JENNER&BLOCK

Corporate Advisory October 2010

SEC Tackles Short-Term Borrowing Disclosures

by Jerry J. Burgdoerfer, William L. Tolbert, Jr., Elaine Wolff and Lee E. Dionne

Overview

On September 17, the Securities and Exchange Commission (the "SEC") approved actions to enhance disclosures about the type of short-term borrowing activities brought to light in the court-appointed Examiner's report on the Lehman Brothers failure,[1] the largest bankruptcy in American history. The Examiner's report drew attention to how Lehman Brothers used short-term borrowing transactions to report misleading leverage amounts. To address this behavior, the SEC proposed rules that would require companies to make new quantitative and qualitative disclosures in management's discussion and analysis ("MD&A") about their short-term financing (the "Proposing Release").[2] In a companion release, the SEC provided interpretive guidance to improve current discussions of short-term borrowing in MD&A with respect to liquidity and funding risks (the "Interpretive Release"; together with the Proposing Release, the "Releases").[3]

The Interpretive Release has already taken effect and companies will need to take this guidance into account when preparing their 10-Qs for the third quarter. The Proposing Release will be open for public comment until November 29, 2010.

Because the guidance in the Interpretive Release is immediately applicable, companies can expect heightened scrutiny of their liquidity and capital resources disclosure in their MD&A. Accordingly, companies will need to consider their current disclosure obligations with respect to:

- repurchase agreements accounted for as sales and other types of financing where intra-period variations may not be fully captured in a period-end balance sheet;
- leverage ratios and other metrics to ensure compliance with past SEC guidance regarding industry and non-GAAP measures; and
- the contractual obligations table to clearly reflect the cash requirements arising from payment obligations and facilitate period-to-period comparisons.

In addition, the Interpretive Release reminds companies of their obligation to discuss known trends and uncertainties that materially affect liquidity, such as difficulty accessing debt, reliance on commercial paper, maturity mismatches and counterparty risk.

The Proposing Release would require companies to provide new disclosures about, among other things:

- the largest amount of short-term debt outstanding at the end of the last day of any month in the reporting period (and for "financial companies,"[4] the largest amount outstanding at the end of any day in the reporting period);

©2010 Jenner & Block LLP. Jenner & Block is an Illinois Limited Liability Partnership including professional corporations. This publication is not intended to provide legal advice but to provide information on legal matters. Transmission is not intended to create and receipt does not establish an attorney-client relationship. Readers should seek specific legal advice before taking any action with respect to matters mentioned in this publication. The attorney responsible for this publication is Jerry J. Burgdoerfer. Masthead image from the Collection of the Supreme Court of the United States. Attorney Advertising. Prior results do not guarantee a similar outcome.

- the amount of short-term debt outstanding at the end of the reporting period and the average amount outstanding for the reporting period;
- weighted interest rates for period-average and period-end amounts; and
- a narrative explanation of the reasons for using each type of short-term financing arrangement, the importance of the arrangements to the company's liquidity and capital resources, the reasons for the maximum amount borrowed during the period, and the drivers of differences between average amounts and period-end amounts outstanding.

The Releases reflect the SEC's concern that company filings, which provide a "snap-shot" of a company's finances at a given moment in time, do not give investors an accurate picture of a company's short-term financing activities throughout the quarterly or annual reporting period. Noting that some changes in short-term borrowings at the end of reporting periods are inevitable, the SEC asserted that some companies engage in deliberate balance sheet "window-dressing," to mask or effectively conceal their short-term financing activities to the detriment of investors. The SEC expects that disclosure of information pertaining to short-term financing tracked throughout the reporting period will present investors with a fuller picture of the role in, and impact on, a company of short-term financing.

Highlights of each of the Releases are discussed below.

Proposing Release – Enhanced Short-Term Borrowing Disclosures

Background

The Proposing Release points to recent events suggesting that investors could benefit from additional transparency about companies' short-term borrowings, including whether these borrowings vary materially during reporting periods compared to amounts reported at period-end.[5] Without a specific requirement to disclose information about intra-period short-term borrowings, the SEC expressed concern that investors may not have access to sufficient information to understand companies' actual funding needs and financing activities or to evaluate the liquidity risks that companies face during the reporting period. Investors' understanding of a company's financial condition at times has been obfuscated through the efforts of reporting companies to mask their short-term financing activities by "window-dressing" their balance sheets to make them more attractive. Even where a company's motive is not to mislead investors, reporting companies are often able to take advantage of the "snap-shot" nature of filings to reduce short-term borrowings immediately prior to the end of SEC filing periods. The Proposing Release provides as an example a retailer that relies on short-term credit to purchase inventory; if the inventory is sold at the end of the reporting period and the creditors repaid, that retailers' filing will not reflect its actual degree of reliance on such financing. This or similar practices may result in filings that consistently understate the role of short-term financing in a given company. As a result, investors may be unable to form an accurate picture of the company's reliance on short-term financing or its ability to endure a disruption in access to short-term credit.

Summary of Proposed Requirements

Under the Proposing Release, Item 303 of Regulation S-K would be amended to require a separately captioned subsection of MD&A addressing short-term borrowing activities. The proposed rules would require that management present investors with a comprehensive explanation of its short-term borrowings, including quantitative data as well as a qualitative discussion and analysis of short-term borrowings.

Proposed Quantitative Disclosure Requirements

Significantly, companies would be subject to quantitative disclosure requirements that closely parallel the Bank Holding Company disclosures under Securities Act Industry Guide 3, Statistical Disclosure by Bank Holding Companies ("Guide 3").[6] Companies would be required to provide quantitative disclosure with respect to the following five categories of "short-term borrowings:"

- 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 company's balance sheet.

As proposed, companies would be required to disclose:

- 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;
- for companies meeting the proposed definition of "financial company," the maximum daily amount of each specified category of short-term borrowings during the reporting period (meaning the largest amount outstanding at the end of any day in the reporting period); and
- for all other companies, the maximum month-end amount of each specified category of short-term borrowings during the reporting period (meaning the largest amount outstanding at the end of the last day of any month in the reporting period).

Proposed Qualitative Disclosure Requirements

Companies also would be also required to include a narrative discussion aimed at providing investors with a better understanding of the role of short-term financing and its related risks to the company as viewed through the eyes of management. The narrative would need to describe:

- the borrowing arrangements included in each category of short-term borrowings data;
- the business reasons for using the particular types of financing techniques;
- the reasons for the maximum amount borrowed during the reporting period (including any non-recurring transactions or events);
- the drivers of differences between average amounts and period-end amounts outstanding for the period; and
- the importance of short-term borrowing arrangements to the company's liquidity, capital resources, market-risk support and credit-risk support.

In an apparent nod to the events involved in the Lehman Brothers failure, the release provides the example of a company with significant repurchase agreements accounted for as sales that will be settled shortly after the balance sheet date. The SEC asserts that the company in this scenario would be obligated to discuss the impact of this practice on the company's liquidity and explain the corresponding risks and implications for the company's future.

Companies subject to new disclosures

In recognition of the different burdens quantitative disclosures may force on reporting companies based upon such factors as company size, nationality and the degree to which the company engages in financial operations, the Proposing Release differentiates between financial and non-financial companies, foreign private issuers and smaller reporting companies. Non-financial companies would face a less onerous burden in that they could calculate their average outstanding amounts on a periodic basis not to exceed one month and need only report monthly maximum short-term financing amounts rather than daily amounts.[7] Foreign private issuers would be subject to substantially similar rules as U.S. companies.[8] Reporting companies that file with the SEC in accordance with the U.S. Canadian Multijurisdictional Disclosure System ("MJDS Filers") would not be subject to the Proposing Release at this time. In addition, the Proposing Release would relax the burden on smaller reporting companies by reducing the amount of historical data they must furnish and the frequency with which they must disclose information. Smaller reporting companies would be allowed to restrict historical data to the previous two fiscal years, rather than the three years to which larger reporting companies are subject. Although quarterly reporting requirements would not

apply to smaller reporting companies, they would still need to address any material changes with respect to short-term financing in quarterly filings.

Reports subject to new disclosures

As proposed, the requirements would apply to annual and quarterly reports and registration statements. For annual reports, companies would present information for the three most recent fiscal years and for the fourth quarter. In addition, registrants preparing registration statements with audited full-year financial statements would be required to include short-term borrowings disclosure for the three most recent full fiscal year periods and interim information for any subsequent interim periods. For quarterly reports, information would be presented for the relevant quarter, without a requirement for comparative data. For non-financial companies that are not subject to Guide 3, the Release contemplates a yearly phase-in of the requirements for comparative annual data until all three years are included in the annual presentation.

Request for Comment on Disclosure of Leverage Ratios

Mindful of the belief that high leverage at financial institutions contributed to the financial crisis, the SEC asserted that investors may benefit from additional transparency about the capitalization and leverage profile of non-financial companies, particularly for those companies that rely heavily on external financing and credit markets to fund their businesses and future growth. As a result, the Proposing Release seeks comment on whether to extend a leverage ratio disclosure requirement to companies that are not bank holding companies as well as on the manner of calculating leverage ratios.

Interpretive Release – Guidance on the Presentation of Liquidity and Capital Resources Disclosure in MD&A.

As a complement to the Proposing Release, the Interpretive Release focuses on existing MD&A disclosure principles related to liquidity, leverage and access to capital resources in order to facilitate an investor's understanding of a company's liquidity and funding risks. The Interpretive Release underscores three aspects of current MD&A disclosure. First, the Interpretive Release reminds companies that existing MD&A disclosure obligations apply to known trends or uncertainties reasonably likely to affect liquidity in any material way. Second, companies that present leverage ratios and other financial or non-financial metrics in their filings must follow the SEC's existing framework for the use of non-financial or non-GAAP measures. Finally, the Interpretive Release addresses "divergent practices" regarding the inclusion and presentation of information in the contractual obligations table.

First, in the context of liquidity and capital resources, the Interpretive Release highlights that narrative disclosure may be required if a company's financial statements do not adequately convey the company's financing arrangements during the period, or the impact of those arrangements on liquidity because of a known trend, demand, commitment, event or uncertainty. The Interpretive Release observes that the Commission's staff has noted confusion 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. In light of this confusion, the SEC is providing guidance to emphasize that under current rules disclosure of intra-period variations would be required to facilitate an understanding of the company's liquidity position if borrowings during the period are materially different than the period-end amounts recorded in the financial statements. Companies should also consider disclosure when trends and uncertainties with respect to liquidity arise in the context of, among others, difficulty accessing debt markets, reliance on commercial paper or similar short-term arrangements, maturity mismatches between borrowing sources and the funded assets, counterparty requests for changed terms, shifts in collateral value and counterparty risk.

In another indication that the circumstances involved in the Lehman Brothers failure sparked the need for additional guidance, the SEC clarified that the absence of specific references to repurchase transactions that are accounted for as sales does not relieve reporting companies of their disclosure

obligations under Regulation S-K. The Interpretive Release stresses that "legal opinions regarding 'true sale' issues do not obviate the need for registrants to consider whether disclosure is required." In deciding whether disclosure in MD&A may be required in connection with a repurchase transaction, securities lending transaction, or other transaction involving the transfer of financial assets with an obligation to repurchase financial assets, companies should "consider whether the transaction is reasonably likely to result in the use of a material amount of cash or other liquid assets."

In addition, the Interpretive Release advises companies that maintain a portfolio of cash or other investments that constitute a material source of liquidity to provide information about the nature and composition of the portfolio, including a description of the assets held and any related market risk, settlement risk or other risk exposure.

Second, the Interpretive Release sets forth the current standards applicable to the inclusion of leverage ratios and other metrics in company filings. The SEC refers to a two-step process in determining the standards that apply to a given metric. First, companies must determine whether the metric is a financial measure. If not, then the standards relevant to industry or value metrics apply. If the metric is a financial measure, then the company must determine whether the SEC's requirements for non-GAAP financial measures apply. In any event, companies should clearly explain the manner of calculation of the ratio or measure, explaining any adjustments for unusual or non-recurring events as well as the reason for any deviations from industry practice. Further, companies need to include disclosure to clearly explain the reasons for presenting the metric to investors and why the measure is useful to understanding the company's financial condition.

Finally, in light of the variable manner by which companies report and present their contractual obligations table disclosures, the Interpretive Release encourages companies to (i) develop a presentation method that is clear, understandable and appropriately reflects the categories of obligations that are meaningful in light of its capital structure and business, and (ii) highlight any changes in presentation so that investors are able to use the information to make comparisons from period to period. The Interpretive Release reminds companies to take account of the purpose of the contractual obligations table disclosure in deciding whether to include a particular item such as interest payments, repurchase agreements, tax liabilities and obligations under off-balance sheet arrangements: "to provide aggregated information about contractual obligations in a single location so as to improve transparency of a registrant's short-term and long-term liquidity and capital resources needs and to provide context for investors to assess the relative role of off-balance sheet arrangements."

Endnotes

[1] See Lehman Brothers Report, *available at* http://lehmanreport.jenner.com.

[2] SEC Release Nos. 33-9143; 34-62932 (Sept. 17, 2010) [hereinafter "Proposing Release"], *available at* http://www.sec.gov/rules/proposed/2010/33-9143.pdf. The SEC notes the disclosure and accounting challenges presented by short-term financing arrangements such as repurchase agreements accounted for as sales, large intra-period fluctuations in borrowed amounts and the lack of an explicit disclosure requirement; "To address these issues, we are proposing to amend the MD&A requirements to enhance disclosure that registrants provide regarding the use and impact of short-term financing arrangements during each reporting period." *Id.* at 7-9.

[3] SEC Release Nos. 33-9144; 34-62934 (Sept. 17, 2010) [hereinafter "Interpretive Release"], *available at* http://www.sec.gov/rules/interp/2010/33-9144.pdf.

[4] The SEC defines a financial company for the purposes of the Proposing Release as: "a registrant that, during the relevant reported period, 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 advisor, a futures commission merchant, a commodity trading advisor, a commodity pool operator, or a mortgage real estate investment trust."

[5] *See, e.g.*, Financial Crisis Inquiry Commission, Hearing on "The Shadow Banking System" (May 5, 2010) (transcript *available at* http://www.fcic.gov/hearings/pdfs/2010-0505-Transcript.pdf). The Financial Crisis Inquiry Commission was created by the Fraud Enforcement and Recovery Act of 2009 to study the domestic and global factors that contributed to the economic crisis in the United States. This commission's final report to Congress and the President is due in December 2010.

[6] Guide 3 is *available at* http://www.sec.gov/about/forms/industryguides.pdf.

[7] Where a reporting company has both financial and non-financial operations, that company would be able to disclose its non-financial data in accordance with the standards applicable to non-financial companies but its financial operations would be held to the heightened standard applicable to financial companies.

[8] Under the Proposing Release, Form 20-F would amend Item 5 (Operational and Financial Review and Prospects) to include a new paragraph to cover short-term borrowings. The terms of the release would allow foreign private issuers that make use of International Financial Reporting Standards ("IFRS") or a similarly recognized accounting system to premise quantitative disclosures upon those accounting standards.

For more information, please contact the following Jenner & Block attorneys:

Jerry J. Burgdoerfer
Partner, Corporate Practice
Tel: 312 923-2820
Email: jburgdoerfer@jenner.com

William L. Tolbert, Jr.
Partner, Corporate Practice
Tel: 202 639-6038
Email: wtolbert@jenner.com

Elaine Wolff
Partner, Corporate Practice
Tel: 202 637-6389
Email: ewolff@jenner.com

Lee E. Dionne
Associate, Corporate Practice
Tel: 312 980-7639
Email: ldionne@jenner.com