

SEC Disclosure Update: Proposed Rules for New Short-Term Borrowings Disclosure; and Guidance on MD&A Liquidity and Capital Resources Disclosure

On September 17, 2010, the Securities and Exchange Commission (the “SEC”) unanimously approved companion releases aimed at providing greater information to investors with which to evaluate registrants’ ongoing liquidity and leverage risks. In the first release, the SEC proposed new rules that would require enhanced quantitative and qualitative disclosure of short-term borrowings in Management’s Discussion and Analysis of Financial Condition and Results of Operation (“MD&A”).¹ The second release provides interpretive guidance on the discussion of liquidity and capital resources in MD&A.² The comment period for the proposed disclosure rules ends on November 29, 2010.

I. Proposed Short-Term Borrowings Disclosure Rules

The proposed rules would require a separately captioned subsection within MD&A which would include both quantitative and qualitative information about a registrant’s short-term borrowings. The nature of the quantitative short-term borrowings disclosure requirements would be similar to the annual disclosure requirements currently applicable to bank holding companies under SEC Industry Guide 3 (“Guide 3”).³

Quantitative Disclosure

The proposed rules would require registrants to provide tabular information for each category of short-term borrowings. “Short-term borrowings” are defined under the proposed rules as amounts payable for short-term obligations that are:

- federal funds purchased and securities sold under agreements to repurchase,
- commercial paper,
- borrowings from banks,
- borrowings from factors or other financial institutions and
- any other short-term borrowings reflected on the registrant’s balance sheet.

Foreign private issuers would be allowed to use alternative categories that correspond to the classifications of short-term borrowings under the comprehensive set of accounting principles used in the preparation of their primary financial statements, provided the level of detail in the disclosure satisfies the objective of the disclosure requirement. Further disaggregation of amounts by currency or interest rate would be required, to the extent necessary to promote understanding of the disclosure or to prevent the aggregate amounts

¹ Short-Term Borrowings Disclosures, Securities Act Release No. 33-9143, Exchange Act Release No. 34-62932, 75 Fed. Reg. 59,866 (Sept. 28, 2010), available at <http://www.sec.gov/rules/proposed/2010/33-9143.pdf>.

² Commission Guidance on Presentation of Liquidity and Capital Resources Disclosures in Management’s Discussion and Analysis, Securities Act Release No. 33-9144, Exchange Act Release No. 34-62934, 75 Fed. Reg. 59,894 (Sept. 28, 2010), available at <http://www.sec.gov/rules/interp/2010/33-9144.pdf>.

³ See Securities Act Industry Guide 3, 17 C.F.R. § 229.801(c) (2010), available at <http://www.sec.gov/about/forms/industryguides.pdf>.

from being misleading. The proposed rules would require additional footnote disclosure describing the disaggregation method, to the extent necessary to facilitate an understanding of the data.

For each category of short-term borrowings, the proposed rules would require registrants to disclose:

- the amount outstanding in such category and the average interest rate on such amount,
- the average amount in such category for the reporting period and the weighted average interest rate on such amount and
- (a) for financial companies, the maximum daily amount in such category during the reporting period or (b) for all other registrants, the maximum month-end amount in such category during the reporting period.⁴

Recognizing that registrants engaging in both financial and non-financial operations may fall within the definition of “financial company,” the proposed rules would permit such registrants to provide separate short-term borrowings disclosure for financial and non-financial operations.

Qualitative Disclosure

The proposed rules would require registrants to supplement the quantitative disclosure of short-term borrowings arrangements with a narrative discussion of such arrangements. The topics to be discussed in the qualitative disclosure are as follows:

- a general description of the short-term borrowings arrangements included in each category (including any key metrics or other factors that could reduce or impair the registrant’s ability to borrow under the arrangements and whether there are any collateral posting arrangements) and the business purpose of those arrangements;
- the importance to the registrant of its short-term borrowings arrangements to its liquidity, capital resources, market-risk support, credit-risk support or other benefits;
- the reasons for the maximum amount for the reporting period, including any non-recurring transactions or events, use of proceeds or other information that provides context for the maximum amount; and
- the reasons for any material differences between average short-term borrowings for the reporting period and period-end short-term borrowings.⁵

In the release, the SEC emphasized that, while there may be some overlap between the proposed narrative discussion of short-term borrowings arrangements and the already existing requirements within MD&A relating to liquidity and capital resources, the proposed disclosure should not merely restate such discussions. Instead, the registrant would be expected to integrate the narrative discussion of short-term borrowings with the existing liquidity and capital resources disclosures in order to portray a more complete picture of the registrant’s liquidity profile.

⁴ “Financial company” would be defined under the proposed rules as a company that “is engaged to a significant extent in the business of lending, deposit-taking, insurance underwriting or providing investment advice, or is a broker or dealer as defined in Section 3 of the Exchange Act” See Short-Term Borrowings Disclosures, 75 Fed. Reg. at 59,871.

⁵ *Id.* at 59,872.

Reporting Periods

The proposed short-term borrowings disclosure rules would apply to annual reports, quarterly reports and registration statements. For annual reports, registrants would be required to disclose information for the three most recent fiscal years and the fourth quarter. Registration statements would need to disclose information for the three most recent full fiscal years and interim information for subsequent interim periods. For quarterly reports, only information for the relevant quarter would need to be disclosed. Foreign private issuers would not be subject to the quarterly disclosure requirements and smaller reporting companies would only be subject to the quarterly disclosure requirements if there have been material changes during the interim period. Furthermore, the proposed rules would allow smaller reporting companies to disclose only two fiscal years in annual reports and registration statements.

The proposed rules contemplate a phase-in period for registrants that are not subject to Guide 3. In the initial year of the proposed rule, registrants not subject to Guide 3 would be required to disclose short-term borrowings information for only the most recent fiscal year. In year two, these registrants would be required to present short-term borrowings information for the two most recent fiscal years, and in year three the transition period would end and all registrants would be required to present short-term borrowings information for the three most recent fiscal years.

II. Interpretive Guidance Regarding Liquidity and Capital Resources

In a companion release, the SEC provided interpretive guidance regarding the discussion of liquidity and capital resources in MD&A. The interpretive guidance specifically addresses liquidity disclosure, leverage ratio disclosure and contractual obligations table disclosure.

Liquidity Disclosure

The SEC reiterated that a registrant must disclose any known trends, demands, commitments, events or uncertainties that will, or are reasonably likely to, result in a material increase or decrease to the registrant's liquidity. Examples of trends and uncertainties that might potentially impact liquidity are "difficulties accessing the debt markets, reliance on commercial paper and other short-term financing arrangements, maturity mismatches between borrowing sources and the assets funded by those sources, changes in terms requested by counterparties, changes in the valuation of collateral, and counterparty risk."⁶ The SEC also stated that additional narrative disclosure might be required in order to adequately impart the registrant's financing activities during the period, or the impact of such activities on liquidity, if financial statements alone are insufficient. The interpretive release posited as an example a registrant whose period-end borrowings differed materially from its borrowings during the reporting period, concluding that disclosure of the intra-period variations is required in such circumstances.

Repurchase agreements that are accounted for as sales and off-balance sheet arrangements are specifically addressed in the release, with the SEC stating that the lack of specific reference to such transactions within

⁶ Commission Guidance on Presentation of Liquidity and Capital Resources Disclosures in Management's Discussion and Analysis, 75 Fed. Reg. at 59,894–59,895.

existing disclosure requirements does not relieve registrants of their disclosure obligations. When deciding whether it is necessary to disclose transactions involving the transfer of financial assets with an obligation to repurchase or other such transactions accounted for as sales, registrants must consider whether the transaction “is reasonably likely to result in the use of a material amount of cash or other liquid assets.”⁷

Registrants are also urged to consider describing any cash management and risk management policies relevant to an assessment of their financial condition. Banks in particular are told to consider discussing their policies and practices in meeting applicable banking agency guidance on funding and liquidity risk management, as well as policies and practices that differ from such guidance. Additionally, the release urges registrants for whom a portfolio of cash and other investments is a material source of liquidity to consider disclosing information regarding “the nature and composition of that portfolio, including a description of the assets held and any related market risk, settlement risk or other risk exposure.”⁸

Leverage Ratio Disclosure

The interpretive release notes that when capital and leverage ratios are included in filings, they must be accompanied by a clear explanation of the calculation methodology. The explanation must articulate the treatment of unusual, infrequent, non-recurring or otherwise adjusted inputs that result in such ratio being calculated differently from directly comparable measures. If a financial measure differs from financial measures commonly used within the registrant’s industry, the registrant must consider whether, in order to ensure the disclosure is not misleading, it is necessary to discuss such differences or present those measures commonly used within the industry. Registrants must also clearly state why the differing measure is useful to the understanding of the registrant’s financial condition.

Contractual Obligations Table Disclosure

Registrants are encouraged to develop a contractual obligations table that presents the information in an unambiguous manner and appropriately reflects the categories of obligations that are meaningful to the registrant. In order to ensure that investors are able to make period to period comparisons, registrants are instructed to highlight any changes made in the presentation of the information. Finally, registrants are instructed to use footnotes where necessary to provide information needed to facilitate an understanding of the timing and amount of the contractual obligations, as well as to consider additional narrative discussion outside of the table where necessary to promote an understanding of the data.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Charles A. Gilman at 212.701.3403 or cgilman@cahill.com; Jon Mark at 212.701.3100 or jmark@cahill.com; John Schuster at 212.701.3323 or jschuster@cahill.com; or Christopher W. Clement at 212.701.3973 or ccllement@cahill.com.

⁷ *Id.* at 59,895.

⁸ *Id.*