary and proportionate, as per s.4 of the Ordinance –

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provision has been determined by that approach that the Tribunal should then "consider whether fundamental freedoms such as freedom of expression, are engaged, and if so, whether any restriction of that freedom serves a legitimate aim and whether the restriction is proportionate." The Tribunal is persuaded by that approach even though, in order to determine the approach to interpretation submitted by Mr. Huggins, it has (for purposes of the exercise) accepted that approach.

[15] Article 16 provides that everyone "shall have the right to freedom of expression; this right shall include freedom to seek, receive and impart information and ideas of all kinds, regardless of frontiers, either orally, in writing or in print, in the form of art, or through any other media of his choice".

[16] See, for example, *HKSAR v Ng Kung Siu* (1999) 2 HKCFAR 442, at 457-460 and *HKTVN v Chief Executive in Council* [2015] 3 HKC 326, paras 141-145.

> "a) to maintain and promote the fairness, efficiency, competitiveness, transparency and orderliness of the securities and futures industry;
>
> b) …
>
> c) to provide protection for members of the public investing in or holding financial products;
>
> d) to minimise crime and misconduct in the securities and futures industry ;
>
> e) to reduce systemic risks in the securities and futures industry; and
>
> f) to assist the Financial Secretary in maintaining the financial stability of Hong Kong by taking appropriate steps in relation to the securities and futures industry."

113. The Tribunal has had no difficulty in coming to the conclusion that the limitations on freedom of expression contained in the relevant statutory provisions have been imposed pursuant to a legitimate aim. That aim is the protection of the securities and futures industry in Hong Kong, an industry that, as already noted, is of vital importance to the Territory's economic sustainability.

114. Equally, the Tribunal has had no difficulty in concluding that the restrictions, as contained in the relevant statutory provisions and in the Code of Conduct, are proportionate. The restrictions relate only to regulated activity, that being the activity in respect of which Moody's sought to be licensed. Moody's may therefore publish all forms of commentaries and reports subject only to the condition that, by reason of their contents, they do not, of themselves, amount to the provision of credit rating services. If, however, they do amount to the provision of credit rating services then, in order to ensure the integrity of the securities and futures industry, they must comply with the entirely unremarkable provisions of the Code of Conduct.

115. In light of these factors, the Tribunal is satisfied that reliance upon Article 16 of the Hong Kong Bill of Rights does not result in a different interpretation of the relevant statutory provisions.

116. The second matter raised in support of a restrictive interpretation is what the Tribunal has described as the asserted principle that a penal statute must be construed strictly. As to that principle, the following has been said in *Bennion on Statutory Interpretation*[17] -

> "The true principle has never been that a penal statute must be construed strictly (though it is often stated in such terms). The correct formulation is that a penal statute must be construed with due regard to the principle against doubtful penalisation, *along with all other relevant criteria*. Furthermore, *penal* needs to be given a meaning which includes any form of detriment. Judges today find it necessary to give greater weight to counter-principles such as the need to protect the public against vicious criminals."

117. S.194 of the Ordinance provides for 'disciplinary action' to be levied in respect of a 'regulated person' when that person is guilty of misconduct (in carrying on any regulated activity) or, in the opinion of the SFC, is not a fit and proper person to remain regulated. The nature and extent of that disciplinary action is clearly enunciated. It is not penal in character, it is protective in that its primary purpose is to protect the industry and those who participate in it, especially investors. Penal results are essentially incidental.

118. In the view of the Tribunal, it is patently in the public interest that there be such protections. Indeed, it would appear that the need for regulatory oversight is accepted almost universally[18].

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[17] 6th ed., at 483

[18] In this regard, see the statement of explanation contained in *Butterworths Hong Kong Securities Handbook*, 4th Ed., page 1279 - headed: [Sch5.18] Credit Ratings - which sets out the background to the introduction of local regulatory oversight of credit rating agencies, reference being made, for

119. While therefore, in coming to a final determination on the issue of a true interpretation of the relevant statutory principles, due regard has been given to the principle of doubtful penalisation along with all other relevant criteria, the Tribunal is satisfied that – either taken on its own or together with the other factors advanced by Mr. Huggins – it does not result in a different interpretation.

120. In summary, on the issue of jurisdiction, the Tribunal is satisfied that, in the preparation and publication of the Report, Moody's was carrying on its regulated activity of providing credit rating services. Accordingly, the SFC was acting within its powers in seeking to impose disciplinary measures in respect of the Report.

The role of the Tribunal in coming to its determinations

121. As stated at the beginning of the judgement, it is now settled law that this Tribunal is required to make a full merits review, conducting the review as if it is the original decision-maker: see *Tsien Pak Cheong David v Securities and Futures Commission*[19]. This does not mean, of course, that the Tribunal has the jurisdiction to commence a new general enquiry if it so wishes, striking out into uncharted territory. The full merits review is limited to matters relevant to the SFC's findings, essentially, that is, to matters which fall for determination in this application.

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example, to the Code of Conduct Fundamentals for Credit Rating Agencies issued by the International Organisation of Securities Commissions.

[19] [2011] 3 HKLRD 533

The standard of proof

122. The standard of proof to be applied by this Tribunal is the civil standard, that is, proof on a balance of probabilities.

123. As Mr. Yu pointed out, in recent years some confusion has been caused by *dicta* in judgments which appear to suggest that the standard of proof may vary according to the gravity of the misconduct alleged or the seriousness of its consequences. Any such confusion has now been dispelled, a clear illustration being contained in the speech of Baroness Hale in *In re B (children) (Care Proceedings: Standard of Proof)*[20] in which she said:

> "Neither the seriousness of the allegations nor the seriousness of the consequences should make any difference to the standard of proof to be applied in determining the facts. The inherent probabilities are simply something to be taken into account, where relevant, in deciding where the truth lies."

Genesis of the Report

124. So that the SFC's substantive findings of culpability and Moody's challenges to those substantive findings may be better considered in context, something further must be said of how it was that the Report came to be published.

[20] [2009] 1 AC 11, at 35 G-H.

125. As indicated earlier in this judgment, in the month or so prior to the publication of the Report, there was widespread concern about the reliability of debt securities issued by rated Chinese corporations. This concern appears to have prompted Moody's to seek to conduct a full review of its ratings and in turn to publish the Report. By way of illustration:

a) On 3 June 2011, the firm, Muddy Waters Research, published a report accusing a Mainland company listed on the Toronto Stock Exchange, Sino Forest Corporation, of accounting fraud. The value of shares in the company plummetted, forcing it eventually to file for bankruptcy protection.

b) A few days earlier, the New York Times had published an article - *The Audacity of Chinese Frauds* – focusing on malpractice within Mainland corporations.

126. The media focus, especially the Sino Forest scandal, caused concern within Moody's which had previously rated Sino Forest. In an email dated 3 June 2011, Michael West, one of Moody's top executives, commented: "we need to undertake a complete scrub[21] of our China ratings." In an email three days later, Brian Cahill, Moody's head of the Asia Pacific, appeared first to have raised the possibility of using 'red flags' that "might identify accounting fraud."

[21] The Tribunal understood the word 'scrub' to have the same meaning as a 'review'.

127. Moody's in New York had at some earlier time created a set of 'red flag metrics' to help identify risks of accounting fraud but it had never been put into operation. In the course of email communications it was suggested that "the concerns we have in China may present a good opportunity to reinvigorate our efforts around the red flag system."

128. Michael West was receptive to the use of a 'red flags' system. In an email dated 7 June 2011, he asked: "Is there anything we could publish at the end, even a warning paper?" The following day, one of those within the Moody's team commented: "Fraud is not easy to detect but we should try to develop a framework to identify those 'higher' risk credits and how to factor [them] into the rating. This could be translated into publication to demonstrate our thought leader[ship] in this area."

129. On 14 June 2011, Standard & Poor's Ratings Services, a global rating agency, withdrew its rating of a Mainland company, Nine Dragons Paper (Holdings) Ltd. Nine Dragons then announced that it would be approaching Moody's to seek a rating. This, it appears, increased the pressure on the completion of a report within a limited time period. A senior employee, Elizabeth Allen, was given the central role in ensuring a "timely outcome". In short, not unusually, there were time pressures.

130. It is apparent that those responsible for compiling the Report intended that it should be more than a mere comment piece. As the Tribunal has already noted, on 23 June 2011 Brian Cahill suggested amendments to Elizabeth Allen's preliminary outline. In doing so, he said:

> "Need to make report more actionable. Important that upfront we identify negative outliers. So we should summarise the average red flags by rating category and then highlight names that are negative outliers. Don't need to make any further commentary than that."

131. There were, however, concerns that the 'red flags' system – which was not a tried and tested system - may not work as accurately and comprehensively as hoped; indeed, that it may send out wrong signals to the market. In this regard, the Tribunal has taken note of the following:

a) The handwritten notes of a meeting held on 10 June 2011 (at which Elizabeth Allen was present) contain the following record of the opinion of one of those present: "Suggests not to publish red flags. Scrapped in past. Concern re sending out wrong signals. More of internal screener. Red flags 5-6 years ago, never went out for that reason."

b) In an email dated 17 June 2011 from Elizabeth Allen to Brian Cahill, she commented: "the key assumption is the red flags work. We got comments yesterday that it may not. We will have a better sense after some more trials today."

c) Meeting notes of 21 June 2011 record doubts expressed by Trevor Pijper, an accounting specialist: "Trevor Pijper: worth testing whether the red flag exercise achieves anything. He is dubious of this. Stock markets predicting 16 of the last 4 recessions. High number of false signals."

d) On 27 June 2011, in an email to Elizabeth Allen, Trevor Pijper said:

> "I wonder whether we might want to give some thought as how my comments on WCC (West China Cement) tie in with our proposed related research offering?
>
> Brian copied me on the outline of the research piece and it seems that we are looking to produce something that is actionable in the sense that it highlights prominently the 5 (or 10) biggest outliers. WCC, with a score of 13, appears to be the biggest outlier so far. Readers might infer that we regard it as the riskiest company.
>
> My review of WCC suggests that there are certainly reasons why its risk profile might be regarded as high (e.g. dominant key individual, high turnover in auditors, recent restatement of the financials to correct several outright errors, accounting control systems seemingly struggling to keep up with growth in the business). *There may, or may not be, valid points in relation to these observations. However, perhaps more importantly, there is (in my opinion) no obvious deficiency in the numbers – they appear to stack up pretty well for a business of this type."* [emphasis added]

132. In the same email, Trevor Pijper made the following observation as to what he saw as a potential internal contradiction in the manner of the Report's presentation:

> "I guess my concern with the research piece is that a nuanced, carefully crafted, approach works best when you are dealing with possible, rather than probable, outcomes. The outline of the SC (as I understand it) seems to be predicated on a rather more blunt approach."

133. As it was, by early July 2011 it appeared to have been recognised that the red flag framework was not as telling as originally hoped. In making suggested amendments to the draft, Brian Cahill recognised that there was 'limited' correlation between lower ratings (of the classic kind) and a greater number of red flags. This lack of 'negative correlation' was particularly true in respect of rated property developers. However, a degree of correlation had been found in respect of non-property firms and in this regard, Brian Cahill suggested adding the

following wording in support of the red flag framework: "We believe this confirms our view that screens for governance or accounting risks are useful as a tool to identify areas to follow up on but cannot be relied on to rank order credit risk."[22]

Guidance in approaching the review

134. In conducting a review as if it is the original decision-maker, the Tribunal has directed itself as follows.

135. First, when considering whether a document is unfair and/or unclear and/or misleading, the Tribunal is entitled to look at the document as a whole in order to see what it means taken together. In this regard, the Tribunal was referred to the speech of Lord Halsbury in *Aaron's Reef v Twiss*[23]. This was a case focused on allegations of fraud; the present matter is very different from that. Nevertheless the Tribunal considers the broad guidance given to be appropriate:

> "Now, if you look at the whole document, taken together, knowing what we now know, and what the jury had before them, I suppose nobody can doubt that this was a fraudulent conspiracy…

[22] The paragraph put before Brian Cahill for consideration read as follows: "**No significant correlation between lower ratings and larger numbers of red flags**. In China, property companies with lower ratings do not tend to have a greater number of red flags. This lack of negative correlation is particularly true for our 29 rated property developers. However, a degree of correlation exists for non-property firms, where, on average, investment-grade issuers of Baa and above trip 6 red flags, while high-yield Ba issuers trip 7. B issuers trip 8, and Caa issuers 12." Brian Cahill deleted the words in the heading 'No significant', replacing them with the word 'Limited'. He then (as stated above) added the following sentence to the end of the paragraph: "We believe this confirms our view that screens for governance or accounting risks are useful as a tool to identify areas to follow up on but cannot be relied on to rank order credit risk."

[23] [1896] AC 273, at 281.

> It is said there is no specific allegation of fact which is proved to be false. Again I protest, as I have said, against that being the true test. I should say, taking the whole thing together, was there false representation? I do not care by what means it is conveyed - by what trick or device or ambiguous language: all those are expedients, by which fraudulent people seem to think they can escape from the real substance of the transaction. If by a number of statements you intentionally give a false impression and induce a person to act upon it, it is not the less false, although if one takes each statement by itself there may be a difficulty in showing that any specific statement is untrue."

136. Second, when considering whether a document is unfair and/or unclear and/or misleading, the Tribunal is entitled to consider not only what is stated within the document but what may be implied or omitted. The damage may lie in the impression conveyed. In this regard, a second authority was put before the Tribunal by Mr. Yu. It was again an authority focused on criminal conduct and thus very different from the present case. However, the Tribunal considered its guidance to be appropriate. The second authority is that of *R v Kylsant*[24] in which the following observations are made:

> "In the opinion of this Court, there was ample evidence on which the jury could come to the conclusion that this prospectus was false in a material particular in that it conveyed a false impression. The falsehood in this case consisted in putting before intending investors, as material on which they could exercise their judgement as to the position of the company, figures which apparently disclosed the existing position, but in fact hid it."

137. Third, in order to illustrate the general approach, a further authority was placed before the Tribunal by Mr. Yu, it being *Fraser and Another v NRMA Holdings Ltd and Others*[25]. For purposes of the guidance given, it is sufficient to cite the following from the headnotes:

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[24] [1932] 1 KB 442, at 448

[25] (1995) 15 ACSR 590

> "While s.52 itself does not by its terms impose an independent duty of disclosure which would require a corporation or its directors to give any particular information to members … where information for that purpose is promulgated, *unless the information given constitutes a full and fair disclosure of all facts which are material to enable the members to make a properly informed decision, the combination of what is said and what is left unsaid may, depending on the full circumstances, be likely to mislead or deceive the membership.*
>
> …
>
> The need to make full and frank disclosure must be tempered by *the need to present a document which is intelligible to reasonable members of the class to whom it is directed, and is likely to assist rather than to confuse*. In complex cases it may be necessary to be selective in the information provided, confining it to what is realistically useful…"
>
> [emphasis added]

The SFC findings of culpability under General Principle 1 of the Code of Conduct

138. As cited earlier in this judgment, General Principle 1 of the Code of Conduct requires that –

> "In conducting its business activities, a licensed or registered person should act honestly, fairly, and in the best interests of its clients and the integrity of the market."

139. General Principle 1 places on licensed or registered persons an obligation to act 'honestly'. During the course of the hearing, Mr. Huggins, on behalf of Moody's, expressed grave concern that the SFC had, if not directly then certainly by implication, come to the finding that Moody's had failed to act honestly. It is understandable that an implication of dishonesty on its part was refuted by Moody's in the strongest terms.

140. There is, of course, a great difference in culpability, both in nature and degree, between a culpable failure arising out of what Mr.

Huggins (in his written submissions) described as a "lack of explanations, lack of clarity, inherent inconsistencies, errors and omissions" and any intention to mislead.

141. The question of any implied dishonesty can be dealt with shortly. The Tribunal accepts that it is a fundamental principle of fairness that a charge of dishonesty should be unambiguously formulated and adequately particularised. There was no such charge set out in the SFC's Notice of Proposed Disciplinary Action or its Decision Notice. The reason, said Mr. Yu, on behalf of the SFC, was because no allegation of dishonest conduct was ever intended.

142. Certainly, in conducting its full merits review, the Tribunal found no evidence of dishonesty on the part of Moody's. Accordingly, no findings contained in this judgment are coloured, obliquely or otherwise, by any determination of any form of dishonest conduct by Moody's, that is, of any intention to mislead.

143. The Tribunal has instead proceeded on the basis that the SFC's findings are limited, first, to findings that Moody's failed to act 'fairly', that is, in an equitable, unbiased manner, and, second, that Moody's failed to act in 'the best interests' of 'its clients', that is, in the best interest of rated issuers as well as subscribers to its publication, and failed to meet its obligations to ensure 'the integrity of the market', that is, to ensure by a rigorous application of professionalism and prudence that nothing was done in the publication of the Report to undermine the transparent, open and efficient operation of the market.

144. The Tribunal accepts that often, perhaps even invariably, when a team of professionals in the finance industry wish to publish a report that is complex in the amount of data set out and nuanced in the matters placed before readers there will be differences of opinion as to how best to construct the report. The fact that more weight is given to one opinion than another or that, in the final analysis, no weight is given at all to certain opinions does not imply dishonesty, that is, an intention to mislead. It implies no more than that, in the construction of any sophisticated report, choices have to be made. Whether such choices (or lack of them) result in any other breach of the code of conduct is, of course, a different matter.

145. In respect of General Principle 1, the SFC found Moody's to be culpable in three distinct respects; namely, that Moody's –

a) had made inconsistent and misleading statements in the press release and the Report regarding the nature and purpose of the Report and had created confusion in the market;

b) had failed to provide sufficient explanations and information for the 'red flags' and to set out relevant justifications in the Report and had, as a result, painted an unfair, unclear and misleading picture; and

c) had chosen to list in the Report the 'red flags' for each company and to highlight six companies with the largest number of red flags as 'negative outliers', despite the fact that, by its own analysts' assessment, there was no

significant correlation between the number of red flags and credit risk.

a) Inconsistent and misleading statements regarding the nature and purpose of the Report

146. In its Notice of Proposed Disciplinary Action, it appears that the basic concern of the SFC was that readers of the Report would have been left in a state of confusion – and thereby misled - as to the true nature and purpose of the red flag framework, that framework, as the Tribunal has already noted, being the central focus of the Report and essentially its rationale. Was the red flag framework to be read as presenting some supplemental means of assessing relative risk, the greater the number of red flags, the greater the need for scrutiny? Or was the red flag framework to be taken as merely some mirror that cast greater clarity on Moody's existing rating methodologies, illustrating them, yes, but intending to add nothing new?

147. In the opinion of the Tribunal, the differences are important, indeed, they are fundamental. If readers were to understand the red flag framework to be supplemental, it would follow that they were effectively being provided with analysis in some respects at least additional to Moody's existing ratings. That would provide additional information upon which, if readers wish, they could act. If, however, readers were to understand the framework to be no more than illustrative of Moody's existing rating methodologies, it would not be intended to add anything to the existing ratings.

148. In this regard, in paragraph 38(b) of its Notice of Proposed Disciplinary Action, the SFC said:

> "The Report and the Press Release created confusion. A reader of Moody's publications would normally try to ascertain how the credit rating of an issuer is impacted. This is not straightforward for the readers of the Report and Press Release as the relationship between the red flag framework and Moody's credit rating was unclear. The Press Release stated that the framework is supplemental to Moody's methodological approach to rating non-financial corporates in the emerging market, while the Report stated that the red flags provided further clarity and detail, but did not represent a change in Moody's rating methodologies or analytical approach. To add to the confusion, the Report stated that there was only limited correlation between lower ratings and large numbers of red flags."

149. In a letter dated 8 August 2011 written to the SFC by Moody's solicitors, it was asserted that the Report clearly explained its own limited parameters, in no way suggesting that existing credit ratings of the companies under review would, or should, be changed. The letter went on to say that the Report neither passed judgment on the companies reviewed nor was it to be taken as constituting investment advice.

150. It does not appear to be the case, however, that such was the unequivocal understanding of those who prepared the Report. First, there was concern expressed that the red flag framework could not be trusted: in the sense that the framework 'worked'. There also appears to have been some concern as to how the Report would be understood by readers generally. In this regard, the Tribunal has earlier spoken of the handwritten note of the meeting held on 10 June 2011 in which one of those at the meeting (not identified) suggested that the red flag framework should not be published, as it had been scrapped in the past and there was a concern that it may send out "wrong signals". Also, as earlier indicated, Trevor Pijper, one of Moody's accounting experts, expressed concern that the rated issuers identified in the Report as negative outliers would be

understood by readers to constitute the companies presenting the greatest credit risk when this did not necessarily follow: certainly not, in his view, in respect of West China Cement, the furthest negative outlier. It may fairly be said that he, too, therefore, at the time of his email, was concerned that the Report may send out "wrong signals".

151. Taking the Report as a whole, the Tribunal has been drawn to the conclusion that there was a failure in clear and unambiguous terms to set out the true nature and purpose of the red flag framework. Looking to the history of the matter, it may perhaps be that, having determined to make the red flag framework the focus of the Report, and having then found that it did not live up to expectations, instead of abandoning the framework or altering its inherent architecture, those responsible for the publication attempted to overcome their difficulties with nuanced qualifications. Regrettably, the result, in the opinion of the Tribunal, was that a fundamental contradiction was built into the Report. Whatever the qualifications, the evidence indicates that the market understood the red flag framework as providing some form of ranking system of credit risk and acted accordingly. Certainly, the impact on the companies classified as negative outliers – as shown earlier in this judgment - was unambiguous.

152. The Tribunal would add that, for it to be said on behalf of Moody's that the Report did not pass judgment on the companies that were reviewed, ignores the very clear consequence of classifying a number of those companies as negative outliers. The phrase itself - negative outliers - is judgmental while the fact that they triggered the highest number of red flags can only be taken as indicating that, in the opinion of Moody's, they deserved to be viewed with the greatest concern.

To that extent, whatever the intended meaning of the word 'actionable' employed by Brian Cahill, the red flag framework presented itself as an 'actionable' methodology.

153. That being said, the Tribunal has had to take note of the fact that, in its Decision Notice of 3 November 2014, when the SFC stated its final decisions, while it remained of the view that the statements in the Report (as read with the press release) were misleading and created confusion in the market, it appears to have limited the parameters of its decision to a single aspect, namely, that the statements created an impression that the red flag methodology was not new but had been employed by Moody's in the past in rating Mainland companies and would continue to be employed in the future. This, said the SFC, was misleading as, on the evidence, it was clear that the red flag methodology was essentially an untested refinement of an earlier discarded methodology. In this regard, paragraph 25 of the Decision Notice said that the statements in the Report and press release –

> "… created an 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. This was misleading. As stated in an email from Brian Cahill, Managing Director of Moody's, on 6 July 2011, the red flag framework was 'a new screen and that is not something [Moody's] have adopted in the past or necessarily in future'."

154. This Tribunal, of course, is required to make a full merits review, acting as if it is the original decision-maker, but, as Mr. Huggins, for Moody's emphasised, it does not follow that it has the power to broaden the matters into which it is obliged to enquire. That being the case, whatever the more generalised findings just made, the scope of its review is limited to the following question: 'did the Report and/or the

press release give the misleading impression that the red flag framework was an established methodology that had been used before and may be used in the future?'

155. The issue of possible future use cannot be disputed. In the Report (page 2), Moody's said:

> "Although we summarise our findings for China, we plan to follow up soon with a report for other HY issuers in the Asian region."

156. The issue therefore is whether the Report gave the misleading impression that the red flag framework was an established methodology.

157. On the evidence, the Tribunal is satisfied that the red flag framework constituted the resuscitation of an earlier, untested and unpublished framework, one that was refined specifically for the purposes of the Report. As such, as Brian Cahill himself acknowledged, it constituted a 'new screen', one that had not been used in the past. That being the case, if the Report and/or the press release, taken as a whole, gave the impression that the red flag framework, far from being new and untested, was itself an established methodology, one that had been employed in the past and may be employed in the future, that would have given a materially misleading impression to readers.

158. On behalf of Moody's, Mr. Huggins submitted that the Report introduced a new concept of red flags as a tool for identifying 'warning signs' which might warrant further investigation. While the concept was itself new, it was emphasised that it did not represent a change in Moody's methodologies. The intention was simply to provide

readers with a helpful, general framework that would give an insight into Moody's analysis of corporate governance and accounting risks. It was therefore never intended to be suggested, nor on a general reading was it suggested, that the concept of red flags was itself an established methodology that had been used in the past and would no doubt be used again.

159. In support of its assertion that a misleading and unfair impression had been given to readers, the SFC in its Decision Notice cited four statements that it said were illustrative, those statements being –

a) "To address investors' concerns and provide transparency on our approach to ratings, this report identifies warning signs – so-called 'red flags' – for our rated, high-yield, non-financial Chinese companies." (page 2 of the Report)

b) "The identified issues that we flag do not represent a change to our analytical approach." (page 2 of the Report)

c) "The red flags provide further clarity and detail, but do not represent a change in our rating methodologies." (page 1 of the Report)

d) "The framework is supplemental to Moody's methodological approach to rating non-financial corporates in the emerging markets, and is aimed at highlighting discreet risks that may warrant further investigation." (the press release).

160. In supporting the SFC's finding, Mr. Yu made mention of a further statement that referred to red flags as 'screens', the statement being to the following effect:

> "In rapidly developing emerging markets, the use of frameworks to assess elements of credit risk provides consistency in identifying relative strengths and weaknesses across a growing pool of rated issuers." (page 1 of the Report)

161. On behalf of the SFC, the point was made that nothing was said in the Report to make it plain to readers that the red flag framework was novel, that it was a new and essentially untested approach. If that had been made plain readers would have been able to interpret and/or act upon the framework in *that* knowledge. It is true that the framework, when considered in isolation, had not itself been employed before but the single impression conveyed was that the red flag framework, when viewed in broader context, was nothing new in that it did not represent a change to Moody's analytical approach. Yes, it was supplementary to Moody's existing methodologies, highlighting potential credit risks that 'may warrant further investigation' but was still so fundamentally rooted in those methodologies as to be taken to be part of them.

162. In the judgment of the Tribunal, educated readers – they being the great majority of subscribers to Moody's publications and therefore the ordinary readers - would have treated the red flag framework as a 'screen' to enable them to be given extra insight into Moody's established systems. For example, in respect of the table (partially cited) in paragraph 105, two companies are given the same credit rating of 'Ba1/Stable' but trip a different number of red flags: the Parkson Retail Group tripping three and Citic Pacific seven. If the red flag framework is used to fine tune Moody's credit ratings (of the classic

kind), it indicates - in *this* example – that Citic Pacific may have had the higher potential credit risk even though both companies had identical credit ratings.

163. On this basis, the Tribunal is satisfied that the red flag framework would have been seen as an extension to Moody's existing methodologies – a means for 'fine tuning' – its ratings (of the classic kind). But does it follow that the framework would therefore have been seen – of itself – as constituting an established methodology or perhaps a new methodology fashioned as an extension to its existing methodologies?

164. The effectiveness (or otherwise) of the red flag framework – in so far as it supplemented or extended Moody's ratings (of the classic kind) – did not depend on whether it was an established methodology, the extension of an established methodology or indeed an entirely new methodology. In the view of the Tribunal, it would have benefitted readers to know that it was an entirely new form of architecture. The fact that such information was not given appears to have arisen out of the ambiguous approach that arose when it was realised that the red flag framework did not work as effectively as had originally been anticipated. But, when looking to the balance of probabilities, the Tribunal has been unable to find that the failure by Moody's to fully explain the genesis of the framework led to an assumption by readers that the framework was itself an established methodology as opposed to a new methodology that merely extended or supplemented its existing ratings.

165. In summary, although the issue was not an easy one to determine, the Tribunal has been drawn to the conclusion that the Report (read with its press release) did not give the misleading impression that

the red flag framework was an established methodology that had been used before.

b) Failure to provide justifications for the red flags, making it impossible for readers to accurately assess the significance of the red flags in context

166. Although - for investors and potential investors - red flags acted as warning signs, with the exception of limited number of negative outliers, the Report did not provide any explanation of how it was that red flags came to be assigned to specific companies nor whether particular red flags, in respect of any particular company, should be given greater or lesser weight. This is despite the fact that summary sheets prepared by Moody's own analysts (for internal purposes only) often provided this type of discerning commentary.

167. Moody's did not dispute the factual basis upon which the SFC came to this finding of culpability. Its response was predicated rather on the assertion that the SFC had misunderstood the essential nature of the Report. It was not intended to be exhaustive in the manner suggested by the SFC. Its nature was altogether more limited, the flags being used as no more than "an interesting screen to identify potential areas of concern for follow-up and closer scrutiny". The Report made clear that there was no need to carefully analyse each red flag, explaining each in its comparative context. This was because Moody's ratings already factored in the "inherent challenges of analysing young, fast-growing Chinese companies with few peers, concentrated family ownership and sometimes poor transparency". That being the case, the red flags did no more than provide further clarity and detail without representing a change in Moody's rating methodologies. It was further

submitted that the detailed consideration of the negative outliers contained in the Report clearly illustrated that the red flags, while constituting warning signs, were far from absolute.

168. The SFC has asserted that, by excluding explanations for the allocation of red flags (other than in respect of the six negative outliers), the Report made it impossible for readers to assess the significance of those flags in context. This, it was said, created a more dramatic impression than was justified which was not in the best interests of Moody's own clients nor fair to the companies themselves that were adversely affected by "the overly negative implication" of the allocation of red flags.

169. The SFC supported this criticism with a number of examples. A short sample illustrates the basis upon which the SFC found Moody's to be culpable.

170. A number of companies were red-flagged for having extraordinary high profit margins (i.e. an EBITDA margin over 40%[26]) relative to their peers. By way of example, Global Diary Holdings Limited had a higher EBITDA margin than its competitors but there appears to have been sound reason for this, the reason (as set out in the relevant summary sheet) being that –

> "Global Dairy saves margins with lean layers of distributors, versus multi-layers of competitors. This is due to different product offering. Competitors require fast outreach to retail outlets with perishable products (e.g. yoghurt)

[26] An EBITDA margin is a measurement of a company's operating profitability. It is equal to 'earnings before interest, tax, depreciation and amortisation' divided by total revenue. Commentators say that, because this measure excludes depreciation and amortisation, it can provide investors with a cleaner view of a company's core profitability.

> while Global Dairy only carries formula milk powder. It also saves on lower advertising cost."

171. The Parkson Retail Group Limited was also assigned a red flag under this category even though the summary sheet prepared by Moody's analysts noted that the EBITDA margin was actually "at a similar level compared to other Chinese retailers". In respect of the Parkson Retail Group, Macquarie Equities Research commented in its article, *Overly Moody*, that –

> "…the EBITDA margin being over 40% is more a function of the fact that it is a department store business (i.e. high margin). Other peers have more than 40% EBITDA margin – so Parkson is actually on the low end to normal end. We don't see anything as being odd here."

172. In explaining its approach to this particular category of red flag, the Report said:

> "Since a company's business model and competitive positioning may justify such high margins, we then assess the margins' veracity and sustainability by looking at rated or unrated peers."

173. However, as the SFC noted, any such assessment, if it was made, was not disclosed in the Report. Readers, therefore, remained essentially uninformed.

174. A further red flag category in the Report bore the description: 'Low tax paid relative to accounting profit'. A total of 18 companies were red-flagged under this category. However, as the SFC expressed it in its Notice of Proposed Disciplinary Action, it appeared from Moody's own summary sheets and publicly available information that at least three of the companies given red flags were able to justify why they had paid

relatively low tax, the reasons being unremarkable: for example, the granting of tax exemptions or preferential tax rates. In this regard, Moody's own summary sheet prepared in respect of Chaoda Modern Agriculture (Holdings) Limited contained the remark: "Agricultural goods business is exempted from income tax in PRC."

175. A total of 41 out of 49 rated companies were red-flagged under the category of "aggressive growth", this description applying when in the past three years a company had doubled its revenue or asset base. But, as Mr. Yu, for the SFC, submitted, growth of this nature was only to be expected when many of the issuers were "relatively small and in a growth phase". Mr. Yu said that Moody's had conceded as much when discussing certain of the negative outliers. More importantly, he said, Moody's was well aware of how misleading this red flag could be. In a handwritten note prepared by a senior member of Moody's, Paul Ulrich, in respect of an internal discussion related to the initial draft of the Report, the following was recorded:

> "Don't want to penalise high growth company. Suggests not to publish red flags - scrapped in past, concern re-sending out the wrong signals. More of internal screener."

176. As Mr. Yu commented: "regrettably, Moody's decided to keep this as one of the red flags. Worse, it did not discuss its limitations and the known justifications."

177. Clearly, the fact that Moody's did not provide commentary on all of the red flags, made it impossible for readers to assess the significance of those red flags in context. Moody's has argued that the Report was not intended to provide detailed commentary on each and

every flag allocated; the framework was altogether more limited, the flags constituting nothing more than an interesting screen to identify potential areas of concern. That may be so, but the Tribunal has found that the red flag framework, as published, presented itself as something more substantive than an 'interesting screen'. It presented itself essentially as an extended method by which the market could assess risk and act on that risk. The red flags were warning signs. The greater the number of red flags, the more salutary the warning. As such, to the many individuals making up the market, and especially to the companies themselves that were burdened with red flags, each and every flag would have been significant: an indicator (in blunt terms) of whether to invest or divest. The flags, however, all carried the same weight. This was the case even though, on the information available to the analysts at Moody's, it was evident that certain red flags should be given less weight than others. More than that, Moody's appreciated that the red flag framework did not work as well as originally anticipated. The risk of sending out the wrong signals was therefore increased. In the circumstances, the Tribunal has had little difficulty in concluding that, in its failure to provide commentary on all of the red flags, Moody's not only made it impossible for readers to accurately assess the significance of the flags in context but, by that fact, created an unfair, unclear and misleading picture of the creditworthiness of a material number of the companies allocated red flags. As such, its failure constituted a breach of General Principle 1 of the Code of Conduct, a breach that had material consequences.

178. The Tribunal recognises that Moody's did not wish to overburden the red flag framework with details. What was being sought was a special comment that would have an immediate impact, in major part by being readily 'accessible' to market participants and observers. It

would, however, have been easy enough for the individual allocation of red flags to be explained in a separate table or an annexure: a point of reference.

c) Labelling the six companies with the highest tally of red flags as 'negative outliers' when Moody's own analysts concluded that there was no significant correlation between the number of red flags and the level of credit risk

179. It was Brian Cahill, who emphasised that it was important, in making the Report "more actionable", to identify those companies which had attracted the highest number of red flags and to identify them as 'negative outliers'. He did not see the need to make any "further commentary than that".

180. As the Tribunal has noted elsewhere in this judgment, the term 'negative outliers', read in the context of the Report, could only be understood as meaning that such outliers not only required the greatest scrutiny in respect of their standards of governance and accounting but, as credit risks, constituted the greatest potential area of concern. Indeed, although (of course) not seen by the public, the first draft of the Report stated that Moody's methodology had flagged certain companies as "the riskiest in the portfolio", this being an indication of the nature of the original concept.

181. However, as also mentioned elsewhere in this judgment, it is apparent that the anticipated strong correlation between higher numbers of red flags and lower ratings did not prove to be entirely accurate. In respect of one of the negative outliers, West China Cement, Trevor Pijper commented in an email dated 27 June 2011 that readers might infer that,

because it had been allocated the biggest number of red flags, it presented the greatest credit risk. But this, he said, was not necessarily the case. He could see no obvious deficiency in the important accounting numbers. As he put it: "they appear to stack up pretty well for a business of this type".

182. In an attempt to meet this difficulty, qualifications were placed in the Report. On behalf of Moody's, it was submitted that these qualifications did away with any potential grounds for inadvertently misleading the market. In this regard, reference was made to the following paragraph in the Report:

> "An issuer's tripping of many red flags does not represent any immediate rating concern because our ratings already reflect many of the issues highlighted by the relevant red flags, and the ratings also incorporate more than just the potential concerns that the flags capture. Moreover, as indicated, there is only limited correlation between lower ratings and a higher number of red flags tripped."

183. In addition, significantly, the negative outliers were the only companies made the subject of short reports so that readers could no more of them in respect both of their weaknesses and strengths.

184. The difficulty, of course, is that, with it being understood that there was in fact only a limited correlation between lower ratings and higher numbers of red flags tripped, as the Tribunal has noted elsewhere in this judgment, the red flag framework was not abandoned nor overhauled. It remained a central focus of the Report and the description of the companies that had attracted the highest number of red flags as negative outliers remained too. In this regard, in its Decision Notice the SFC came to the determination that –

> "Moody's highlighted the six companies prominently in the Report because they have the largest number of red flags, labelling these companies with the pejorative term 'negative outliers'. Moody's stated in the Report that these companies should 'attract greater scrutiny'. Moody's created an alert to readers of the Report and to the market that these outliers were potentially riskier listed companies in terms of the quality of their corporate governance and financial reporting."

185. The SFC was of the view that the qualifications contained in the Report were not of sufficient weight to address the "seriously negative connotations" in labelling the companies as negative outliers. As the Tribunal has itself commented earlier in this judgment[27]: "whatever the qualifications [contained in the Report], the evidence indicates that the market understood the red flag framework as providing some form of ranking system of credit risk and acted accordingly. Certainly, the impact on the companies classified as negative outliers - as shown earlier in this judgement- was unambiguous."

186. In the judgment of the Tribunal, the companies designated as negative outliers would have been viewed by the average reader as falling into an exceptional class, a class to be considered with the utmost caution. The description 'negative outliers' carries with it an emotive content which is immediately effective. No doubt, from a publishing point of view, impact was what was intended – to get the readers' attention, and not, as was said in ancient times; 'there be lepers'. The result, however, especially as the description was used as a form of headline, was more damning than perhaps was intended and, in the view of the Tribunal, would have acted to push nuanced qualifications to one side. Clearly, the market reacted, doing so materially to the detriment of the companies classified in this special class. In the circumstances, as there was no significant correlation between the number of red flags and the level of

[27] See paragraph 151.

credit risk, retaining the description was misleading and unfair and amounted to a breach of the Code of Conduct.

The SFC findings of culpability under General Principle 2 of the Code of Conduct

187. As cited earlier in this judgment, General Principal 2 of the Code of Conduct requires that:

> "In conducting its business activities, 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."

188. In its Notice of Proposed Disciplinary Action, the SFC spoke of 13 "glaring errors" that had appeared in the Report. Moody's itself had detected 12 errors which it had reported to the SFC, each of them related either to wrongly assigning a red flag or failing to do so. In its Notice, the SFC set out a table containing details of the 12 errors as follows –

	Company	Red flag wrongly assigned/(omitted)	Reason
1.	Agile Property Holdings Limited	Quality of cash flow	Mathematical error.
2.	China Fishery Group Limited	Large negative FCF	Input error.
3.	China Fishery Group Limited	Concentrated family ownership	Input error.
4.	China Glass Holdings Ltd	Shareholder concentration	Input error.
5.	China South City Holdings Limited	Change of senior management	Newly created management role was mistaken as a change.
6.	Fosun International Ltd	Complicated group structure	Input error.

	Company	Red flag wrongly assigned/(omitted)	Reason
7.	Greentown China Holdings Ltd	Quality of cash flow	Mathematical error.
8.	Kaisa Group Holdings Ltd	Change in auditors	Input error.
9.	Road King Infrastructure Limited	Concentration of family ownership	Input error.
10.	SPG Land (Holdings) Limited	Change of senior management	Newly created management role was mistaken as a change.
11.	Shanghai Industrial Urban Development Group Limited	EBITDA margin exceeding 40%	Mathematical error.
12.	Yuzhou Properties Company Limited	EBITDA margin exceeding 40% (Omitted)	Mathematical error.

189. It was the SFC that identified the final error; namely, an incorrect statement on page 5 of the Report relating to one of the negative outliners, Winsway Coking Coal. The statement said "The ratings also reflect a red flag for related-party transactions…" when elsewhere in the Report (Appendix 4) 'related-party transactions' were not marked as a red flag for the company.

190. Moody's did not dispute the fact of the errors. It did, however, dispute their impact on the overall accuracy of the Report. In this regard, in a letter to the SFC dated 8 April 2013, Linklaters, Moody's solicitors, explained that –

i. there were 980 flags, the errors therefore, comprising "approximately 1 per cent of the total";

ii. the flags were of equal weighting; and

iii. the errors did not involve negative outlier companies.

191. In its Decision Notice, the SFC summarised Moody's submissions in the following terms:

> " … Moody's believes that these errors are *de minimis* in nature and do not render the Report misleading or inaccurate as Moody's considers that the red flag is simply a screening indicator of a possible risk worthy of further investigation and is not itself conclusive."

192. The SFC did not accept these submissions. In its Decision Notice, it determined as follows:

> "We do not agree they can be viewed as *de minimis* or inconsequential errors. The errors led to Moody's assigning red flags to companies where no red flag ought to have been raised. The consequence was to enlarge the appearance of risk for those companies affected by the errors. This is not a *de minimis* or inconsequential result for those companies nor for those who had invested in them.
>
> In our view, the number of errors in the Report also demonstrates that Moody's failed to act with due skill and care in ensuring the accuracy of the red flags assigned to the companies under the framework, which was purportedly supplemental to Moody's credit rating methodology."

193. In advocating the SFC's determination that the errors constituted substantive and substantial breaches of General Principle 2, Mr. Yu made the point that Moody's had assigned red flags as warning signs[28], and that, in the circumstances, erroneous red flags created a wrong and potentially harmful impression in the eyes of the market. The fact that red flags did not constitute ratings (of the classic kind) was not to the point. They were still intended to impact on the market and they did so. The errors, suggested Mr. Yu, were essentially careless mistakes and should have been spotted if due skill and diligence had been applied. The errors therefore revealed a breach of General Principle 2.

[28] Mr. Yu described them as "adverse labels".

194. The Tribunal is persuaded by Mr. Yu's submissions. There will always be minor errors in a report as substantial as the one under consideration, especially when there are time pressures. In the present case, however, the errors were errors of consequence. Moody's, holding a special place in the market, must have appreciated that its publication would be followed carefully, indeed, anxiously, and that the allocation of red flags could, and no doubt would, have a materially negative effect on the companies so burdened. There was, in this case, therefore, an increased need for accuracy. The failure to ensure such accuracy not only reduced the standing of the Report itself, but undermined the interests of Moody's own clients and the market.

The SFC findings of culpability under paragraph 4.3 of the Code of Conduct

195. As cited earlier in this judgment, paragraph 4.3 of the Code of Conduct required that :

> "A licensed or registered person should have internal control procedures and financial and operational capabilities which can be reasonably expected to protect its operation, its clients and other licensed or registered persons from financial loss arising from theft, fraud, and other dishonest acts, professional misconduct or omissions."

196. During the course of the hearing, it was not suggested that Moody's had acted in contravention of paragraph 4.3 by failing to have in place internal control procedures related to its core business, namely, the provision of rating services. It was instead the determination of the SFC that Moody's had acted in contravention of the Code of Conduct by failing to have in place adequate control procedures concerning the preparation and publication of the Report.

197. It was accepted by Moody's that at the relevant time specific procedures were not in place governing the preparation and publication of special comment reports. In this regard, Moody's solicitors, Linklaters, informed the SFC in terms of a letter dated 30 August 2012 that –

> "At the time when the Report was prepared, Moody's did not have specific procedures in relation to the preparation and publication of special comment reports. Nevertheless, Moody's did have a general outline of the approval process for special comment reports, as well as general guidelines that emphasised standards of quality, consistency and transparency which were applicable to special comment reports."[29]

198. Concerning the documents referred to in Linklaters' letter, the Tribunal is satisfied that, as useful as they may have been, they cannot accurately be described as constituting internal control procedures reasonably expected to protect Moody's from assertions of professional misconduct in publishing special comment reports[30].

199. While Moody's accepted that less stringent guidelines were in place to govern the preparation and publication of special comment reports, it was argued that there was "nevertheless a clear understanding amongst the relevant contributors to the report on the internal drafting and approval procedures that were to be followed". Again, in the view of the Tribunal, an understanding by co-professionals as to drafting and

[29] Linklaters went on to say that since September 2011 Moody's had sought to enhance these general standards with more prescriptive policies and procedures governing research publications, including special comment reports. These had been finalised and implemented in or about May 2012.

[30] The one document, an outline of the approval process for special comment reports, consisted of a single page flow chart containing some seven steps. The first step was the bringing together of the analyst and a financial writer, the final step consisted of the financial writer editing the final draft and placing it before the analyst and the MD for approval. The other document contained general guidelines as to writing style and the principles of research, an example of the latter being the direction that a researcher should present himself or herself as a credit analyst and not as a ratings minder.

approval procedures, while they may help to fashion 'operational capabilities' do not amount to the provision of formalised 'internal control procedures' sufficient to meet the requirements of paragraph 4.3 of the Code.

200. During the course of the hearing, the more fundamental submission made on behalf of Moody's, however, was that, as the publication of the Report was not part of its regulated activities, it was not in any way subject to the Code. That submission has been rejected by the Tribunal. The finding of the Tribunal has been that, even if unintended, in its preparation and publication of the Report, Moody's was carrying on its regulated activities.

201. In anticipation of such a finding, Mr. Huggins, for Moody's, submitted that, if the Tribunal came to such a finding, there would thereby be no failure on the part of Moody's to put in place the necessary control procedures; such procedures were already in place. The fault, if it was such, would have been in the failure of the editorial staff to recognise that the transformation of the Report brought it within the ambit of its existing internal control procedures. As Mr. Huggins commented: "If you were to accept… this is providing credit ratings then the one thing that would have to come out of this review is the striking down of the findings in relation to [paragraph] 4.3 and the fine under 4.3."

202. The SFC, however, based its case on a different premise. While it accepted that Moody's "might have had some business process in place" in respect of the preparation and publication of the Report, it was of the view that –

> "Moody's had insufficient internal controls and procedures in place to consider and ensure that its business activities, which were related to and [are] part and parcel of the regulated activities for which it is licensed, were in compliance with applicable rules and regulations And not prejudicial to the interests of its clients and [the] interest of the investing public…"

203. In the judgment of the Tribunal, there was clearly a failure on the part of Moody's to recognise that, in its publication of the red flag framework report, it was very much in issue whether it was publishing a form of credit rating or some form of guide to credit risk so closely allied to a rating that it may itself be considered – in accordance with the wording of the Ordinance - to constitute a credit rating. It may be that the Moody's team, which appears to have begun work on the Report before the licensing regime came into force, simply did not turn its attention to the matter. Nevertheless, while that is a mitigating factor, it cannot divert from the fact that it was a failure by the Moody's team of very damaging consequence.

204. That said, the issue to be determined is not whether there was a failure on the part of Moody's to recognise that the red flag framework constituted a form of rating according to the statutory definition, the issue to be determined is whether, pursuant to paragraph 4.3, Moody's had in place relevant internal control procedures to ensure all forms of ratings were subject to formal protection.

205. That issue is primarily an issue of law.

206. As stated earlier in this judgment, codes of conduct may only be used by the SFC to discipline licensed corporations to the extent that such codes govern the carrying on of the regulated activities in respect of which such corporations are licensed. While codes of conduct are not to

be interpreted as statutes, they are not capable of extending the SFC's jurisdiction to non-regulated activities, even when such non-regulated activities are closely collateral to regulated activities. Licensed corporations are entitled to certainty as to the extent of their obligations. That being the case, the division between regulated and non-regulated activities is not some broad swathe of uncertainty, the full breadth of which must be subjected to internal control procedures to ensure safety. A prudent licensed corporation may decide to follow that course but the law imposes no such obligation. What separates regulated activities from non-regulated activities is, therefore, a bright line. Put another way, either an activity is regulated (and subject to paragraph 4.3) or it is not.

207. That being the case, at all material times Moody's was only required to have in place internal control procedures governing the activity for which it was licensed, that is, preparing credit ratings. Any other activity, such as providing commentaries on the nature of its work or how it perceives the health of any particular segment of the market, may be 'related' to its core activity, indeed closely related, but is not part of it and is not therefore a regulated activity.

208. The SFC has contended that 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. That contention, despite the conjunctive 'and' appears to be a binary one. In the judgment of the Tribunal, read in the present context, business activities merely 'related to' Moody's core activity would not be part of it and would therefore constitute unregulated activity. By contrast, business activities which were 'part and parcel' of

its core activity would themselves constitute the preparation of credit ratings and would require no separate internal control procedures.

209. It has been accepted that at all material times Moody's had in place sufficient internal control procedures to regulate its core activity of providing ratings. The true complaint, therefore, must be, not that it had no such procedures in place, but that it failed to recognise that ratings other than those of the classic kind, for example, all forms of ratings that fell under the definition contained in the Ordinance, were subject to those existing procedures.

210. In light of this finding of law, the Tribunal must strike down the SFC's findings of culpability under paragraph 4.3.

211. That is not to say, however, that, if the SFC considers it proper, a public reprimand may not contain reference to the fundamental failure of the Moody's team to recognise that the red flag framework fashioned by it constituted quite clearly a form of rating in terms of the Ordinance, that failure being one of damaging consequence.

The issue of penalties

212. Moody's presented two fundamental challenges to the decision by the SFC to impose a total pecuniary penalty of HK$23 million. The first challenge was based on the assertion that the SFC acted outside its powers – that is, it acted *ultra vires* - in imposing a penalty of HK$23 million. The second challenge was based on the assertion that the SFC chose arbitrarily to break down Moody's misconduct into three

distinct instances of misconduct when in reality they amounted to no more than three separate particulars of a single act of misconduct.

213. S.194(2) of the Ordinance provides that, subject to certain procedural provisions, where a 'regulated person'[31] - such as Moody's - is found to be guilty of 'misconduct' or where the SFC is of the opinion that a regulated person is not a fit and proper person to remain regulated, the SFC may, in addition to its other disciplinary powers, order the regulated person to pay a pecuniary penalty not exceeding $10 million[32]. As mentioned earlier in this judgment[33], 'misconduct' is itself defined as "an act or omission relating to the carrying on of any regulated activity". It is clear, therefore, that separate pecuniary penalties not exceeding $10 million each may be imposed in respect of each separate "act" or "omission" constituting misconduct.

214. A course of misconduct may, depending on its nature and characteristics, consist of a number of separate acts and/or omissions. The finding that there had been a breach of General Principle 1 of the Code of Conduct was broad in its compass, enclosing within its parameters the presentation of a report that was intended to have an impact on the market but was fundamentally inconsistent and misleading, a report that was contradictory and confusing and, as such, undermined the best interests of Moody's own clients and the integrity of the market. The finding that there had been a breach of General Principle 2 was much

[31] The definition of a regulated person in the Ordinance (s.194(7)) includes a licensed person, Moody's being licensed to carry on Type 10 regulated activity.

[32] The section directs that the SFC may order a regulated person to pay a pecuniary penalty not exceeding whichever is the greater of $10 million or three times the amount of any profit gain or loss avoided. In the present case, no issue of profit gain or loss avoided has arisen.

[33] See paragraph 47.

narrower in its compass, namely, that there had been a failure to act with due skill, care and diligence by failing to identify and remove a number of errors, all related directly or indirectly to the assignment of red flags.

215. In the judgment of the Tribunal, the various forms of culpable conduct identified in this judgment are separate and distinct. That said, the Tribunal accepts that the breaches arose out of the same course of endeavor by Moody's and, as such, regard must be had to the totality principle. The principle requires the Tribunal to look at the total of the penalties imposed to ensure that it is not disproportionate to the gravity of Moody's conduct.

216. In determining appropriate penalties, the Tribunal remains under the obligation to make a full merits review as if it is the original decision-maker. Accordingly, the Tribunal does not proceed on the basis that it is for Moody's to satisfy it that the penalties imposed by the SFC are inappropriate. Equally, however, it does not mean that it entirely ignores the penalties determined by the SFC; the level of those penalties is one of the factors to be taken into account by the Tribunal in making its full merits review.

217. The SFC determined that Moody's should be made subject to a public reprimand[34]. For any individual or organisation which has earned a position of high regard within the securities profession, as Moody's has done, a public reprimand is a penalty of substantive effect. It puts into the public arena – perhaps internationally - a finding that Moody's has fallen short of the standards of professionalism expected of

[34] Pursuant to s.194(1)(iii).

it. In addition to the damage to reputation, it carries with it, potentially at least, damage to its business interests.

218. In the present case, the Tribunal is satisfied that a public reprimand is justified. Its publication, however, is a factor to be taken into account when considering if any further penalties should be imposed and, if so, the level of such penalties.

219. For its three breaches of General Principle 1, the SFC determined that, in addition to a public reprimand, a pecuniary penalty of $9 million should be imposed, this being $3 million in respect of each of the three breaches. The SFC said that it had taken into account two mitigatory factors: first, that the preparation and publication of the Report had constituted a unique set of circumstances which were unlikely to be repeated and, second, that an extended period of time had been taken by the SFC to come to a final determination.

220. In respect of the first mitigatory factor, the Tribunal accepts that Moody's was attempting - at a time of considerable market concern as to governance and accounting risks related to Mainland issuers of debt securities - to give further assistance to the market in a novel and accessible way. The Tribunal accepts, therefore, that the preparation and publication of the Report did constitute a unique set of circumstances, unlikely to be repeated. Moody's may have been under time constraints but that itself is not to be criticised: market commentaries must be timely. The fact that Moody's wanted the Report to make an impact, that is, to have some influence in the market, is again entirely legitimate.

221. That said, however, the Moody's team working on the preparation of the Report came to understand that the red flag framework was not as accurate as originally had been anticipated and in that lay the very real potential for issuing a publication that was misleading and confusing. It appears that by the time the misgivings were being recognised the forward momentum to have the Report published was determinative. Qualifications were therefore inserted but, on any ordinary reading of the publication as a whole, those qualifications acted more to compound the confusion rather than to set it aside. In the result, a special commentary was issued to the market that was not simply below par but breached General Principle 1 in the manner set out in this judgement.

222. As one of the three largest credit rating agencies in the world, Moody's must have appreciated that, at that time of very real concern, the Report would carry considerable weight in the market and, importantly, would bear heavily on those corporations burdened with the highest number of red flags. Yet, despite internal concerns as to the accuracy of the red flag framework, Moody's persisted in the publication. The Report was, of course, a product for sale, the purpose being to take advantage of market interest. As Mr. Yu, for the SFC, put it, as a commercial organisation, one of Moody's principal objectives in the publication must have been to bolster its own reputation.

223. In all the circumstances, the Tribunal is satisfied that the pecuniary penalty of $3 million imposed by the SFC for each breach of General Principle 1 was appropriate. In light of the fact that the Tribunal has found that there were only two breaches, it has determined that a

pecuniary penalty - in addition to a public reprimand - should be imposed of $6 million.

224. For its breaches of General Principle 2, the SFC determined that a pecuniary penalty of $6 million was appropriate. While Moody's did not dispute the fact of the errors which pointed to its lack of due skill, care and diligence, it was contended that, in all the circumstances, those errors were of little or no consequence. As Linklaters, Moody's solicitors, explained: the red flag framework consisted of some 980 red flags and the errors comprised approximately 1% of that total; the flags in any event were of equal weighting and, importantly, none of the errors involved companies which, because they were labelled negative outliers, were likely to be most carefully scrutinised by the market.

225. The Tribunal accepts that these factors go to the level of culpability but it rejects any contention that the errors were *de minimis* and of no consequence. It accepts that, the red flags acting as warning signs, their erroneous application (or lack of application) would have created a harmful impression. The errors did more than reduce the professionalism of the publication; as evidence of a lack of due care and diligence on the part of Moody's, they compounded the misleading nature of the Report.

226. In the circumstances, the tribunal is satisfied that a pecuniary penalty of $5 million for the breaches of General Principle 2 is appropriate.

227. Finally, stepping back and looking at the totality of the penalties in the context of the damage to the market, the Tribunal is

satisfied that $11 million, coupled with a public reprimand, is an appropriate penalty.

228. As to the content of the public reprimand, this must be edited in light of the Tribunal's findings. In the first instance, that is a matter for the SFC. However, recognising that, in carrying out its full merits review, the Tribunal is also ultimately responsible for the wording of the public reprimand, should there be any dispute as to its proposed contents, the Tribunal will determine such dispute on application made to it.

Summary

229. Accordingly, having found that, in the preparation and publication of the Report, Moody's was carrying on its regulated activity of providing credit rating services, and having found that there were substantive breaches of General Principles 1 and 2 of the Code of Conduct, the Tribunal has determined that Moody's should be subject to a public reprimand together with a pecuniary penalty of $11 million. In respect of the pecuniary penalty, $6 million is for the breaches of General Principle 1 and $5 million for the breaches of General Principle 2.

230. In respect of costs, in the exercise of its discretion, the Tribunal is of the view that Moody's should pay 60% of the SFC's costs, such costs to be taxed or agreed. Such costs are also to include provision for two counsel, the Tribunal being satisfied that the complexity of the matter justified briefing two counsel. There will therefore be an *order nisi* to this effect. Should either party seek to challenge this order, application must be made within 30 days of the date of this judgement.

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(The Hon Mr. Justice Hartmann, NPJ)
Chairman, Securities and Futures Appeals Tribunal

(Dr Billy Mak Sui-choi)
Member

(Ms Ding Chen)
Member

Mr. Adrian Huggins, SC, instructed by Messrs Linklaters
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