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SEC Disclosure and Corporate Governance

Another MD&A "Heads-Up" From the SEC:

Short-Term Liquidity and Funding Risks

To enhance the transparency of short-term borrowing practices by non-financial as well as financial companies, the Securities and Exchange Commission recently voted unanimously to propose expansive new requirements for disclosure in Management's Discussion and Analysis of Financial Condition and Results of Operations of intra-quarter fluctuations in corporate short-term borrowings and the related risks and uncertainties. The 60-day public comment period began to run on September 28, 2010, when the proposing release was published in the Federal Register.[1] In a companion interpretive release (the "MD&A Liquidity Release"),[2] the SEC provided guidance under the current MD&A disclosure regime intended to facilitate investors' understanding of the liquidity and funding risks posed by short-term borrowing practices, including repurchase transactions. This interpretive guidance, which is now effective, is the second SEC interpretive release published this year that emphasizes the importance of giving investors an early warning of material risks facing public companies.[3] The MD&A Liquidity Release is of immediate relevance to calendar-year reporting companies whose third-quarter Form 10-Qs are due in early November.

We begin with a discussion of the SEC's interpretive guidance under the existing MD&A disclosure requirements relating to liquidity and capital resources, capital and leverage ratios, and the contractual obligations table reflecting both short-term and long-term cash demands arising from contractual payment obligations.[4] The SEC staff will expect companies to have considered this guidance carefully in preparing their upcoming quarterly reports on Form 10-Q. We will then turn to the SEC's release proposing amendments to MD&A disclosure requirements that, if adopted, will substantially expand line-item disclosure of on-balance sheet financing arrangements by all companies, not just those financial institutions that traditionally have been subject to heightened disclosure standards in this area.

The New Interpretive Guidance

Renewed Emphasis on Disclosure of Material Liquidity Risks, Whether On- or Off-Balance Sheet

In the MD&A Liquidity Release, the SEC noted the proliferation of complicated short-term financing techniques now available to companies, and reminded management of the importance of 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 registrant's liquidity increasing or decreasing in any material way." To illustrate this point, the SEC listed the following "additional important trends and uncertainties relating to liquidity":

- 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 borrowing terms requested by counterparties;
- changes in collateral valuation; and
- counterparty risk.

The SEC also took this opportunity to highlight what it views as management's *current* duty – independent of the proposed new short-term borrowing line-item disclosure requirements discussed below – to use the MD&A to explain instances in which period-end liabilities reflected in the company's financial statements do not communicate adequately the risks and uncertainties attendant to material intra-period fluctuations in amounts borrowed. Situations arose during the recent financial crisis in which companies were unable to tap such normally reliable sources of immediate liquidity as funds held in money-market accounts or the commercial paper markets, and the SEC staff for some time has been emphasizing (in comment letters and other forms of guidance) the importance of alerting investors to the possibility that the historical results reported in Form 10-K's and 10-Q's may not be indicative of future performance should significant liquidity demands arise.

While acknowledging that there is no specific reference in Item 303(a) to repurchase agreements, share-lending transactions and other off-balance sheet arrangements or contractual repurchase obligations that may be accounted for as sales despite the seller's continuing involvement with the transferred assets,[5] the SEC stated that companies nevertheless must analyze whether a particular transaction "is reasonably likely to result in the use of a material amount of cash or other liquid assets." If so, MD&A disclosure may be necessary – "particularly where the registrant does not otherwise include such information in its off-balance sheet arrangements [disclosure] or its contractual obligations table."

The SEC went on to urge companies to consider disclosing cash management and risk management policies that are relevant to an evaluation of their financial condition, in order "[t]o provide context for the [material] exposures identified in the MD&A." Banks, for example, could discuss policies and practices intended to satisfy banking agency guidance on managing liquidity and funding risk and, to the extent applicable, any policies and practices that might differ from such guidance. A company that relies on a portfolio of cash and other investments as a material liquidity source should weigh whether to disclose the nature and composition (by asset type) of that portfolio, the existence of market, settlement or other risk exposure associated with the various asset types, and any limits or restrictions on access that might impair the company's ability to fund business operations.

Corporate managers should note the repeated references in the MD&A Liquidity Release to previously issued guidance on the importance of using the MD&A to provide clear and understandable disclosure regarding known trends, events, demands, commitments and uncertainties that management believes are reasonably likely to have a current or future material impact on a company's liquidity and capital resources. These include the SEC's 2003 MD&A Interpretive Release,[6] the 2003 Off-Balance Sheet Arrangements Adopting Release,[7] the 2002 SEC Statement on MD&A,[8] and the March 2010 and December 2007 Dear CFO Letters.[9]

Leverage Ratios

A company that opts to disclose capital or leverage ratios in its MD&A that either are not dictated by specific regulations (*e.g.*, banking), or that are calculated pursuant to a methodology that differs from the accepted or prescribed form, must consider whether these ratios constitute financial or non-financial measures. If a particular ratio does not involve a financial measure, the company should consult the SEC disclosure guidance published in 2003 focusing on the use in SEC filings of such non-financial measures as industry or value metrics.[10] In the event the ratio is a financial measure, the company should evaluate whether it is a non-GAAP financial measure subject to Item 10(e) of Regulation S-K and related guidance.[11]

Regardless of whether a ratio or other metric included in a filing is a financial or non-financial measure, it "should be accompanied by a clear explanation of the calculation methodology." The requisite explanation should articulate clearly the treatment of any inputs that are unusual, infrequent or non-

recurring, or that are otherwise adjusted so that the ratio in question is calculated differently from directly comparable measures. In the case of a financial measure that differs from those commonly used by a company's competitors, the company should assess whether a description of these differences or a presentation of the standard industry measures would be necessary or appropriate to avoid rendering its own disclosure misleading. Last but not least, the company should assess whether it needs to disclose why the measure would help investors understand the company's financial condition. Where the ratio is presented in the context of a discussion of the company's debt instruments and related covenants, the company should follow the SEC's past guidance – set forth in the 2003 Interpretive Release – on disclosure of debt instruments, guarantees and covenants.

Contractual Obligations Table

Finally, the SEC encouraged companies to remember the central purpose of the contractual obligations table mandated by Item 303(a)(5) of Regulation S-K when drafting the MD&A – "to provide aggregated information about contractual obligations and [contractual] contingent liabilities and commitments in a single location so as to improve the 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[.]" While aware that the SEC staff continues to field questions from companies on the appropriate disclosure methodology for such covered items as repurchase agreements, interest payments, tax liabilities, synthetic leases and liabilities arising under various off-balance sheet arrangements, the SEC reaffirmed its preference for a flexible, "facts-and-circumstances" analytical approach. Each company "should 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 highlight any changes in that method to enable investors to use the information to make period-to-period comparisons. Any uncertainty "about what to include or how to allocate amounts over the periods required in the table should be resolved consistent with ... [the SEC's stated purpose, as noted above]." Where necessary to enhance investor understanding of the timing and amount of the specified contractual obligations, companies should add footnotes or additional narrative to explain the data presented in the table.

The SEC offered this helpful example in footnote 17 of the release: "[I]f useful to a clear understanding of the information presented, a registrant might consider separating amounts in the [contractual obligations] table into those that are reflected on the balance sheet and those arising from off-balance sheet arrangements, particularly where such a distinction helps to tie the information to financial statement disclosure and other MD&A discussion [*e.g.*, under the separately-captioned section for disclosure of off-balance sheet arrangements prescribed by Item 303(a)(4) of Regulation S-K]."

Proposed Short-Term Borrowing Disclosure Requirements

In the companion Short-Term Borrowing Proposing Release, the SEC is seeking public comment on whether it should require a new, separate section of the MD&A that would contain both tabular and narrative disclosures intended to highlight for investors the nature and scope of the many different types of short-term financing arrangements on which financial and non-financial companies alike have come to rely. Aimed at illuminating the impact of practices sometimes described as balance sheet "debt-masking" or "window-dressing," whereby companies pay down certain short-term debt liabilities near the end of a quarterly or annual period but re-incur them after that period ends,[12] the proposed amendments would apply to all "short-term borrowings," a term that would be defined to include these categories of debt obligations:

- Federal funds purchased and securities sold under agreements to repurchase;
- Commercial paper;
- Borrowings from banks;
- Borrowing from factors or other financial institutions; and
- A "catch-all" category comprised of any other short-term borrowings reflected on the company's balance sheet.

Building on annual short-term borrowing disclosure requirements now applicable only to bank holding companies (now set forth in what is commonly referred to as "Guide 3"),[13] the proposed amendments would codify these requirements (as amplified) in

new Item 303(a)(6) of Regulation S-K, expand them to apply to all companies that must provide an MD&A in their periodic reports (and registration statements or other filings), and mandate disclosure of such borrowings on a quarterly as well as an annual basis.[14] The quarterly disclosure obligation would differ from the typical approach taken under Form 10-Q (per Item 303(b) of Regulation S-K), in that a full presentation for the quarter – rather than material changes from the most recent annual reporting period – would be necessary for each interim period. Such disclosure also would be required for the fourth quarter presented in an annual report. Given the SEC's primary focus on changes in annual borrowing amounts and any intra-period deviations from period-end borrowing amounts, however, no comparative information would be necessary.

If adopted, the proposed amendments would require the following quantitative information – presented in a tabular format – with some variation, depending on whether the particular company is classified as "financial" or "non-financial" in nature (we discuss the proposed definition of "financial companies", and the special treatment of companies with hybrid financial and non-financial operations, below):

- The amount outstanding in each specified category of short-term borrowings (e.g., commercial paper), 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 *during* the reporting period, and the weighted average interest rate on those borrowings – with different methodologies to be used by financial vs. non-financial companies, as follows:
  - for financial companies, the average amount outstanding per category during the reporting period, which must be calculated on a daily average basis, along with the weighted average interest rate on such amount, and
  - for non-financial companies, the average amount outstanding per category during the reporting period, using an averaging period that need not be daily but cannot exceed one month, and the weighted average interest rate on this amount; and
- The maximum amount of each specified category of short-term borrowings *during* the reporting period, which for financial companies would be computed on a daily basis (for each category) and, for non-financial companies, on a month-end basis (for each category, resulting in a total of three snapshots per quarter per category).

The SEC proposes to define a "financial company" as a company that is "engaged to a significant extent" during the reporting period in the business of lending, deposit-taking, insurance underwriting, or the provision of investment advice, or that is a broker or dealer as defined in Section 3 of the Securities Exchange Act of 1934, as amended. This definition, which the SEC stressed is non-exclusive, would extend to holding companies of banks, savings associations, insurance companies, brokers, dealers, business development companies, investment advisers, futures commission merchants, commodity trading advisors, commodity pool operators or mortgage real estate investment trusts. The SEC has not proposed to define the phrase "to a significant extent, " choosing instead to permit separate presentation of short-term borrowings corresponding to their use to subsidize financial and non-financial business operations, as explained further below.

Because many companies are engaged in both financial and non-financial activities, the SEC has proposed to permit such companies to provide separate borrowing-related disclosures for their financial and non-financial business operations. Accordingly, a manufacturing company with a financing subsidiary that extends loans to parent customers who wish to purchase parent products would be able to break out the short-term borrowings of each of its non-financial and financial businesses. Here, an explanatory footnote would have to be added to the table to explain how the operations were grouped for disclosure purposes.

To provide context for the tabular information, companies would be required to include a narrative description of their short-term borrowing arrangements by category, and identify the business purpose for these arrangements. Companies also would have to discuss and analyze the importance of these arrangements to liquidity, capital resources, market-risk support, credit-risk support, or any other benefits.

In addition, companies would have to disclose the reasons for incurring the maximum amount of indebtedness disclosed in the table, and explain any material differences between average and period-end short-term borrowings. The SEC believes that this combination of "a company's short-term borrowings data, with a comprehensive discussion of its overall approach to short-term financings and the role of short-term borrowings in the company's funding of its operations and business plan, can provide investors with additional information necessary to better evaluate a registrant's current short-term liquidity profile and potential future trends in its liquidity and funding risks."

Proposed Item 303(a)(6) of Regulation S-K would apply to all annual and quarterly reports and registration statements. For annual reports, information would be presented for the three most recent fiscal years and for the fourth quarter, whereas registration statements with audited full-year financial statements would have to include short-term borrowings disclosure for the three most recent full fiscal-year periods and interim information for any subsequent interim periods. Quarterly reports, as noted, will contain only the prescribed information for the quarter, without comparative data. Those companies that are not subject currently to Guide 3[15] would have the benefit of a yearly phase-in for comparative annual data, until all three years' worth of short-term borrowings information appear in the annual presentation.

What to Do Now

We recommend that companies focus on the interpretive guidance outlined in the MD&A Liquidity Release in preparing the upcoming Form 10-Q, and consider its broader applicability to material liquidity and funding risks of all types. Also keep your eye on developments regarding the Short-Term Borrowing Proposing Release throughout the ongoing, 60-day comment period, and monitor the comment letters submitted. You may wish to consider commenting, particularly with respect to the feasibility of complying with the proposed disclosure requirements.

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1 *See* Short-Term Borrowing Disclosure, SEC Rel. No. 33-9143 (Sept. 17, 2010), 75 FR 59,866 (Sept. 28, 2010)("Short-Term Borrowing Proposing Release"), *available at* http://www.sec.gov/rules/proposed/2010/33-9143.pdf.

2 *See* Commission Guidance on Presentation of Liquidity and Capital Resources Disclosures in Management's Discussion and Analysis, SEC Rel. No. 33-9144 (Sept. 17, 2010), 75 FR 59,984 (Sept. 28, 2010), *available at* http://www.sec.gov/rules/interp/2010/33-9144.pdf.

3 *See* Commission Guidance Regarding Disclosure Related to Climate Change, SEC Rel. No. 33-9106 (Feb. 2, 2010), 75 FR 6290 (Feb. 8, 2010), *available at* http://www.sec.gov/rules/interp/2010/33-9106.pdf. As explained in our client briefing, this guidance stressing the importance of providing "early warning" of incipient material risks of all types – in the MD&A and elsewhere in periodic reports – establishes an analytical framework that transcends the particular topic of climate change risk disclosure. *See* Weil Briefing: SEC Disclosure and Corporate Governance, "Climate Change Disclosure: Nothing New Under the Sun," *available at* http://www.weil.com/news/pubdetail.aspx?pub=9739.

4 Foreign private issuers filing annual reports on Form 20-F should note that, while directed toward domestic companies, the MD&A Liquidity Release is also relevant to disclosure provided in the Operating and Financial Review and Prospects section called for by Item 5 of Form 20-F.

5 The SEC indicated that companies were on notice, prior to publication of the MD&A Liquidity Release, that they were obligated to "discuss 'any material impact on liquidity or operations and risk resulting from involvement with repurchase and reverse repurchase agreements.'" MD&A Liquidity Release at n. 10 (citation omitted).

6 Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations, SEC Rel. No. 33-8350 (Dec. 19, 2003), [68 FR 75,056], *available at* http://www.sec.gov/rules/interp/33-8350.htm.

7 Disclosure in Management's Discussion and Analysis About Off Balance Sheet Arrangements, Contractual Obligations and Contingent Liabilities and Commitments, SEC Rel. No. 33-8182 (Jan. 28, 2003), [68 FR 5982], *available at* http://www.sec.gov/rules/final/33-8182.htm.

8 Commission Statement About Management's Discussion and Analysis of Financial Condition and Results of Operations, SEC Rel. No. 33-8056 (Jan. 22, 2002), [61 FR 3746], *available at* http://www.sec.gov/rules/other/33-8056.htm.

9 Sample Letter Sent to Public Companies Asking for Information Related to Repurchase Agreements, Securities Lending Transactions, or

Other Transactions Involving the Transfer of Financial Assets (March 2010), *available at* http://www.sec.gov/divisions/corpfin/guidance/cforepurchase0310.htm ("March 2010 Dear CFO Letter"); Sample Letter Sent to Public Companies That Have Identified Investments in Structured Investment Vehicles, Conduits or Collateralized Debt Obligations (Off-balance Sheet Entities)(Dec. 2007), *available at* http://www.sec.gov/divisions/corpfin/guidance/cfoffbalanceltr1207.htm.

10 2003 Interpretive Release, cited in n. 13 of the MD&A Liquidity Release.

11 Conditions for Use of Non-GAAP Financial Measures, SEC Rel. No. 33-8176 (Jan. 22, 2003), [68 FR 4820], *available at* http://www.sec.gov/rules/final/33-8176.htm.

12 SEC Chairman Schapiro observed, during the open meeting at which the SEC approved publication of the interpretive and proposing releases relating to MD&A disclosure of short-term borrowings, that "[w]e are not suggesting there is anything wrong with these borrowing practices – indeed, they may reflect the best financing alternatives available to a company. But investors should have the tools to better understand how companies finance their businesses and how much risk they take on through borrowings that, simply because of timing, do not show up on the balance sheet." Opening Statement of SEC Chairman Mary L. Schapiro at the SEC Open Meeting (Sept. 17, 2010), *available at* http://www.sec.gov/news/speech/2010/spch091710mls.htm.

13 *See* Industry Guide 3, Statistical Disclosure by Bank Holding Companies ("Guide 3"), 17 CFR 229.801, Item VII.

14 Annual reports on Form 20-F, which are filed with the SEC by foreign private issuers, likewise will be amended to add short-term borrowing disclosure requirements to current Item 5, prescribing an MD&A counterpart known as the Operating and Financial Review and Prospects section. Because foreign private issuers are not subject to quarterly reporting obligations in the United States, however, the proposed short-term borrowings disclosure line-item would cover only annual periods (although registration statements filed after the end of an annual period would have to include financial information for any subsequent interim periods). In addition, foreign private issuers that do not present financial statements under U.S. GAAP would be permitted to define their categories of short-term borrowings on the basis of home-country GAAP.

15 Guide 3 would be rescinded if the SEC were to adopt the proposed amendments.

If you have any questions on these matters, please do not hesitate to speak to your regular contact at Weil or to any member of the Firm's Public Company Advisory Group:

Howard B. Dicker	howard.dicker@weil.com	+1 212 310 8858
Catherine T. Dixon	catherine.dixon@weil.com	+1 202 682 7147
Holly J. Gregory	holly.gregory@weil.com	+1 212 310 8038
P.J. Himelfarb	pj.himelfarb@weil.com	+1 202 682 7197
Robert L. Messineo	robert.messineo@weil.com	+1 212 310 8835
Ellen J. Odoner	ellen.odoner@weil.com	+1 212 310 8438

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