

Hot Topic

Update on major accounting
and auditing activities

SEC proposal: Credit ratings disclosure

Contents

Introduction.....	1
Proposed credit rating disclosures	2
Triggering events.....	2
General information	2
Potential conflicts of interest	2
Ratings shopping	3
Rating changes.....	3

Introduction

On 7 October 2009, the US Securities and Exchange Commission (SEC) published a proposal that would require additional disclosure in registration statements when credit ratings are used by issuers, underwriters or other offering participants. The proposed amendments are designed to provide investors with a better understanding of a credit rating and its limitations.

The proposed disclosures reflect SEC concerns that investors may not have sufficient information to understand the scope or meaning of a credit rating or to appreciate potential conflicts of interest that could affect the credit rating. The proposed disclosures are intended to identify potential instances of "ratings shopping," as well as provide information in the prospectus when a credit rating is used to market the securities.

Currently in registration statements and periodic reports, an issuer may, but is not required to, disclose the credit rating assigned to classes of its debt securities, convertible debt securities or preferred stock. As proposed, the amendments would require the following disclosure about credit ratings in the prospectus and

registration statement if a credit rating is used by the issuer, underwriters or other participant in connection with the related securities offering:

- ▶ General information regarding the credit rating, including the scope of the rating and any related limitations
- ▶ Potential conflicts of interest (e.g., other fees paid to the credit rating agency)
- ▶ All preliminary or final credit ratings obtained from other credit rating agencies for the same class of securities

The proposal also would add Item 3.04 to Form 8-K to require timely reporting of changes to or withdrawals of a credit rating that the issuer was required to disclose in any of its registration statements.

The following provides an overview of the more significant aspects of the proposal, *Credit Ratings Disclosure* (SEC Release No. 33-9070). However, this summary does not address every aspect of the proposal, the full text of which is available from the SEC's website at www.sec.gov.

The SEC has requested that comments on the proposal be submitted no later than 14 December 2009.

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Proposed credit rating disclosures

The SEC is not proposing to require issuers to obtain credit ratings, but to require disclosure about a credit rating when it is used in connection with a registered securities offering.

The proposal would affect registration statements filed under the Securities Act of 1933 (Securities Act) (e.g., Forms S-1, S-3, S-4), the Securities Act of 1934 (Exchange Act) (e.g., Forms 10 and 20-F) and the Investment Company Act of 1940 (Investment Company Act) (e.g., Form N-2).

Triggering events

When an issuer, underwriter or other offering participant uses a credit rating in connection with a registered securities offering, the proposal would require the issuer to provide credit ratings disclosures in the related prospectus and registration statement.¹ As a result, the selling and marketing activities of underwriters and other offering participants, whether oral or written, could trigger the requirement for the issuer to file the proposed disclosures in the related registration statement. For example, an issuer could be required to provide the disclosures when an underwriter or selling security holder solicits a credit rating and uses it even though the issuer was not directly involved.

In the case of a registered exchange offer for securities originally offered in reliance on an exemption from registration under the Securities Act, credit ratings disclosures would be required in the related registration statement if a credit rating had been used in connection with the private placement of the securities subject to the exchange offer. That is, an issuer could not avoid making the

proposed disclosures by disclosing a credit rating to investors in a private offering but not “using” a credit rating in connection with the registered exchange offer of substantially identical securities.

General information

As proposed, disclosure of general credit rating information would be required upon a triggering event, including:

- ▶ The identity of the credit rating agency and whether it is a Nationally Recognized Statistical Ratings Organization (NRSRO)
- ▶ The credit rating assigned, the date assigned and the relative rank of the credit rating within the credit rating agency’s classification system
- ▶ A credit rating agency’s definition or description of the category of the credit rating
- ▶ All material scope limitations of the credit rating²
- ▶ How any contingencies related to the offered securities are or are not reflected in the credit rating
- ▶ Any published designation reflecting the results of any other evaluation done by the credit rating agency, along with an explanation of the designation’s meaning and the relative rank of the designation³
- ▶ Any material differences between the terms of the securities as assumed or considered by the credit rating agency and (i) the minimum obligations of the security as specified in the governing instruments and (ii) the terms of the securities as used in any marketing or selling efforts

▶ A statement informing investors that:

- ▶ a credit rating is not a recommendation to buy, sell or hold securities
- ▶ the credit rating may be subject to revision or withdrawal
- ▶ each credit rating is applicable only to the specific class of securities to which it applies
- ▶ investors should perform their own evaluation as to whether investment in a security is appropriate

A preliminary prospectus would be required to include the credit rating disclosure for any credit rating used in connection with that securities offering. When a final rating is not determined until after the effectiveness of the registration statement, an issuer would disclose the initial rating (if any) in the preliminary prospectus. If a disclosed rating changes or if a different rating becomes available before effectiveness, the issuer would be required to communicate the rating change to the purchaser through a revised prospectus. The final prospectus would be required to reflect the final rating assigned and all related disclosures.

Potential conflicts of interest

When the disclosure criteria are triggered, the proposed amendments would require disclosure of the identity of the party compensating the credit rating agency. Such disclosure is intended to allow investors to assess the impartiality of the credit rating agency.

If the credit rating agency provided any other services to the issuer or its affiliates during the issuer’s last fiscal year and any subsequent interim period up to the date of filing, the proposed disclosures would require a description of any other services, and disclosure of the fee paid for the credit rating as well as the aggregate fees paid for those other services. An issuer would not be required to disclose the fee paid for the

¹ For purposes of the disclosure trigger, “use” of a credit rating in an offering would include both oral and written communications, as well as offers to provide a rating upon request. However, the proposed disclosures would not be triggered just because the registration statement or any filing incorporated by reference mentions a credit rating in connection with disclosures about risk factors, the issuer’s liquidity, cost of funds, credit rating changes or the terms of other agreements.

² A limited scope rating is a rating that assesses less than the promised or expected return on a security.

³ If the credit rating includes a related published designation that does not solely reflect credit risk (e.g., non-credit payment risk assessment or volatility assessment), the proposed rule would require a description of the additional analysis performed by the credit rating agency.

credit rating unless it also is required to disclose the total of fees paid to the credit rating agency for other services.

Ratings shopping

Sometimes issuers seek the highest credit rating available by soliciting multiple credit rating agencies, which the SEC refers to as “ratings shopping.” The SEC wants investors to be able to identify potential instances of ratings shopping.

As proposed, when the credit rating disclosures are triggered, the issuer also would be required to disclose all preliminary and final credit ratings from other credit rating agencies for the same class of securities.⁴ If applicable, the following disclosure would be required about the other ratings(s):

- ▶ The identity of the other credit rating agency and whether it is an NRSRO
- ▶ The other credit rating determined or indicated (or a description of the range of categories indicated)

- ▶ The date the other rating was conveyed to the underwriter, the issuer or any party acting on behalf of the issuer
- ▶ The relative rank of the other credit rating within that credit rating agency’s classification system
- ▶ Any material scope limitations of the other credit rating
- ▶ Any material differences between the terms of the securities on which the other rating was determined and the terms of the securities on which the primary disclosed rating was determined

Except as discussed above in connection with a preliminary prospectus, the proposal would not require disclosure of preliminary ratings obtained from the credit rating agency that issues the primary disclosed rating. However, the proposal would require the disclosures about any preliminary rating obtained from another agency even if there were changes in the terms of the security for which a final rating must be disclosed.

Rating changes

As proposed, an issuer would be required to file a current report on Form 8-K when a credit rating that it was required to disclose in any of its registrations statements changes, is withdrawn or is no longer being updated. An issuer⁵ would disclose the following under a new Item 3.04 of Form 8-K and within four business days of receiving communication on the decision⁶ from the credit rating agency:

- ▶ The date the credit rating notice or communication was received
- ▶ The name of the rating agency and whether it is an NRSRO
- ▶ Nature of the rating agency’s decision

Item 3.04 of Form 8-K would not require a discussion of the effect of the change on the registrant.⁷ Instead, a discussion of the material effect of any change in a credit rating would be required in periodic reports (e.g., in MD&A in Form 10-Q or Form 10-K).

The new Form 8-K reporting requirement would only apply to changes in credit ratings obtained or used subsequent to the effectiveness of the new disclosure requirements.

⁴ For this purpose, the SEC intends “preliminary rating” to be interpreted broadly to include all preliminary indications of a rating, including any unpublished rating and any oral or other indication of a potential rating or range of ratings.

⁵ A foreign private issuer would be required to provide disclosure regarding any such credit rating changes in its next annual report on Form 20-F.

⁶ A Form 8-K would not be required to report discussions with the credit rating agency about a possible rating change or withdrawal until the issuer receives notice that the agency has made a final decision.

⁷ In some cases, a rating change could trigger the reporting requirement under Item 2.04 of Form 8-K (i.e., acceleration or increase of a direct financial obligation or obligation under an off-balance sheet arrangement).

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