BEFORE APPELLATE BENCH NO. 1

In the matter of

Appeal No. 06 of 2016

Pakistan Credit Rating Agency Limited ...Appellant

Versus

(i) Securities and Exchange Commission of Pakistan
(ii) JCR-VIS Credit Rating Company Limited ...Respondents

Date of Hearing 14/07/16

For the Appellant:

(i) Muhammad Adnan Afaq, Managing Director Pakistan Credit Rating Agency
(ii) Jhangeer Hanif, Unit Head Ratings, Pakistan Credit Rating Agency
(iii) Syed Ahmad Hassan Shah, Counsel
(iv) Gulalay Zeb, Counsel

For the Respondent No .1:

(i) Nasir Askar, Director (SMD)
(ii) Muhammad Arshad, Joint Director (SMD)

For the Respondent No.2

(i) Faheem Ahmad, CEO JCR-VIS
(ii) Ijaz Ahmed, Advocate Supreme Court

ORDER

1. This order shall dispose of appeal No. 06 of 2016 filed under section 33 of the Securities and Exchange Commission of Pakistan Act, 1997 (SECP Act) against the order dated 19/01/16 (Impugned Order) passed by Director (Securities Market Division) of Securities and Exchange Commission of Pakistan (Respondent No.1).

2. The brief facts of the case are that Respondent No.1 received a complaint dated 28/08/15 from JCR-VIS Credit Rating Company (Respondent No.2), wherein, Respondent No.2 informed that one of their clients, Faysal Asset Management Ltd (FAML), has used services of the Pakistan Credit Rating Agency Limited (Appellant) for their fund stability rating without obtaining No Objection Certificate (NOC) or giving notice to them in contravention of the Conduct for Credit Rating Agencies (Code). The matter was referred to the Appellant for their comments.

3. After analyzing the complaint in light of the Appellant's comments received, Show Cause Notice dated 06/10/15 (SCN) was issued to the Appellant as to why penalty may not be imposed on them under section 22 of the Securities and Exchange Ordinance, 1969 (Ordinance) for violating clause 2.3.3(b) of the Code.

4. The Appellant, through Barrister Panni & Associates (Counsel) submitted its reply to the SCN on 16/10/15. Hearing in the matter was held on 22/10/15, wherein, Counsel appeared on behalf of the Appellant.

5. The Respondent No.1 dissatisfied with the response of the Appellant held that the Appellant has violated Clause 2.3.3(b) of the Code. Pursuant to clause 1.5 of the Code, all the credit rating companies are required to follow the Code, which has been issued by the Commission in exercise of the powers conferred by Rule 7 of the Credit Rating Companies, Rules 1985 (Rules). In terms of clause 2.3.3(b) of the Code, the Appellant was required to obtain a prior written confirmation from FAML that it would continue its rating with Respondent No.2 till the period mentioned in the rating agreement. However, no such written confirmation was obtained by the Appellant from FAML in contravention of clause 2.3.3(b) of the Code. The Appellant announced the ratings of the funds of FAML on 20/08/16 and FAML vide its letter dated 21/08/15 informed Respondent No.2 to withdraw its ratings for the funds under its management i.e. prematurely terminated its rating agreement with Respondent No.2. The failure to comply with the requirements of the Code attracts penal provisions of section 22 of the Ordinance. In exercise of

powers under section 22 of the Ordinance, the Respondent No.1 imposed a penalty of Rs.600,000 on the Appellant for the contravention of prescribed regulatory framework.

6. The Appellant has preferred the instant appeal on the following grounds:

a) The Code of Conduct is only a "procedural framework for credit rating companies". Clause 2.3.3(b) stipulates that a CRA will not accept a rating assignment where a client has prematurely terminated a rating contract with its existing CRA, unless such client obtains No Objection Certificate (NOC) from its existing CRA or ensure in writing that it shall continue credit rating with its existing CRA till the period as agreed in the rating agreement. A clause to this effect shall be included by the CRA in each rating agreement.

In terms of the above provision, CRA should not accept a rating assignment where a client has already prematurely terminated a rating contract with its existing CRA whereas, in the instant case, rating was assigned by the Appellant prior to any termination having taken effect with the other CRA. Assuming without conceding that the observation in the Impugned Order is correct that the Code of Conduct does not make any differentiation between credit rating for limited life and perpetual life products/entities and, therefore, has not specified any separate procedures in case of switchover/obtaining multiple rating; merely extending the application of this rule to a case in which the client sought multiple rating does not constitute stricto senso a contravention of Clause 2.3.3(b) of the Code of Conduct and more importantly such conduct cannot be held liable for penalty in terms of section 22 of the Ordinance.

b) Breach of the Code of Conduct is not a specified offence in the Ordinance or the Rules. In terms of section 22 of the Ordinance, the Respondent No.1 is empowered to impose a penalty if it is satisfied that "refusal, failure, or contravention was willful". In this regard, the Respondent No.1 in its own order in the case of Sherman Securities (Pvt.) Limited v Joint Director (SMD) Securities and Exchange Commission of Pakistan 2012 CLD 612 defined the term "willful" while placing reliance on the definition of "willful" as reproduced in Black Law

Dictionary "as an act done with stubborn purpose, but not with malice, as done intentionally, knowingly and purposely as distinct from an act done carelessly, thoughtlessly, heedlessly or inadvertently." However, the Impugned Order has attempted to make it an offence of strict liability, which is clearly not the intent of the statute i.e. provision of section 22 of the Ordinance. The view taken in the Impugned Order is diametrically opposed in the view expressed and adopted earlier by the Respondent No.1 and consistently followed by the Courts. Furthermore, the use of the word "may" in section 22 of the Ordinance implies that even in the event that the Respondent No.1 finds a person guilty of an offence which renders the application of the said provision, it is still in the discretion of the Respondent No.1 to decide whether or not to impose the penalty. The Respondent No.1 has in the past taken a lenient view even where contravention of the relevant provisions has been made out by the parties, particularly where violations were committed for the first time or is related to an interpretational issue and were not willful.

c) The Appellant faced an interpretational issue of the law and consequently wrote to the then Commissioner on 03/06/14 seeking an amendment in the wording of Clause 2.3.3(b). The interpretation issue arose as a similar directive under the Rules was issued on 17/02/05. Despite similar wording, the prevailing practice was such that no NOC was issued. It needs to be appreciated that in the past several clients have left the Appellant and moved to Respondent No.2 since the enactment of the Code of Conduct in conditions similar to those of FAML, and Respondent No.2 never sought an NOC from the Appellant. The Appellant in its reply dated 04/09/15 took the ground that it was of the view that Clause 2.3.3(b) did not even apply to it with reference to the concerned ratings. Assuming without conceding, any alleged non-compliance with the said Clause was only inadvertent and did not warrant a penalty. It may also be material to state that this is the first time that proceedings have been initiated against the Appellant in respect of a violation of Clause 2.3.3(b), which in effect resulted from a misunderstanding regarding its applicability and interpretation of the provision. Therefore, it could not justify imposition of penalty. It is the Appellant's bona fide submission that the Appellant opted a conduct which itself has been practiced by the complainant

i.e. Respondent No.2 and is viewed as normal practice of the rating industry worldwide. The Appellant enjoys a standing and reputation in the business industry and is committed to ensure compliance with the law. Such imposition of penalty has unfairly jeopardized the reputation and is being misused for maligning the Appellant and its business by its competitors. Such tactical efforts against the Appellant call for an immediate intervention from the Commission.

7. The Respondent No.1 has rebutted the arguments as follows:

a) The Respondent No.1 has prescribed Code of conduct to address quality and integrity of credit rating companies. In order to enhance the credibility to the process and procedure associated with credit rating, the Respondent has prescribed the framework to ensure transparency and disclosure in the rating process. Therefore, the question of procedural framework does not arise. The Code places two responsibilities on the CRA with regard to rating assignment a) to obtain NOC in case of premature termination b) to continue rating in case of switch over of rating. In the instant case, the Appellant has not followed the Code in letter and spirit and has not obtained the NOC as required under the Code.

b) The Appellant is taking the plea that 'pre-mature termination' mentioned in clause 2.3.3(b) applies only in case of time-bound ratings and the Code does not bar perpetual ratings. The same stance was also taken in the earlier hearing. The Code has been written in plain language and even a cursory reading of the Code would reveal that it does not make any differentiation between credit rating for limited life and perpetual life products/entities and, therefore, has not specified any separate procedures in case of switchover/obtaining multiple rating. Therefore, the Appellant should have followed the procedure laid down in clause 2.3.3(b) of the Code while accepting the rating assignment of funds of FAML. Further, given the role of credit rating companies in financial crisis, it is imperative that necessary enforcement action should be taken to curb rating shopping. The Respondent No.1, therefore, while protecting the interest of stake holders, deemed appropriate to take strict action to avoid such instances in future.

c) Section 22 of the Ordinance outlines penal provision in case of non-compliance of any directions issued under the Ordinance. The failure to comply with the requirements of the directive has attracted penal provisions of section 22 of the Ordinance. A default in the case of breach of duty will be considered 'willful' even if it arises out of being recklessly careless, even though there may not be knowledge or intent. In the case of Appellant, the Respondent No.1 felt that a penalty needs to be imposed to discourage future rating shopping cases, therefore, powers under section 22 of the Ordinance were exercised. Further, section 22 of the Ordinance provides a maximum amount of penalty of up to Rs.50 million, however, in the instant case, the Respondent No.1 has imposed a penalty of only Rs.600,000 using its discretion for penalizing the Appellant. The Appellant has certainly breached the Code of conduct by indulging in practices which had the effect of interfering with fair and smooth functioning of the market. The unfair practices like rating shopping are harmful for the development of the capital market. The Respondent No.1 is bound to protect the interest of investors and in doing so has been empowered to deal with elements which effect the smooth functioning of the market.

8. The Respondent No.2 has rebutted the arguments as follows:

a) The Ordinance does not contain any provisions for Appeal. Without prejudice to the aforesaid, the provisions of section 33 of SECP Act as originally enacted only provides an appeal against the order passed by a Commissioner. The later amendments made through Finance Acts are invalid in view of the judgments of the superior courts of Pakistan. The appeal, therefore, is not maintainable. The Respondent No.2 was not associated with the proceedings of the SCN, nor was it heard at any stage. Consequently, this primary issue was left out of consideration from the entire proceedings. The Respondent No.2 has also not been provided a copy of the Appellant's response to the Respondent No.2's letter that the Appellant claims to have filed.

b) Respondent No.2's complaints do not relate to the issue of multiple ratings nor the said issue is relevant to the core issue of rating shopping. The Appellant awarded higher ratings to the FAML funds by deviating from its own criteria. The

Appellant, therefore, encouraged FAML to switch ratings from the Respondent No.2, which is against the letter and spirit of the applicable law. The Appellant's conduct of deviation from its own rating criteria is definitely willful breach of its legal obligations.

c) The Appellant has failed to raise any such ground and instead has requested leniency, which is an implicit acceptance of fact that the Appellant has acted in breach of the law. Leniency granted to the Appellant in one case cannot constitute ground in another case. To the contrary such repeated conduct calls for a stricter action. The particulars provided by the Appellant are vague and in any case do not support the Appellant's assertion. Furthermore, the Appellant has failed to address the primary issue of encouraging rating shopping by going out of its way to award higher ratings to the FAML funds.

9. We have heard the parties i.e. the Appellant and the Respondents.

10. Without going into the merits of the appeal, we have noted that Respondent No.2 has argued that they were not heard at any stage in the show cause proceedings initiated against the Appellant on the basis of complaint filed by them. In the interests of justice, it is important that Respondent No.2 being the Complainant and a necessary party to the case be heard.

11. In view of the foregoing, we remand the matter to Respondent No.1 to make Respondent No.2 a party to the proceedings in this regard. Further the Bench is of the view that conduct of FAML should also be examined by the Respondent No. 1.

(Zafar Abdullah)
Commissioner (SCD)

(Tahir Mahmood)
Commissioner (CLD)

Announced on: 01 SEP 2016