



SECURITIES AND CAPITAL MARKETS UPDATE

SEC Guidance Relating to Sovereign Debt and Other Exposures in Europe

On January 6, 2012, the Division of Corporation Finance of the Securities and Exchange Commission issued detailed guidance to SEC registrants (primarily financial institutions) relating to their disclosures concerning direct and indirect exposure to European sovereign debt.¹ All issuers should address this disclosure guidance in their future SEC filings. Issuers with immediate plans to access the US public markets should review the adequacy of the information in their previous filings in light of the guidance in order to determine whether additional information should be provided to investors. In addition, although of particular importance to SEC filers, the guidance will likely be viewed as relevant to financial institution issuers, underwriters and their advisers in Rule 144A and other non-registered securities offerings in the United States.²

Over the past 12 months in particular, financial institutions have had to reassess the quality of and risks associated with their holdings of European sovereign debt. Although concerns initially focused on Ireland, Portugal and Greece, a broader reassessment of larger European country exposures has since become appropriate. The Division's guidance results from its view that, while disclosure by financial institution issuers has improved during the past year, issuers have been inconsistent (both as to substance and presentation) in their disclosures (both filed and furnished) relating to these exposures and risks and that, as a result, investors are not being provided with the easily understandable and comparable disclosures needed to make informed investment decisions.³

¹ CF Disclosure Guidance: Topic No. 4, "European Sovereign Debt Exposures," January 6, 2012, which is available at <http://www.sec.gov/divisions/corpfina/guidance/cfguidance-topic4.htm>. Notwithstanding the title and introductory paragraph, the Division appears to envisage non-sovereign as well as sovereign exposures being addressed as a result of this disclosure guidance. Although the guidance represents the views of the Division (and is not a rule, regulation or formal statement of the Commission), SEC comment letters are expected to require registrants to follow the guidance. The guidance is equally applicable to US domestic and foreign private issuer registrants.

² In the case of 144A offering documents aimed at qualified institutional buyers (which are not subject to review by the SEC staff), there will likely be some pressure to follow the Division's guidance, although perhaps allowing more flexibility as to the detail and manner in which the transaction participants are willing to see disclosures presented.

³ As examples of what the Division viewed as inconsistent disclosures in 2011, the guidance refers to instances of (i) disclosure of aggregate exposure or separate quantification of exposure to each country of concern; (ii) disclosure of aggregate exposure to sovereign debt, corporate-level debt and loans to retail customers in the identified countries or quantification of exposures with respect to each type of disclosure; (iii) disclosure of net exposures or disclosure of both gross and net exposures; and (iv) disclosure of the effect of purchased credit default swap contracts based on nominal values or based on fair market values. In reviewing these disclosures, the staff has issued comments requesting enhanced disclosures, including (a) gross sovereign, financial institution, and non-financial corporation exposure, separately by country; (b) quantified disclosure as to how gross exposures are hedged; and (c) discussion of the circumstances under which losses may not be covered by purchased credit protection.

Because this is an interpretation of existing disclosure requirements, it is effective immediately. The Division expects financial institution issuers (presumably only where they have significant exposures) to disclose their gross funded exposure to the countries in question, as well as (again where appropriate) their gross unfunded commitments to these countries. In addition, the Division expects registrants to provide information regarding hedges so as to clearly establish the registrant's net funded exposures. The Division has provided specific guidance as to the manner in which gross funded and unfunded commitments and related disclosures should be presented. This detailed guidance is attached as Annex A.

The Division has not indicated which European countries are covered by its guidance. In determining which countries to focus on, registrants are expected to concentrate on those "experiencing significant economic, fiscal and/or political strains such that the likelihood of default would be higher than would be anticipated when such factors do not exist." The Division expects that the countries covered will vary and that the disclosures "should be sufficiently flexible to capture those risks as they change over time." Registrants are encouraged to disclose the basis used for identifying the countries included in the disclosure.

It should be noted that the Division's guidance supplements the SEC's existing MD&A requirement to disclose known trends, events or uncertainties, and its Guide 3 disclosure requirements, including Item III.C.3 of Guide 3 which requires registrants to identify cross-border outstandings to borrowers in each foreign country where the exposures exceed 1% of total assets. It also supplements the Guide 3 requirement for disclosure where "current conditions in a foreign country give rise to liquidity problems which are expected to have a material impact on the timely repayment of principal or interest on the country's private or public sector debt," including tabular disclosure of changes in outstandings, and in some cases tabular disclosure of restructured outstandings. The Division notes that, while Guide 3 is expressly applicable only to bank holding companies, Staff Accounting Bulletin Topic 11:K provides that, "to the extent particular guidance [in Article 9 of Regulation S-X and Guide 3] is relevant and material to the operations of an entity [that engages in similar lending and deposit activities], the staff believes the specified information, or comparable data, should be provided." Finally, it supplements the SEC's existing requirements to disclose (in a non-"boilerplate" manner) material risks, including market risk.

Certain of these disclosure issues were addressed by members of the Division's Office of the Chief Accountant in presentations in early December 2011 at the National Conference on Current SEC & PCAOB Developments. Their presentation also encouraged registrants to evaluate whether impairments or exposures to sovereign debt appear consistent with IAS 39 or ASC Topic 320-10-35.⁴

Our issuer and investment banking clients should contact us if they wish to discuss the Division's guidance in more detail.

⁴ See "Current Developments in the Division of Corporation Finance: National Conference on Current SEC & PCAOB Developments," December 6, 2011, available at <http://www.sec.gov/news/speech/2011/spch120611nsco.pdf>.

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ANNEX A

European Sovereign Debt and Other Exposures

Disclosure should be provided separately by country, segregated between sovereign and non-sovereign exposures, and by financial statement category, to arrive at gross funded exposure, as appropriate. In deciding what disclosure is relevant and appropriate for the particular facts of each registrant, the Division has encouraged registrants to consider the following:

I. Gross Funded Exposure

a. Countries

- i. The basis for the countries selected for disclosure.
- ii. The basis for determining the domicile of the exposure.

b. Type of Counterparty

- i. Separate categories of exposure to Sovereign and Non-Sovereign counterparties.
 1. Sovereign exposures consist of financial instruments entered into with sovereign and local governments.
 2. Non-Sovereign exposures comprise exposure to corporations and financial institutions. To the extent material, separate disclosure may be required between financial and non-financial institutions.

c. Categories of Financial Instruments

- i. Categories to be considered for disclosure include loans and leases, held-to-maturity securities, available-for-sale securities, trading securities, derivatives and other financial exposures to arrive at a gross funded exposure.
 1. For loans and leases, the gross amount prior to the deduction of the impairment provision and the net amount after impairment provision.
 2. For held-to-maturity securities, the amortized cost basis and the fair value.
 3. For available-for-sale securities, the fair value, and if material, the amortized cost basis.
 4. For trading securities, the fair value.
 5. For derivative assets, the fair value, except that amount could be offset by the amount of cash collateral applied if separate footnote disclosure quantifying the amount of the offset is provided.
 6. For credit default contracts sold, the fair value and notional value of protection sold, along with a description of the events that would trigger payout under the contracts.
 7. For other financial exposures, to the extent carried at fair value, the fair value. To the extent carried at amortized cost, the gross amount prior to the deduction of impairment and the net amount after impairment.

II. Unfunded Exposure

- a. The amount of unfunded commitments by type of counterparty and by country.
- b. The key terms and any potential limitations of the counterparty being able to draw down on the facilities.

III. Total Gross Exposure (Funded and Unfunded)

- a. The effect of gross funded exposure and total unfunded exposure should be subtotaled to arrive at total gross exposure as of the balance sheet date, separated between type of counterparty and by country.
- b. Appropriate footnote disclosure may be provided highlighting additional key details, such as maturity information for the exposures.

IV. Effects of Credit Default Protection to Arrive at Net Exposure

- a. The effects of credit default protection purchased separately by counterparty and country.
- b. The fair value and notional value of the purchased credit protection.
- c. The nature of payout or trigger events under the purchased credit protection contracts.
- d. The types of counterparties that the credit protection was purchased from and an indication of the counterparty's credit quality.
- e. Whether credit protection purchased has a shorter maturity date than the bonds or other exposure against which the protection was purchased. If so, clarifying disclosure about this fact and the risks presented by the mismatch of maturity.

V. Other Risk Management Disclosures

- a. How management is monitoring and/or mitigating exposures to the selected countries, including any stress testing performed.
- b. How management is monitoring and/or mitigating the effects of indirect exposure in the analysis of risk. Disclosure should explain how the registrant identifies their indirect exposures, examples of the identified indirect exposures, along with the level of the indirect exposures.
- c. Current developments (rating downgrades, financial relief plans for impacted countries, widening credit spreads, etc.) of the identified countries, and how those developments, or changes to them, could impact the registrant's financial condition, results of operations, liquidity or capital resources.

VI. Post-Reporting Date Events

- a. Significant developments since the reporting date and the effects of those events on the reported amounts.