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Research reports: The pen is mightier than the sword, but no match for a Hong Kong regulator

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Writing research reports has come under the regulatory spotlight, with the Hong Kong Securities and Futures Commission (SFC), crossing swords with research analysts (the Moody's[1] case) and short-sellers (Mr. Left[2], the Citron case). In both cases, the SFC challenged the factual accuracy and conclusions of the reports, and also the methodologies used in their creation.

The consequences for both have been significant. Mr. Left[3] was ordered to disgorge his profits and subsequently banned from trading securities in Hong Kong for 5 years, and Moody's was publicly reprimanded and fined HK$11 million.

Points to note when writing reports

(i) *The report's factual background*: In specialist or unfamiliar areas (for example, the accounting standards of an overseas jurisdiction), expert advice should be sought.
(ii) *The report's conclusion*: This should be presented fairly. Attaching qualifying statements or disclaimers may not be sufficient.
(iii) *The reasoning behind the report's conclusion*: Depending on the nature of the report, adequate disclosure of the reasoning adopted may be necessary.
(iv) *The methodology*: This should be set out clearly.

Out of jurisdiction?

The SFC has many weapons in its armoury. Coupled with cross-border regulatory co-operation, the laws of Hong Kong can have effective extra-territorial reach. For example, Mr. Left of Citron is based in the U.S. and was not licensed in Hong Kong; he was, nevertheless, caught under section 277 [4] of the Securities and Futures Ordinance, or SFO, for disseminating false or misleading information inducing transactions in Hong Kong securities.

A sour experience: The Citron case

In 2012, Mr. Left published a report alleging that a Hong Kong listed company, Evergrande Real Estate Group Limited, or Evergrande, was insolvent and engaged in fraudulent accounting; for example, using "off-balance sheet" vehicles to underreport its debt (Citron Report). The Citron Report was based entirely on public information, and on a 68-page draft sent to Mr. Left on an anonymous basis.

The Evergrande board swiftly published a clarification announcement to rebut the allegations made. Nevertheless, the share price of Evergrande dropped 19.6% from the previous day's close, when (in comparison) the Hang Seng Index declined 1.3%.

The SFC brought the first ever action, under section 277 of the SFO, against Mr. Left to the Market Misconduct Tribunal, or MMT.

The offence

Section 277 makes disclosure of false or misleading information inducing transactions of Hong Kong securities an offence.

The MMT laid out the four elements of the offence:

(i) Whether in Hong Kong or not, the person must publish information or be concerned in its dissemination.
(ii) The information must be likely to induce another person to buy or sell securities in Hong Kong, or must be likely to maintain, increase, reduce or stabilise the price of securities in Hong Kong.
(iii) The information must be false or misleading as to a material fact.
(iv) The person who has disseminated the information must know, or be reckless, or negligent, as to whether the information is false or misleading as to a material fact.

[1] Moody's Investors Service Hong Kong Limited.
[2] Mr. Andrew Left of Citron Research.
[3] Mr. Left is reportedly planning to appeal.
[4] Section 277 has the wide ambit of covering *any* person who disclosed false or misleading information inducing transactions.

The MMT concluded all four elements were met; we highlight below the MMT's reasoning in respect of elements (iii) and (iv).

Element (iii): Did the Citron Report contain false material facts?

Amongst other things, the Citron Report alleged that:-
"*Evergrande uses JV equity partners to finance individual projects. The JV partnerships are structured with mandatory buyback guarantees. Therefore, Evergrande's equity JV partners are lenders in reality. The JV scheme allows Evergrande to grossly underreport its debt*" (Alleged Off-balance Sheet Debt).

The SFC's case against Mr. Left was partly built upon the falsity of the Alleged Off-balance Sheet Debt. The SFC, accordingly, bore the burden of proof. A preliminary tactic by Mr. Left, i.e. to compel Evergrande to produce documents used in its audited financial statements, was rejected by the MMT.[5]

The MMT relied on expert evidence and accepted the Alleged Off-balance Sheet Debt as a false material fact, because, amongst other things:-

(i) there were no "off balance sheet" vehicles such as "JV equity partners". In fact, the so-called off-balance sheet debts were shadow bank loans, which were:
  (a) recorded as "borrowings" in Evergrande's consolidated balance sheet, and
  (b) identified in the independent accountants' report and the relevant financial statements, as lenders financing the acquisition of Mainland land-holding corporations; and

(ii) this form of financing was recognised and permitted by the applicable accountancy standards.

The MMT said that Mr. Left failed to understand the common land acquisition financing method in Mainland China. It stated that Citron, which "*held itself out as a crusader against corporate fraud…had a responsibility to fully understand the nature of trust financing before making*" bold allegations of Evergrande being engaged in "fraudulent accounting".

Element (iv): Was Mr. Left reckless as to the falsity of the information contained in the Citron Report?

On the facts, the MMT determined that:-

(i) Mr. Left undertook a verification exercise of the draft sent to him. This showed his appreciation of the presence of a real risk that the draft's sensationalist allegations may constitute false material facts; and

(ii) the Alleged Off-balance Sheet Debt involved complex accountancy regulations and standards, in which Mr. Left had no expertise.

In such circumstances, the MMT held that it was unreasonable for Mr. Left to ignore the risk, and the fact that he, nonetheless, went on to publish the Citron Report was sufficient to establish recklessness.

What is also noteworthy about this case is that Mr. Left has no presence in Hong Kong, but that did not deter the SFC from pursuing him. However, it may be that extra-territorial challenges discouraged the SFC from prosecuting Mr. Left in the criminal courts, which it could have done as an alternative to the MMT route.

Seeing red: The Moody's case

In July 2011, Moody's published a 25-page "special comment" report headed "*Red Flags for Emerging-Market Companies: A Focus on China*" (Moody's Report). In this report, it assessed and assigned red flags, which are representations of five categories of potential credit risks (e.g. "*faster-growing business strategies*" and "*poor quality of earnings or cash flow*") to certain Mainland Chinese companies, and concluded six companies with the most red flags as "negative outliers".

The Moody's Report was qualified by the statement that:-
"*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…Moreover, as indicated, there is only limited correlation between lower ratings and a higher number of red flags tripped*" (Qualification).

[5] The MMT reasoned that as Mr. Left had solely used public information in compiling the Citron Report, his culpability should be determined solely using such information available at the time.

On close of trading the next day, four of the six "negative outliers" suffered significant drops in their share prices.

The SFC concluded that Moody's was in breach of the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (Code of Conduct), for:-

(i) misleadingly and unfairly labelling companies "negative outliers" whilst concluding there was no significant correlation between the number of red flags and credit risk levels;
(ii) not providing explanations for its red flags making it impossible for readers to accurately assess credit risk implications; and
(iii) in respect of the report's errors, failing to act with due skill and care in ensuring its accuracy.

Moody's was reprimanded and fined HK$11 million; it unsuccessfully appealed to the Securities and Futures Appeals Tribunal (SFAT). We discuss some key issues below.

Issue 1: Was it misleading and unfair to label companies "negative outliers" whilst concluding there was no significant correlation between the number of red flags and credit risk levels?

Moody's defence was that the Qualification clearly set out that the red flag framework merely identified areas to review but could not serve to rank credit risks, and thus, it was not misleading and unfair.

The SFAT disagreed. It held that the effect of the Qualification cannot be viewed in isolation but in light of the whole report.

Firstly, in its view, the red flag framework contained a very clear structure, which suggested that "*the greater the accumulation of red flags, the greater the relative weakness of a company made subject to review.*"

Secondly, the SFAT took into account Moody's intention behind publishing the report, that is, to attract readers' attention.

Accordingly, these had the impact of "*[pushing] nuanced qualifications to one side*", making it misleading and unfair to label the companies "negative outliers". Moody's was, therefore, in breach of General Principle 1 (GP1) of the Code of Conduct, which states that:-

"*[i]n 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.*"

The SFAT viewed the Moody's Report as a whole, and the impression it created in light of ordinary and reasonable reading. It rejected the argument that the presence of qualifications is a conclusive defence, which negates the misleading and unfair impression created by the report.

Issue 2: Did the absence of explanations for red flags allocations make it impossible for readers to accurately assess credit risk implications?

The SFC's case was that the general absence of such explanations (except for the "negative outliers") made it impossible for readers to assess the significance of those flags in context, and created a more dramatic impression than was justified.

Moody's submitted, amongst other things, that it was unnecessary to provide such explanations, by arguing that the nature of the red flag framework, was no more than "*an interesting screen to identify potential areas of concern for follow-up and closer scrutiny*".

The SFAT, again, rejected Moody's submission. It held that the report had the effect of presenting the framework as something more substantive than an "interesting screen". It was presented as an "*extended method by which the market could assess risk and act on that risk.*".

Therefore, by not providing commentaries on all of the red flags, Moody's "*created an unfair, unclear and misleading picture of the creditworthiness of a material number of the companies allocated red flags*", and was, accordingly, in breach of GP1.

Encouragingly, the SFAT did not ignore commercial practicalities:-

"*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…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.*"

Issue 3: With respect to the errors in the report, whether Moody's failed to act with due skill and care in ensuring the accuracy of the red flags?

Moody's case was that the errors created minimal impact on the report's overall accuracy. The SFAT acknowledged that there will always be minor errors in reports, especially when prepared under time pressure. However, the SFAT held that as the errors in question were "errors of consequence", Moody's was, accordingly, held to have failed to act with due skill and care, and was in breach of General Principle 2 of the Code of Conduct.

Interestingly, the SFAT appeared to have held Moody's to a higher standard of skill and care. In its reasoning, it said that for Moody's "*special place in the market*", there is "*an increased need for accuracy*".

Learn to navigate the regulatory minefield

It is clear that the stakes are getting higher for those involved in carrying out research and issuing reports and ratings. Besides keeping the market misconduct provisions of the SFO in mind, do be aware of the regulatory expectation that the "softer" obligations, such as those found in the SFC Code of Conduct, apply. Those are, acting honestly and with due care and skill, avoiding conflicts of interests and having due regard to the integrity of the market. Hong Kong regulators have many weapons in their armoury to keep the peace in the financial markets.

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