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Remarks Of

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Recent Derivatives Regulatory Developments

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*/ The views expressed herein are those of Commissioner Roberts and do not necessarily represent those of the Commission, other Commissioners or the staff.

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I. Introduction

I appreciate the opportunity to participate in this conference. As the use of derivative financial products has increased, the concern of financial regulators everywhere, both domestically and internationally, has increased as well. Hardly a day goes by without a recent development pertaining to the topic of derivatives. Recently, several companies have declared multi-million dollar first quarter charges against earnings as a result of losses incurred in various derivatives activities. I suspect that there will be more joining this group which includes to date, among others, Proctor & Gamble, Mead, Dell, Marion Merrell Dow, and Gibson Greetings. Interestingly enough, these companies are not considered to be derivatives dealers as such. The experience of these companies makes it clear how important the accurate and adequate disclosure of a company's derivatives activities is to the marketplace. Potential investors need to know what the derivatives activities of a company are and the nature and level of the risks involved in order to make an informed investment decision.

I noticed recently that the Comptroller of the Currency has expressed an interest in restricting the ability of national banks to engage in some derivatives activities. That probably makes a great deal of sense in the banking area where federal deposit insurance is on the line. It is not as applicable in the securities area where market forces and market discipline are largely the rule. I am inclined to believe that, as a general proposition, the marketplace and not the Commission should determine the success or failure of the various potential investment products available.

However, for the securities marketplace to be able to make efficient decisions and to employ the discipline I alluded to, sufficient information must be provided to the marketplace in a timely manner about the derivatives activities of publicly-held companies. This is not the case currently. Thus, enhanced disclosure of derivatives activities has become a very important regulatory issue at the Commission.

Lack of clear disclosure notwithstanding, I do anticipate that derivative products will continue to grow in use. The ability to tailor an investment product to suit the investor has made the derivative instrument a valuable commodity. The investment customization trend that has emerged in the early 90s should continue throughout the decade. If used properly, derivatives are an important risk management tool. Although much more speculative, investments in derivative instruments can also be beneficial from a return standpoint. Of course, the rule of thumb in the securities area is that the potential for high rewards is usually accompanied by an exposure to higher risks.

Most derivative products have been developed in an environment of falling interest rates and relatively favorable returns, with a view to leveraging market risks in order to achieve even higher returns. The liquidity of some of these products as interest rates begin to climb is unknown. There has always existed at the Commission the sentiment that some of these products would not perform as advertised under adverse market conditions. This appears to have been the case thus far in 1994. Indeed, since the beginning of this year, as interest rates have spiked upward, I understand that both the performance and liquidity of many derivative products have been challenged.

I believe that it is incumbent upon all regulators to adjust their regulatory systems, where applicable, in recognition of the continued presence and growth of derivative financial products in our capital markets. Along these lines, it is my intention today to discuss some regulatory developments that are relevant to derivatives activities and that I hope are of interest to you.

II. Disclosure

Since I have stressed the importance of enhancing the disclosure of the derivatives activities of publicly-held companies to the marketplace, it is probably appropriate to begin with a discussion of one recent development in the derivatives disclosure area. This would be the recent issuance by the Financial Accounting Standards Board ("FASB") of an exposure draft of a proposed Statement of Financial Accounting Standards ("Exposure Draft") entitled *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments.*

Several years ago, the FASB accelerated a part of its ongoing project on financial instruments and off-balance-sheet financing to improve the disclosure of information about financial instruments. This resulted in the issuance of FASB Statement No. 105, entitled *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk*, and FASB Statement No. 107, entitled *Disclosures about Fair Value of Financial Instruments.*

Since the issuance of Statements 105 and 107, several parties, including the Commission, have called for further improvements in disclosure about derivative financial products. In response to those requests, the FASB issued the Exposure Draft. The Exposure Draft would require improved disclosures about derivative financial instruments, which would include futures, forwards, swaps, option contracts, or other financial instruments, by amending the existing requirements of Statements 105 and 107.

The Exposure Draft would require disclosures about the amounts, nature, and terms of derivative financial instruments that are not subject to Statement 105 because they do not result in off-balance-sheet risk of accounting loss. It would require that a distinction be made between financial instruments held or issued for the purpose of trading (including dealing or other activities reported in a trading account and measured at fair value) and financial instruments held or issued for purposes other than trading.

For derivative financial instruments held or issued for trading, the Exposure Draft would require disclosure of average, maximum, and minimum aggregate fair values and of net trading gains or losses. For derivative financial instruments held or issued for purposes other than trading, it would require disclosure about those purposes, about how the instruments are reported in financial statements, and – if the purpose is hedging anticipated transactions – about the anticipated transactions, the amounts of hedging gains and losses deferred, and the transactions or other events that result in recognition of the deferred gains or losses in income. With respect to derivative financial instruments held or issued for purposes other than trading, the Exposure Draft would encourage, but not require, quantitative information about interest rate or other market risks of derivative financial instruments, and also of other assets and liabilities, that is consistent with the way the company manages or adjusts risks and that is useful for comparing the results of applying the company's strategies to its objectives for holding or issuing the derivative financial instruments. Moreover, the Exposure Draft would amend Statement 107 to require that fair value information be presented without combining, aggregating, or netting the fair value of separate financial instruments of a different class and that fair value information be presented in one location, together with the related carrying amounts, in a form that makes it clear whether the amounts are favorable (assets) or unfavorable (liabilities).

The FASB apparently intends for the Exposure Draft to be effective for financial statements issued for fiscal years ending after December 15, 1994, except for entities with less than $150 million in total assets. For those entities, the effective date would be for financial statements issued for fiscal years ending after December 15, 1995. The comment period for the Exposure Draft is scheduled to expire on July 1, 1994.

While the Exposure Draft, if implemented, will improve substantially the current state of derivatives disclosure, more could and should be required by the FASB in the derivatives disclosure area.[1]

For example, the Exposure Draft requires disclosures by "class of derivative financial instruments." The meaning of class of financial instruments apparently is not defined clearly in the accounting literature. Many companies may broadly interpret the meaning of class of financial instrument and provide disclosures for general, non-descriptive classes of financial instruments, such as options, swaps, futures, and forward contracts. Many times disclosures about such general classes of financial instruments are not meaningful because different types of financial instruments are aggregated and presented under one general caption. For instance, there are big differences between purchased put options, written put options, purchased call options, and written call options, yet all of these instruments may be described in one class of financial instrument called "options." I believe that the FASB should consider (i) clarifying the meaning of a class of financial instrument and (ii) providing better examples of classes of financial instruments.

Further, the Exposure Draft only requires qualitative information about derivative financial instruments held or issued for purposes other than trading. The Exposure Draft does not require any quantitative information about derivative financial instruments held or issued for purposes other than trading. While the Exposure Draft does encourage such quantitative disclosures, it should require both qualitative and quantitative disclosures about derivative financial instruments held or issued for

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1 See "Take Me Out to the Ball Game," Remarks delivered by Walter P. Schuetze, Chief Accountant, Commission, to the 1993 Eighteenth Annual AICPA National Conference on Banking, Washington, D.C., November 5, 1993; and "Current Accounting Projects," Remarks delivered by Steven M. Swad, Professional Accounting Fellow, Commission, to the Twenty-First Annual National Conference on Current SEC Developments, Washington, D.C., January 11, 1994.

purposes other than trading in my opinion. I consider this to be a very important point.

Finally, for derivative financial instruments held or issued for purposes other than trading, the Exposure Draft does not require disclosure of the current period impact of derivative financial instruments on either net interest income, if applicable (e.g., if the company is a financial institution), or income from continuing operations. I believe that information about the impact of derivatives activities on income is important to investors because investors are likely to apply one price-to-earnings multiple to earnings from derivatives activities and another price-to-earnings multiple to earnings from other activities.

I commend the FASB for moving expeditiously and issuing the Exposure Draft. I understand that the FASB is also pondering the issuance of additional accounting requirements to apply to derivatives activities, and I urge the FASB to move expeditiously on that project as well. With the issuance of the Exposure Draft, the FASB has exhibited strong leadership in the derivatives disclosure area. However, I urge the FASB to consider amending the Exposure Draft in accordance with my suggestions.

III. Coordination

Next, I wish to point out that no market development highlights the need for more coordination and consistency from a financial regulatory standpoint than does the increase in derivatives activities. This applies internationally as well as domestically.

The need for enhanced coordination between financial regulators and for more regulatory consistency in the derivatives area has been stressed by Congressman Leach and the CFTC derivatives study, among others. I expect that this point will be emphasized as well by the GAO derivatives study expected to be released next month.

To some extent, Secretary Bentsen has filled this void by resurrecting periodic joint meetings between the heads of the various federal financial regulatory agencies. Chairman Levitt has made it clear to me that discussion on derivatives has dominated these meetings. Further, it is my understanding that joint staff meetings on derivatives activities have been held as well.

On the international front, the Commission, the CFTC, and the U.K. Securities and Investments Board ("SIB") last month issued a joint statement setting forth an agenda for oversight of the OTC derivatives market. This is the first international understanding among securities and futures regulators for developing and coordinating a regulatory approach to the OTC derivatives market. Moreover, I understand that substantial progress was made by Chairman Levitt last week in Tokyo toward achieving cooperation on a trilateral basis between the U.S., U.K., and Japan in further study of the issues addressed in the joint statement.

I applaud the recent efforts aimed at improving derivatives regulatory consistency and coordination. Derivative financial products connect all markets and thus cut across all regulatory jurisdictional boundaries, domestically and internationally. Derivatives market activities require a collective regulatory response, and I encourage the continuation of the current federal domestic and international regulatory collective efforts in this area.

IV. Capital

No discussion of Commission developments in the derivatives area would be complete without mentioning the ongoing project to adjust the net capital rule to take into consideration derivatives activities by securities firms. Of course, the Commission addresses the credit and market risks of a broker-dealer's operations through capital charges. As a result of the exponential growth of derivatives activities by securities firms, the Commission embarked on a project to adjust its net capital rule to take into consideration these activities. The current rule on OTC derivative instruments is very conservative and should be reviewed.

As everyone here is probably aware, a concept release explaining the net capital rule project was issued last year. The Commission recently proposed for comment, as a part of this project, amendments to the net capital rule that would allow broker-dealers to use a binomial pricing model to determine capital charges for proprietary exchange-listed options and related positions. This represents a somewhat novel approach since currently the net capital rule requires capital charges based on defined strategies contained in the rule. Later in the year, Commission staff are expected to tackle the net capital rule amendments necessary to take into consideration the market risk associated with, among other things, interest rate swaps. Sometime thereafter, I would expect the staff to tackle the even more formidable task of determining the appropriate capital treatment to take into consideration the credit risk posed by these swaps.

For various reasons, a great deal of derivatives activities undertaken by securities firms are apparently being conducted in a subsidiary other than the Commission registered broker-dealer. Although the Commission has not yet answered this question, it appears to me that a strong argument can be made that most of these subsidiaries may in fact be operating as unregistered broker-dealers which should be subject to the Commission's net capital rule, particularly if interest rate swaps are treated as securities.

I understand that the federal banking regulators are also continuing to adjust their own capital rules to take into consideration bank derivatives activities. I hope that eventually the banking and securities regulatory capital requirements for derivatives activities will become fairly consistent.

V. Risk Assessment

In addition to the net capital project, the Commission is monitoring the derivative activities of individual securities firms through the risk assessment information now being filed quarterly with the Commission. I understand that the federal banking regulators are engaged in a similar program and that the CFTC has embarked on the same exercise. So here again a common regulatory theme has emerged providing an opportunity for more derivatives regulatory consistency and coordination.

My view is that the best protection against this systemic risk would be the adoption by each firm of prudent risk management policies and procedures. Of course, senior management should be involved in the risk management process.

I suspect that even the best policies, procedures, and controls operate as intended only if the risk valuation and reporting is accurate. I further suspect that the risk management functions must be independent from the business sector or the valuations and reporting may not be objective and thus probably are inaccurate.[2] Therefore, I hope that in the coming months, the staff of the Commission, will pay particular attention, through the examination process, to the valuation of derivative products portfolios and to the internal controls on position reporting. The recent Kidder Peabody situation should have emphasized the point that inaccurate valuations or reporting can very quickly lead to serious problems.

VI. Sales Practice

There is one other area where the Commission will be focusing quite a bit of attention that I wish to point out to you today. This is the sales practice area, and the Commission focus will definitely be concentrated on derivatives sales practices. The

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2 See "Derivatives Regulation: Lessons From the Past and a Proposal for the Future," Remarks delivered by Thomas A. Russo, Managing Director, Lehman Brothers Inc., to the Futures Industry Institute, March 4, 1994.

concern lingers at the Commission that some derivative products are being marketed more for the fat profit margin they make available to the securities firm than for their suitability to the potential customer. If I had any one suggestion for securities firms who sell derivatives, that suggestion would be to take all the reasonable steps necessary to ensure that the derivative products being sold are suitable investments for the prospective purchasers. This would apply to institutional customers as well.

My concerns in the customer suitability area have increased as the class of investors to whom derivative products are sold continues to broaden. It should be expected that the Commission, along with the CFTC and the SIB, will consider a special suitability rule for OTC derivatives.

The continuing education effort currently underway by the self-regulatory organizations, if developed adequately, could alleviate my derivative sales practice concerns to some extent. The development of a continuing education program for securities industry registered representatives and principals should assist in ensuring the clear, understood communication of the risks of derivative products to investors seeking both higher returns and safety. Certainly, as securities firms expand sales activity in the area of derivative products, the need for special training and qualification standards, sales and supervisory procedures, and adequate disclosure to investors becomes much greater.

On a similar note, recently, the Commission proposed a rule which would make explicit an investment adviser's suitability obligations. While an implied suitability obligation has always existed, an express requirement should heighten the awareness of the investment adviser community of this obligation. Some advisers apparently forget that a suitability obligation exists, albeit somewhat differently, even with an institutional client. This rule, if implemented, would be applicable to derivatives transactions.

VII. Conclusion

Unfortunately, time does not allow me to mention several other areas where the Commission is actively working which will have an impact on derivatives activities. However, it should suffice to say that where there exists complexity, illiquidity, and leverage, the Commission will remain concerned. Derivative products have provided a great deal of flexibility to issuers and to investors, allowing them to structure a portfolio and to manage risks in a certain manner. I believe that it is important to allow market participants the freedom to meet customer needs with new and innovative financial products. However, I also believe it is necessary to adjust our securities regulatory system to provide the marketplace with the information necessary to function efficiently and to provide investors with reasonable and cost-effective investor protection safeguards.