



**Securities and Exchange Commission of Pakistan
Securities Market Division**

Before The HOD/Director (LCID)

**In the matter of Show Cause Notice issued to Pakistan Credit Rating Agency under
Section 22 of the Securities and Exchange Ordinance, 1969**

Date of Hearing: November 11, 2015

Present at the Hearing:

Representing Pakistan Credit Rating Agency (PACRA)

- | | |
|------------------------|---|
| (i) Mr. Adnan Afaq | Chief Executive Officer/Managing Director |
| (ii) Ms. Humaira Jamil | Manager Compliance |

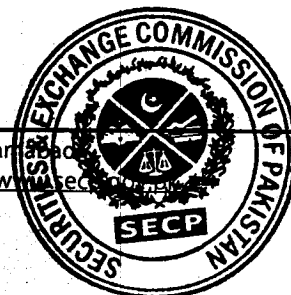
Assisting the Director/HOD (LCID)

- | | |
|-------------------------|-----------------|
| (i) Mr. Muhammad Arshad | Joint Director |
| (ii) Ms. Nazish Zubair | Deputy Director |

ORDER

1. This Order shall dispose of the proceedings initiated through Show Cause Notice issued under section 22 the Securities and Exchange Ordinance, 1969 ("Ordinance") of bearing No.SMD/CR/PACRA/2/2015 dated October 16, 2015, ("**SCN**") served to Pakistan Credit Rating Agency ("**Respondent**"), a Credit Rating Agency (CRA) registered by the Securities and Exchange Commission of Pakistan ("**Commission**") under Rule 5 of the Credit Rating Companies Rules, 1995 ("**Rules**").

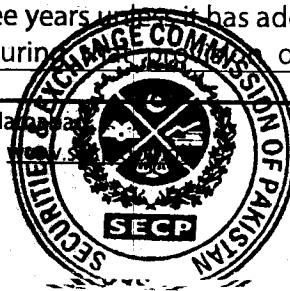
2. Brief facts of the case are that the Commission conducted an onsite inspection of the Respondent in exercise of its powers conferred by Section 29(2) of the Securities and Exchange Commission of Pakistan Act, 1997 ("**the Act**") read with Rule 7 of the Rules. The inspection revealed that the Respondent was, *prima facie*, noncompliant with the following clauses of the Code of Conduct for Credit Rating Companies/Agencies (**CRC Code**) issued under Rule 7 of the Rules:





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#	Clause	Requirement
1	Clause 2.1(a)	develop well-defined rating criteria, methodologies and procedures for solicited and unsolicited credit ratings, each class of entity, instrument and issue and such rating criteria, methodologies and procedures will act as guiding principles for analysts to enable them to analyze and interpret the information appropriately. The criteria, methodologies and procedures shall be updated proactively, taking into account changes in the market environment;
2	Clause 2.1(d)(i)	Quality of the rating process: CRA shall (d) keep the following records in support of each credit rating and review thereof: (ii) summary of discussions with the issuer, its management, auditors and creditors which have a bearing on the credit rating;
3	Clause 2.1(d)(ii)	Quality of the rating process: CRA shall (d) keep the following records in support of each credit rating and review thereof: (ii) decisions of the rating committee, including voting details and notes of dissent, if any, by any member of the rating committee;
4	Clause 2.2(a)	monitor all the outstanding ratings continuously and any potential change therein due to any event associated with the issuer, the security arrangement, the industry etc, is disseminated to the market, in a timely and effective manner, after appropriate consultation with the entity/issuer;
5	Clause 2.3.1(a)(ii)(D)	Appointment of the Compliance Officer: (a) CRA shall (ii) ensure that compliance officer shall be responsible for: (D) redressal of creditors', investors' and other stakeholders grievances and complaints; and
6	Clause 3.1(a)(vii)	Independence and Conflict of Interest: (a) CRA shall ensure that: (vii) it shall not provide consultancy/advisory services or other services to any of its clients or to any of its clients' associated companies and associated undertakings that is being rated or has been rated by it during the preceding three years unless it has adequate mechanism in place ensuring of such





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		services does not lead to a conflict of interest situation with its rating activities;
7	Clause 3.6	Adoption of the Code of Corporate Governance: CRAs are encouraged to adopt the Code of Corporate Governance issued by the Commission for listed companies
8	Clause 4.3.2.2	List of Fee/Charges: A CRA shall prepare list of charges relating to rating services and disseminate the same on its website. The list of charges must contain all the rating services render and functions perform by it and the rate of fee for each such service and function. The fee may be provided in terms of percentage, in the form of range (i.e. minimum and maximum) or in the form of fixed amount for each service/function.

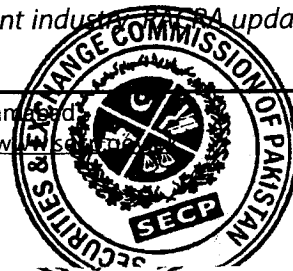
3. In light of the inspection findings, the Commission served a SCN on the Respondent under section 22 of the Ordinance. Hearing in the matter of aforesaid SCN was scheduled for November 03, 2015 at the Commission Head Office, NIC Building, Islamabad.

4. Mr. Adan Afaq, Managing Director of the Respondent submitted reply vide letter dated October 22, 2015 and he also appeared for hearing scheduled on November 11, 2015. The arguments put forth by the Respondent during the course of hearing are summarized below:

- (i) *Methodologies, like laws and codes of conduct, are meant to hold true for longer period of time. These warrant meaningful and essential revision when either:*
- (i) *A fundamental change occurs in the underlying rating factors, or*
 - (ii) *New rating factors emerge that the methodology hitherto doesn't capture. Examples could be changes in business model, operating landscape, etc.*

The robustness of a methodology, hence, isn't evident from its date of issuance but an examination of what the methodology contains in terms of rating factors and how they are to be evaluated. Whereas, methodologies provide broad guidelines, the details of opinion evolution is derived by employing quantitative rating tools that are frequently fine-tuned to appraise cyclical / seasonal variations, shifts in operating environment and relative importance of rating factors etc. In FY15, PACRA issued a separate methodology for Microfinance Institutions which were previously covered only by the Master Methodology on banks. In the asset management industry, PACRA updated its Mutual Funds Ranking Methodology.

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(ii) PACRA does not agree with this observation.

As far as the Issuer and its management are concerned, a meeting is an essential part of the rating process. Such meeting is termed a "Management Meeting" by PACRA. A document titled "Management Meeting Minutes" can be found in all client files. In the year under consideration, there is not a single incident where a management meeting was not minuted. Meetings with auditors and creditors are not routine. If they take place, they will also be documented and recorded. Though, such records were made available to the inspectors for examination, PACRA is sharing a copy of its management meeting minutes for your review

(iii) The purpose of a rating committee is to finalize an opinion based upon a conclusive stance on various rating factors. It is the outcome of the discussion (rather than the discussion itself) that these minutes are meant to preserve. Such outcome is established and conveyed through detailed analysis of each rating factors, peer comparison and financial ratios which are all documented in the RC minutes. The code requires:

- Decision of the rating committee
- Voting details
- Notes of dissent
- PACRA RC minutes contain all these.

(iv) PACRA does not agree with this observation.

Surveillance is a highly structured activity at PACRA which takes place very quarter. In the year under consideration, no quarter was missed. Though, ratings are monitored on an on-going basis, every quarter, a formal surveillance exercise is carried out to consolidate and examine at length the rating factors underlying each outstanding rating. The quarterly surveillance is made to coincide with the publication of quarterly numbers. As proof, you can examine the spreadsheets in PACRA Rating Reports and note that quarterly figures have been accounted for. Also, analysts make formal telephone calls to clients to discuss any fresh developments. All these findings are then brought into a meeting session where a formal presentation is made which is attended by the rating team and select RC members. The entire surveillance activity is documented.

(v) Follow this link on PACRA's website to see the complaints portal as set up by PACRA. Thus far, no complaint has been received through it:
http://www.pacra.com.pk/pages/contact_us/contact_us.asp





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- (vi) *Clause 3.1-a-vii states: "CRA shall ensure that it shall not provide consultancy/advisory services or other services to any of its clients or to any of its clients' associated companies and associated undertakings that is being rated or has been rated by it during the preceding three years unless it has adequate mechanism in place ensuring that provision of such services does not lead to a conflict of interest situation with its rating activities;"*

This clause allows the CRA itself to offer such services to its own clients provided that adequate conflict of interest management measures are instituted first.

In PACRA's case, such services are offered by a separate company entirely with its own human resource. Hence, no conflict of interest situation arises. What is even more pertinent, in any case, trainings, being the most offered product of PACRA Analytics, amounts to institutional capacity building – an activity encouraged by the code via clause 4.8-1 which states:

"A CRA shall arrange and conduct training programs from time to time for the capacity building and skill development of the officers of other institutions;"

- (vii) *We thought SECP would appreciate our efforts.*

SECP has used the word "encouraged" in this clause; hence, PACRA understands that the adoption of this code is left to PACRA's discretion. Notwithstanding the above, PACRA has adopted material clauses out of the Code of Corporate Governance. This took place on a voluntary basis and well before the code encouraged it. This observation was noted by PACRA and resolved since then.

Please follow this link to see PACRA standard fee structure containing both a minimum and a maximum fee for each class of rating:

<http://www.pacra.com.pk/pages/relationship/fee.php>

5. I have examined the inspection findings, the response of the Respondent to the show cause notice, their verbal arguments and the departmental representatives on the date of hearing. As evident from the response to the Notice, the Respondent has agreed with the following observations of the inspection team:

- (i) Clause 2.1(a)
- (ii) Clause 2.1(d)(ii)
- (iii) Clause 3.1(a)(vii)
- (iv) Clause 4.3.2.2

The following observations of the inspection team were argued at length by the Respondent. The outcomes of the discussions are as under;

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Clause 2.1(d)(i)-Summary of discussion with the issuer

During the inspection it was observed that the Respondent did not maintain any record of summary of discussion made with the entity. During the course of hearing, the Respondent shared the record of discussion, which was shared with the inspection team and they agreed with Respondent's point of view.

Clause 2.1(d)(ii)- Minutes of rating committee

A rating is based on an analytical decision of the rating committee. Being professionals, the members of rating committee are expected to provide objective and fair opinions on the rating to be assigned. Therefore, it is imperative that deliberations among the members are recorded in detail. This would ensure the independence and transparency of the rating process. After exchanged of arguments in detail, the Respondent agreed to record the discussions made in the rating committee in detail.

Clause 2.2(a)-Monitoring and surveillance of outstanding rating

During the inspection it was observed that the Respondent did not conduct monitoring and surveillance of its outstanding ratings as required under clause 2.2(a) of the CRC Code. During the hearing the Respondent stated that they did monitor all their outstanding ratings and provided reports regarding monitoring and surveillance of the credit rating conducted by the Respondent. The Respondent presented related reports and documents which were shared with the inspection team and they agreed with Respondent's point of view.

Clause 2.3.1(a)(ii)(D)- Appointment of compliance officer for redressal of compliant

During the inspection it was observed that no mechanism has been developed by the Respondent for lodging complaints by stakeholders and no portal was available on Respondent's website. The Respondent during the course of hearing furnished the list of complaints handled by them. Further, the Respondent stated that link has also been available on its website to address the grievances of investors. Both the documents were shared with the inspection team and they agreed with the Respondent's contention.

Clause 3.1(a)(vii)-independence and conflict of interest

The Respondent, contested that no conflict of interest arise when services are being provided by its subsidiary company i.e PACRA Analytics to the same clients to whom they are providing rating services. The Respondent further asserted that it is in line with international precedents.

Concerning the observation made in inspection report that PACRA Analytics, a fully owned subsidiary of Respondent providing consultancy services to clients of Respondent, I am of the view that the independence of rating agency and the integrity of the rating process can be compromised by potential conflicts of interest. Such conduct may affect the transparency, fairness and independence of the rating process towards its





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clients. The Credit Rating Agency is a critical organization which provides investors reliable information on the potential risks inherited in the entity, such conflict of interest can wreak havoc in the markets. Globally, credit rating companies are not involved, directly or indirectly, in any business activities outside of their core activities. In line with international precedents and given the critical nature of credit rating business, the Respondent should enhance control environment to address the potential conflict of interest and put in place strong fire walls to ensure the integrity of rating process while providing ancillary services to the clients.

Clause 3.6 Adoption of the Code of Corporate Governance:

The Respondent emphasized that they are materially compliant with the Code of Corporate Governance. In this regard, the Respondent during the course of hearing shared record pertaining to the BOD minutes, which was shared with the inspection team and they agreed with the contention of the Respondent. Nevertheless, it is reiterated reiterated that the objective of Code of Corporate Governance is to improve transparency and enhance governance culture in CRAs, therefore, the Respondent should take further steps to comply with the Code of Corporate Governance letter and spirit.

6. The onsite inspection was the first ever inspection of a credit rating company since its inception. The Respondent has tried to comply with various requirements of the CRC Code and provided evidence suggesting rectification of some of the violations noted during inspection. The Respondent has also shown its willingness to comply with the requirements of the CRC Code in letter and spirit in future. Hence, keeping in view the observations made by the inspection team and the comments submitted by the Respondent thereto, I am not imposing any monetary penalty on the Respondent. However, the Respondent is hereby strictly warned to ensure strict compliance of regulatory framework as any non-compliance in future would render the Respondent liable to monetary penalties stipulated under the law.

7. This Order is issued without prejudice to any other action that the Commission may initiate against the Respondent in accordance with the law on matter subsequently investigated or otherwise brought to the knowledge of the Commission.


(Nasir Askar)
HOD/Director (LCID)

Announced on January 19, 2016
Islamabad.

