

ALERTS AND UPDATES

SEC Proposes New MD&A Disclosure Requirement for Short-Term Borrowing Arrangements

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Aiming to enhance investors' understanding of a public company's current short-term liquidity and potential future trends in its liquidity and funding risks, the U.S. Securities and Exchange Commission (the "SEC") recently voted unanimously to consider expanding what registrants are required to disclose about their short-term borrowing arrangements. The [proposals](#) would require "a registrant to provide, in a separately captioned subsection of Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A"), a *comprehensive* explanation of its short-term borrowings, including both quantitative and qualitative information" (emphasis added). As proposed, these requirements would be applicable to annual and quarterly reports, proxy or information statements and registration statements under the Securities Act of 1933 and the Securities Exchange Act of 1934.

Noting that short-term financing techniques – including commercial paper, repurchase transactions and securitizations – have become increasingly common among financial institutions and industrial companies, the SEC release observes that these types of arrangements can be impacted, sometimes severely and rapidly, by illiquidity in the markets as a whole. In addition, the SEC noted that when market liquidity is low, short-term borrowings can present increased risks (e.g., that financing rates will increase, terms will become unfavorable, or that it will become more costly or impossible to roll over short-term borrowings). The release also notes that due to their short-term nature, a registrant's use of short-term borrowing arrangements can fluctuate materially during a reporting period, which means that presentation of period-end amounts of short-term borrowings alone may not be indicative of that registrant's funding needs or its activities during the period.

The new regulations would require a tabular presentation together with a substantive *discussion and analysis* about the registrant's short-term borrowings. Although the current MD&A disclosure rules generally require disclosure of a registrant's use of short-term borrowing arrangements and the registrant's exposure to related risks and uncertainties,¹ the SEC views the proposed additional disclosures in the MD&A section regarding short-term debt as beneficial to investors by affording them additional transparency about a registrant's liquidity and capital resources, and thus greater insight into its actual funding needs and financing activities and the ability to better evaluate the liquidity risks faced by the registrant.

The proposed rules would codify the SEC's Industry Guide 3, currently applicable only to bank holding companies; extend the disclosure requirements in Industry Guide 3 to all companies that provide MD&A disclosure; and require disclosure of quantitative information in tabular format on an annual and quarterly basis for each of the following categories of short-term borrowings utilized by the registrant:²

- 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 registrant's balance sheet.

The proposed regulations would require a registrant to provide disclosure for each category of short-term borrowings relevant to it, even if one or more of those categories would not be required to be reported as a separate line item on its balance sheet under Regulation S-X.

For each category of short-term borrowings identified, the registrant would be required to provide the following information on a tabular basis:

- the amount of short-term borrowings at the end of the reporting period and the weighted average interest rate on those borrowings;
- the average amount of short-term borrowings for the reporting period and the weighted average interest rate on those borrowings; and
- for a registrant meeting the proposed definition of "financial company,"³ the maximum daily amount of short-term borrowings during the reporting period or, for any other registrant, the maximum month-end amount of short-term borrowings during the reporting period.

Financial companies would be required 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). Registrants that are not financial companies would be required 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) and to disclose the basis used for calculating the average amounts reported. Non-financial companies would not be required to compute the averages on a daily basis, but would be required to use an averaging period of not more than a month.

Some registrants that are engaged in both financial and non-financial businesses may meet the definition of a "financial company," such as a manufacturing company with a subsidiary that provides financing to its customers to purchase its products. Such registrants would be permitted to provide separate short-term borrowings disclosure for their financial and non-financial business operations.

Where necessary to promote a better understanding of the information or to prevent aggregate amounts from being misleading, a registrant would be required to disaggregate the amounts presented in the table by currency, interest rate or otherwise. The proposed regulations do not include a quantitative threshold for purposes of disaggregating amounts into categories of short-term borrowings, but the proposal does require footnote disclosure describing the method for disaggregation, where necessary for an understanding of the data presented.

As proposed, Item 303(a)(6)(ii) of Regulation S-K would require a discussion of a registrant's short-term borrowings to the extent necessary for an understanding of such borrowings and the current or future effect on the registrant's financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources. Registrants would be required to provide a narrative discussion and analysis that would contain:

- a general description and the business purpose of the short-term borrowing arrangements included in each category (including any key metrics or other factors that could reduce or impair the registrant's ability to borrow under the arrangements and whether there are any collateral posting arrangements);

- the importance to the registrant of its short-term borrowing arrangements to its liquidity, capital resources, market-risk support, credit-risk support or other benefits;
- the reasons for the maximum amount for the reporting period, including any non-recurring transactions or events, use of proceeds or other information that provides context for the maximum amount; and
- the reasons for any material differences between average short-term borrowings for the reporting period and period-end short-term borrowings.

The proposed short-term borrowings discussion and analysis is intended to highlight short-term financing activities and to complement the other MD&A requirements relating to liquidity and capital resources, but is not intended to be repetitive of other disclosures relating to liquidity and capital resources.

If the proposed regulations are adopted, registrants will need to consider ways to integrate the new disclosures, together with disclosures made under existing MD&A requirements, into a clear, comprehensive description of its liquidity profile. Disclosure of a registrant'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 funding of its operations and business plan, could, in the SEC's view, provide investors with additional information necessary to better evaluate the registrant's current short-term liquidity profile and potential future trends in its liquidity and funding risks.

In annual reports, information would be presented for the three most-recent fiscal years (or, in the case of a smaller reporting company, the two most-recent fiscal years) and, in the case of a registrant other than a smaller reporting company, for the most-recently completed fourth quarter.⁴ In quarterly reports, the proposed short-term borrowings disclosure would be presented for the most-recently completed fiscal quarter, without a requirement for comparative data, but a smaller reporting company would not be required to include the quarterly disclosures in the absence of material changes during the quarter.⁵

For their annual reports, registrants would be allowed to phase in their compliance over a three-year period. Thus, in the first year, a registrant would be required to provide the short-term borrowings information only for its most-recently completed fiscal year (plus the fourth quarter information, in the case of a registrant other than a smaller reporting company). In the second year, the registrant would be required to provide that information for the two most-recently completed fiscal years (plus, if applicable, information for the fourth quarter of the most-recently completed fiscal year), so that only in the third and subsequent years after the regulations take effect would a registrant be required to provide short-term borrowing information for three completed fiscal years. Notwithstanding this transitional accommodation, all registrants would be permitted to provide three full years of disclosure during the transition period.

In order to align the existing reporting requirements applicable to short-term debt obligations under Items 2.03 and 2.04 of Form 8-K with the definition of short-term borrowings in proposed Item 303(a)(6), the SEC is also proposing to amend clause (4) of the definition of direct financial obligation to refer to "a short-term borrowing, as defined in proposed Item 303(a)(6)(iii) of Regulation S-K (17 CFR 229.303(a)(6)(iii)) that arises other than in the ordinary course of business." In doing so, the existing carve-out in the definition of direct financial obligation for obligations that arise in the ordinary course of business would be preserved in order to maintain the focus of Items 2.03 and 2.04 on real-time disclosure of individual transactions that are not routine or "ordinary course" financing transactions. The proposing release cautions, however, that a registrant experiencing a material increase in short-term borrowings during a reporting period that is not consistent with past practices would likely need to consider carefully whether the underlying transactions causing the fluctuations fall within the "ordinary course of business" for purposes of Items 2.03 and 2.04.

The SEC is not proposing to extend the safe harbor in Item 303(c) of Regulation S-K to include disclosure of forward-looking information made pursuant to proposed Item 303(a)(6). It is the SEC's preliminary belief that the proposed short-term disclosure requirements, which primarily concern disclosure of historical amounts together with qualitative information about the registrant's use of short-term borrowings, would not present any distinctive issues under the application of the statutory safe harbor, and accordingly, it is not proposing to provide any specific provision or guidance on its application to this information.

The SEC is soliciting comments for up to 60 days and will post all comments online at www.sec.gov/rules/proposed.shtml.

To further its goal of enhancing an investor's understanding of a registrant's liquidity and funding risks, the SEC also issued a companion release providing interpretative guidance for the existing disclosure requirements aimed to improve the overall discussion of liquidity and capital resources in the MD&A. The guidance reminds registrants to:

- identify and separately describe internal and external sources of liquidity and discuss any material unused sources of liquidity;
- disclose known trends, demands, commitments, events or uncertainties that would result, or are reasonably likely to result, in the registrant's liquidity increasing or decreasing;
- consider difficulties in accessing the debt markets and reliance on commercial paper or other short-term pricing arrangements; and
- consider maturity mismatches between borrowing sources and assets funded by those sources, changes in terms requested by counterparties, changes in the valuation of collateral and counterparty risk.

For Further Information

If you have any questions regarding the proposed short-term borrowings disclosure provisions discussed above, including how they may affect your company, please contact any [member](#) of the [Securities Law Practice Group](#) or the lawyer in the firm with whom you are regularly in contact.

Notes

1. See Item 303(a)(1) and (2) of Regulation S-K.
2. A foreign private issuer that does not prepare financial statements under U.S. GAAP would be permitted to provide disclosure of categories that correspond to the classifications used for such types of short-term borrowings under the comprehensive set of accounting principles that the issuer uses to prepare its primary financial statements, as long as the disclosure was provided at a level of detail that satisfies the objective of the proposed disclosure requirement.
3. Financial company would mean a registrant that, during the relevant reporting 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 and includes, without limitation, 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.

4. Registrants preparing registration statements with audited full-year financial statements would be required to include short-term borrowings disclosure for the three most-recent full fiscal-year periods and interim information for any subsequent interim periods.
5. The SEC is requesting comment on whether comparative information should be required for quarterly and interim information; and whether year-to-date information in addition to quarterly information for interim periods should be required.