

October 13, 2010

SEC Proposes New Rules on Short-Term Borrowing Disclosures and Issues Interpretive Guidance on Liquidity and Capital Resource Disclosures

On September 17, 2010, the Securities and Exchange Commission ("SEC") issued proposed rules governing short-term borrowing disclosures¹ and interpretive guidance on liquidity and capital resource disclosures in Management's Discussion and Analysis ("MD&A").² Both the proposed rules and the interpretive guidance aim to boost the disclosure of companies' short-term liquidity and funding risks. The SEC hopes that its proposed rules and interpretive guidance will enhance the transparency of short-term borrowings, especially whether these borrowings vary materially during reporting periods.

The proposed rules are subject to a 60-day public comment period ending on November 29, 2010. The interpretive guidance became effective on September 28, 2010.

The Proposed Rules on Short-Term Borrowings

The proposed rules aim to improve the disclosure of a company's actual funding needs and financing activities. Although current SEC rules require the disclosure of short-term borrowings at the end of the applicable reporting period, no requirement exists to disclose the amount of short-term borrowings outstanding throughout the reporting period. Consequently, investors generally cannot see whether the period-end amounts of short-term borrowings are lower or higher than the amounts outstanding during the period.

If implemented, the proposed rules would require a company to provide, in a separately captioned subsection of MD&A, a comprehensive explanation of their short-term borrowings. This disclosure would include both quantitative and qualitative information. The proposed amendments would be applicable to annual and quarterly reports, proxy or information statements that include financial statements and Securities Act and Securities Exchange Act registration statements.

Quantitative Disclosures. Companies would be required to provide quantitative disclosures of short-term borrowings in tabular form, including:

- 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 (as is currently required under existing SEC rules);

¹ Short-Term Borrowings Disclosure, <http://sec.gov/rules/proposed/2010/33-9143.pdf>.

² Commission Guidance on Presentation of Liquidity and Capital Resources Disclosures in Management's Discussion and Analysis, <http://sec.gov/rules/interp/2010/33-9144.pdf>.

- The average amount in each specified category of short-term borrowings for the reporting period and the weighted average interest rate on those borrowings. "Financial companies" (see the definition below) must compute the amount outstanding at the end of each day, averaged over the reporting period. Non-financial companies would have the option of using a longer averaging period that does not exceed one month;
- "Financial companies" must disclose the maximum daily amount of each specified category of short-term borrowings during the reporting period (*i.e.*, the largest amount outstanding at the end of any day in the reporting period); and
- Non-financial companies must disclose the maximum month-end amount of each specified category of short-term borrowings during the reporting period (*i.e.*, the largest amount outstanding at the end of any month in the reporting period).

Qualitative Disclosures. Companies must also provide a discussion and analysis of short-term borrowings. Topics proposed to be included in this qualitative disclosure include:

- A general description of short-term borrowings arrangements (including any factors that could reduce or impair the company's ability to borrow under the arrangements and whether there are any collateral posting arrangements) and the business purpose of those arrangements; and
- The reasons for any material differences between average short-term borrowings for the reporting period and period-end short-term borrowings.

Definitions.

"Short-Term Borrowings". "Short-term borrowings" include:

- 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.

"Financial Companies". A "financial company" is a company 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. This definition of "financial company" 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. It should be noted that the proposed rule does not provide a definition of the phrase "to a significant extent," although the SEC has asked for comments as to whether it should define "significant" or otherwise provide a numerical, threshold-based definition for the determination of whether an issuer is a financial company.

Some companies that are engaged in both financial and non-financial businesses may meet the definition of "financial company" (e.g., a manufacturing company that has a subsidiary to provide financing to its customers). For those companies, the proposed rule would permit the company to provide separate short-term borrowing disclosures for its financial and non-financial business operations that comply with the requirements applicable to financial companies and non-financial companies, respectively.

Treatment of Foreign Private Issuers and Smaller Reporting Companies.

Foreign Private Issuers. The proposed rules would apply to foreign private issuers other than Canadian MJDS filers in a manner substantially similar to the proposed provision applicable to U.S. issuers, with the following exceptions:

- Annual Disclosure. Unless a foreign private issuer files a Securities Act registration statement that includes interim period financial statements and related MD&A equivalent disclosure, it would not be required to update its disclosure more than annually.
- Categories of Short-Term Borrowings. Foreign private issuers may base the categories of short-term borrowings they present on the types of short-term borrowings included pursuant to the comprehensive set of accounting principles used by the issuer in the preparation of their financial statements (e.g., home country GAAP or IFRS).

Small Reporting Companies. The proposed short-term borrowings disclosure requirements would apply to smaller reporting companies, except that quarterly disclosures would not be required unless material changes have occurred during that interim period and information for the fourth fiscal quarter would not be required in annual reports. In addition, for smaller reporting companies providing financial information on net sales and revenues and on income from continuing operations for only two years, only two years of short-term borrowings disclosure would be required.

The Interpretive Guidance on MD&A Liquidity and Capital Resource Disclosures

The purpose of the SEC's interpretive guidance is to facilitate understanding by investors of a company's liquidity and funding risks.

The interpretive guidance has three components: (1) liquidity disclosure; (2) leverage ratio disclosures; and (3) contractual obligations table disclosures.

Liquidity Disclosure. Item 303(a)(1) of Regulation S-K requires companies to "identify and separately describe internal and external sources of liquidity, and briefly discuss any material unused sources of liquid assets." As the financing activities undertaken by companies become more diverse and complex, the interpretive guidance reminds companies of their obligation to disclose 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. The interpretive guidance provides a variety of suggestions for trends that may warrant MD&A disclosure, including:

- 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.
- Counterparty risk.

Regarding repurchase transactions, the interpretive release notes that "there may be confusion on the part of companies 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." The interpretive guidance reminds companies that MD&A requires the disclosure of a known commitment, event or uncertainty that will result in (or is reasonably likely to result in) the company's liquidity increasing or decreasing in a material way.

With regard to cash and risk management policies and portfolios, the interpretive release calls for companies to describe their cash and risk management policies. This call is directed primarily at bank holding companies and financial institutions but also applies to other companies. Consequently, companies with access to a portfolio of cash and other material sources of liquidity should consider providing material information about the portfolio's composition and nature.

Leverage Ratio Disclosures. The interpretive guidance also reminds companies that leverage ratios must conform to the SEC's rules on the inclusion of non-GAAP measures in their SEC filings. The use of any ratio or measure should be accompanied by a clear explanation of the calculation methodology. Additionally, the company should consider whether to discuss why the calculation is important and how such a measure differs from other measures commonly used in the company's industry.

Contractual Obligations Table Disclosures. Finally, the interpretive guidance reminds companies that the contractual obligations table provides investors with the context to assess the relative role of off-balance sheet arrangements. Therefore, companies need to carefully construct their contractual obligations table in order to improve the transparency of their liquidity and capital resource needs. In some cases, a qualitative description of the information presented in the contractual obligations table may be needed to ensure that investors fully appreciate the information presented to them.

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