September 22, 2010

SEC Proposes New Disclosure Rules Targeting Balance Sheet Window-Dressing and Issues New MD&A Guidance

On September 17, 2010, the Securities and Exchange Commission (the "SEC") unanimously proposed new disclosure rules with respect to short-term borrowings.[1] The new rules would require enhanced disclosure of liquidity positions by all SEC reporting companies (whether domestic or foreign (other than those reporting under MJDS)). The proposed disclosure requirements would be similar to requirements currently applicable only to bank holding companies. In addition, bank holding companies would be subject to stricter reporting requirements in respect of short-term borrowings. The new disclosure would be required in annual and quarterly periodic reports filed under the Securities Exchange Act of 1934, in registration statements filed under the Securities Act of 1933 and under the Securities Exchange Act of 1934, and in proxy or information statements that include financial statements.

The aim of the proposed SEC rulemaking is to address, in the words of the SEC Chairman, "balance sheet window dressing," whereby levels of short-term borrowings are reduced at quarter end, so as to present healthier balance sheets that capture only a snapshot at quarter end of a registrant's liquidity. The proposed disclosure would provide investors with additional information necessary to better evaluate a company's current short-term liquidity profile and potential future trends in its liquidity and funding risks.

Concurrently, the SEC approved the issuance of new interpretive MD&A guidance, which is effective upon publication in the Federal Register.[2] This new guidance is intended to improve investors' overall understanding of the potential liquidity and funding risks faced by registrants.

Proposed Short-Term Borrowings Disclosure

Concepts

The new disclosure rules on short-term borrowings would apply disclosure requirements similar to those in *SEC Industry Guide 3, Statistical Disclosure by Bank Holding Companies* ("Guide 3") guidance on short-term borrowings, currently applicable only to bank holding companies, with certain changes, to all financial and non-financial SEC reporting companies. SEC reporting companies would need to provide, under a new subheading in the MD&A, quantitative disclosure regarding short-term borrowings in tabular format by category of borrowings, accompanied by qualitative discussion.

[1] Release No. 33-9143; 34-62932 (2010).

[2] Release No. 33-9144; 34-62934 (2010).

For purposes of the proposed rules:

- ***Short-term borrowings*** would include amounts payable for short-term obligations that are (1) federal funds purchased and securities sold under agreements to repurchase; (2) commercial paper; (3) borrowings from banks; (4) borrowings from factors or other financial institutions; and (5) any other short-term borrowings reflected on the company's balance sheet.

- ***Financial companies*** would include companies that during the reporting period are engaged to a "significant extent" in the business of lending, deposit-taking, providing investment advice or insurance underwriting, or are a broker or a dealer. An entity that is a holding company, 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 adviser, a commodity pool operator, or a mortgage real estate investment trust is a financial company. The proposed definition is intentionally flexible and would capture companies with both financial and non-financial businesses.

Qualitative disclosure of short-term borrowings

The qualitative (narrative) disclosure of short-term borrowings would have to include:

- a discussion necessary to an understanding of such borrowings and the current or future effect on the company's financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditure or capital resources;

- 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 company's ability to borrow the borrowings under any of its arrangement and whether collateral might be required) and the business purpose of the short-term borrowings;

- the importance to the company of its short-term borrowings to 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 end of period short-term borrowings; and

- the reasons for the maximum outstanding amounts in each reporting period, including any non-recurring transactions or events, use of proceeds or other information that provides context for the maximum amount.

This qualitative disclosure is not intended to be repetitive of other disclosure relating to liquidity and capital resources. Instead, the discussion of short-term borrowings should be integrated with disclosures regarding cash requirements in the contractual obligations table, disclosures of off-balance sheet arrangements and other liquidity and capital resources disclosures to present a clear, comprehensive description of the company's liquidity profile.

Quantitative disclosure of short-term borrowings

The quantitative disclosure of short-term borrowings would have to include, by category of short-term borrowings, (1) the amount and weighted average interest rate of short-term borrowings at the end of the reporting period, (2) the average amount and the weighted average interest rate of short-term borrowings during the reporting period and (3) the maximum amount of short-term borrowings during the reporting period. The amounts of short-term borrowings would have to be disaggregated by currency, interest rates or other meaningful category if the aggregate presentation would be misleading, and footnotes would have to be used to explain the calculations.

The proposed rules distinguish between financial companies and non-financial companies for purposes of reporting maximum amounts and average amounts outstanding during a reporting period. Financial companies would have to compile and report data for the maximum daily amounts outstanding (meaning the largest amount outstanding at the end of any day in the reporting period) and the average amounts outstanding during the reporting period computed on a daily average basis (meaning the amount outstanding at the end of each day, averaged over the reporting period). Non-financial companies would have to report the maximum month-end amounts outstanding (meaning the largest amount outstanding at the end of the last day of any month in the reporting period); these companies would not be required to present average outstanding amounts computed on a daily average basis, but the averaging period could not exceed one month.

A company that has both non-financial and financial businesses would have the option to report the maximum and average amounts of short-term borrowings of non-financial businesses on a monthly basis and to report only the maximum and average amounts of short-term borrowings of its financial businesses on a daily basis.

Periods for which short-term borrowings disclosure would be required

In annual reports, the disclosure of short-term borrowings would have to be made for each of the three most recent fiscal years, and separately for the fourth fiscal quarter (presented in the manner of an interim period). For quarterly reports, the disclosure for only the relevant quarter would be required (without comparative data). For registration statements with audited full-year financial statements, companies would be required to include the disclosure for the most recent three fiscal periods and information for any subsequent interim periods (comparative data would not be required). In addition, disclosure would be required to highlight any material changes from prior periods.

No distinction in the level of detail would be made between annual and quarterly reports. In quarterly reports, companies would need to include full presentation of quantitative and qualitative information for short-term borrowing during the quarter, rather than only disclosing material changes that have occurred since the previous balance sheet date.

Applicability to foreign private issuers

Foreign private issuers would be subject to substantially the same disclosure requirements as other SEC reporting companies with respect to short-term borrowings. However, the categories of short-term borrowings for foreign private issuers may be based on the classifications for short-term borrowings specified by the comprehensive set of accounting standards used by foreign private issuers to prepare their primary financial statements, so long as the disclosure provides the same level of detail.

Foreign private issuers would need to provide the disclosure only for most recent three fiscal years. As foreign private issuers are not required to file quarterly reports, there would be no obligation for these issuers to report short-term borrowings on a quarterly basis. Nonetheless, in registration statements, foreign private issuers would be required to include quarterly information on short-term borrowing for any subsequent periods. Some foreign private issuer financial companies may have developed certain Guide 3 disclosure practices based on SEC waivers or otherwise. These financial companies may need to review their Guide 3 disclosure practices to ensure compliance with the new requirements.

Applicability to MJDS filers

The proposed amendments would not affect Canadian filers eligible to use the MJDS.

Applicability to Smaller Reporting Companies

Smaller reporting companies would be subject to substantially the same disclosure requirement as other SEC reporting companies with respect to short-term borrowings disclosure. However, smaller reporting companies would not be required to disclose short-term borrowings in their quarterly reports, unless material changes have occurred during the relevant interim period. Smaller reporting companies would also be permitted to omit the fourth fiscal quarter short-term borrowings disclosure in their annual reports. Furthermore, smaller reporting companies would be permitted to disclose only the two most recent fiscal years of short-term borrowings, rather than three years.

Applicability of Safe Harbor Protection

The disclosure of short-term borrowings required by the proposed amendments could include forward-looking information, which would be treated by the SEC in the same manner as any other MD&A disclosure for purposes of the statutory safe harbors.

Leverage Ratios

The SEC is considering whether to extend a leverage or capital ratio disclosure requirement to registrants that are not bank holding companies, in order to enable investors to better evaluate a company's debt levels and capital adequacy. As stated by the SEC, there does not appear to be a one-size-fits-all leverage or capital ratio that is used by companies or investors. Different metrics are used in different industries, sophisticated investors have their own proprietary models and calculate their own ratios, and that there is no consensus on how to measure and treat off-balance sheet leverage for purposes of calculating ratios. The SEC requested comment as to the scope of a potential disclosure requirement for leverage or capital ratios for non-financial companies and how such a requirement would take into account the differences among metrics and industries while still providing comparability.

Transition Periods

All companies that are not bank holding companies or subject to Guide 3 would be allowed to phase-in compliance with the comparable annual period disclosure. A yearly phase-in of the requirements for comparative annual data would be permitted until all three years are included in a company's annual report. In the initial year, such companies would be allowed to include short-term borrowing information for the most recent fiscal and omit it for the two preceding fiscal years. In the second year, such companies would be allowed to omit the information for the third preceding fiscal year. In the third year, disclosure for all three preceding fiscal year would be required.

Guidance on Liquidity and Capital Resources Disclosure

The SEC has issued additional interpretive guidance to improve the discussion of liquidity and capital resources in the MD&A.

Liquidity disclosure

The SEC's MD&A rules and interpretations require companies to provide investors with disclosure that facilitates an appreciation of the known trends and uncertainties that have impacted historical results or are reasonably likely to shape future periods, in each case from the perspectives of management. In the context of liquidity, disclosure of known trends or any known demands, commitments, events or uncertainties that will result in, or that are reasonably likely to result in, the company's liquidity increasing or decreasing in any material way is required.

The SEC has used the focus on short-term borrowings as another opportunity to remind SEC reporting companies that, as financing activities become more diverse and complex, they need to make sure that their disclosure meets the objectives of the MD&A, is clear and is not misleading.

Important trends and uncertainties. In addition to areas that the SEC has highlighted in its past interpretive releases on MD&A, the SEC has now provided additional examples of important trends and uncertainties relating to liquidity that must be addressed. These include 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 general counterparty risk.

Intra-period debt amounts. The SEC has clarified that if a company's financial statements do not adequately convey the company's financing arrangements during the reporting period, or the impact of those arrangements on liquidity, the company may be required to add narrative disclosure to enable an understanding of the amounts depicted in the financial statements. For example, depending on the company's circumstances, if borrowings during the reporting period are materially different than the period-end amounts recorded in the financial statements, disclosure about the intra-period variations is required under the current rules to facilitate investor understanding of the company's liquidity position. (Thus, even in the absence of new rules on short-term borrowings, the SEC is on record as requiring companies to address intra-period movements in their levels of debt, if the maximum amounts are materially different from the amounts at period-end.)

Repurchase transactions. The absence of specific references in existing disclosure requirements for off-balance sheet arrangements or contractual obligations to (a) repurchase transactions that are accounted for as sales or (b) any other transfers of financial assets that are accounted for as sales, does not relieve registrants from MD&A disclosure requirements if a known commitment, event or uncertainty will result (or is reasonably likely to result) in the company's liquidity increasing or decreasing in a material way. Companies have to consider whether the transactions, such as repurchase, securities lending or any other transaction involving the transfer of financial assets with an obligation to repurchase the financial assets that has been accounted for as a sale, are reasonably likely to result in the use of a material amount of cash or other liquid assets. If so, then such transactions must be disclosed, particularly where the company does not otherwise include such information in its discussion of off-balance sheet arrangements or in its contractual obligations table.

Cash management and risk management policies. Companies also need to describe cash management and risk management policies that are relevant to an assessment of their financial condition. Banks in particular should consider their policies and practices in meeting applicable agency guidance on funding and liquidity risk management, or any policies and practices that differ from applicable agency guidance. Companies that maintain or have access to a portfolio of cash and other instruments that are a material source of liquidity should consider providing information about 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, which could include information about the nature of any limits or restrictions on the company's ability to use or access those assets to fund its operations.

Leverage ratio disclosure

If a company chooses to include capital or leverage ratios in its MD&A, such ratios need to be accompanied by a clear explanation of the calculation methodology. The explanation should articulate the treatment of any items that are unusual, infrequent or non-recurring, or that are otherwise adjusted, so that the ratio is calculated differently from directly comparable measures. The company must either discuss the differences of its measure with a directly comparable measure in the registrant's industry, or present that comparable measure to avoid the disclosure being misleading. Registrants will also need to consider their reasons for presenting the particular financial measure and include disclosure stating why the measure is useful to understanding its financial condition.

Registrants are also reminded that capital or leverage ratios that are presented in the absence of regulatory requirements prescribing a methodology or in a form that differs from the prescribed form will need to consider whether the measure is a financial measure or a non-financial measure, and then apply the relevant guidance.[3] Presentation of ratios in the context

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[3] See Release No. 33-8350 (2003) and Release No. 33-8176 (2003).

of discussions of debt instruments and covenant compliance should also conform to prior guidance.

Contractual obligations table disclosure

The contractual obligations table in the MD&A is meant to provide aggregated information about contractual obligations and contingent liabilities and commitments in a single location to improve transparency of short-term and long-tem liquidity and capital resources. Companies are encouraged to develop a presentation methodology that is clear, understandable and appropriately reflects the categories of obligations that are meaningful in light of their capital structure and business. Companies should highlight any changes in presentation so that investors can compare the new presentation to the presentation of prior periods. Footnotes or even additional narrative disclosure should be used where appropriate and may be necessary to explain what the table does and does not include.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Moreover, we are not accountants and do not purport to be interpreting any accounting standards. Questions concerning issues addressed in this memorandum should be directed to:

Mark S. Bergman	+44 20 7367 1601
David S. Huntington	(212) 373 3124
John C. Kennedy	(212) 373-3025
Raphael M. Russo	(212) 373 3309
Tong Yu	+(81-3) 3597-6306

NEW YORK
1285 Avenue of the Americas
New York, NY 10019-6064
+1-212-373-3000

BEIJING
Unit 3601, Fortune Plaza Office
Tower A
No. 7 Dong Sanhuan Zhonglu
Chao Yang District, Beijing 100020
People's Republic of China
+86-10-5828-6300

HONG KONG
12th Fl., Hong Kong Club Building
3A Chater Road
Central Hong Kong
+852-2846-0300

LONDON
Alder Castle, 10 Noble Street
London EC2V 7JU
United Kingdom
+44-20-7367-1600

TOKYO
Fukoku Seimei Building, 2nd Floor
2-2, Uchisaiwaicho 2-chome
Chiyoda-ku, Tokyo 100-0011
Japan
+81-3-3597-8101

WASHINGTON, D.C.
2001 K Street NW
Washington, DC 20006-1047
+1-202-223-7300

WILMINGTON
500 Delaware Avenue, Suite 200
Post Office Box 32
Wilmington, DE 19899-0032
+1-302-655-4410