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United States Senate

COMMITTEE ON
HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS
WASHINGTON, DC 20510–6250

November 29, 2010

VIA EMAIL (Rule-Comments@sec.gov)

Ms. Elizabeth M. Murphy
Secretary
Office of the Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

RE: Improved Disclosure of Short-Term Borrowing Activities, File No. S7-22-10

Dear Ms. Murphy:

The purpose of this letter is to express support for a rule proposed by the Securities and Exchange Commission ("SEC" or "Commission") to enhance short-term borrowing disclosures by publicly traded corporations to investors. Access to market information is central to investors' ability to analyze a company's financial well-being and make informed investment decisions. The proposed rule will help ensure that investors, as well as regulators, gain a more accurate understanding of companies' short-term borrowing activities, leverage, and liquidity.

Subcommittee Investigation. Over the past two years, the Permanent Subcommittee on Investigations, which I chair, has conducted an extensive investigation delving into key causes of the financial crisis. As a part of that investigation, the Subcommittee has analyzed issues related to short-term financing activities, margin and capital requirements, use of leverage, risk management, and related accounting principles. We gathered and reviewed extensive documentation, and interviewed dozens of financial institution employees, government officials, and academic experts, including loan originators, securitizers, credit rating agency personnel, and executives from major Wall Street banks, broker-dealers, and investment advisors. We also held four hearings and released thousands of hearing exhibits.

As part of that investigation, the Subcommittee became aware of and examined numerous instances of high risk, short-term borrowing activities, including the "Repo 105" transactions at Lehman Brothers and similar transactions at Citibank and Bank of America. The Subcommittee also reviewed materials related to the SEC's Consolidated Supervised Entity program which included government oversight of broker-dealer activities impacting capital, liquidity, and leverage ratios. This work disclosed the fact that, in the years leading up to the financial crisis, a number of major U.S. financial institutions maintained a large amount of debt on their books and were becoming increasingly leveraged, placing them at greater financial risk if they were unable to make payments on their debt. In some cases, the level of debt and the institution's reliance on short-term financing arrangements to maintain that debt were hidden from investors and regulators. In some cases, excess leverage and insufficient liquidity reserves contributed to the collapse of major firms, such as Lehman Brothers and Bear Stearns.

Congress enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), in part, to prevent similar disasters in the future by ensuring financial institutions have reasonable levels of leverage as well as sufficient liquidity and capital reserves. Similar concerns apply to nonfinancial corporations. Strengthened disclosures of short-term borrowing activities are an important reform to help ensure that investors, regulators, policymakers, and other analysts gain an accurate understanding of corporate risk.

Background. Companies currently obtain short-term borrowings from a variety of sources, including bank loans, debt instruments, trade credit, commercial paper, securitizations, and repurchase agreements.

Information regarding a company's liquidity and capital reserves is currently disclosed to investors in the Management Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") portion of the company's annual report. The MD&A disclosure is intended to provide investors with information that is "necessary to an understanding of [the company's] financial condition, changes in financial condition and results of operations."[1] Currently, this disclosure includes a discussion of a company's short-term borrowing arrangements insofar as they are likely to result in a material increase or decrease in the issuer's liquidity.[2] These financing arrangements raise particular disclosure concerns because of their short-term nature. In addition, while a company's short-term borrowings may fluctuate significantly throughout a reporting period, that fluctuation will not be reflected in the company's period-end disclosures, where only a snapshot of the company's assets and liabilities are captured. This snapshot disclosure can mislead investors who, after viewing a company's financial disclosures, may believe that the company is less leveraged than it is. The proposed rule would strengthen short-term borrowing disclosures to provide a more complete picture of the company's financial situation.

The proposed rule's strengthened disclosure requirements are, in part, a response to increased short-term borrowing by major U.S. companies through use of a repurchase agreement, often referred to as a "repo." Repurchase agreements are technically structured as sales, but substantively operate as short-term loans secured by securities. In a typical repurchase agreement, the initial "seller" (the borrower) sells securities to the initial "buyer" (the lender) for cash. Simultaneously, the parties enter into a contract in which the initial seller agrees to buy back the securities from the initial buyer at a later date, usually at a price greater than the initial purchase price. Through these linked transactions, the initial seller effectively becomes the borrower of cash, the initial buyer becomes the lender, and the difference in purchase price is the fixed rate of interest on the loan.

Although the sale and repurchase of the securities changes legal ownership of the collateral securities, this transaction is not typically recognized as a sale and repurchase for tax

[1] 17 CFR § 229.303(a).
[2] 17 CFR § 229.303(a)(1).

purposes.[3] Nor is it recognized as a "true sale" under accounting principles, since the seller of the securities (the borrower) commits to buying back the securities at a specified date and price.[4] Instead, the transaction is recorded as a financing transaction, in which the transferred securities remain in the inventory of the "selling" company and are reflected in that company's balance sheet. The borrowed cash is shown as an increase in the company's total assets, while the obligation to repay the loan (through the repurchase of the securities) is shown as an increase in the company's total liabilities. The company's final balance sheet is intended to reflect that the company has obtained a secured loan that will be repaid at the time the company re-purchases its securities.

During the financial crisis, some U.S. companies failed to record their repurchase agreements as loans, instead treating them on their books as sales of securities. This accounting treatment erroneously inflated their sales revenue and reduced their debt. The most notorious example involves the Lehman Brothers' "Repo 105" transactions which took place at the end of a reporting period, treated the firm's repurchase agreements as securities sales, and left the impression that firm had more funds and less debt than it actually did. Investors viewing the Lehman financial statements were not informed that the company had a contractual obligation to buy back the securities "sold" during the reporting period. The Lehman Bankruptcy Examiner determined in his report that "Lehman's primary motive for undertaking tens of billions of dollars in Repo 105 transactions at or near each quarter-end in late 2007 and 2008 was to temporarily remove the securities inventory from its balance sheet in order to report lower leverage ratios than Lehman actually had."[5] He determined that, in its 2008 financial statement, Lehman had removed approximately $49 billion in debt from its balance sheet through Repo 105 transactions.[6]

Inaccurate accounting treatment of repurchase agreements was not confined to Lehman Brothers. Other investment banks, such as Bank of America and Citigroup, have, in response to SEC inquiries, acknowledged that they erroneously recorded repurchase agreements as sales rather than as financing transactions. Although no formal complaint has been filed by the SEC against either institution, those two banks have together admitted misreporting approximately $20 billion in repos over the period of 2007 through 2010.[7]

Improved Disclosure. The proposed rule would strengthen the financial disclosures that must be provided by companies to ensure that, in addition to being provided a snapshot of a corporation's financial condition at quarter- or year-end, investors are fully apprised of the corporation's short-term borrowing activities throughout the reporting period.

The proposed rule would apply to all companies that currently provide an MD&A disclosure in their public filings, requiring them to provide additional information regarding their short-term borrowings. Under the proposed rule, companies would be required to include in the

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[3] Report of Examiner Anton R. Valukas, at 766 n.2955 [hereinafter Lehman Brothers Bankruptcy Report] (citing Nebraska Dep't of Revenue v. Loewenstein, 513 U.S. 123, 130-31 (1994)).
[4] See Financial Accounting Standards Board, Financial Accounting Standard No. 140.
[5] Lehman Brothers Bankruptcy Report at 761.
[6] Lehman Brothers Bankruptcy Report at 801.
[7] See April 30, 2010 letter from Citibank CFO to the SEC; May 13, 2010 letter from Bank of America Corporate Controller to the SEC.

MD&A portion of their annual reports a table with specified information about their short-term borrowing activities over the covered reporting period, broken down into five specified categories.[8] The table would provide, for example, the average amount of the short-term borrowings in each category for that reporting period, as well as the weighted average interest rate on those borrowings. In addition, financial companies would be required to disclose the maximum daily amount of short-term borrowings held during the reporting period in each category, while non-financial companies would have to disclose their maximum monthly amount of short-term borrowings. These disclosures, which are modeled after those already required for bank holding companies, are well-designed to aid investors in understanding a company's short-term borrowing activities and identifying any substantial differences between a company's period-end and average borrowings over the course of the period. In addition, by presenting the information in a table with a specified format, the proposed rule would provide investors with clear, organized, and consistent data that can be used for inter-company or industry sector analysis. The data should also help regulators monitor systemic risk.

In addition to the data table, the proposed rule would require covered companies to provide a narrative discussion and analysis of their short-term borrowing arrangements in the MD&A portion of their annual reports. This discussion would be required to include a description of the company's short-term borrowing arrangements, the business purpose for such arrangements, the reasons for the maximum amount of borrowings reported by the company, the reasons for any material differences between the average short-term borrowings for the period and the period-end short-term borrowings, and any significance such short-term borrowing arrangements would have for the company's liquidity or capital reserves. The annual report would also have to provide short-term borrowing information for the three most recent fiscal years, providing investors with additional context for the company's borrowing activity. This expanded disclosure would provide investors with the reasons behind a company's short-term borrowing activities that would otherwise be unavailable, enable investors to better evaluate the company's current and future liquidity, and allow more informed investment decisions. The proposed frequency for the expanded disclosure would also provide investors with timely information regarding the company's financial obligations.

Foreign Private Issuers and Smaller Companies. The proposed rule would apply its strengthened disclosure requirements, not only to domestic companies, but also to foreign private issuers, other than filers that comply with the U.S.-Canadian Multijurisdictional Disclosure System. Foreign private issuers would be required to make the same short-term borrowings disclosures as domestic companies in their Form 20-F filing. Such disclosures, however, would only be required on an annual basis, since foreign private issuers do not provide quarterly reporting. As with domestic reporting companies, foreign private issuers would be required to provide short-term borrowings data for the three most recent fiscal years.

Extending the strengthened short-term borrowing disclosure requirements to foreign private issuers is critical to ensuring that U.S. investors obtain accurate information about companies traded on U.S. exchanges. The risk that transactions like Repo 105 may be used to

[8] The five categories of short-term borrowing that would be included in the table are: (1) federal funds purchased and securities sold under repurchase agreements; (2) commercial paper; (3) borrowings from banks; (4) borrowings from factors or other financial institutions; and (5) other borrowings on the balance sheet.

mask a company's leverage and debt levels is just as great in the case of a foreign private issuer. If the rule were instead to exempt foreign private issuers from the disclosure obligations, it might create an unwarranted incentive for domestic companies to establish foreign operations outside of direct SEC oversight.

The rule also proposes imposing fewer reporting requirements on smaller companies. Specifically, smaller companies would be required to make disclosures on an annual basis and certain companies would be allowed to provide short-term borrowings information for only the two most recent fiscal years in their annual reports. Smaller companies would be required to make interim period disclosures only when there is a material change. This approach is undertaken on the premise that more timely disclosures would overburden smaller companies, but that concern should be measured against the need for investors and regulators to obtain accurate information about the short-term borrowings of smaller issuers that, like large companies, may be tempted to mask debt. It should also be evaluated in light of the statute's objectives to discourage excessive leverage and reliance on short-term borrowing to reduce risk. A better approach might be to apply the same disclosure requirements to smaller companies as larger companies where practicable.

Leverage Ratios. The proposed rule also requests comment on whether issuers, in addition to bank holding companies, should be required to disclose their leverage ratios. Excessive leverage, and the failure to accurately measure and manage the risk it creates, was central to the financial crisis. Requiring all companies to disclose a leverage ratio would provide investors, regulators, and policymakers with needed insight into how much a company is relying on outside loans to finance its business.

The proposed rule notes that, currently, a variety of metrics are used to calculate leverage ratios. Specifying how the ratio is to be determined would help ensure consistent ratios that analysts could use to compare companies, research industry sectors, and assist in the efforts to identify and manage systemic risk. Disclosure of leverage ratios could also give investors the information needed to apply market discipline to firms taking excessive risks. Investors, regulators, and policymakers should not have to guess at the extent to which a publicly traded corporation is leveraged; this fundamental data should be disclosed as a matter of course for all registered companies.

Thank you for the opportunity to comment on this proposed rule.

Sincerely,

Carl Levin

Carl Levin
Chairman
Permanent Subcommittee on Investigations