SEC ADOPTS FINAL RULES UNDER THE SARBANES-OXLEY ACT: OFF-BALANCE SHEET ARRANGEMENTS AND CONTRACTUAL OBLIGATIONS

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On January 28, 2003, the Securities and Exchange Commission adopted final rules and revisions to SEC forms to implement Section 401(a) of the Sarbanes-Oxley Act of 2002 (the "Act").[1] The new rules require expanded disclosures of off-balance sheet arrangements and contractual obligations in management's discussion and analysis ("MD&A") sections in registration statements and periodic reports filed under the Securities Act of 1933 or the Securities Exchange Act of 1934.[2]

The SEC has recently adopted final rules regarding several other provisions of the Act. We are preparing separate memoranda regarding these other important developments (including a separate memorandum for registered investment companies), each of which will also be available upon request or at our web site at *www.simpsonthacher.com*.

EXECUTIVE SUMMARY

Under the new rules, a registrant is required to discuss in its MD&A any off-balance sheet arrangements that have, or are be reasonably likely to have, a material effect on its results of operations or financial condition. In addition, the registrant must include a table that discloses the amounts of specified key contractual obligations.

The new rules are part of initiatives to "improve the transparency and quality of corporate disclosure", in the aftermath of Enron and other corporate disclosure and accounting failures. The SEC has long viewed the MD&A as one of the principal means of promoting

[1] SEC Release Nos. 33-8182 and 34-47264 (January 28, 2003) (the "Release"). Registered investment companies are excluded from the scope of the new rules. The new rules would apply, however, to business development companies, as defined in Section 2(a)(48) of the Investment Company Act of 1940, as amended. The SEC release proposing the new rules (SEC Release Nos. 33-8144 and 34-46767) was issued on November 4, 2002.

[2] This memorandum supplements our memoranda regarding the Act. These memoranda are available upon request or at our website: *www.simpsonthacher.com*.

investor understanding of financial-related considerations relevant to an issuer. The Release notes that "[t]he disclosure in MD&A is of paramount importance in increasing the transparency of a company's financial performance and providing investors with the disclosure necessary to evaluate a company and to make informed investment decisions."

The new rules are intended to improve the disclosure of a registrant's off-balance sheet arrangements and to provide an overview of its key contractual obligations. The SEC believes that a more comprehensive explanation of a registrant's off-balance sheet arrangements and a clear summary of its contractual obligations will enable investors to understand the registrant's business, assess the quality of its earnings, understand the risks not reflected in the financial statements and comprehend the registrant's short- and long-term liquidity and capital resource needs.[3]

We understand that recently released FASB Interpretation No. ("FIN") 46, *Consolidation of Variable Entities* (January 2003), will result in consolidation of certain previously unconsolidated (*i.e.*, off-balance sheet) entities into the financial statements of many registrants. As a result, certain historical off-balance sheet arrangements will become reflected on the registrant's financial statements and, thus, disclosure under the new rules may not be required, although the registrant must consider whether traditional MD&A disclosure is required with respect to such arrangements. Registrants should consult with their independent accountants regarding the implications of FIN 46, which generally becomes effective as of June 15, 2003.

EFFECTIVE DATES

Registrants must comply with the new off-balance sheet arrangement disclosures in registration statements, annual reports and other disclosure documents that are required to include financial statements for fiscal years ending on or after June 15, 2003.

Registrants must include the table of contractual obligations in registration statements, annual reports and other disclosure documents that are required to include financial statements for fiscal years ending on or after December 15, 2003.

We anticipate that some registrants will, on a voluntary basis, include the new disclosures before these effective dates.

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[3] The new required disclosures regarding off-balance sheet arrangements and contractual obligations are, in broad outline, consistent with disclosures recommended by the SEC in its *Commission Statement about Management's Discussion and Analysis of Financial Condition and Results of Operation* (January 22, 2000). Release Nos. 33-8056; 34-45321; FR-61.

DISCLOSURE OF OFF-BALANCE SHEET ARRANGEMENTS

DEFINITION OF OFF-BALANCE SHEET ARRANGEMENT

The new rules define the term "off-balance sheet arrangement" to include any "transaction, agreement or other contractual arrangement to which an entity unconsolidated with the registrant is a party", under which the registrant has:

- any obligation under certain guarantee contracts;
- a retained or contingent interest in assets transferred to an unconsolidated entity or similar arrangement;
- any obligation under certain derivative instruments; or
- any obligation under certain material variable interests in an unconsolidated entity.[4]

Categories of Off-Balance Sheet Arrangements. As defined, off-balance sheet arrangements fall into four basic categories. Each of these four categories is defined, in large measure, by reference to accounting concepts or accounting body interpretations under generally accepted accounting principles in the United States ("U.S. GAAP"). For purposes of the definition, the references to U.S. GAAP will be relevant even in the case of a foreign private issuer.

- **Guarantees.** A guarantee contract that constitutes an off-balance sheet arrangement is any obligation under a guarantee contract that has characteristics identified in paragraph 3 of FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* (November 2002). Under FIN 45, a guarantee contract with any of the following characteristics generally requires disclosure as an off-balance sheet arrangement:
  - contracts that contingently require the guarantor to make payments to the guaranteed party based on changes in a specific interest rate, price or other variable that is related to an asset, liability or equity security of the guaranteed party (*examples*: financial standby letter of credit or guarantee of the market price of the common stock of the guaranteed party);

[4] The new rules add paragraph (a)(4) to Item 303 of Regulation S-K and paragraph (c) to Item 303 of Regulation S-B.

- contracts that contingently require the guarantor to make payments to the guaranteed party based on another entity's failure to perform under an agreement (*example*: performance guarantee);

- indemnification agreements that contingently require the indemnifying party to make payments to an indemnified party based on changes in an interest rate, price or other variable that is related to an asset, liability or equity security of the indemnified party; and

- indirect guarantees of the indebtedness of others, which arise under an agreement that obligates one entity to transfer funds to a second entity upon the occurrence of specified events and where creditors may enforce the second entity's claims against the first entity under such agreement (*example*: keepwell agreement) [5].

- **Retained or Contingent Interests.** A registrant may structure an off-balance sheet arrangement by retaining an interest in assets transferred to an unconsolidated entity. An example of such an off-balance sheet arrangement is a subordinated retained interest in a pool of receivables transferred to an unconsolidated entity to provide credit support to that entity by cushioning the senior interests in the event that a portion of the receivables becomes uncollectible. A decline in the value of the retained interest may have material effect on the registrant's financial condition. Accordingly, the new rules require that a retained or contingent interest of this type be disclosed as an off-balance sheet arrangement.

- **Derivatives.** A derivative instrument which is indexed to the registrant's own equity securities and classified within stockholders' equity in its statement of financial position constitutes the third category within the definition of "off-balance sheet arrangement". Under paragraph 11 of Statement of Financial Accounting Standards ("SFAS") No. 133, *Accounting for Derivative Instruments and Hedging Activities*, derivative instruments of this type generally are not required to be recognized as an asset or a liability and measured at fair value and, as a result, their effect on the registrant's results of operations or financial condition may not always be transparent to investors.

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[5] Paragraph 6 and paragraph 7 of FIN 45 exclude certain guarantee contracts for the general purposes of FIN 45 and, as a consequence, the definition of "off-balance sheet arrangements" for purposes of the new rules. The excluded guarantee contracts are, among others, the following: certain guarantees issued by insurance and reinsurance companies; a lessee's guarantee of the residual value of leased property in a capital lease; product warranties; guarantees that are accounted for as derivatives; contingent consideration in a business combination; guarantees issued between either parents and their subsidiaries or corporations under common control; a parent's guarantee of a subsidiary's debt to a third party; and a subsidiary's guarantee of the debt owed to a third party by either its parent or another subsidiary of that parent.

- **Variable Interests.** Obligations arising out of a material variable interest held by the registrant in an unconsolidated entity, where such entity provides financing, liquidity, market risk or credit risk support to, or engages in leasing, hedging or research and development services with, the registrant are considered off-balance sheet arrangements. The term "variable interest" is defined in FIN 46 and generally encompasses an investment or other interest that will absorb part of an entity's expected losses or receive part of the entity's expected residual returns, in each case if they occur.

As noted above, key elements of the definition of "off-balance sheet arrangement" are based upon technical accounting standards under U.S. GAAP. As a result, registrants will need to involve their internal accounting personnel and independent auditors, as well as counsel, in identifying material off-balance sheet arrangements and in preparing the required MD&A disclosures. Foreign private issuers whose financial statements are prepared in accordance with non-U.S. GAAP will need to refer to the same U.S. GAAP standards in *identifying* the off-balance sheet arrangements even though the substantive MD&A disclosures should focus on the effect of such arrangements on their results of operations and financial condition in accordance with non-U.S. GAAP. In other words, the U.S. GAAP definitional concepts will need to be taken into account by foreign private issuers in preparing the related MD&A discussions based upon non-U.S. GAAP financial statements.

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

DISCLOSURE THRESHOLD

The new rules require disclosure of off-balance sheet arrangements that either have, or are *reasonably likely* to have, a current or future effect on the registrant's results of operations or financial condition[6] that is material to investors. The SEC had initially proposed that disclosure be required when the likelihood of either the occurrence of a future event implicating an off-balance sheet arrangement, or its material effect, was more than remote. The "reasonably likely" disclosure threshold represents a return to existing disclosure standards generally applicable to MD&A disclosures.

To apply the disclosure threshold adopted in the new rules, management must:

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[6] The new rules require that the analysis of effect of off-balance sheet arrangements on a registrant be made in terms of a registrant's "financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources" -- a litany that is overlapping in some respects. Solely for convenience, this memorandum uses the short-hand phrase "results of operations or financial condition" in relation to the above-enumerated financial line items and concepts as to which analysis of the effect of off-balance sheet arrangements is required.

- first, identify and analyze the registrant's off-balance sheet arrangements; and

- second, assess the likelihood of the occurrence of any known trend, demand, commitment, event or uncertainty that could affect an off-balance sheet arrangement.

If management concludes that a known trend, demand, commitment, event or uncertainty affecting an off-balance sheet arrangement is reasonably likely to occur and have a material effect on the registrant's results of operations or financial conditions, then disclosure in the MD&A is required under the new rules. If management cannot make that determination, it must evaluate the consequences of the trend, demand, commitment, event or uncertainty on the assumption that it will occur. Disclosure then is required unless management concludes that a material effect on the registrant's financial condition, changes in financial condition or results of operations is not reasonably likely to occur.

REQUIRED DISCLOSURES

The new rules require a registrant to make the following disclosures in its MD&A to the extent necessary to an understanding of a registrant's off-balance sheet arrangements and their material effects on the registrant's results of operations or financial condition:

- the nature and business purpose of the off-balance sheet arrangements. For example, a registrant might explain that a particular off-balance sheet arrangement enables it to obtain cash through sales of its loans to a trust, to finance inventory costs without recognizing a liability or to lower borrowing costs of affiliates by extending guarantees to their creditors;

- the importance to the registrant of the off-balance sheet arrangements, and the circumstances that could cause material obligations or liabilities to arise in respect of items currently regarded as contingent. Disclosure is required, to the extent material to investors' understanding, of the following:

  - the amounts of revenues, expenses and cash flows of the registrant arising from the off-balance sheet arrangements;

  - the nature and total amount of any interests retained, securities issued and other indebtedness incurred by the registrant in connection with such arrangements; and

  - the nature and amounts of any other obligations or liabilities (including contingent obligations or liabilities) of the registrant arising from the arrangements that are, or are reasonably likely to become, material and the triggering events or circumstances that could cause them to arise;

- any known event, demand, commitment, trend or uncertainty that will, or is reasonably likely to, result in the termination, or material reduction in availability to the registrant, of its off-balance sheet arrangements. For example, a registrant must disclose any material contractual provisions calling for the termination or material reduction of an off-balance sheet arrangement. Similarly, the registrant must disclose known circumstances that are reasonably likely to cause its credit rating to fall below a specified level and discuss the material consequences of such a ratings decline, including any restriction on, or reduction in the benefits of, engaging in off-balance sheet arrangements. In addition, the registrant must discuss its actual or planned course of action to respond to any termination or material reduction in the availability of such off-balance sheet arrangement.

The registrant must provide an analysis of the degree to which it relies on off-balance sheet arrangements for its liquidity and capital resources or market risk support or credit risk support or other benefits. This disclosure should explain the importance of off-balance sheet arrangements to the continuing operations of a registrant's business. For example, if a registrant relies on off-balance sheet arrangements for liquidity and capital resources, the registrant may need to disclose how often it securitizes financial assets, to what degree securitizations constitute a material source of liquidity, whether it has increased or decreased securitizations from past periods and to explain such increase or decrease.

Together with other disclosure requirements, the registrant should provide information sufficient for investors to assess the extent of the risks that have been transferred and retained as a result of the off-balance sheet arrangements.

In addition to the above disclosures, the registrant must include in its MD&A discussion any other information that it believes is necessary for an understanding of its off-balance sheet arrangements and effects. The disclosure must cover the most recent fiscal year and should also address changes from the prior year to the extent necessary for an understanding of the disclosure.

Registrants may aggregate similar off-balance sheet arrangements in its disclosure; however, important distinctions in terms and effects of these arrangements must be discussed.

The instructions to the new rules indicate that a registrant is not required to make disclosure in respect of an off-balance sheet arrangement until a definitive agreement that is unconditional or subject only to customary closing conditions exists or, if there is no such agreement, when settlement of the transaction occurs.

The MD&A discussion of off-balance sheet arrangements need not repeat information provided in the notes to the financial statements, provided that such discussion clearly cross-references to specific information in the relevant notes and integrates the substance of the notes into such discussion in a clear and effective manner.

TABULAR DISCLOSURE OF CONTRACTUAL OBLIGATIONS

The new rules require tabular disclosure of the amounts of contractual obligations as of the latest balance sheet date, aggregated by type of contractual obligation, for at least the periods specified in the sample table set forth below.[7] The registrant may place the tabular disclosure of known contractual obligations in any MD&A location that the registrant deems to be appropriate. To provide flexibility, a registrant may disaggregate the specified categories by using other categories suitable for its business, but the table must include all the obligations that fall within the specified categories. The table should be accompanied by notes sufficient to provide an understanding of the timing and amount of the contractual obligations in the table. A significant portion of the information required to complete the tables will likely be found in the notes to the financial statements of most registrants. To the extent that the information is not included in the financial statement notes, the registrant's internal accounting staff and independent accountants will be required to compile the data for the table.

Contractual Obligations	Payments due by period				
	Total	Less than 1 year	1-3 years	3-5 years	More than 5 years
Long-Term Debt					
Capital Lease Obligations					
Operating Leases					
Purchase Obligations					
Other Long-Term Liabilities Reflected on the Registrant's Balance Sheet under GAAP					
Total Contractual Obligations					

Because U.S. GAAP already requires registrants to identify and aggregate categories of "long-term debt", "capital lease obligations" and "operating leases", these three categories are, for purposes of the table, defined by reference to specified technical accounting standards.[8] A non-U.S. registrant which prepares financial statements in accordance with a non-U.S. GAAP

[7] The new rules add paragraph (a)(5) to Item 303 of Regulation S-K.

[8] "Long-term debt obligations" means a payment obligation under long-term borrowings referenced in FASB No. 47, *Disclosure of Long-Term Obligations* (March 1981). "Capital lease obligation" means a payment obligation under a lease classified as a capital lease pursuant to FASB No. 13, *Accounting for Leases* (November 1976). "Operating lease obligation" means a payment obligation under a lease classified as an operating lease and disclosed pursuant to FASB No. 13, *Accounting for Leases* (November 1976).

should include contractual obligations in the table that are consistent with the classifications used in the generally accepted accounting principles under which its primary financial statements are prepared.

A "purchase obligation" is defined as an agreement to purchase goods and services that is enforceable and legally binding on the registrant and that specifies all significant terms, including the following: fixed or minimum quantities to be purchased; fixed, minimum or variable price provisions; and the approximate timing of the transaction.

A domestic U.S. registrant is not required to include in interim reports, such as a quarterly report on Form 10-Q, the tabular disclosure of contractual obligations. Instead, the registrant need only disclose material changes from previously disclosed information by including a discussion of the relevant changes.

The new rules do not require a specific tabular or textual disclosure of aggregate contingent liabilities or commitments, as had been originally proposed by the SEC. However, a registrant must still consider whether contingent liabilities and commitments may be material to its results of operations or financial condition and, as a result, addressed in its MD&A.

APPLICATION OF NEW RULES TO FOREIGN PRIVATE ISSUERS

The new rules apply to foreign private issuers which file annual reports on Form 20-F or Form 40-F.[9] In the view of the SEC, Section 401(a) of the Act, which mandated the new rules, does not distinguish between foreign private issuers and domestic U.S. companies.

Foreign private issuers will be required to include the new mandated MD&A disclosures in their annual reports on Form 20-F or Form 40-F. Unlike a domestic U.S. issuer, a foreign private issuer generally will not be required to update such disclosures on a quarterly or other interim basis. However, if a foreign private issuer files a registration statement that must include interim financial statements, the MD&A included in the registration must be updated to contain information complying with the new rules.

[9] The new rules add sections E and F to Item 5 of Form 20-F and subsections 11 and 12 to General Instruction B of Form 40-F.

SAFE HARBOR FOR FORWARD-LOOKING INFORMATION

To encourage disclosure of information and analysis necessary for investors to understand the effect of off-balance sheet arrangements and contractual obligations, the new rules specify that the safe harbor provided in Section 27A of the Securities Act and Section 21E of the Exchange Act will apply to forward-looking statements relating to off-balance sheet arrangements and contractual obligations made by the registrant under these new rules. This statutory safe harbor contains provisions that protect forward-looking statements against private legal action alleging a material misstatement or omission. This safe harbor extends not only to the registrant, but also to any person acting on its behalf, an outside reviewer retained by the registrant who makes statements on behalf of the registrant, or an underwriter with respect to information provided by the registrant.

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This memorandum is for general information purposes and should not be regarded as legal advice. Please contact your relationship partner if we can be of assistance regarding these important developments. The names and office locations of all of our partners, as well as additional memoranda regarding recent corporate governance developments, can be obtained from our website, *www.simpsonthacher.com*.

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