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SEC Proposes New Rules on Disclosure of Off-Balance Sheet Arrangements and Other Commitments

The SEC has proposed new rules requiring the disclosure of:

- off-balance sheet transactions, arrangements, obligations (including contingent obligations) and other relationships of an issuer with unconsolidated entities or other persons;
- aggregate contractual obligations; and
- contingent liabilities and commitments.

The new disclosure would be located in the "Management's Discussion and Analysis of Financial Condition and Results of Operations" ("MD&A") section in a company's disclosure documents. The disclosure regarding off-balance sheet arrangements would be made in a separately captioned subsection of MD&A.

The proposed rules would apply to both domestic and non-U.S. reporting companies and would amend Item 303 of Regulation S-K and the MD&A requirements of Form 20-F. The proposed rules would not change the current disclosure requirements of generally accepted accounting principles ("GAAP") or the disclosure requirements for financial statement and the related footnotes.

The proposed rules are subject to a 30-day comment period. The SEC is required to adopt final rules by January 26, 2003.

I. Background

The proposed rules would implement Section 401(a) of the Sarbanes-Oxley Act of 2002 (the "Act"), which requires the SEC to adopt rules that would require each annual and quarterly financial report filed with the SEC to disclose all material off-balance sheet transactions, arrangements, obligations (including contingent obligations), and other relationships of the issuer with unconsolidated entities or other persons, that may have a material current or future effect on financial condition, changes in financial condition, results of operations, liquidity, capital expenditures, capital resources, or significant components of revenues or expenses. The language and concepts in Section 401(a) of the Act are consistent with a statement made by the SEC in January 2002, which called for enhanced disclosure of off-balance sheet arrangements and of contractual obligations and other contingent liabilities.

II. Off-Balance Sheet Arrangements

A. Scope of Arrangements Covered

The proposed rules would define off-balance sheet arrangements as any transaction, agreement or other contractual arrangement to which an entity unconsolidated with the registrant is a party, under which the registrant, whether or not a party to the arrangement, has, or in the future may have:

- any obligation under a direct or indirect guarantee or similar arrangement;
- a retained or contingent interest in assets transferred to an unconsolidated entity or similar arrangement;

- derivatives, to the extent that the fair value thereof is not fully reflected as a liability or asset in the financial statements (e.g., derivatives classified as shareholder's equity); or
- any obligation or liability, including a contingent obligation or liability, to the extent that it is not fully reflected in the financial statements (excluding the footnotes thereto). Such obligations and liabilities include, without limitation:
    - obligations that are not classified as a liability according to GAAP;
    - contingent liabilities as to which, as of the date of the financial statements, it is not probable that a loss has been incurred or, if probable, is not reasonably estimable; or
    - liabilities as to which the amount recognized in the financial statements is less than the reasonably possible maximum exposure to loss under the obligation as of the date of the financial statements.

The last item includes contingent liabilities that are partially accrued according to GAAP, but excludes liabilities recorded at fair value as of the date of the financial statements. For example, GAAP requires an accrual for a loss equal to the company's best estimate within a range of possible losses and requires footnote disclosure of the additional exposure to loss if there is at least a reasonable possibility of a loss in excess of the amount accrued. In that case, the contingent obligation would fall within the scope of the proposed definition because the amount accrued reflects only the most probable estimate, but does not reflect other probabilities of losses as of the date of the financial statements.

In contrast, a liability is considered to be fully reflected in the financial statements, and therefore outside the scope of the proposed definition, if it is recorded at its fair value. Because contingent liabilities recorded at fair value reflect the present value of all probabilities of all possible outcomes, as opposed to the most probable estimate within a range, they are considered to be fully reflected in the financial statements. For example, in some circumstances a company is required to recognize certain liabilities, such as derivatives and recourse obligations, at fair value. Under the proposed definition of off-balance sheet arrangements, those liabilities would be considered to be fully reflected in the financial statements, and outside the scope of the proposed definition, even though the fair value of those liabilities may substantially increase in the future in response to changing events or circumstances.

Contingent liabilities arising out of litigation, arbitration or regulatory actions (not otherwise related to off-balance sheet arrangements) are not off-balance sheet arrangements.

The proposed definition of off-balance sheet arrangements diverges from the exact language of Section 401(a) of the Act. For example, the proposed definition refers to "any obligation, including a contingent obligation, that is not fully reflected in the financial statements," whereas Section 401(a) refers to "obligations (including contingent obligations), and other relationships of the issuer with unconsolidated entities or other persons."

Another aspect of the proposed definition that is not explicitly stated in the Act is that the arrangements are contractual. The proposed rules include an instruction that no obligation to make disclosure of an off-balance sheet arrangement shall arise until an unconditionally binding definitive agreement, subject only to customary closing conditions, exists or, if there is no such agreement, when settlement of the transaction occurs.

B. Required Disclosure

The proposed rules would require that every MD&A discussion include, in a separately-captioned section, a discussion of the registrant's off-balance sheet arrangements that may have a current or future material effect on the registrant.

The disclosure would have to include the following items to the extent necessary to an understanding of the effect of the off-balance sheet arrangements on the registrant's financial condition, changes in financial condition, revenues and expenses, results of operations, liquidity, capital expenditures and capital resources:

1. Business Purpose

The disclosure regarding the nature and business purpose of the off-balance sheet arrangements should explain to investors why and how the company engages in off-balance sheet arrangements. For example, a company may indicate that the arrangements enable the company to lease certain facilities rather than acquire them, where the latter would require the registrant to recognize a liability for the financing. Other possible disclosure under this proposed requirement may indicate that the off-balance sheet arrangement enables the registrant to readily obtain cash through sales of groups of loans to a trust; to finance inventory, transportation or research and development costs without recognizing a liability; or to lower borrowing costs of affiliates by extending guarantees to their creditors.

2. Significant Terms

The requirement to disclose the significant terms and conditions of off-balance sheet arrangements may include disclosure of the terms of credit or liquidity enhancement provided by a registrant, leases, limitations on the activities or life of a special purpose entity, contracts between the registrant and a special purpose entity for goods or services or specific rights of third parties to participate in the management of a special purpose entity. This proposed disclosure requirement applies to arrangements to which a registrant is a party and to arrangements under which the registrant may have a direct or contingent obligation even though it is not a party to the arrangement. The disclosure should inform investors of the significant terms and conditions of any arrangements that may implicate a company's pre-existing guarantees, keepwell agreements or other arrangements. Terms and conditions that are not necessary to an understanding of the disclosure required under the proposals are not required to be disclosed.

3. Assets and Liabilities of the Off-Balance Sheet Entity

The proposals would require a company to disclose the nature and amount of the total assets and total obligations and liabilities (including contingent obligations and liabilities) of an entity in which off-balance sheet activities are conducted. This disclosure should provide the information that investors need to understand the dynamics and business activities of a registrant's off-balance sheet arrangements. For example, a registrant would have to identify the total amount of assets that it transferred to the off-balance sheet entity, amounts receivable or payable and any debt obligations incurred by the entity. This information also should provide insight into an off-balance sheet entity's risk exposure, which in turn could expose the registrant to material risk.

4. Magnitude of Off-Balance Sheet Arrangements

The proposed disclosure would also provide investors with insight into the overall magnitude of a company's off-balance sheet activities, the specific impact of the arrangements on a registrant and the circumstances that could cause material contingent obligations or liabilities to come to fruition. Specific disclosure would be required of:

- the amounts of revenues, expenses and cash flows arising from the arrangements;
- the nature and total amount of any interests retained, securities issued and other indebtedness incurred; and
- the nature and amount of any other obligations or liabilities (including contingent obligations or liabilities) of the registrant arising from the arrangements that are, or may become, material and the triggering events or circumstances that could cause them to arise.

For example, this disclosure would include identification of the class and amount of any debt or equity securities issued by the company, either to the entity or to third parties, amounts of any guarantees, lines of credit, standby letters of credit, take-or-pay contracts and throughput contracts. This proposed disclosure requirement would also include provisions in financial guarantees or commitments, debt or lease agreements or other arrangements that could trigger a requirement for an early payment, additional collateral support, changes in terms, acceleration of maturity or the creation of an additional financial obligation.

In addition, the proposals would require disclosure of the circumstances under which the company's obligations and liabilities (including contingencies) could arise, such as adverse changes in the registrant's credit rating, financial ratios, earnings, cash flows, or stock price, and changes in the value of underlying, linked or indexed assets.

5. Analysis of Material Effects of Off-Balance Sheet Arrangements

Under the proposals, a company would have to provide its management's analysis of the material effects of the off-balance sheet arrangements and resulting obligations and liabilities on its financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures and capital resources. Possible disclosure may include a discussion of the amounts of gains or losses that were derived from sales of assets to special purpose entities in current and past periods, including the reasons for changes from period to period. If necessary, a company also may be required to disclose changes in the amount of third-party at-risk equity of special purpose entities and the material consequences of those changes.

To adequately inform investors of the effect of an off-balance sheet arrangement on liquidity and capital resources, a company may have to disclose that an off-balance sheet arrangement requires it to maintain a certain balance of liquid assets for an extended period of time. In that instance, the disclosure should include the amount and source of the assets required to be maintained and how that restriction on capital resources will affect ongoing operations.

To inform investors of the material effects of the contingent obligations that arise from off-balance sheet arrangements, a company would be required to disclose the amount of assets that may be required to settle any contingent obligation, the potential sources of necessary funding and whether or not circumstances indicate that a contingency will come to fruition.

The proposed analytical disclosure should provide investors with management's insight into the impact and proximity of the potential risks that may arise from material off-balance sheet arrangements. In addition, to increase investor understanding of circumstances that would have common effects with respect to a number of off-balance sheet arrangements, the proposals would require disclosure of management's analyses in the aggregate. For example, if particular triggering events or circumstances would require a company to become directly obligated or accelerate its obligations under a number of off-balance sheet arrangements, and the overall obligations would be material, then the proposed rules would require an analysis of the triggering events or circumstances and their aggregate effect.

Management would have to provide an analysis of the degree to which the company relies on off-balance sheet arrangements for its liquidity and capital resources or market risk or credit risk support or other benefits. This disclosure should provide investors with an understanding of the importance of off-balance sheet arrangements to the continuing operations of a company's business. For example, if a company relies on off-balance sheet arrangements for its liquidity and capital resources, a company may be required to disclose:

- how often it securitizes financial assets,
- to what degree its securitizations are a material source of liquidity,

- whether it has increased or decreased securitizations from past periods and the reasons for any such increases or decreases.

If the company relies on off-balance sheet arrangements for market risk or credit risk support, disclosure may be required of the extent to which a group of assets has been over-collateralized and the extent to which the company has continuing exposure to loss. Together with the other disclosure requirements, companies should provide information sufficient for investors to assess the extent of the risks that have been transferred and retained as a result of the arrangements.

Management also would have to discuss the effects of a termination or material reduction in the benefits of off-balance sheet arrangements. If under a contractual provision, or as a result of a known event, demand, commitment, trend or uncertainty, it is reasonably likely that an off-balance sheet arrangement that materially benefits the company will be terminated or the benefits of the arrangement will be materially reduced, disclosure would be required of the circumstances under which such termination or reduction may occur and the material effects of any such termination or reduction.

A company would also have to disclose any contractual provisions calling for the termination or material reduction of an off-balance sheet arrangement. The disclosure would also be required to address factors that are reasonably likely to affect the company's ability to continue using off-balance sheet arrangements. For example, if a company's credit rating were to fall below a certain level, some off-balance sheet arrangements may require a registrant to purchase the assets or assume the liabilities of a special purpose entity. In addition, a change in a company's credit rating could either preclude or materially reduce the benefits to engaging in off-balance sheet arrangements. In such cases, the company would have to disclose known circumstances that would be reasonably likely to cause its credit rating to fall to the specified level and discuss the material consequences.

Disclosure regarding similar arrangements should be aggregated to the extent practicable, but important distinctions in terms and effects of aggregated arrangements must be discussed. Effects that are common or similar with respect to a number of off-balance sheet arrangements must be analyzed in the aggregate to the extent the aggregation increases understanding. An analysis of the degree to which the registrant relies on off-balance sheet arrangements for its liquidity and capital resources or market risk or credit risk support or other benefits would also be required.

C. "Remoteness" Threshold

Consistent with the language in Section 401(a) of the Act, the threshold for disclosure of off-balance sheet arrangements falling within the proposed definition is whether they "may" have a current or future material effect on the company. The proposed disclosure would be required if management determines either that an off-balance sheet arrangement is material in the current period or that it may become material in the future. Disclosure would not be required for off-balance sheet arrangements where the likelihood of either the occurrence of an event, or the materiality of its effect, is remote.

The "remoteness" standard differs from existing standards for MD&A and for disclosure generally. In a previous interpretive release on MD&A disclosure, the SEC had stated that a registrant has a duty to disclose prospective information in its MD&A where a trend, demand, event, commitment or uncertainty is both presently known to management and "reasonably likely" to have a future material effect on the registrant's financial condition or results of operations. According to the prior interpretation, if management were unable to determine the reasonable likelihood of the occurrence of a future event or the materiality of its effect, then disclosure would be required.

Prior SEC interpretations also stated that the probability/magnitude test for materiality approved by the Supreme Court in *Basic v. Levinson* is inapposite to MD&A disclosure. The SEC has made clear its view that disclosure of prospective information in MD&A does not depend upon the balancing of probability and magnitude because the

MD&A rules and interpretive guidance specify the level of probability that would require disclosure of prospectively material information.

Instead of adopting the "reasonably likely" standard, the SEC has proposed the required disclosure of items that "may" have a material current or future effect. In proposing the rule changes, the SEC indicated its view that an appropriate interpretation of the disclosure threshold called for by the Act is best captured by the concept of "remoteness." Accordingly, the proposals would require disclosure of off-balance sheet arrangements under circumstances where management concludes that the likelihood of the occurrence of a future event and its material effect is higher than remote.

Consistent with other disclosure threshold determinations that management must make in drafting MD&A, the assessment of remoteness must be objectively reasonable, viewed as of the time the determination is made.

D. Location and Format of Disclosure

The proposals would require a registrant to present the proposed disclosure about off-balance sheet arrangements in a separate, designated subsection of MD&A. The proposed MD&A discussion should be presented in language and a format that is clear, concise and understandable. Similar arrangements may be aggregated to the extent practicable, but important distinctions in terms and effects of the aggregated arrangements must be discussed. The SEC warned in its proposing release that disclosure that could easily be transferred from year to year, or from company to company, with no change would neither inform investors adequately nor reflect the independent thinking that must accompany the assessment by management that is intended under the proposal.

III. Contractual Obligations and Contingent Liabilities and Commitments

The SEC has also proposed changes to the MD&A rules to require tabular disclosure of the company's known contractual obligations as of the latest balance sheet date. The proposed disclosure is similar to that called for by the SEC in its January 2002 statement regarding MD&A. The tabular presentation would be required to include at least the periods of less than one year, one to three years, three to five years and more than five years. The table would be required to provide amounts, aggregated by type of contractual obligation, and would have to categorize the obligations in a manner suitable to the company's business. A presentation of total contractual obligations for at least the periods specified would also be included. The tabular presentation may be accompanied by footnotes to describe provisions that create, increase or accelerate obligations, or other pertinent data. The proposed format of such schedule is provided in Annex A to this memorandum.

The proposals also call for the disclosure of the expected amount, range of amounts or maximum amount of contingent liabilities or commitments that are expected to expire in less than one year, from one to three years, from three to five years, and more than five years. The disclosure should indicate whether the amount disclosed is an expected amount or maximum amount if a range is not presented. The contingent liabilities or commitments must be aggregated by type in a manner that is suitable for the company's business. Examples of contingent liabilities or commitments that would be covered under the proposals are lines of credit, standby letters of credit, guarantees and standby repurchase obligations. The disclosure should address, in footnotes to the table or in the text, provisions of contingent liabilities that create, increase or accelerate obligations, or other pertinent data. The presentation may be in tabular or narrative form.

A company would not be required to include the table or repeat the other proposed required textual disclosure in quarterly reports. Instead, a company may disclose material changes by including a discussion of the relevant changes.

IV. Other MD&A Disclosure

According to the release, the SEC's new proposals are intended to complement and clarify the more general MD&A disclosure provisions that require a registrant to provide information about how known trends or uncertainties affect its liquidity, capital resources and results of operations, and other information necessary to an understanding of its financial condition, changes in financial condition and results of operations. While that disclosure mandate is general in nature, responsive MD&A disclosures should be sufficiently detailed and tailored to the registrant's individual circumstances.

In an effort to provide guidance to public companies, the SEC issued a statement in January 2002 regarding a number of factors that management should consider to identify the trends, demands, commitments, events and uncertainties that require disclosure with respect to liquidity and capital resources. It also addresses MD&A disclosure of relationships and transactions with persons or entities that derive benefits from their non-independent relationships with the registrant or the registrant's related parties. To avoid unnecessary duplication of disclosure, the SEC has only proposed to codify the positions in the January 2002 statement as they relate to off-balance sheet arrangements. The factors addressed in the January 2002 statement remain useful for management to consider in meeting its MD&A disclosure obligations of liquidity and capital resources and transactions with persons or entities that derive benefits from their non-independent relationships with the registrant or the registrant's related parties.

It is worth noting that some transactions that, while referred to as "off-balance sheet arrangements," may not fall within the scope of the proposals are nevertheless required to be discussed in MD&A. For example, some off-balance sheet arrangements do not create contingent liabilities or obligations that would lead to disclosure under the proposed rules. A registrant may routinely securitize financial assets without providing any recourse or credit or liquidity support to a special purpose entity. Existing MD&A requirements may require a registrant to discuss those activities in its MD&A discussion of liquidity and capital resources. If an off-balance sheet arrangement does not fall within the scope of the proposed disclosure requirements, yet disclosure would be required under the other provisions of MD&A, the company may choose whether or not to provide the disclosure in the separately-captioned section required by the proposal.

V. Application of the Proposals to Foreign Private Issuers

The proposed MD&A disclosure requirements would apply to foreign private issuers that file annual reports on Form 20-F or on Form 40-F. This represents a continuation of the SEC's general policy that the MD&A-equivalent requirements for foreign private issuers mirror the substantive MD&A requirements for U.S. companies.

The proposed MD&A disclosure requirements would also apply to Canadian issuers that file Form 40-F. Although a Canadian issuer typically prepares its Form 40-F MD&A discussion in accordance with Canadian disclosure standards, the SEC has nevertheless proposed that Form 40-Fs include disclosure of off-balance sheet arrangements in accordance with the proposed SEC rules.

Section 401(a) of the Act also requires the SEC to adopt off-balance sheet disclosure rules that apply to quarterly financial reports. Foreign private issuers are not required to file "quarterly" reports with the SEC and the proposed rules would not apply to Form 6-K reports. Thus, unless a foreign private issuer files a Securities Act registration statement that must include interim period financial statements and related MD&A disclosure, it would not be required to update the proposed MD&A disclosure more frequently than annually.

VI. Proposed Safe Harbor for Forward-Looking Information

To encourage the type of information and analysis necessary for investors to understand the impact of off-balance sheet arrangements, the proposals include a safe harbor for forward-looking information. The proposed safe harbor explicitly applies the existing statutory safe harbor protections (Sections 27A of the Securities Act and 21E of the Exchange Act) to forward-looking information that would be required to be disclosed by the proposals.

The proposed safe harbor is designed to remove possible ambiguity about whether the statutory safe harbor would apply to some of the statements made in response to the proposed disclosure requirements. The proposed safe harbor language specifies that, except for historical facts, all information called for regarding management's analysis of the material effects of off-balance sheet arrangements and the discussion of the effects of termination or reduction of off-balance sheet arrangements would be deemed to be a "forward-looking statement" as that term is defined in the statutory safe harbor. Under the proposed MD&A safe harbor, all of the conditions of the statutory safe harbors must be met.

The proposed safe harbor for forward-looking statements is in addition to the existing safe harbors for forward-looking statements under the Securities Act and the Securities Exchange Act as well as Securities Act Rule 175 and Exchange Act Rule 3b-6. Under those rules, a forward-looking statement made by or on behalf of a registrant is deemed not to be a fraudulent statement if it is made in good faith and made or reaffirmed with a reasonable basis. The rule-based safe harbors apply to a registrant if it is a reporting company at the time it makes the forward-looking statement. These safe harbors also apply to a registrant that is not a reporting company, but makes the statement in a Securities Act registration statement or an Exchange Act registration statement. The safe harbors cover forward-looking statements in filed documents, in annual reports to shareholders and in Part 1 of Form 10-Q.

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This memorandum provides only a general overview of the SEC's statement regarding MD&A disclosure. It is not intended to provide or constitute legal advice, and no legal or business decision should be based on its contents. Any questions concerning the foregoing should be addressed to members of the Paul Weiss Securities Group (see below). In addition, memoranda on related topics may be accessed under Securities Group publications on our web site (www.paulweiss.com).

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Annex A

Contractual Obligations	Payments Due by Period				
	Total	Less than 1 year	1-3 years	4 - 5 years	After 5 years
Long-Term Debt Capital Lease Obligations Operating Leases					
Unconditional Purchase Obligations					
Other Long-Term Obligations					
Total Contractual Cash Obligations					