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SEC'S INTERPRETIVE MD&A GUIDANCE ON LIQUIDITY AND CAPITAL RESOURCES AND PROPOSED NEW RULES ON SHORT-TERM BORROWING DISCLOSURE

The SEC has responded to concerns about balance sheet "window dressing" and other perceived liquidity disclosure problems with an interpretive release regarding MD&A liquidity and capital resources disclosure and proposed new rules that would require detailed MD&A disclosure on short-term borrowing arrangements.

New Interpretive Guidance

The SEC's new interpretive guidance is the most recent in a series of MD&A interpretive releases.[1] Interpretive releases are designed to clarify existing rules and, while approved by the SEC Commissioners, do not go through the full rulemaking process. The MD&A section of registration statements and periodic reports is required to provide clear and understandable information about known trends, events, demands, commitments and uncertainties regarding a company's financial position, particularly where they are reasonably likely to have a current or future material impact on the company.

Liquidity Discussion

The interpretive guidance states that in preparing the liquidity discussion included in the MD&A, companies may not rely on financing structures (whether "on-balance sheet" or "off-balance sheet") that mask their financial condition. The SEC also emphasized the need to disclose important trends and uncertainties related to liquidity, such as:

- 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

- counterparty risk.

If a company's financial statements do not adequately convey financing arrangements during the period, or the impact of those arrangements on liquidity, additional disclosure may be required to help investors understand the financial statement entries. The guidance focuses on several perceived reporting inadequacies, such as intra-period variations in borrowing and transactions involving repurchase obligations.

Liquidity disclosure may be required for repurchase transactions, securities lending transactions, or any other transaction involving the transfer of financial assets with an obligation to repurchase financial assets, even where those transactions are properly accounted for as a sale and even though the company may have obtained a "true sale" legal opinion. In evaluating whether disclosure is required, companies should consider whether the transaction is reasonably likely to result in the use of a material amount of cash or other liquid assets and whether the company does not otherwise include information regarding the transaction in its off-balance sheet arrangements or contractual obligations table. The SEC points out that the absence of specific references to transactions that are accounted for as sales in existing rules for off-balance sheet arrangements or contractual obligations does not mean that disclosure regarding these transactions is not required.

To provide context for the exposures identified in MD&A, companies should consider describing cash management and risk management policies relevant to an assessment of their financial condition. In addition, a company should consider providing information about the nature and composition of any cash or other investment portfolio that it maintains or to which it has access that is a material source of liquidity. Disclosure might include a description of the assets held and any related market risk, settlement risk or other risk exposure, including information about the nature of any limits or restrictions and their effect on the company's ability to use or to access those assets to fund its business operations.

Capital or Leverage Ratio Disclosures

To improve transparent financial reporting, the SEC's new interpretive guidance emphasizes that leverage ratios and other metrics included in SEC filings must be calculated and presented in a way that does not obscure the company's leverage profile or reported results. In particular:

- Companies should include a clear explanation of the calculation methodology of any capital or leverage ratio included in MD&A. The explanation should articulate the treatment of any inputs that are unusual, infrequent or non-recurring, or that are otherwise adjusted so that the ratio is calculated differently from directly comparable measures.

- If the metric is a financial measure and it differs from other common industry metrics, a discussion of the differences or a presentation of the common industry metrics may be necessary to make the disclosure not misleading. A company should also disclose why the metric is useful to understanding its financial condition.

- If the metric is a non-financial measure and there is no commonly accepted method of calculating the particular metric, companies should explain how the metric was calculated to allow investors to compare the metric with those of other companies within the industry.

- If there is no prescribed regulatory methodology for calculating the ratio or the company calculates the ratio using a modified methodology from its prescribed form, the company should determine whether the SEC's rules regarding the use of non-GAAP financial measures apply.

Contractual Obligations Table Disclosures

The purposes of the contractual obligations table are (a) to provide aggregated information about contractual obligations and contingent liabilities and commitments in a single location and (b) to provide context for investors to assess the relative role of off-balance sheet arrangements. The new guidance suggests that to help investors better understand the tabular data and what it includes and does not include, companies should use footnotes to the table or additional narrative.

The SEC's new interpretive guidance urges companies to focus on providing informative and meaningful disclosure about their future payment obligations. Table requirements provide companies with flexibility so that the presentation can reflect company-specific information in a way that is suitable to its business and capital structure. Nonetheless, the presentation method should be clear, understandable and appropriately reflect the categories of its obligations. Changes in presentation should be accompanied by a description of the change and disclosure permitting period-to-period comparisons.

Proposed Rules on Short-Term Borrowing Disclosures

Financial statements and notes currently disclose short-term borrowings at the end of each fiscal period, but there are no specific disclosure requirements regarding variation in short-term borrowings during the periods. (Note however that the companion interpretive release summarized above indicates that disclosure of inter-period variations in borrowing may be required to disclose important trends and uncertainties regarding liquidity.) The proposed rules are designed to address balance sheet “window dressing” alleged to have been practiced during the financial crisis. These proposed rules do not derive from any mandate in the Dodd-Frank Wall Street and Consumer Protection Reform Act.

The proposed rules would require both quantitative and qualitative disclosures of a company's short-term borrowings during reported periods. Quantitative disclosures would include for each specified category of short-term borrowing:

- The amount outstanding at the end of the reporting period and the weighted average interest rate on such borrowings.
- For non-financial companies:
    - The average amount outstanding during the reporting period, using an averaging period not to exceed one month (that is, averaging the highest amount outstanding during each monthly or shorter period during the reporting period), and the weighted average interest rate; and
    - The maximum month-end amount outstanding during each reporting period.
- For financial companies:
    - The average amounts outstanding during the reporting period computed on a daily average basis and the weighted average interest rate; and
    - The maximum daily amount outstanding during each reporting period.

The SEC proposed a subjective qualitative definition for determining what constitutes a "financial company" based on whether a company 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. Unlike the Dodd-Frank Act, there is no objective test.

Qualitative disclosures required would include a narrative analysis of short-term borrowings, which would include a discussion of: the types of short-term borrowings used, the business purposes and importance of the borrowings, and the material differences between the maximum or average intra-period borrowings and the period end borrowings.

While not proposed in detail in this release, the SEC also indicated it is considering proposing mandatory disclosure of leverage ratios.

The proposed rules would include phase-in periods for non-bank holding companies but would eventually apply to the three most recent fiscal years and most recent quarter for annual reports, and the most recent completed quarter (without comparative data) for quarterly reports.

The SEC has explicitly sought comment on a number of aspects of the proposed rules. Public comments are due by November 29, 2010.

When is the SEC's new interpretive guidance effective?

The guidance is effective now.

What should you do now?

Companies should immediately review the new interpretive guidance for implementation in their next periodic report and/or in any new or pending registration statements.

What if you have questions?

For any questions or more information on these or any related matters, please contact any attorney in the firm's corporate and securities practice group.

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[1] The most comprehensive of these is the December 19, 2003 release, Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations, Release No. 33-8350, available here. MD&A is short for Management's Discussion and Analysis of Financial Condition and Results of Operations.