SEC PROPOSES ENHANCED DISCLOSURE AND ISSUES INTERPRETIVE GUIDANCE REGARDING SHORT-TERM BORROWINGS

The SEC recently proposed regulations that would impose new disclosure requirements regarding short-term borrowings in public companies’ filings with the SEC. The SEC also issued a companion interpretive release that provides guidance on liquidity and capital resources disclosures required under current regulations. Both of these SEC releases are designed to address SEC concerns regarding end-of-quarter “window dressing” through the use of so-called Repo 105 transactions and other off-balance sheet devices that mask the true picture of a registrant’s intra-period liquidity and capital resources. According to the SEC, disclosure relating to liquidity and capital resources, including a company’s access to short-term funding, is critical to an assessment of its prospects, particularly in the current economic environment.

I. Proposed Amendments

Under the proposed amendments, registrants would be required to provide additional disclosure regarding their short-term borrowings, similar to that currently required for bank holding companies under Industry Guide 3. The amendments would be applicable to annual and quarterly reports, proxy and information statements that include financial statements, registration statements under the Securities Exchange Act of 1934 (the “Exchange Act”) and registration statements under the Securities Act of 1933. Form 8-K would also be amended to conform to the terminology in the proposed short-term borrowings disclosure requirement. The SEC solicits comment on numerous questions raised in the release; the comment period on the proposed amendments expires on November 29, 2010.

A. Proposed New Short-term Borrowings Disclosure in MD&A

The amendments would require reporting companies to include in their Management’s Discussion and Analysis of Financial Condition and Results of Operations (“MD&A”) a new,
separately captioned section that would provide tabular information about their short-term borrowings, as well as a discussion and analysis of those short-term borrowings. As proposed, Item 303 of Regulation S-K would be amended to require registrants to provide tabular disclosure in MD&A of:

- the amount in each specified category of short-term borrowings at the end of the reporting period and the weighted average interest rate on those borrowings;
- the average amount in each specified category of short-term borrowings for the reporting period and the weighted average interest rate on those borrowings; and
- for registrants meeting the proposed definition of “financial company,” the maximum daily amount of each specified category of short-term borrowings during the reporting period, and for all other registrants, the maximum month-end amount of each specified category of short-term borrowings during the reporting period.

Short-term borrowings categories would include (i) federal funds purchased and securities sold under repurchase agreements; (ii) commercial paper; (iii) borrowings from banks; (iv) borrowings from factors or other financial institutions; and (v) any other short-term borrowings reflected on the registrant’s balance sheet. Each category applicable to the types of short-term financing activities a registrant uses must be included regardless of whether the category is otherwise required to be reported as a separate line item on the registrant’s balance sheet, with no minimum quantitative threshold for inclusion. Further disaggregation of data by currency and/or interest rate would be required to the extent necessary to prevent aggregate amounts from being misleading.

As discussed above, a “financial company” would have greater reporting requirements than a registrant that does not fit this definition.4 A registrant engaged in both financial and non-financial businesses, such as a manufacturing company with a subsidiary that provides financing to its customers, may provide separate short-term borrowings disclosure for its financial and non-financial business operations.

To provide context for the short-term borrowings data, a narrative discussion of short-term borrowings arrangements would be required to create a clear, comprehensive description of a company’s liquidity profile. This narrative discussion would be required to include:

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4 The proposed amendments broadly define “financial company” to mean a registrant 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, and includes, without limitation, an entity that is, or is the holding company of, a bank, a savings association, an insurance company, a broker, a dealer, a business development company, an investment adviser, a futures commission merchant, a commodity trading advisor, a commodity pool operator, or a mortgage real estate investment trust.
• a general description of short-term borrowings arrangements 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 of short-term borrowings for the reporting period, including any non-recurring transactions or events, use of proceeds or other contextual information; and

• the reasons for any material differences between the average short-term borrowings for the reporting period and the period-end short-term borrowings.

This new disclosure is intended to complement, but not repeat, the other MD&A disclosures relating to liquidity and capital resources, including disclosures in the contractual obligations table, disclosures of off-balance sheet arrangements and other liquidity and capital resource disclosures.

B. Proposed New Reporting Requirements

These new requirements would be applicable to annual and quarterly reports as well as registration statements and proxy and information statements that include financial statements. Information in annual reports would be presented for the three most recent fiscal years and for the fourth quarter. Information in quarterly reports would be presented for the relevant quarter in the same level of detail as required for annual periods, but without comparative period data.Registrants would be required to discuss material changes from previously reported disclosures. Registration statements with audited full-year financial statements would be required to include short-term borrowings disclosure for the three most recent fiscal year periods and interim information for any subsequent interim periods.

Smaller reporting companies would be subject to the proposed requirements, except that quarterly disclosures would not be required unless material changes occurred during the interim period and information for the fourth fiscal quarter would not be required in annual reports. In addition, smaller reporting companies would be required to provide only two years of short-term borrowing information in their annual reports, rather than three.

Since foreign private issuers do not file quarterly reports, they would be subject to the proposed disclosure requirements only for their annual report on Form 20-F.

For non-bank holding companies, the comparative data requirements for annual reports would be phased in over three years, with disclosure for only the most recent fiscal year required in the first year and for the two most recent fiscal years required in the second year. However, registrants would be allowed to voluntarily include the full three years of comparative
data in their annual report during the phase-in period if they so choose. Since comparative data from prior years is not required for quarterly reports, there is no phase-in for this requirement.

C. Proposed Leverage Ratio Requirement

The SEC is also contemplating extending a leverage ratio disclosure requirement to companies that are not bank holding companies. While not making any specific proposal, the SEC release solicits comments regarding what ratios to require and how such a requirement would take into account the differences among metrics and industries while still providing comparability.

D. Proposed Form 8-K Amendments

To provide consistency of disclosure, Form 8-K would be amended in order to align the current definition of “direct financial obligation” under Items 2.03 and 2.04 of Form 8-K with the new proposed definition of short-term borrowings. However, the existing carve-out in the definition of “direct financial obligation” for obligations that arise in the ordinary course of business would be retained in order to maintain Form 8-K’s focus on disclosure of non-routine transactions only.

II. Commission Interpretive Guidance

In conjunction with the proposed amendments described above, the SEC also issued interpretive guidance regarding current MD&A requirements. As with its previous interpretive releases relating to MD&A, the SEC notes that disclosure regarding window dressing and other liquidity concerns is, in many instances, already required under existing principle-based MD&A disclosure requirements. Unlike the proposed amendments, this interpretive guidance has immediate effect.

In the guidance the SEC seeks to clarify certain requirements under Regulation S-K to improve discussions in MD&A of liquidity and capital resources to facilitate understanding by investors of the liquidity and funding risks facing the registrant. The SEC provides clarification on the following points:

- Pursuant to Item 303(a)(1) of Regulation S-K, registrants must describe internal and external sources of liquidity and disclose known trends and uncertainties that materially impact liquidity in MD&A. The guidance suggests additional trends and uncertainties relating to liquidity that may require disclosure, including difficulties accessing the debt markets, reliance on commercial paper or 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.

- Additional explanatory narrative disclosure may be required where the registrant’s financial statements do not adequately convey its financing arrangements during the period, or their impact on liquidity due to a known trend, commitment, event or
uncertainty. If borrowings during the reporting period are materially different from the period-end amounts recorded in the financial statements, disclosure about the intra-period variations is required to facilitate investor understanding of the company’s liquidity position.

• Despite there being no specific disclosure requirements for repurchase transactions that are accounted for as sales, disclosure of such transactions may be required where the transaction is reasonably likely to result in the use of a material amount of cash or other liquid assets, especially where the registrant does not otherwise include such information in its off-balance sheet arrangements.

• Companies should consider describing cash management and risk policies relevant to an assessment of their financial condition in order to provide context for the exposures identified in MD&A. Banks, in particular, should consider discussing their policies and practices in meeting applicable banking agency guidance on funding and liquidity risk management, along with any other practices that differ from the applicable agency guidance. Limits or restrictions on a company’s ability to access its cash or other investments should also be disclosed.

• Any ratio or measure included in a filing should be accompanied by a clear explanation of the calculation methodology, including an articulation of the treatment of any unusual, infrequent or non-recurring inputs. This disclosure should also state why the included ratio or measure is useful to understanding the registrant’s financial condition. If the metric is a financial measure, registrants should make sure that the disclosure complies with Regulation G governing non-GAAP financial measures.

• The contractual obligations table under Item 303(a)(5) of Regulation S-K is designed to present cash requirements arising from contractual payment obligations and commitments in a single location. Registrants are encouraged to present the information in a way that is tailored to the company’s business, with footnotes and additional narrative discussion as necessary to clarify the nature, timing and amount of the obligations. To improve transparency, registrants may consider separating amounts in the table into those reflected on the balance sheet and those arising from off-balance sheet arrangements.

With the issuance of these two releases, the SEC has stressed its continued focus on MD&A disclosure and particularly disclosure relating to a registrant’s liquidity and capital resources. When preparing these disclosures, all registrants should be mindful of the concerns raised in the interpretive release as well as those items raised in the proposed amendments.
If you have any questions regarding this memorandum or would like to comment on the proposed regulations, please contact Jeffrey S. Hochman (212-728-8592, jhochman@willkie.com) or the Willkie attorney with whom you regularly work.

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