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European Sovereign Debt Crisis: SEC Staff Publishes Disclosure Guidance Regarding European Sovereign Debt Exposures

On January 6, 2012, the Division of Corporation Finance of the US Securities and Exchange Commission (the “SEC”) published guidance setting out the division’s views regarding disclosure of financial institutions’ direct and indirect exposures to the debt of certain European countries. The Division of Corporation Finance’s Disclosure Guidance: Topic No. 4 is available at <http://www.sec.gov/divisions/corpfin/guidance/cfguidance-topic4.htm>.

The ongoing European sovereign debt crisis coupled with current market uncertainty and fluctuating conditions in the global economy continue to affect many companies. As a result, it is important for all SEC registrants preparing periodic or annual reports, as well as those in the process of preparing offering documents, to reassess their disclosures relating to the risks and financial and other impacts posed by these events.

Financial Institutions

In light of the current European sovereign debt crisis, the Division of Corporation Finance is focused on the risks posed to financial institution registrants from exposure to direct or indirect holdings of the debt of certain affected countries. In its guidance, the division expressed its views that disclosures on this topic included in registrants’ 2011 periodic reports have been inconsistent in both substance and presentation. The division reported that it has issued comments in respect of these reports requesting registrants to disclose for each country:

- gross sovereign, financial institutions, and non-financial corporations’ exposure;
- quantified disclosure explaining how gross exposures are hedged; and
- a discussion of the circumstances under which losses may not be covered by purchased credit protection.

To improve clarity and comparability more broadly, the Division of Corporation Finance’s guidance published on January 6, 2012 seeks to help all registrants determine what information they should consider disclosing in respect of their exposure to the European sovereign debt crisis. The guidance, which represents the views of the Division of Corporation Finance, does not set out new SEC rules, regulations or disclosure requirements.

The guidance is focused on the need for greater disclosure on this topic for registrants to meet the requirements of four existing principles-based disclosure items:

- **Known trends and uncertainties:** Companies are required to provide in their Management's Discussion & Analysis ("MD&A") disclosure relating to any trend, demand, commitment, event or uncertainty unless the company is able to conclude either that it is not reasonably likely that the trend or uncertainty will occur, or that a material effect on the company's results of operations, liquidity or capital resources is not reasonably likely to occur.
- **Industry Guide 3 – Bank Holding Companies:** Registrants that provide Guide 3 disclosure are required to not only state the name of the country and aggregate amount of cross-border outstandings to borrowers in each foreign country where such outstandings exceed 1% of total assets, but must provide more detailed disclosure, including tabular disclosure of changes in outstandings, when conditions in a foreign country give rise to liquidity problems that are expected to have a material impact on the timely payment of principal or interest on the country's private or public sector debt.
- **Risk Factors:** Periodic reports are required to disclose the most significant risks to the registrant or its industry that make an investment in the company's securities speculative or risky.
- **Market Risk:** Registrants are required to provide quantitative and qualitative market risk disclosure in respect of their portfolios.

In its new guidance, the Division of Corporation Finance advises that in providing greater disclosure on registrants' exposure to European debt, such disclosure should be:

- provided on a country-by-country basis;
- segregated by sovereign and non-sovereign exposures; and
- segregated by financial statement category to arrive at gross funded exposure, as appropriate.

The guidance also suggests that registrants should consider:

- disclosing gross unfunded commitments; and
- providing information regarding hedges in order to present an amount of net funded exposure.

In determining which countries to focus on, registrants should concentrate on those that are experiencing significant, economic, fiscal and/or political tension that the company believes increases the likelihood of default. Companies should also consider disclosing the rationale for choosing the countries they have included.

The SEC's publication includes a detailed list of considerations that registrants are encouraged to take account of when preparing disclosure in accordance with the guidance.

Registrants should also consider disclosures relating to their risk management strategies, including how they are monitoring or mitigating direct exposure to the selected countries and/or the effects of indirect exposure. Disclosures about developments in the selected countries, such as ratings downgrades and financial relief plans may also warrant inclusion, as they may affect registrants' financial condition, results of operation, liquidity or capital resources. Finally, registrants should consider whether any significant post-reporting date events necessitate disclosure.

Non-Financial Institutions

Registrants that are not financial institutions that are exposed, directly or indirectly, to European sovereign debt affected by the current crisis should also take note of the Division of Corporation Finance's guidance as a guide for assessing their disclosures related to this topic.

In addition, registrants should consider updating or including in their MD&A and risk factors information relating to risks and uncertainties created by the current economic and fiscal climate. Disclosure and risk factors on credit risk and the challenging economic environment used in 2008 and 2009 periodic reports and offering documents could be helpful and should be revisited and updated to reflect current developments. In particular, risk factors should highlight specific elements related to the European sovereign debt crisis and the uncertainty emanating from the situation in the euro zone. For example, registrants may wish to disclose, in addition to risk factors related to their exposure to European sovereign debt, the risks related to:

- their liquidity posed by a disruption in the capital markets resulting from the ongoing crisis;
- a potential change to the composition of the European Monetary Union, including the possible dissolution of the euro;
- dividends, foreign cash balances and investments resulting from fluctuations in exchange rates; and
- failures of hedging policies, where applicable.

Registrants must also disclose in their MD&A known trends and uncertainties resulting from the challenging economic environment, as well as the European sovereign debt crisis, that may affect their liquidity, capital resources or results of operations.

If you wish to review further information regarding these issues, you may refer to our client publication entitled “The 2011 Form 20-F: New Developments, Practices and Trends” at <http://www.shearman.com/the-2011-form-20-f-new-developments-practices-and-trends-12-13-2011/>.

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This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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