

US Securities and Exchange Commission Proposes New Short-Term Borrowings Disclosure

On September 17, 2010, the Securities and Exchange Commission (SEC) unanimously approved Release Nos. 33-9143; 34-62932¹ (the Proposing Release), proposing a new, separately captioned subsection of Management's Discussion and Analysis of Financial Condition and Results of Operations (MDA) that would contain detailed quantitative and qualitative information about a registrant's short-term borrowings for annual and quarterly periods. This proposal is designed to address balance sheet "window dressing," a practice whereby some companies intentionally pay down short-term indebtedness just before the end of a reporting period so that such debt, which may be important to the company's operations, does not appear on the balance sheet. The proposed amendments would highlight short-term financing practices throughout a period, rather than providing only a period-end snapshot. They would codify in new Item 303(a)(6) of Regulation S-K an adaptation of current Industry Guide 3, Statistical Disclosure by Bank Holding Companies (Guide 3), which would be applicable to all companies that provide MD&A disclosure. Comments on the short-term borrowings disclosure proposal are due on or before November 29, 2010.

Short-Term Borrowings Disclosure

Tabular Disclosure. Proposed new Item 303(a)(6) would require companies to include a table disclosing the amount of their borrowings *at the end* of the applicable reporting period, as well

as the weighted average interest rate, for short-term obligations falling within the following specified categories:

- Federal funds purchased and securities sold under agreements to repurchase
- Commercial paper
- Borrowings from banks
- Borrowings from factors or other financial institutions
- Any other short-term borrowings reflected on the registrant's balance sheet.

In addition, companies would have to disclose the *average* amount of short-term borrowings they had outstanding in each specified category *during* the reporting period and the weighted average interest rate on those borrowings. A registrant would have to present the information for each category that is relevant to the types of short-term financing it conducts, even if it is not required to report such a category as a separate balance sheet line item.

The new disclosure would have to be presented separately for each category of short-term obligations. Unlike Guide 3, the proposed rules *do not* permit categories falling below a quantitative threshold of outstanding debt to be aggregated. In addition, the categories would have to be further disaggregated by currency, interest rate or other meaningful category if that is necessary to promote understanding or prevent the presented information from being misleading. In such cases, a footnote would be required to describe the

method of disaggregation, as well as pertinent data such as the timing and exchange rates used for currency translations.

The proposed rules distinguish between “financial companies” and other companies. Under the proposal, a financial company is defined to mean a registrant that, during the 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. The definition includes 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.

If a registrant is a financial company, it would have to report the maximum *daily* amount it had outstanding in each specified category of short-term borrowings during the reporting period. Similarly, financial company registrants would have to present the required averages computed on a *daily* average basis.

Non-financial company registrants would be required to report the maximum amounts outstanding on a *month-end*, rather than daily, basis. These registrants would be able to present average outstanding amounts computed on a period not to exceed a month, disclosing the basis used for calculating the average amounts reported.

If a registrant conducts both financial and non-financial businesses, it would be permitted to provide short-term borrowings disclosure separately for these two types of operations, presenting its financial company business using the daily concepts, with the non-financial company business using the month-end maximum amount outstanding and the more flexible average amount outstanding presentation. If such a registrant elects to follow this bifurcated method of presentation, it would have to provide a

footnote to the table to explain how operations were grouped for the purpose of disclosure.

Narrative Disclosure. Proposed new Item 303(a)(6)(ii) of Regulation S-K would require a narrative discussion and analysis of short-term borrowing arrangements in the MD&A. To the extent necessary for an understanding of the company’s short-term borrowings and their current or future effect on the financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources, this qualitative disclosure would have to address:

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

The SEC anticipates that when preparing the short-term borrowings discussion and analysis a registrant “would need to consider its disclosures of cash requirements presented in the contractual obligations table, its disclosures of off-balance sheet arrangements, as well as its other liquidity and capital resources disclosures.” The Proposing Release also states that a registrant should consider ways to integrate the new disclosures

with existing MD&A requirements to provide a clear and comprehensive description of its liquidity profile, perhaps by “organizing its discussion to address overall liquidity, and then short-term and long-term borrowings and liquidity needs.”

Reporting Periods. As proposed, the short-term borrowings requirements would be applicable to annual and quarterly reports and registration statements. Annual reports would contain short-term borrowings disclosure for the three most recent fiscal years. Annual reports would also have to contain fourth quarter short-term borrowings disclosure. Quarterly reports would contain full (i.e., *not* limited to material changes) short-term borrowings information for the relevant quarter, without any comparative data requirement. Registration statements containing audited full-year financial information would have to contain short-term borrowings disclosure for the three most recent full fiscal year periods, as well as interim information for any subsequent period.

Forward-Looking Language. The SEC did not propose any specific provision or guidance as to the applicability of the statutory safe harbor for forward-looking statements to short-term borrowings disclosure that may contain forward-looking information, and did not expand or limit the scope of the statutory safe harbor or safe harbor rules. Therefore, forward-looking information provided with respect to the proposed new short-term borrowings disclosure requirements would need to be treated in the same manner as other MD&A disclosure.

Variations for Certain Issuers

Foreign Private Issuers. The proposed rules for short-term borrowings disclosure would apply to foreign private issuers, other than filers using the US-Canadian Multijurisdictional Disclosure System (the MJDS), through proposed new paragraph H under Item 5 of Form 20-F. However, since foreign private issuers are not required to file quarterly reports with the SEC, they would only have to provide the new short-

term borrowings disclosure on an annual basis. Also, if a foreign private issuer does not prepare its financial statements under US GAAP (Generally Accepted Accounting Principles), it would be permitted to present categories of short-term borrowings disclosure that correspond to the classifications used in the comprehensive set of accounting principles under which such company prepares its primary financial statements, provided that the level of detail satisfies the objective of the disclosure requirement.

MJDS Filers. The proposed short-term borrowings disclosure rules would not apply to registrants that file SEC reports and registration statements under MJDS.

Smaller Reporting Companies. The proposed short-term borrowings disclosure rules would apply to registrants that qualify as “smaller reporting companies,” except that they would only need to provide quarterly information to the extent material changes have occurred during that period.

Transition Period

The SEC has proposed a transition period for registrants that are not bank holding companies or subject to Guide 3. These companies would be able to phase in the annual reporting requirement over three years so that in the initial year, they would only have to include the short-term borrowings information for the most recent fiscal year. During the second year of the transition period, such companies would only have to report short-term borrowings information for the two most recent fiscal years. Full three-year disclosure would begin in the third year of the transition period.

Other Matters

Leverage Ratio Disclosure Issues. The Proposing Release indicates that the SEC is considering whether to extend a leverage ratio disclosure requirement to companies that are not bank holding companies. The SEC has requested

comment about the scope of such a disclosure requirement, particularly how such a requirement should take into account differences among metrics used to evaluate debt levels and capital adequacy and among industries while providing comparability.

Technical and Conforming Amendments. The Proposing Release contains technical amendments to reflect the Financial Accounting Standards Board's (FASB) codification of accounting standards. The proposed amendments would also conform the definition of "direct financial obligation" in Form 8-K to align the existing reporting obligations under Items 2.03 and 2.04 of Form 8-K with the proposed new MD&A definition of short-term borrowings.

Companion Release. At the same time that the SEC approved the Proposing Release, it issued Release Nos. 33-9144; 34-62934,² providing interpretive guidance on existing MD&A requirements. That interpretive release is discussed in our Legal Update³ dated September 22, 2010 titled "US Securities and Exchange Commission Issues MD&A Interpretive Guidance."

Practical Considerations

- Not only did the SEC take the time to propose short-term borrowings disclosure when its regulatory calendar is very full with rulemaking projects mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act, it did so unanimously. This signals that all the Commissioners believe this proposal to be an important initiative. Therefore, it appears likely that short-term borrowings disclosure requirements will become part of the MD&A. Accordingly, public companies should begin consideration of how they will gather and report the required information and integrate the new disclosures with the existing MD&A requirements.
- Some companies may believe that it will be burdensome to compile and present the

information that would be required by the proposed new short-term borrowings reporting requirements, or by specific portions of the proposed rules. The SEC is seeking comments on many aspects of its short-term borrowings disclosure proposal. Companies should consider whether they want to prepare a comment letter, or join an industry group comment letter, in order to have input on the scope and form of the final disclosure requirement.

Endnotes

¹ Available at <http://www.sec.gov/rules/proposed/2010/33-9143.pdf>

² Available at <http://www.sec.gov/rules/interp/2010/33-9144.pdf>

³ Available at <http://www.mayerbrown.com/securities/article.asp?id=9684&nid=10707>

If you have any questions regarding the SEC's proposed short-term borrowings rules, please contact the author of this Legal Update, Laura D. Richman, at +1 312 701 7304, or any of the lawyers listed below or any other member of our Corporate & Securities group.

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