

SEC Shines a Spotlight on Short-Term Borrowings: Issues Guidance and Proposes New Disclosure Requirements

On September 17, 2010, the SEC [proposed amendments](#) which would require both financial and nonfinancial companies to disclose additional information in registration statements and periodic reports about intra-period short-term borrowings. At the same time, the SEC also issued [interpretive guidance](#) on existing liquidity and capital resource disclosure requirements, particularly with respect to short-term borrowings.

The amendments and guidance are consistent with the SEC's recent focus on liquidity and capital resource disclosure and are clearly intended to address concerns that companies have engaged in "window dressing" by reducing their debt shortly before the end of a quarter to improve their financial statement data. Window dressing gained scrutiny as a result of reports alleging that Lehman Brothers had artificially reduced its debt levels through repurchase transactions, and a number of press reports have alleged that other financial institutions also took steps to reduce debt right before the end of fiscal periods. We believe that the release is also informed by the responses to the "Dear CFO" letters that the SEC staff sent to many major financial institutions earlier this year.

The interpretive guidance is effective immediately and should be considered by U.S. public companies as they prepare their third quarter Form 10-Qs. The proposed amendments are subject to a comment period ending 60 days after publication of the proposing release in the Federal Register (expected to occur shortly). The SEC likely hopes to finalize these amendments in time for the next annual reporting season.

Interpretive Guidance on MD&A Liquidity and Capital Resource Disclosure Requirements

While the SEC's interpretive guidance largely reiterates what has been communicated informally by the staff in the past or in prior releases, the new guidance serves as yet another reminder that the staff is now intensely focused on this type of disclosure. Specifically, the guidance discusses:

Liquidity Disclosure. The SEC has repeatedly emphasized the need to provide MD&A disclosure of known liquidity sources, used and unused, as well as known trends and uncertainties in funding sources. The new guidance reiterates these requirements and also provides the following examples of "important trends and uncertainties relating to liquidity" that may need to be addressed:

- 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 value of collateral; and
- counterparty risk.

Repurchase Transactions. The guidance also suggests that, in certain circumstances, existing rules already require the disclosure of material intra-period borrowing variations and certain types of repurchase agreements. Noting that "there may be confusion on the part of registrants about how to address disclosure of certain repurchase agreements that are accounted for as sales, as well as other types of short-term financings that are not otherwise fully captured in period-end balance sheets," the guidance suggests that MD&A disclosure may be required if a repurchase agreement or other commitment will result in (or is reasonably likely to result in) the registrant's liquidity increasing or decreasing in a material way or is reasonably likely to result in the use of a material amount of cash or

other liquid assets. This may be particularly true with respect to material off-balance sheet or other transactions that are not disclosed in the contractual obligations table or explicitly required to be disclosed elsewhere.

Cash and Risk Management Policies and Portfolios. The guidance requests that companies, particularly bank holding companies and financial institutions, consider describing their cash and risk management policies. To the extent the company maintains or has access to a portfolio of cash and other material sources of liquidity, it should also consider providing information about the nature and composition of the portfolio.

Leverage Ratio Disclosure. Next, the guidance reminds companies that any leverage ratio or other metric included within MD&A must comply with the SEC's rules on the use of non-GAAP measures, to the extent the metric is a non-GAAP measure, and be accompanied by a clear explanation of the calculation methodology. The calculation methodology should clearly articulate the treatment of any inputs that are unusual, infrequent or nonrecurring, or that are otherwise adjusted so that the ratio is calculated differently from directly comparable measures. The company should also disclose why the measure is useful and consider disclosing how the measure differs from other measures commonly used in the company's industry if necessary to make the disclosure not misleading.

Contractual Obligations Table. Lastly, the guidance reminds companies that the objective of the contractual obligations table is to improve transparency of a company's short-term and long-term liquidity and capital resources needs and provide context for investors to assess the relative role of off-balance sheet arrangements. Companies should prepare the contractual obligations disclosure with that objective in mind and utilize footnotes or narrative information as needed to satisfy that objective.

In general, the guidance is designed to remind companies, especially financial institutions, that they need to disclose the risk of their reliance on short-term financing sources and other aspects of their liquidity. Companies should be mindful of the events of 2007-2008 and ensure that their liquidity section properly describes the risks of their funding situation.

Proposed Disclosure of Intra-period Short-term Borrowings

The proposed amendments would require both quantitative and qualitative disclosures of companies' short-term borrowings, which are defined 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.

Quantitative Disclosures. The proposed quantitative disclosures would be similar to those already provided by bank holding companies under Guide 3, *Statistical Disclosure by Bank Holding Companies* ("**Guide 3**"). Specifically, the required tabular disclosures would include, for each specified category of short term borrowings:

- The amount outstanding at the end of the reporting period and the weighted average interest rate thereon.
- For nonfinancial companies:
 - the average amount outstanding during the reporting period, using an averaging period not to exceed one month, and the weighted average interest rate thereon; and

- the maximum month-end amounts outstanding (*i.e.*, the largest amount outstanding at the end of the last day of any month in the reporting period).
- For financial companies:
 - the average amounts outstanding during the reporting period computed on a daily average basis (*i.e.*, the amount outstanding at the end of each day, averaged over a reporting period) and the weighted average interest rate thereon; and
 - the maximum daily amount outstanding (*i.e.*, the largest amount outstanding at the end of any day in the reporting period).

This is a change from Guide 3 which only requires bank holding companies to provide month-end maximum amounts. Guide 3 also does not require the above quantitative information for any category of short-term borrowings for which the average balance outstanding during the period was less than 30 percent of stockholders' equity at the end of the period. The proposed amendments do not include a comparable threshold.

The proposal defines a financial company as one 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 Securities Exchange Act of 1934. Unlike the Dodd-Frank Act with its quantitative test of 85 percent of revenues or assets related to financial activities, the SEC has decided not to include a quantitative test and it is possible that the SEC means to capture a broader range of companies. At the very least, the SEC has made clear that its definition would include bank holding companies, savings and loan holding companies, insurance companies, brokers, dealers, business development companies, investment advisors, futures commission merchants, commodity trading advisors, commodity pool operators, and mortgage real estate investment trusts. Public companies that have both financial and nonfinancial operations, such as manufacturing companies that have a subsidiary that provides financing to its customers to purchase its products, or energy companies that have a trading operation, would be permitted to provide separate short-term borrowings disclosure for their financial and nonfinancial business operations.

Qualitative Disclosures. Companies would also be required to provide a narrative analysis of their short-term borrowings which would include a discussion of:

- the types of short-term borrowings used,
- the business purpose and importance of the borrowings, and
- any material differences between the maximum or average intra-period borrowings and the period end borrowings.

Some of this disclosure is likely required under existing MD&A requirements in certain circumstances. For example, the guidance on liquidity and capital resources discussed above notes that "depending on the registrant's circumstances, if borrowings during the reporting period are materially different than the period-end amounts recorded in the financial statements, disclosure of intra-period variations is required under current rules to facilitate investor understanding of the registrant's liquidity position."

Reporting Periods. The short-term borrowing disclosure would be required in quarterly and annual reports and registration statements. With respect to annual reports, information would be presented for the three most recent fiscal years and the fourth quarter. The SEC would permit companies other than bank holding companies (which already provide similar disclosure under Guide 3) to phase in this annual reporting requirement by providing short-term borrowing information for the most recent fiscal year in the initial year of compliance and the most recent two fiscal years in the second year of compliance. In the third year of compliance, and thereafter, all companies would be required to include disclosure for each of the three most recent fiscal years.

Companies would not be required to provide comparative information in quarterly reports.

Comment Requested on Possible Leverage Ratio Disclosure. While not proposed at this time, the SEC is also requesting comment on whether to require the disclosure of a company's leverage ratio and, if so, what form such a metric should take in light of the wide variety of metrics used by public companies and the various industries in which they operate. U.S. bank holding companies are already required to disclose certain capital and leverage ratios in regulatory filings and some also include disclosure of these ratios in MD&A.

Foreign private issuers. The proposal would amend Form 20-F to add a new paragraph H under Item 5 (Operational and Financial Review and Prospects) requiring foreign private issuers to provide the short-term borrowing disclosures discussed above. Unlike U.S. issuers, however, which would be required to provide the information in quarterly reports, foreign private issuers would only be required to update the information annually unless filing a registration statement that includes interim information. Foreign private issuers would also be encouraged, but not required, to file interim short-term borrowing information on Form 6-K if required to make such information public under home country or stock exchange regulations.

Foreign private issuers would be permitted to base the categories of short-term borrowings presented on the classification for such types of short-term borrowings required under the comprehensive set of accounting principles used by the company to prepare its financial statements (for example, IFRS or home country GAAP).

Foreign private issuers that are also bank holding companies or treated as bank holding companies may be particularly interested in responding to the SEC's request for comment on whether to generally require leverage ratio disclosure since many of these companies are not currently subject to a regulatory leverage ratio although such a ratio is planned as part of the changes in Basel III.

Conclusion

As stated above, the SEC's interpretive guidance and proposed amendments are consistent with its intense focus on liquidity and capital resources disclosure, which has undoubtedly become increasingly critical in light of the financial events of the past few years. Companies should pay careful attention to the guidance and the information called for by the proposed amendments. We also encourage financial and nonfinancial companies to consider providing comments or engaging in dialogue with the SEC staff on the feasibility of disclosing some type of leverage ratio as well as the short-term borrowing information called for by the proposed amendments. While the SEC is unlikely to waver in its worthwhile goal of requiring greater clarity about companies' short-term financing practices, the Commission and staff do appear open to crafting disclosure requirements that are illuminating without being unfairly burdensome. Companies' input will be critical in this regard.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

| | | |
|----------------------------------|-----------------|--|
| Sarah E. Beshar | 212 450 4131 | sarah.beshar@davispolk.com |
| Julia K. Cowles | 650 752 2007 | julia.cowles@davispolk.com |
| John L. Douglas | 212 450 4145 | john.douglas@davispolk.com |
| Luigi L. De Ghenghi | 212 450 4296 | luigi.deghenghi@davispolk.com |
| Randall D. Guynn | 212 450 4239 | randall.guynn@davispolk.com |
| Michael Kaplan | 212 450 4111 | michael.kaplan@davispolk.com |
| Theodore A. Paradise | +81 3 5561 4430 | theodore.paradise@davispolk.com |
| Richard J. Sandler | 212 450 4224 | richard.sandler@davispolk.com |
| Margaret E. Tahyar | 212 450 4379 | margaret.tahyar@davispolk.com |
| Richard D. Truesdell, Jr. | 212 450 4674 | richard.truesdell@davispolk.com |
| Janice Brunner | 212 450 4211 | janice.brunner@davispolk.com |
