SEC Proposes New Disclosure Requirements for Short-term Borrowings

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On September 17, 2010, the Securities and Exchange Commission (SEC) unanimously voted to approve proposed rules that would require public companies to provide enhanced disclosure of short-term borrowings.1 The SEC also approved interpretive guidance for current disclosure requirements in a company’s Management’s Discussion and Analysis of Financial Condition and Results of Operation (MD&A).2 The proposed rules are subject to a 60-day public comment period. The interpretive guidance is effective immediately upon publication in the Federal Register.

Proposed MD&A Disclosures

What are the proposed new disclosure requirements?

The SEC is proposing to amend the current MD&A requirements to require both quantitative and qualitative disclosure about a company’s short-term borrowings during the reporting period. The disclosure would be required in a company’s quarterly and annual reports for the period covered by the report.

Currently, the SEC requires this disclosure by bank holding companies on an annual basis under the SEC’s Industry Guide 3, Statistical Disclosure by Bank Holding Companies (Guide 3).3 However, under the proposal, the disclosure would be required on a quarterly and annual basis for all companies that provide MD&A.4 The proposed rules would codify these standards in Item 303 of Regulation S-K. In addition to tabular data related to short-term borrowings, a company would also be required to include narrative discussion in order to provide context for the tabular disclosure. Item 303 of Regulation S-K would require:

- 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;
- the average amount in each specified category of short-term borrowings for the reporting period and the weighted average interest rate on those borrowings;
- for registrants meeting the proposed definition of "financial company," the maximum daily amount of each specified category of short-term borrowings during the reporting period; and
- for all other registrants, the maximum month-end amount of each specified category of short-term borrowings during the reporting period.

How does the proposed rule define "short-term borrowings"?

The SEC proposes to apply the new disclosure obligations to the various categories of


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arrangements reflected as short-term obligations in a company's financial statements:

- 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.

These specified categories were derived from the categories of short-term borrowings specified in Guide 3 and Rule 9-03 of Regulation S-X, as well as certain categories of current liabilities set forth in Rule 5-02 of Regulation S-X.

How are financial and non-financial companies treated differently?

In proposing the rules, the SEC stated that it believes that investors in financial companies should receive particularly robust disclosure about short-term borrowings. Therefore, the proposed rules distinguish between companies that engage in financial activities as their business and companies that do not.

Financial companies would be required to compile and report data for the maximum daily amounts outstanding—that is, the largest amount outstanding at the end of any day in the reporting period. Financial companies would also be required to compile and report the average amounts outstanding during the reporting period computed on a daily average basis.

Non-financial companies would be required to report the maximum month-end amounts outstanding—that is, the largest amount outstanding at the end of the last day of any month in the reporting period. Non-financial companies would also be required to disclose the basis used for calculating the average amounts reported. Non-financial companies would not be required to present average outstanding amounts computed on a daily average basis, but the proposed rules would not allow the averaging period to exceed one month.

How are "financial companies" defined?

The proposed rule would use an activities-based definition of financial companies. This definition would include companies involved to a significant extent in lending, deposit taking, insurance underwriting, or providing investment advice, or that are brokers or dealers as defined under Section 3 of the Securities Exchange Act of 1934, as amended. The proposed rules would also enumerate, in a non-exhaustive list, certain entities deemed to be engaged in the business of investing as financial companies, such as banks, savings associations, insurance companies, brokers, dealers, business development companies, investment advisers, futures commission merchants, commodity trading advisors, commodity pool operators, and mortgage real estate investment trusts. The list is intended to be non-exclusive, and would be provided as guidance to companies.

In the proposing release, the SEC seeks comment on the scope of the definition of financial companies and the cost of compliance associated with the proposed requirement.

How are companies treated that conduct both financial and non-financial business?

The proposed rules acknowledge that some companies engage in both financial and non-financial businesses. Under the proposed rules, such companies would be permitted to provide the disclosure separately for each of the segments. Therefore, a company would be required to provide averages computed on a daily average basis and maximum daily amounts for the short-term borrowings of its financial operations, but could provide disclosure of its non-financial operations in accordance with the requirements for non-financial companies.

What would the narrative discussion and analysis require?
The proposed narrative discussion and analysis is intended to provide investors with a deeper understanding of the company's use of particular types of financings, including:

- a general description of the short-term borrowings arrangements included in each category and the business purpose of those arrangements;
- the importance of the company's short-term borrowings 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.

This discussion would be intended to highlight short-term financing activities and to complement the other MD&A requirements relating to liquidity and capital resources.

*How would the new disclosure requirements be phased in?*

As stated above, the new disclosure requirement would be included in the MD&A disclosure requirements applicable to annual and quarterly reports and registration statements. For registrants not currently subject to Guide 3, the SEC proposes a yearly phase-in of the requirements for comparative and annual data until all three years are included in the annual presentation.

*Would the proposed disclosure requirements apply to foreign private issuers?*

The proposed rules would amend Form 20-F to require foreign private issuers to provide similar disclosure. For purposes of the disclosure of the categories of short-term borrowings, those issuers who use International Financial Reporting Standards, or other accounting principles other than U.S. generally accepted accounting principles, would be permitted to base the categories of short-term borrowings used in their disclosure on the classifications of the applicable accounting standards.

*Would the proposed rules apply to smaller reporting companies?*

The proposed rules would require that smaller reporting companies comply with the short-term borrowings disclosure requirements. However, the SEC has proposed certain exclusions designed to balance the impact of the proposed disclosure obligations and the need for investors to have greater disclosure of liquidity risks. Under the proposed rules, and consistent with current practice for other MD&A requirements, smaller reporting companies would be permitted to present information for two fiscal years instead of three. Also, smaller reporting companies would not be required to disclose full quantitative and qualitative quarterly short-term borrowings information in their quarterly reports, or that disclosure for the fourth quarter in their annual reports. Instead, smaller reporting companies would only be required to report material changes to short-term borrowings information on a quarterly basis.

*New Interpretive Guidance*

The interpretive guidance reminds companies of longstanding MD&A principles as they apply to the disclosure of critical liquidity matters, including the identification of known trends and uncertainties. The guidance also encourages companies to review previous interpretive guidance related to MD&A issued by the SEC, especially as it relates to discussion of cash requirements, cash management, and sources of cash, as well as a company's debt instruments and guarantees and related covenants.

In addition, the SEC reminds companies that MD&A must clearly communicate material liquidity risks.
The release highlights several important trends and uncertainties relating to liquidity, such as:

- difficulties accessing debt markets;
- reliance on commercial paper or other short-term financing arrangements;
- maturity mismatches between borrowings sources and the assets funded by those sources;
- changes in terms requested by counterparties;
- changes in valuation of collateral; and
- counterparty risk.

The interpretive release also reminds companies that if their financial statements do not adequately convey their financing arrangements during the period covered, or the impact of those arrangements on liquidity, due to a known trend, demand, commitment event, or uncertainty, additional narrative disclosure should be considered, and may be required to enable an understanding of the amounts depicted in the financial statements. The interpretive release also makes clear that the use of financing structures in a manner that masks a company’s reported financial condition is not permitted. In addition, the interpretive release explains the disclosure requirement for the presentation of leverage ratios and other financial measures in order to emphasize that such ratios must be calculated and presented in a way that does not obscure the company’s leverage profile or reported results.

Finally, the interpretive release provides guidance on the requirement to provide tabular disclosure of contractual obligations, an area where the SEC is concerned that companies have drawn divergent conclusions as to the disclosure requirements. The guidance emphasizes the inherent flexibility in the requirement and discusses the use of footnotes and narrative disclosure to supplement the tabular disclosure required in a company’s MD&A.

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