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Alert Memo

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SEC Proposes Increased Disclosure of Short-Term Borrowings

At its open meeting on September 17, 2010, the SEC voted unanimously to propose new disclosure rules regarding short-term borrowing practices and to publish interpretive guidance on the SEC's current MD&A disclosure requirements relating to liquidity and capital resources. The SEC's press release may be found at http://www.sec.gov/news/press/2010/2010-169.htm. The proposing release may be found at http://www.sec.gov/rules/proposed/2010/33-9143.pdf and the interpretive guidance may be found at http://www.sec.gov/rules/interp/2010/33-9144.pdf. SEC Chairman Mary Schapiro described an objective of these actions to be an attempt to prevent the undisclosed "window dressing" of balance sheets by companies, which might otherwise have incentives to decrease the amount of their borrowings at each quarter's end in order to present a better liquidity picture to investors.

The interpretive MD&A guidance, which will be effective immediately upon publication in the Federal Register, is designed to emphasize and implement the SEC's position that companies may not use financing structures to mask their financial condition. It also clarifies the appropriate manner of presentation of leverage and other financial ratios, reminds registrants of existing obligations regarding disclosure of known trends and uncertainties, and addresses discrepancies in the way public companies are satisfying requirements regarding the presentation of contractual obligations, contingent liabilities and commitments. (We take the reference to contingent liabilities and commitments in the guidance to be to contractual contingent liabilities and contractual commitments.)

Short-term borrowings are used by many companies as a regular part of their financing activities and may include borrowing from the Federal Reserve or commercial banks, commercial paper or repurchase agreements. The proposed rules, which are subject to a 60-day comment period following their publication in the Federal Register, would require public reporting companies to provide increased quantitative and qualitative disclosure of their short-term borrowings on a quarterly basis. The rules expand the universe of companies required to provide disclosure regarding their short-term borrowings, which currently is limited to bank holding companies. The proposed rules do not cover off-balance sheet financing arrangements, which are covered by existing disclosure requirements.

Currently, bank holding companies must annually disclose the daily average amount outstanding, the month-end maximum amounts outstanding and the average weighted interest rates of their short-term borrowings, according to the terms of SEC Industry Guide 3. The proposed rules would codify the Guide 3 provisions in Regulation S-K, although reporting would

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be increased beyond what Guide 3 requires and extended beyond bank holding companies. They would require reporting on a quarterly basis, with daily rather than month-end maximum short-term borrowing amounts, and extend the disclosure requirements to a new category of "financial companies." Financial companies include all companies engaged to a significant extent in lending, deposit-taking, insurance underwriting or providing investment advice, as well as broker-dealers, mortgage REITs and other similar companies.

Non-financial companies would also be subject to the proposed rules, although they would be allowed to calculate their average position and maximum level of borrowing on a monthly, rather than daily, basis. When companies conduct both finance and non-finance activities, they would be allowed to present their short-term borrowings separately, calculated on both a daily and monthly basis, as applicable.

Registrants would also be required to present a narrative description of their short-term borrowing practices, including the business purpose for each type of borrowing and the importance of short-term borrowing to liquidity. In addition, they would have to explain the reasons for the maximum reported level of short-term borrowing and for material differences between the average and period-ending short-term borrowing amounts.

Similar rules would apply to the annual reports on Form 20-F of foreign private issuers and to smaller reporting companies, although smaller reporting companies would be required to report only material changes in their quarterly reports.

Chairman Schapiro in her opening remarks said that while the Dodd-Frank Wall Street Reform and Consumer Protection Act does not require the proposed rules, the rules and guidance are designed to address issues that were brought into focus by the financial crisis. The SEC believes current reporting requirements are insufficient to give investors a clear view of a company's liquidity and borrowing practices. Timing issues mean that quarterly snapshots do not necessarily capture all borrowing risks a company may assume during the course of a period. The SEC believes intra-period averages and maximums will allow investors to better gauge whether a company will be able to respond adequately to a sudden liquidity crisis of the type that occurred in the fall of 2008.

Chairman Schapiro emphasized that there is nothing "wrong" with short-term borrowing practices, which may be the best available to a company. It is the disclosure of the practices that must improve so that investors can better understand how companies finance their businesses and the consequences, including risks, that may result. She noted that short-term borrowings may present increased risks in markets with volatile liquidity, as interest rates and terms may suddenly worsen or it may become difficult or impossible to borrow or roll over existing borrowings.

Please feel free to contact any of your regular contacts at the firm or any of our partners and counsel listed under "Capital Markets" or "Corporate Governance" in the "Practices" section of our website (http://www.clearygottlieb.com/) if you have any questions.

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