

FUNDING, LIQUIDITY AND SHORT-TERM BORROWINGS: TIME TO REVISIT MD&A DISCLOSURE

September 23, 2010

To Our Clients and Friends:

On September 17, 2010, the Securities and Exchange Commission (the “SEC”) issued interpretive guidance about disclosure of liquidity and funding risks in Management’s Discussion and Analysis of Financial Condition and Results of Operations (“MD&A”) and proposed new required disclosure with respect to short-term borrowings.

LEHMAN BROTHERS “REPO 105”

The interpretive guidance and proposed short-term borrowings disclosure follow in the wake of the revelation of cases of financial window-dressing, including the Lehman “Repo 105” and “Repo 108” transactions. Whereas standard repurchase and resale (“repo”) transactions¹ are accounted for as financing transactions, beginning in 2001, Lehman applied existing accounting guidance to account for Repo 105 and Repo 108 transactions as “sales” based upon the overcollateralization (105% and 108%, respectively) in these transactions. Cash from these transactions was then used to pay down Lehman’s other liabilities, thereby reducing both its total liabilities and total assets and lowering its leverage ratios during the life of the transaction. Lehman accelerated use of these transactions in the days leading up to the end of a financial reporting period. Several days after a new quarter began, Lehman would then borrow funds to repay the cash obtained under the repos plus interest, repurchase the securities, and restore the assets to its balance sheet. Lehman’s public reporting, however, did not disclose Lehman’s obligation to repurchase the collateral securities upon maturity of the transaction, its significant use of these transactions (especially in 2007 and 2008) or the impact of these transactions on Lehman’s net leverage ratio.

DISCLOSURE OF LIQUIDITY AND FUNDING RISK IN MD&A

The interpretive guidance addresses liquidity and funding risk in three types of disclosure within MD&A: (1) liquidity disclosure, (2) leverage ratio disclosure and (3) contractual obligations table disclosure. The interpretive guidance does not purport to introduce new

¹ *In a repo transaction, one party transfers an asset or security to another party as collateral for a short-term borrowing of cash, while simultaneously agreeing to repay the cash and take back the collateral at a specific point in time. When the repo transaction matures, the borrower repays the funds plus an agreed upon interest rate and takes back its collateral.*

disclosure obligations, but instead reminds reporting companies to review past SEC MD&A guidance. A list of past SEC guidance on MD&A disclosure is provided in Attachment A to this memorandum.

With respect to liquidity disclosure, the SEC reminds registrants of their obligation to disclose any known trends, demands, commitments, events or uncertainties that will result in, or that are reasonably likely to result in, the registrant's liquidity increasing or decreasing in any material way. These include matters 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. In addition, if a registrant's financial statements do not adequately convey the registrant's financing arrangements during the period, or the impact of those arrangements on liquidity, the registrant should add additional narrative disclosure. For example, if borrowings during a reporting period are materially different than period-end amounts presented in the financial statements, disclosure about the intra-period variations is required.

In evaluating whether disclosure in MD&A may be required in connection with a repurchase transaction, securities lending transaction, or any other transaction involving the transfer of financial assets with an obligation to repurchase financial assets, that has been accounted for as a sale under applicable accounting standards, registrants should consider whether the transaction is reasonably likely to result in the use of a material amount of cash or other liquid assets. Disclosure may be required in the discussion of liquidity and capital resources, particularly where the registrant does not otherwise include information relating to such transactions in the disclosure regarding its off-balance sheet arrangements or its contractual obligations.

Finally, to provide context for the exposures identified in MD&A, registrants should consider describing cash management and risk management policies relevant to an assessment of their financial condition. Banks, in particular, should consider discussing their policies and practices in meeting applicable banking agency guidance on funding and liquidity risk management, or any policies and practices that differ from applicable agency guidance. A company that maintains or has access to a portfolio of cash and other investments that is a material source of liquidity should consider providing information about the nature and composition of that portfolio, including a description of the assets held and any related market risk, settlement risk or other risk exposure.

With respect to leverage ratio disclosure, the SEC reminds registrants of (i) the SEC guidance provided in 2003 in Release 33-8350 with respect to non-financial measures and (ii) Item 10(e) of Regulation S-K with respect to use of non-GAAP financial measures in SEC filings. In both cases, a ratio or measure included in an SEC filing should be accompanied by an explanation of the calculation methodology, including disclosure of

treatment of unusual, infrequent or non-recurring inputs or that are otherwise not calculated consistently with directly comparable measures, as well as a statement of the registrant's reasons for including the financial measure.

For contractual obligations table disclosure, registrants are encouraged to develop a presentation that appropriately reflects the categories of obligations that are meaningful in light of the registrant's capital structure and business. In order to facilitate period-to-period comparisons, registrants should highlight any changes made in the disclosure. Registrants should also include footnote (or additional narrative) disclosure to provide the information necessary for an understanding of the timing and amount of the specified contractual obligations.

The interpretive guidance may be found at <http://www.sec.gov/rules/interp/2010/33-9144.pdf>.

PROPOSED SHORT-TERM BORROWINGS DISCLOSURE REQUIREMENT

The proposed rule changes would require a registrant to provide, in a separately captioned subsection of MD&A, a comprehensive explanation of its short-term borrowings, including both quantitative and qualitative information. The proposed rule changes would apply to a registrant's annual and quarterly reports, proxy or information statements that include financial statements and registration statements under the Securities Act of 1933, as amended, and the Securities Exchange Act of 1934, as amended (the "Exchange Act").² The most significant proposed rule changes to enhance short-term borrowings disclosure include:

- a new MD&A disclosure requirement applicable to all registrants relating to short-term borrowings, substantially similar to existing annual disclosure requirements for short-term borrowings by bank holding companies under Industry Guide 3, Statistical Disclosure by Bank Holding Companies, supplemented by a new required narrative explanation; and
- a similar requirement for interim period disclosure of short-term borrowings with the same level of detail as is proposed for annual presentation.

The proposed rule changes would require registrants to disclose in tabular format for each category of short-term borrowings (as described below) (A) the average amount outstanding

² The proposed rule changes would apply to the annual disclosures of foreign private issuers other than Canadian "MJDS" filers. The proposed rule changes also provide separate requirements for smaller reporting companies which are not discussed in this memorandum.

during each reported period and the weighted average interest rate thereon, (B) the amount outstanding at the end of each reported period and the weighted average interest rate thereon and (C)(i) for registrants that are financial companies (as defined below), the maximum daily amount outstanding during each reported period or (ii) for registrants that are not financial companies, the maximum month-end amount outstanding during each reported period. These disclosures must be disaggregated by currency, interest rate or other meaningful category, to the extent presentation of separate amounts is necessary to promote understanding or to prevent aggregate amounts from being misleading, and include a footnote to the table indicating the method of disaggregation and any other pertinent data relating to the calculation of the amounts presented, including, without limitation, the timing and exchange rates used for currency translations.

In addition to tabular disclosure, the proposed rule changes would require registrants to provide a narrative explanation (not currently required in bank holding company Guide 3 disclosure) that includes (A) a general description of the short-term borrowings included in each category (including any key metrics or other factors that could reduce or impair the company's ability to borrow under any of such arrangements and whether there are any collateral posting arrangements) and the business purpose to the registrant of such short-term borrowings, (B) the importance to the registrant of such short-term borrowings in respect of its liquidity, capital resources, market-risk support, credit-risk support or other benefits, (C) the reasons for any material differences between average short-term borrowings and period-end borrowings and (D) the reasons for the maximum outstanding amounts in each reported period, including any non-recurring transactions or events, use of proceeds or other information that provides context for the maximum amount.

The proposed rule changes define "short-term borrowings" to include amounts payable for short-term obligations (generally, those that are scheduled to mature within a year of the balance sheet date) that are: (A) federal funds purchased and securities sold under agreements to repurchase, (B) commercial paper, (C) borrowings from banks, (D) borrowings from factors or other financial institutions and (E) any other short-term borrowings reflected on a registrant's balance sheet. The proposed rule changes define "financial company" as a registrant that, during the 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, 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. The proposed rules intentionally do not include a specific threshold or definition of "significant extent" but do include a request for comment on the point.

The new disclosure requirement would be applicable to annual and quarterly reports and registration statements. For annual reports, information would be presented for the three most recent fiscal years and for the fourth quarter. In addition, 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, consistent in each case with general MD&A requirements and instructions applicable to the relevant registration statement form requirements. For quarterly reports, information would be presented for the relevant quarter, without a requirement for comparative data.³ For registrants that are not subject to Guide 3, the requirements for comparative annual data would be phased in until all three years are included in the annual presentation.

Proposed instructions to the rule changes clarify that where a registrant meets the definition of financial company, but also has operations that do not involve lending, deposit-taking, insurance underwriting, providing investment advice, or broker or dealer activities, it may present the required tabular information separately for such operations and in doing so, the registrant may disclose averages and maximum amounts for such operations using the rules and instructions applicable to registrants that are not financial companies, provided that it must disclose averages computed on a daily average basis and maximum daily amounts for its operations that fall within the definition of financial company.

Finally, the proposed rule change release includes a request for comment on whether to extend leverage ratio disclosure requirements to companies that are not bank holding companies and on the scope of such a requirement, including how it would take into account the differences among metrics and industries while still providing comparability.

The proposed rule changes may be found at <http://www.sec.gov/rules/proposed/2010/33-9143.pdf>.

NEXT STEPS

The interpretive guidance is effective as soon as it is published in the Federal Register. As a result, SEC registrants should review their MD&A and other disclosure against the recommendations of the MD&A interpretive guidance. For registrants with a calendar year fiscal year, this exercise begins with the upcoming Form 10-Q for the quarter ending September 30. All registrants, especially those that are not “financial companies,” will want to review their operations to assess what changes would be required to make the proposed

³ *Quarterly reporting requirements would not apply to foreign private issuers as they are not subject to quarterly reporting requirements. Similarly, their annual reports would not be required to include fourth quarter disclosure.*

required short-term borrowings disclosure. Registrants whose business includes activities of both a “financial company” and otherwise will want to analyze whether they would opt to present bifurcated disclosure for financial company and other operations. Comments to the proposed rule changes for short-term borrowings disclosure are due within 60 days of publication of the proposed rule changes in the Federal Register, *i.e.*, late November or early December.

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Please do not hesitate to contact us to discuss the interpretive guidance, proposed new required disclosure with respect to short-term borrowings or this memorandum generally.

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Selected SEC Guidance Relevant to MD&A Disclosure

Release No. (Date)	Title	Link to Release
33-6621 (Jan. 22, 1986) [51 FR 3765]	Disclosure Amendments to Regulation S-X Regarding Repurchase and Reverse Repurchase Agreements	http://content.lawyerlinks.com/library/sec/sec_releases/33-6621.htm
33-6835 (May 18, 1989) [54 FR 22427]	Management's Discussion and Analysis of Financial Condition and Results of Operations; Certain Investment Company Disclosures	http://www.sec.gov/rules/interp/33-6835.htm
33-7386 (Jan. 31, 1997) [62 FR 6044]	Disclosure of Accounting Policies for Derivative Financial Instruments and Derivative Commodity Instruments and Disclosure of Qualitative and Quantitative Information About Market Risk Inherent in Derivative Financial Instruments, Other Financial Instruments and Derivative Commodity Instruments	http://www.sec.gov/rules/final/33-7386.txt
33-8040 (Dec. 12, 2001)	Cautionary Advice Regarding Disclosure About Critical Accounting Policies	http://www.sec.gov/rules/other/33-8040.htm
33-8056 (Jan. 22, 2002) [67 FR 3746]	Commission Statement About Management's Discussion and Analysis of Financial Condition and Results of Operations	http://www.sec.gov/rules/other/33-8056.htm
33-8144 (Nov. 4, 2002) [67 FR 68054]	Disclosure in Management's Discussion and Analysis About Off Balance Sheet Arrangements, Contractual Obligations and Contingent Liabilities and Commitments	http://www.sec.gov/rules/proposed/33-8144.htm
33-8176 (Jan. 22, 2003) [68 FR 4820]	Conditions for Use of Non-GAAP Financial Measures	http://www.sec.gov/rules/final/33-8176.htm
33-8182 (Jan. 28, 2003) [68 FR 5982]	Disclosure in Management's Discussion and Analysis About Off Balance Sheet Arrangements, Contractual Obligations and Contingent Liabilities and Commitments	http://www.sec.gov/rules/final/33-8182.htm
(Feb. 2003)	Summary by the Division of Corporation Finance of Significant Issues Addressed in the Review of the Periodic Reports of the Fortune 500 Companies	http://www.sec.gov/divisions/corpfin/fortune500report.htm
33-8350 (Dec. 19, 2003) [68 FR 75056]	Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations	http://www.sec.gov/rules/interp/33-8350.htm
(June 2005)	Staff of the U.S. Securities and Exchange Commission, Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 On Arrangements with Off-Balance Sheet Implications, Special Purpose Entities and Transparency of Filings by Issuers	http://www.sec.gov/news/studies/soxoffbalancerept.pdf
(Dec. 2007)	Division of Corporation Finance, Sample Letter Sent to Public Companies That Have Identified Investments in Structured Investment Vehicles, Conduits or Collateralized Debt Obligations (Off-Balance Sheet Entities)	http://www.sec.gov/divisions/corpfin/guidance/cfoffbalanceltr1207.htm
(Mar. 2008)	Sample Letter Sent to Public Companies on MD&A Disclosure Regarding the Application of SFAS 157 (Fair Value Measurements)	http://www.sec.gov/divisions/corpfin/guidance/fairvalueltr0308.htm
(Sept. 2008)	Sample Letter Sent to Public Companies on MD&A Disclosure Regarding the Application of SFAS 157 (Fair Value Measurements)	http://www.sec.gov/divisions/corpfin/guidance/fairvalueltr0908.htm
(Mar. 2010)	Division of Corporation Finance, Sample Letter Sent to Public Companies Asking for Information Related to Repurchase Agreements, Securities Lending Transactions, or Other Transactions Involving the Transfer of Financial Assets	http://www.sec.gov/divisions/corpfin/guidance/cforepurchase0310.htm