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TESTIMONY OF

ARTHUR LEVITT, CHAIRMAN
U.S. SECURITIES AND EXCHANGE COMMISSION

CONCERNING
DERIVATIVE FINANCIAL INSTRUMENTS

BEFORE THE SUBCOMMITTEE ON TELECOMMUNICATIONS AND FINANCE
COMMITTEE ON ENERGY AND COMMERCE

UNITED STATES HOUSE OF REPRESENTATIVES

MAY 25, 1994

U. S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

EXECUTIVE SUMMARY

STATEMENT OF ARTHUR LEVITT, CHAIRMAN U.S. SECURITIES AND EXCHANGE COMMISSION REGARDING FINANCIAL DERIVATIVES

Derivative products are an important and useful financial management tool. Their complexity and leverage, however, require users, dealers, and regulators to examine such products carefully. The Commission has addressed the risks of derivative products. In addition, the Commission currently is working with other financial regulators, both domestic and foreign, as well as the industry, to design programs to further increase the ability of the Commission and investors to monitor the risks and benefits of these products.

The GAO Report is a welcome addition to the ongoing effort to focus attention on this important issue. It contains a thoughtful assessment of the derivatives marketplace and accurately identifies a broad range of goals and objectives for the regulatory community. We look forward to working through the particulars of each recommendation and we are firmly committed to working internally and together with our counterparts in addressing the complex problems arising in the derivatives market.

Set forth below is a list of issues highlighted by the GAO, together with a brief statement of the Commission's future initiatives in some of those areas.

Accounting and Disclosure. One of the highest priorities for regulators and the industry is to improve accounting and disclosure for derivative transactions.

- The Commission believes the Financial Accounting Standards Board (FASB) should act promptly to address derivatives issues, including hedge accounting. FASB expects to have a final standard on disclosure for derivatives by year end.

- Based on the Commission's review of 1993 annual reports, the Commission will publish additional guidance for public companies regarding disclosure of derivatives and risk management activities. This guidance will be published in time for use in preparing 1994 annual reports.

Audit Committees. Through its disclosure, enforcement, and oversight programs, the Commission has promoted the use of independent, effective audit committees. For example, the Commission worked with the stock exchanges and the National Association of Securities Dealers to encourage listed companies to have audit committees. Today, the largest U.S. securities markets require listed companies to have audit committees with at least a majority of independent directors. In view of these existing requirements and other policy considerations, the Commission does not endorse a federally imposed mandate governing the composition of audit committees for all public companies. The Commission believes investors would be better served by enhancing the disclosure that they receive than requiring specific corporate governance mechanisms.

End-Users' Internal Controls for Derivatives. Clear risk management policies and controls including those governing the use of derivative instruments, defined and overseen at the highest levels of an enterprise are critical to a sound risk management system. Equally vital, is a system of internal controls to assure that the risk management program including the use of derivative instruments is properly executed consistent with management risk policies and controls. Given existing audit requirements and the provisions of the Foreign Corrupt Practices Act, rather than requiring auditor reports that are public on internal controls, there should be more transparent disclosure and accounting for derivative activity, including management policies. Such enhanced public reporting will not only better inform investors, but will help assure that auditors as well as management carefully review the information provided, and assure that adequate controls are in place with respect to the activities required to be disclosed.

Mutual Funds' Use of Derivatives. The use of derivatives by mutual funds, other than money market funds, generally appears to be limited. The Commission is concerned, however, about investor protection issues raised by mutual fund investments in derivatives and is focusing on a broad range of issues, including disclosure, risk management, pricing, leverage, and liquidity. To date, the Commission has taken the following actions in this area:

- Examining the derivatives disclosure of mutual funds and issuing a letter encouraging funds to identify areas of derivatives disclosure that can be modified to enhance investor understanding;

- Continuing to review prospectuses filed by mutual funds to improve derivatives disclosure and considering whether rulemaking is appropriate to enhance risk disclosure;

- Inspecting funds' management controls and, as appropriate, considering rulemaking to encourage better management controls;

- Reviewing leverage and liquidity restrictions in the context of derivative instruments to determine whether they continue to reflect appropriate regulatory policies and whether they should be supplemented by other forms of regulation; and

- Monitoring the use of derivatives by money market funds.

Dealers' Activities. The Commission has several programs in place to monitor the derivatives activity of broker-dealers and their affiliates. One such initiative, the **risk assessment program**, requires broker-dealers to report information on their material affiliates within the holding company group. Through this program the Commission receives quarterly and annual financial statements, as well as information on the volume, replacement cost, and significant counterparty concentrations for interest rate, foreign exchange, securities, and commodities products. The Commission also receives and reviews the **risk management policies** used by the major U.S. securities firms and tracks **credit exposures** by examining counterparty concentrations. The issue of whether the Commission receives sufficient information to detect potential credit risk problems is one that will be reviewed in light of the GAO's recommendations.

The Commission agrees with the GAO regarding the importance of prudent capital standards for OTC derivatives. To achieve this goal, the Commission currently is engaged in a comprehensive review of its net capital rule, with the goal of developing a net capital treatment that appropriately measures market and credit risk for derivative products. The Commission intends to revise the net capital rule so that it reflects modern financial theory and risk management strategies.

Suitability. The Commission recognizes the different levels of sophistication possessed by end-users of these products and believes that suitability requirements must take these differences into account. In order to move ahead on this issue, Commission staff will work with the self-regulatory organizations (SROs) requesting a meeting between Commission staff and SRO representatives to evaluate the requirements applicable to broker-dealers recommending derivatives, and the development of suitability standards for OTC products.

Regulatory and International Coordination. The Commission continues to work with other financial regulators, both in the U.S. and abroad, on possible parallel approaches to regulation of derivative products.

Conclusion. The Commission believes that regulation of the derivatives market requires a combination of vigilance, flexibility and close coordination. This issue is too important to the nation to allow jurisdictional conflicts to interfere with a coherent and comprehensive regulatory scheme. I am confident that my fellow regulators share this view.

TESTIMONY OF

ARTHUR LEVITT, CHAIRMAN
U.S. SECURITIES AND EXCHANGE COMMISSION

CONCERNING DERIVATIVE FINANCIAL INSTRUMENTS

BEFORE THE SUBCOMMITTEE ON TELECOMMUNICATIONS AND FINANCE
UNITED STATES HOUSE OF REPRESENTATIVES

MAY 25, 1994

Chairman Markey and Members of the Committee:

I am pleased to appear today to testify on behalf of the Securities and Exchange Commission ("Commission" or "SEC") regarding derivative financial instruments and the General Accounting Office's ("GAO") report concerning financial derivatives ("GAO Report").[1]

It is widely recognized that derivative instruments[2] are important financial management tools that, in many respects, reflect the unique strength and innovation of the American capital markets. In fact, U.S. markets and market professionals have been the global leaders in derivatives technology and development.[3] When used properly, derivatives provide significant benefits to corporations, financial institutions, and institutional investors in managing the risks of their business exposures or financial assets. Derivatives permit corporations and local governments to lower their funding costs and, in many instances, can be a cheaper and more liquid way of attaining desired exposure than a position in the cash market. OTC derivative products frequently are preferred by investors because such contracts can be structured to match their particular portfolios or investment strategies and their flexibility enables businesses to control ancillary risk in their commercial and investment transactions. Indeed, properly used, such products can facilitate the ability of an institution to undertake a variety of investments, expand credit availability, and help absorb or dampen market shocks.

At the same time, it is acknowledged that the complexity and leverage inherent in these instruments require special scrutiny of their usage.[4] As others have noted, even though these instruments may serve to reduce risk in many situations, in an aberrant, stressful market the leverage, complexity, liquidity risk, and global nature of OTC derivatives may make dealing with exigent circumstances more difficult. This is because derivatives, both listed and OTC, tend to link different market segments. Thus, a failure in one part of the system, such as the insolvency of a major intermediary or a sharp fall in a specific market, potentially could reverberate throughout the financial markets. Although these concerns may not be unique to derivatives, this is an area where we are concerned that a difference in degree becomes a difference in kind.

Broadly speaking, there are two types of risks regulators are addressing regarding derivative instruments. The first is firm-specific risk. This is the risk that an individual firm might mismanage its derivatives activities and incur significant losses. Such losses could be incurred by a dealer subject to the Commission's financial responsibility and oversight rules, a corporate end-user that may be subject to the Commission's disclosure rules, or a mutual fund subject to the Commission's disclosure and substantive regulation. The second risk is systemic risk, or the risk that losses at one firm could spillover to other firms, that market liquidity will deteriorate if many market participants try to liquidate their positions at the same time, or that cash market trading activities, designed to adjust derivatives exposures, could unduly disrupt the cash markets.

While the Commission cannot, and should not, try to eliminate the consequences of mismanagement by an individual firm, we can, and will, try to ensure that investors and counterparties are not unwittingly exposed to the risk of a firm's error. In continuing its efforts to address both the firm-specific and systemic risks associated with derivatives activities, the Commission is working on revised capital rules for derivative dealers, enhanced suitability standards, improved disclosure standards for public companies engaging in derivatives activities, and improved disclosure and management controls for mutual fund derivatives activities.[5] In addition, we are working with banking regulators and the Commodity Futures Trading Commission ("CFTC"), both separately and in the context of the President's Working Group on Financial Markets ("Working Group"), to identify those areas where systemic risk could be present in order to evaluate the ability of the financial system to withstand market shocks and to improve it where appropriate. Two such potential areas are in the clearance and settlement system and the enforceability of netting provisions in OTC derivative contracts.

Concerns about derivative instruments reflect the size and growth of the derivatives marketplace. The GAO Report estimated that the total global derivatives volume expressed in notional or contractual amount as of the end of fiscal year 1992 was at least $12.1 trillion. Information filed by registered broker-dealers with the Commission indicates that derivatives activity expressed in notional or contractual amount (including exchange-traded futures and options and OTC instruments), as of 1993 year-end, for the major U.S. non-bank affiliated broker-dealers and their affiliates had increased 38% to $5.1 trillion from $3.7 trillion at fiscal 1992 year-end. More importantly, the aggregate replacement cost associated with these contracts, or the estimated exposure undertaken by securities firms, surged 70% to $30.9 billion from $18.2 billion in 1992.

This growth is significant, but it must be seen in its proper context. We have found that for U.S. securities firms, meaningful OTC derivatives activity has been concentrated in six firms, which are the most highly capitalized in the securities industry. Moreover, the overall replacement cost of their derivatives transactions, while growing, still reflects a small percentage of the total notional amount of those contracts. Furthermore, although the Commission has no formal examination authority over the unregistered affiliates of broker-dealers, our risk assessment data relevant to the credit risk underlying securities firms' replacement cost indicates that counterparty credit exposure is primarily confined to investment grade entities, is short-term, and is generally not concentrated with any particular counterparty.

Further, the balance sheets of broker-dealers registered with the Commission tend to be highly liquid, as do the balance sheets of those broker-dealer affiliates transacting an OTC derivatives business that have obtained a "AAA" rating from a rating agency. In addition, the discipline demanded by the marketplace is a positive force which tends to foster credit consciousness and strong risk management. Generally, we believe that the largest broker-dealers have systems in place to assess the market and counterparty risks attendant to their derivatives portfolios. For example, broker-dealers monitor their positions and value them at fair value ("mark-to-market") on a daily basis. With regard to broker-dealer affiliates, we have found that they have systems in place to monitor the market and credit risk of OTC derivatives on a frequent basis.

Nonetheless, concerns remain. Recent losses by U.S. companies, such as Procter & Gamble, Air Products & Chemicals Inc., Gibson Greetings and Marion Merrell Dow, and losses incurred by the ARCO pension fund,[6] raise questions about whether the directors and senior management of the end-users of OTC derivative products understand fully the risks inherent in these instruments, as well as possible questions about the sales practice/suitability standards used by dealers in selling these products. These recent losses also underscore the pressing need for improved accounting and disclosure standards applicable to the derivatives activities of end-users, as well as dealers. I expect that the Financial Accounting Standards Board ("FASB"), as well as the Commission, will take action this year to enhance both the accounting and disclosure guidance applicable to derivatives transactions.

In light of these concerns, the GAO Report contains a thoughtful assessment of the derivatives marketplace and accurately identifies a broad range of goals and objectives for the regulatory community. As my testimony will indicate, we have been working actively to pursue many of the goals set forth in the GAO Report's Recommendations to Regulators. These items reflect, we believe, important areas for us, as regulators, to address in n timely and effective manner. We look forward to working through the particulars of each Recommendation to Regulators and we are firmly committed to working internally and together with our counterparts in addressing the complex problems arising in the derivatives market.

COMMISSION'S PROGRAM FOR REGULATION OF DERIVATIVE PRODUCTS

The Commission has devoted resources in many areas to address the risks of derivative products. I would like to discuss the Commission's efforts to date and the areas where additional study, and possible improvement, is needed.

A. Disclosure and Accounting Issues

Clearly the dramatic proliferation and increasing complexity of derivatives has outdistanced the development of accounting and disclosure standards that govern the issues of recognition, measurement, and information reporting. The need for substantially enhanced disclosure and more transparent accounting has been recognized by all who have considered this market.[7] Thus, one of the highest priorities for regulators and the industry must be improving the accounting and disclosure for derivatives transactions.

The Group of Thirty's recommendations[8] in this area exemplify the basic thrust of most recommendations with respect to accounting and disclosure, including:

- The need to develop international accounting standards for financial instruments so as to harmonize accounting treatment and thereby enhance the relevance of both dealers' and end-users' financial statements;
- The need for information about management's attitude toward financial risk, how instruments are used, and how risks are monitored and controlled;
- Disclosure of accounting policies;
- Analyses of derivatives positions at balance sheet date; and
- Analyses of credit risk inherent in those positions.

I fully concur in the need for enhanced disclosure and accounting for financial instruments including derivatives transactions. In fact, a number of initiatives already are underway, including a broad ranging project by the FASB to address accounting issues raised by the use of varied financial instruments. Standards already resulting from that project include:

- Statement of Financial Accounting Standards ("SFAS") No. 105, Disclosure of Information about Financial Instruments with Off-Balance Sheet Risk and Financial Instruments with Concentrations of Credit Risk (March 1990);
- SFAS No. 107, Disclosures about Fair Value of Financial Instruments (December 1991);
- SFAS No. 110, Reporting by Defined Benefit Pension Plans of Investment Contracts (August 1992);
- SFAS No 114, Accounting by Creditors for Impairment of a Loan (May 1993); and
- SFAS No. 115, Accounting for Certain Investments in Debt and Equity Securities (May 1993).

Recognizing the pressing need to address the accounting and disclosure issues raised by derivatives activity in the near term, the FASB, in November 1993, added a new "fast track" disclosure initiative to its agenda. That initiative resulted in the publication last month of an exposure draft entitled, "Disclosures About Derivative Instruments and Fair Value of Financial Instruments."[9]

The exposure draft would require new disclosures by traders in financial instruments and by parties that are end-users of such contracts, such as financial institutions and industrial companies. The exposure draft on derivatives disclosure is in addition to, and is not a substitute for, the development of standards that are needed to address important recognition and measurement issues. In particular, the FASB's project on hedge accounting will address when hedge accounting, pursuant to which accounting recognition of the fair value of the instrument, and related gains and losses, is deferred, is appropriate. Where hedge accounting is not appropriate, a derivative position is recognized on the balance sheet at fair value, and current increases or decreases in value run through the income statement.

We agree with the GAO that it is critical that these issues be addressed expeditiously. We have expressed the need for prompt action to the FASB, and the FASB expects to have a final standard on disclosure of derivative products in place by the end of this year that would apply to the preparation of 1994 year end financial statements. While the FASB has not yet scheduled the publication of an exposure draft on hedge accounting, I expect, given the critical importance of this issue, that the FASB will have as its highest priority publication of the exposure draft by year end.

The FASB's disclosure exposure draft would make a distinction between derivatives activities undertaken for trading purposes and those undertaken for purposes other than trading. The disclosures required for derivatives held for trading would include:

- The average, minimum, and maximum fair value of derivatives during the reporting period, reported separately by class of derivative instrument; and
- The net gains or losses from derivatives trading activities.

For derivatives held for purposes other than trading, the exposure draft would require the following disclosures:

- A description of the objectives of holding derivative instruments;
- A discussion of the context needed to understand those objectives;
- The strategies for achieving those objectives;
- A description of the financial reporting of the derivatives activities; and

- A description of the derivatives used to hedge anticipated transactions and disclosure of deferred gains and losses.

In addition, the exposure draft encourages the disclosure of quantified information about interest rate or other market risks in a manner that is consistent with the way the entity manages risks and would be useful in examining the success of the entity's strategies for holding and issuing derivative financial instruments. The exposure draft recommends that similar information, classified by type of risk, also be disclosed about the risks of other financial instruments or nonfinancial assets and liabilities to which derivative financial instruments are related by a risk management strategy.[10]

While the exposure draft is a good first step, we firmly believe that quantified disclosure of derivatives activity is essential. Our review of recent reports by registrants disclosing significant derivatives activity has made clear the need for quantified disclosure to provide a clearer understanding of the derivative and risk management activities of the registrant. The Commission staff, through the review and comment process, has been working with registrants reporting significant derivatives activities to expand their disclosures to obtain textual and quantified information that will provide a better understanding to investors of the type, extent, and potential effects of registrants' derivatives activities. Information sought through the comment process includes, depending on the nature of the activities:

- Revenues from derivatives trading, including a breakdown of revenues derived from foreign exchange, interest, equity, and other major types of derivative products quantified and separately identified;
- A description of the registrant's significant end-user activities indicating the specific risk being managed and the type of instrument and strategy used to

manage that risk (e.g., foreign currency swaps used to manage exchange rate risk in designated foreign currency denominated transactions), including quantified information related to the on balance sheet position (if any) being managed and the related derivative positions;

- A summary of open derivatives positions at period end that includes for each major category of derivative instrument the notional amount, carrying value, fair value, gross unrealized gains and gross unrealized losses for each category;
    - For interest rate swaps, the summary should include categories for year of maturity, major swap terms and average interest rates for each of the receive fixed/pay variable, and the pay fixed/receive variable categories, and other information to enable investors to understand the interest rate exposure of the instruments;
    - For futures, forwards, and options, including puts and calls, the period end summary should distinguish between contracts written and contracts purchased, and should aggregate instruments with similar risk characteristics such as interest rate, foreign exchange, commodity and equity price risk.
    - For complex instruments which contain several risks, disclosure of each instrument and its terms and attributes.
- Quantified information concerning terminations of derivative positions accounted for as hedges including the amounts of gross realized gains and gross realized losses from terminations prior to maturity, including the amounts of any such gains and losses where income statement recognition is being deferred. For such deferred gains and losses, disclosure of the fiscal year in which recognition in income is expected; and

- Management methods and quantified parameters used to monitor and control risk management strategies, including stress testing and sensitivity analysis.

Based on the results of the staff's review of 1993 annual reports, the Commission will publish additional guidance on the disclosures expected regarding derivatives and risk management activities in time for use in preparing 1994 annual reports. In the event the final FASB standard on derivatives disclosure does not require end-users to disclose quantitative/numerical information about their derivative contracts or positions, as I hope it will, the Commission will develop its own guidance on the type of quantitative information needed to inform investors adequately.

Accounting issues need to be addressed on an international basis as well. The International Accounting Standards Committee is developing an international accounting standard for financial instruments that would address, among other items, the accounting for equity and debt securities, loans receivable, forward contracts, options, interest rate swaps, hybrid instruments, and hedge accounting. A draft standard has been published twice for comment. The Commission staff has commented on both versions of the proposed standard and has recommended a number of significant changes to the proposal that would, among other things, provide more transparent reporting of derivatives activity.

I also would like to discuss the GAO's recent recommendations in the accounting and disclosure area. The GAO recommends that the Commission establish criteria for independent audit committees and for public reporting on entities' internal control systems. As discussed below, we do not concur in the specific proposals to mandate under federal law the establishment of independent audit committees or financial statement disclosure of auditors' reports on internal controls. These are issues that the Commission has given extensive consideration during the past 15 years.

B. Audit Committees

Since the 1940s, the Commission has been among the strongest advocates for, and a driving force behind, the use of audit committees by public companies.[11] In 1972, the Commission endorsed the establishment by all public companies of audit committees composed of outside directors.[12] In the following years, principally at the urging of then-SEC Chairman Williams, the use of audit committees spread and gained acceptance in the business community.[13] The SEC has acted in its disclosure, enforcement, and oversight programs to promote the use of independent, effective audit committees.

Over the years, the SEC has required substantive disclosure regarding audit committees. Disclosure of information concerning an audit committee's members, functions, and number of meetings is required in connection with the solicitation of proxies.[14] Further, when a change in independent accountants occurs, issuers must disclose in Commission filings whether a registrant's audit committee recommended or approved the change in accountants, and whether it consulted with the former accountant concerning disagreements with management and certain other matters.[15]

In addition, the Commission has required the establishment of audit committees, with designated duties, as ancillary relief in some enforcement actions.[16] The duties required in such actions generally involve, among other things, the review of a defendant's internal accounting controls, approval of certain filings and press releases, and meeting with the defendant's independent accountants.

Rather than imposing a direct requirement for registrants to maintain audit committees, the Commission has worked with the self-regulatory organizations ("SROs") to require listed companies to have audit committees. The Commission has taken this approach because it believes that the SROs' experience places them in a position to exercise flexibility in the formulation and implementation of audit committee standards. Currently, the New York Stock Exchange ("NYSE") requires listed companies to have audit committees composed solely of independent directors. The National Association of Securities Dealers, Inc. ("NASD") with respect to all national market companies, the American Stock Exchange, with limited exceptions, and the Chicago Stock Exchange, with respect to all companies, require that listed companies have audit committees with a majority of independent directors.

In 1988, the Commission considered the recommendation of the National Commission on Fraudulent Financial Reporting ("Treadway Commission") that the Commission require all public companies to have an audit committee composed entirely of independent directors. The Commission determined that the best course of action was to continue to work with the exchanges and the NASD to encourage independent audit committees and enhance the quality of their operations. The Commission based its decision on its continued belief that the SROs through their listing standards had the requisite degree of flexibility to effectively address standards relating to the independence of audit committee members and the advisability of partial or total exemptions from these requirements for smaller companies. The Commission wrote to each of the SROs (other than the NYSE, which already required independent audit committees), encouraging enhancement of their audit committee listing requirements and encouraging a move to requiring independent audit committees. In response the American Stock Exchange adopted its requirement that listed companies have audit committees with at least a majority of independent directors.

I support the Commission's policies on this issue. Audit committees are key corporate governance mechanisms and, like all corporate governance standards depend on the character, integrity, and diligence of those involved. The training and experience of the committee members are basic factors in establishing an effective audit committee.[17] In this regard, it may be difficult, if not impossible, for some small, local, or regional companies to find qualified individuals who are willing to participate on their committees. Additional SEC regulations likely would not alleviate this problem and probably would not result in significant new disclosures. Such regulations, however, may remove some of the flexibility available in the SROs' requirements and may impose costs that could be significant for smaller companies. Therefore, I am not prepared to endorse a federally imposed mandate governing the composition of audit committees for all public companies.

C. Internal Controls-Reporting for End-Users of Derivatives

Critical to a sound risk management system that incorporates use of derivative instruments are effective management controls of the system - understood and evaluated at all levels of management including senior executives and the board of directors. Boards and senior executives should define the fundamental risk management policy of the entity including clearly articulated policies governing the use of derivatives. The board of directors and senior management should provide effective oversight of these activities for consistency with the defined policies and should monitor the continued appropriateness of the policies in light of business and market developments. Equally essential is a system of internal controls to assure that the risk management program, including use of derivative instruments is properly executed consistent with management risk policies and controls.

The subject of internal controls is one where the Commission has played an active role. Certain entities regulated by the Commission, such as investment companies,[18] broker-dealers,[19] and transfer agents,[20] are required to file with the Commission reports from their independent auditors regarding possible material weaknesses or inadequacies in their accounting systems, internal accounting controls, and procedures for safeguarding assets. In addition, the Foreign Corrupt Practices Act ("FCPA")[21] requires issuers with securities registered under section 12 of the Securities Exchange Act of 1934 ("Exchange Act") or that have sold securities under the Securities Act of 1933 ("Securities Act") to devise and maintain a system of internal accounting controls. Under the FCPA, internal controls must be sufficient to provide reasonable assurance that (1) transactions are executed in accordance with management's authorizations, (2) transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles or other applicable criteria and to maintain accountability for assets, (3) access to assets is permitted only in accordance with management's authorization, and (4) the recorded accountability for assets is compared at reasonable intervals and appropriate action is taken with respect to any differences. Thus, public companies that are end-users of OTC derivatives already are subject to certain internal control standards.

The Commission has proposed on two separate occasions a requirement that management of a public company be required to report on the effectiveness of its internal control systems relating to financial reporting and that the registrant's independent accountant report on the entity's internal control system relating to financial reporting. The first proposal was withdrawn in 1980 due to voluntary and private sector initiatives in the area and because of commentators' concerns about the costs of the proposed rule and whether the proposal, in effect, required a report on compliance with the internal control provisions of the FCPA.[22]

In 1988, the Commission again published for comment proposed rules that would have required a report from management on its responsibilities for the registrant's financial statements and internal controls to be included in annual reports and certain other documents.[23] A majority of the commentators supported the requirement for a statement by management concerning its responsibilities for the establishment and maintenance of a system of internal controls for financial reporting. Commentators, however, expressed concerns regarding: (1) the management assessment of the effectiveness of such controls; (2) disclosure of how management would respond to significant recommendations concerning the registrant's internal controls by its internal auditors and independent accountants; (3) the requirement that the report be signed by the registrant's senior officers; and (4) the potential for over reliance by investors on the proposed report. As in 1980, commentators questioned whether a report noting deficiencies in a registrant's internal controls would constitute an admission of a violation of the FCPA. Further, most commentators addressing whether independent accountants should be required to report on either the registrant's internal controls or the proposed management report, opposed such auditor reporting, principally on the basis that the costs would exceed the benefits. On April 16, 1992, the Commission withdrew this proposed rulemaking.[24]

Other federal legislation addresses internal controls for certain regulated entities. Under the Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA"), certain banks and savings and loans are required to file with bank regulators management reports containing management's assessment of the effectiveness of the entity's internal control structure and financial reporting procedures. The entity's independent auditor is required to attest to, and separately report on, management's assertions.[25] In supporting the need for such reporting, the GAO indicated that it could aid in ensuring that accounting principles were applied properly in call reports and financial statements, and could act as an "early warning" of breakdowns in banks' corporate governance systems.[26] A private sector study has been completed that is intended to provide guidance in conducting assessments of entities' internal control structures.[27] In implementing the FDICIA requirement, the FDIC did not develop separate criteria for internal controls. Instead, the FDIC stated that each institution should determine its own standard for an internal control structure and procedures for financial reporting, and that the auditor's attestation should be in accordance with generally accepted standards for attestation engagements.[28]

Where federal regulators are responsible for overseeing on a substantive basis the financial condition of an enterprise as in the case of banks and savings and loans reports on internal controls may be an important tool in such oversight. Where, as in the case of public companies, federal regulation is focused on full and fair disclosure to investors, the issue is whether a public report by a company's auditors on internal controls will materially improve disclosure to investors. Under generally accepted auditing standards, independent auditors currently are required to design their audits to provide reasonable assurance of detecting misstatements that are material to the financial statements.[29] As discussed above, the FCPA requires maintenance of a system of internal controls. The likelihood of an auditor's reporting on management's assessment of an entity's internal control structure being substantially more effective than an audit of the financial statements in preventing and detecting management fraud is open to question. Likewise it is unclear why or how the management of a registrant will understand better the risks inherent in derivative and cash instruments if it is required to report publicly on the effectiveness of the registrant's internal controls and its independent auditor is required to examine and publicly report on management's assertion about the registrant's internal controls.

Investors will be better served by improved disclosure and accounting of a registrant's derivative and other risk management activities. Such enhanced public reporting will not only better inform investors, but also help assure that auditors, as well as management, carefully review the information provided, and assure that adequate controls are in place with respect to the activities required to be disclosed.

D. Mutual Fund Use of Derivative Instruments

Mutual funds, other than money market funds, use derivative products for a wide variety of purposes including, for example, to hedge interest rate, currency, and other market risks, to substitute for a direct investment in the underlying instrument, or to increase potential yield and risk. Fund disclosures indicate that many funds have the authority to use derivative instruments, but our inspections to date suggest that the actual use of derivatives by most stock and bond funds is limited. There are exceptions, however, to this general observation. Funds dedicated to mortgage-backed securities, for example, generally have significant investments in derivatives, ranging from relatively straightforward securities issued by the Government National Mortgage Association and the Federal National Mortgage Association to more complex, riskier collateralized mortgage obligation tranches. Longer-term municipal funds also use derivatives for the purpose of seeking increased tax-exempt return. In addition, funds investing internationally may use certain derivative investments to lessen currency risks.

A recent industry survey of long-term (non-money market) funds suggests that mutual fund use of derivatives is limited. The survey reported that the total market value of all derivatives held by participating funds was $7.5 billion, representing 2.13% of the total net assets of all funds reporting derivatives holdings and 0.78% of the total net assets of the fund complexes participating in the survey. The total notional amount of these derivatives was $54.3 billion, representing 15.51% of the total net assets of all funds reporting derivatives holdings and 5.67% of the total net assets of the fund complexes participating in the survey. The survey also indicated that the level of use of derivatives varied by fund type, with fixed income funds accounting for 84% of the total market value of all derivatives held by reporting funds and 62% of the total notional amount.[30]

Notwithstanding that the use of derivatives by mutual funds generally appears to be limited, in recent weeks there have been reports of significant losses by some investment companies from investments in derivative instruments.[31] For example, one short-term government bond fund investing in mortgage securities was reported to have declined 4% in value in one day this month,[32] and another was reported to have lost 23% in 1994.[33]

Months before these reports surfaced, the Commission was concerned about investor protection issues raised by mutual fund investments in derivatives. In the past year, the Commission has taken a multi-faceted approach to mutual fund use of derivative instruments, focusing on a broad range of issues, including disclosure, risk management, pricing, leverage, and liquidity. A staff task force has examined the derivatives disclosures of 100 investment companies, representing a broad sample of complexes and fund types, and the Commission's fund disclosure review staff has given heightened scrutiny to derivatives disclosure in prospectuses and registration statements. In addition, our inspection staff is examining and reporting on the derivatives activities of each fund inspected. We are considering whether our inspection process should be augmented by periodic reporting to the Commission of fund portfolio holdings.

We believe it is important that investors receive understandable disclosure about the manner in which a mutual fund uses derivatives and the associated risks. To address this problem, last February, the Commission staff issued a letter to all registered investment companies, noting that in many cases fund disclosures regarding derivative instruments are unduly lengthy and technical. The letter encourages funds to identify areas of derivatives disclosure that can be modified to enhance investor understanding of the risks associated with derivative instruments.[34]

The Commission continues to work to improve derivatives disclosure through our review of prospectuses filed by mutual funds. We also are considering whether rulemaking is appropriate to enhance risk disclosure to mutual fund investors, perhaps through requiring some form of standardized, quantitative risk disclosure.

Adequate management controls are critical to a mutual fund's ability to monitor the risks associated with derivatives. Adequate management controls also are important to accurate pricing of derivative instruments, which may be a difficult task in the case of certain OTC derivatives. In our inspections, we have found that a number of funds appear to have strong management controls in place, but we remain concerned that these funds may not be fully representative of the industry. We will continue to inspect funds' management controls and will consider rulemaking, as appropriate, to encourage better management controls.

We also are reviewing the regulatory limitations on mutual fund investments in derivatives. In general, the Investment Company Act of 1940 ("Investment Company Act") does not contain broad prohibitions on a mutual fund's investment in any particular type of instruments, including derivatives. The Investment Company Act does, however, contain limitations on a fund's use of leverage,[35] which the Commission staff has interpreted as restricting fund investments in certain derivative instruments that create fund obligations to someone other than fund shareholders -- for example, a put option written by the fund that obligates the fund to purchase securities from the option holder.[36] The staff also has taken the position that mutual funds must not invest more than 15% of their net assets in illiquid assets,[37] and certain derivative instruments are illiquid. We are reviewing these leverage and liquidity restrictions in the context of derivative instruments to determine whether they continue to reflect appropriate regulatory policies and whether they should be supplemented by other forms of regulation.

The use of derivatives by money market funds is another area that has merited our special attention.[38] Over the past two and one-half years, we have been looking at money market fund use of financially engineered instruments that may be able to achieve their intended results only in a stable interest rate environment. In particular, we are concerned that money market funds have purchased new types of adjustable rate instruments whose market value may not return to par at the time of an interest rate adjustment, with the result that fund share price stability could be threatened.[39] Most recently, we raised the issue in proposing amendments to Rule 2a-7 under the Investment Company Act, our money market fund rule.[40] Money market funds form a particularly important segment of the industry because, despite the disclaimers, individual investors often perceive these funds as the functional equivalent of insured bank accounts.

We have acted, and will continue to act, to enhance investor protection in the area of mutual fund derivative investments. I also have urged fund directors to exercise meaningful oversight of fund derivative investments, involving themselves in portfolio strategies, risk management, disclosure and pricing issues, accounting questions, and internal controls.[41] While the Commission's resources are sufficient to permit it to scrutinize the derivatives activities of individual mutual funds on only a periodic basis,[42] the directors of each fund are positioned and obligated to promote the interests of the fund's shareholders on an ongoing basis.

E. Dealers' Activities

Broker-dealers in securities and their affiliates have been involved in the OTC derivatives business since its inception. Generally acting as intermediaries, these firms principally undertake a dealer or market making function. Within this context, dealers attempt to create so called "matched books" in derivatives by utilizing offsetting derivatives contracts or by hedging their exposures with securities or other types of financial instruments, such as futures. These dealers play a significant role in the OTC derivatives market; in relation to banks, however, as the GAO Report points out, the amount of activity undertaken by securities firms is relatively small. Moreover, as noted earlier, the aggregate replacement cost of derivatives contracts by securities firms is a small percentage of the total notional amount of these contacts.

Significant trading by securities firms in OTC derivatives has been confined to six highly capitalized institutions. These firms tend to be sophisticated global conglomerates whose activities cross financial products and international borders. Although expanding, the client base of these firms also tends to be large, sophisticated institutional counterparties, sensitive to credit exposures and attentive to sound risk management. The sophistication and credit sensitivity of the marketplace, together with the discipline imposed by the rating agencies, has led to the development of a generally well-managed and capitalized dealer community.

Moreover, the derivatives activities of securities firms are not conducted in the dark. To the extent derivatives are transacted in the broker-dealer registered with the Commission, the entity and the products are subject to the entire panoply of Commission regulation, including capital standards, suitability requirements and strong examination and enforcement programs. To the extent OTC derivatives products are booked in an affiliate of the broker-dealer, not only does market discipline demand a high degree of creditworthiness and sophistication, but the Commission's risk assessment program provides us with substantial information concerning the activities and exposures of unregistered OTC derivatives dealers.

We view the information gathered under the risk assessment program as a significant complement to the Commission's existing broker-dealer regulatory authority. The risk assessment rules developed based upon the Commission's need for information about the activities of broker-dealer affiliates within holding companies. Several years ago, the Commission petitioned Congress for, and received under the Market Reform Act of 1990 ("Market Reform Act"), broad authority to require information concerning the activities of broker-dealer affiliates. Pursuant to the Market Reform Act, the Commission adopted rules establishing a risk assessment program[43] that requires broker-dealers to report information on their material affiliates within the holding company group. In this way, the Commission monitors the activities of unregistered OTC derivatives dealers.[44]

Under the risk assessment program, the Commission receives sufficient information to assess the nature of the business transacted by derivatives dealers, their exposures, and the potential risk affiliates may cause to registered broker-dealers. Specifically, the Commission receives quarterly and annual financial statements, including profit and loss information, from material affiliates engaged in derivative financial activities, together with information on the volume, replacement cost, and significant counterparty concentrations for interest rate, foreign exchange, securities, and commodities products. Additionally, the Commission receives and reviews the risk management policies employed by major U.S.

securities firms. Such policies include the broker-dealer's methods for monitoring and controlling market, credit, and funding risk. To enable the Commission to monitor significant credit exposures, the rules require broker-dealers to furnish for OTC derivatives a counterparty breakdown where credit risk exceeds a defined materiality threshold. The GAO Report suggests that the Commission's threshold is too high to obtain sufficient information for detecting potential credit risk problems among OTC dealer affiliates of securities firms. This is an area I expect will be reviewed in connection with the staff's ongoing review of the risk assessment program.

Beyond formal reporting requirements, the Commission works closely with representatives of the major dealers to gain an in-depth understanding of their OTC derivatives activities based on the information contained in the filed reports. Commission staff routinely meets with the major U.S. securities dealers and reviews, in some detail, the nature and extent of dealer exposures. Particular attention is paid to a review of the controls employed by the major U.S. securities firms to manage credit risk. These reviews generally include an examination of credit functions, such as the capability to perform credit analyses, approve and set counterparty credit limits, approve specific transactions, recommend credit reserves, and manage overall credit exposure. Reviews also typically include an evaluation of whether standards requiring that senior management approve transactions involving extensions of credit above authorized levels are being followed.

It is extremely important that derivatives activities be undertaken in entities that operate under a broad umbrella of risk management policies, commensurate with the level of risk involved, that include adequate systems of risk management controls. Adequate risk management policies, for example, must include the maintenance by derivatives dealers of independent risk management functions, such as the establishment of credit and internal audit committees separate from the trading functions of the firm.[45]

Moreover, the role of chief executive officers and board members cannot be overlooked. While the board and senior management may not work in the trenches of the trading room, ultimately they are responsible for the direction of the firm, and its "appetite for risk." I believe it is important that they be fully aware of the nature and extent of risk inherent in the derivatives activities undertaken by the trading operation. Optimally, the board should promulgate clearly articulated policies concerning derivatives, and work actively to update those policies as business and market climates change. I applaud boards that have taken such active roles in derivatives risk management and encourage all boards and CEOs to strive to do more in this area.

In order to assess the state of dealer risk management controls, I recently instructed the staff to survey the major U.S. securities firms to determine the extent to which the major derivative broker-dealers and their affiliates are utilizing or implementing the 20 risk management control recommendations contained in the Group of Thirty Report.[46] The responses to our survey of risk management controls indicate substantial conformity to the Group of Thirty Report's recommendations among the top-tier of U.S. securities firms. The firms surveyed account for virtually all of the OTC derivatives activity undertaken by U.S. securities firms. Although this is positive news, we also believe that risk management policies must continue to evolve and adapt to changes in business practices and technology.

In addition to this effort to examine the risk management systems of derivatives dealers, the Commission's existing financial responsibility rules provide a check on the internal controls of broker-dealers registered with the Commission. Specifically, the

Commission's rules require the independent audit of a broker-dealer's internal controls, and the auditor's report to management, or the Commission, if necessary, of any material inadequacies in such internal controls.[47]

We do not believe it is appropriate at this time for the Commission to mandate specific management policies applicable to dealers in derivatives. One of the strengths of the OTC derivatives market is its flexibility and its ability to change. For this reason, the "state-of-the-art" in management controls can be expected to evolve; to freeze today's standard for the future may prove to be a mistake. We would advocate a more fluid approach, whereby industry representatives and regulators would act together to ensure that risk management systems are up to the complex task of controlling the risks in OTC derivatives trading. Our focus will be on the details of internal and external audit functions, and the operation of audit committees. Our goal will be communication and implementation of the most sound risk management practices.

Currently, we regulate only those entities, including broker-dealers, that are registered with the Commission. The Commission always has advocated a strong broker-dealer regulatory program, which requires strong capital standards. Capital standards should provide protection against market downturns and excessive leverage, while not preventing the flow of capital into the securities industry or unduly diminishing a dealer's return on equity. The Commission's primary financial responsibility standard, the net capital rule, ensures that sufficient net, liquid assets are maintained by broker-dealers and is designed to insulate them against potential market and credit risks.[48]

Under the net capital rule, broker-dealers are required to maintain certain amounts of liquid assets, or net capital, based on the amount and type of business the firm transacts.

Because the net capital rule's existing structure reflects the traditional nature of a broker-dealer's business, which historically was a short-term trading business, the growing importance of OTC derivative products, which tend to be longer term and reliant on credit, has presented new challenges. Currently, the net capital rule discourages broker-dealers from incurring credit risk by assessing a 100% capital charge on unsecured receivables. We have been informed that these charges have contributed to the movement of activities in many OTC derivatives, such as swaps, from registered broker-dealers to their affiliates.

Due to concerns that the net capital rule may not appropriately reflect the risks inherent in derivative products, and in light of the practice among dealers to conduct OTC derivatives activities in unregistered entities, the Commission currently is undertaking a comprehensive review of its capital rule. On May 4, 1993, the Commission issued a concept release regarding the application of the net capital rule to derivative products,[49] which sought public comment on the appropriate net capital treatment of the market risk on options, currency forwards, currency swaps, interest rate swaps, and equity swaps and the credit risk on OTC derivative products. Although the Commission's net capital rule applies only to registered broker-dealers, the concerns raised in the concept release are relevant to all derivatives dealers, as well as end-users transacting business with derivatives dealers.

As a first step in revising the net capital rule in the derivatives area, the Commission, on March 15, 1994, issued a release proposing the use of a theoretical pricing model to set capital charges for listed options and related positions.[50] This proposal is significant because it would incorporate, for the first time, modern portfolio theory into the net capital rule. The proposal only applies to listed options and related positions because the Commission believed it would be appropriate to begin this more sophisticated approach to capital charges under a controlled environment. Commission staff, however, is currently working with the industry on an objective approach that would extend this theoretical pricing approach to OTC options, including debt options.

As a second step in revising the net capital rule, the Commission staff is developing an approach that would integrate interest rate swaps, futures and forward contracts on debt instruments, government securities, and debt securities into a unified computation of market risk capital charges. This initiative is substantially similar to the international proposal of the Basle Committee on Banking Supervision, and we have been working with our international counterparts in developing it.

Finally, in addition to the market risk proposals discussed above, the staff is developing a proposal that would assess capital charges on the credit risk inherent in certain OTC derivative products including OTC options, interest rate swaps, and foreign currency forwards. As mentioned above, the net capital rule currently assesses a 100% charge on unsecured receivables, or credit risk. The staff is reviewing proposals of various industry representatives in devising a more sophisticated approach that would accommodate broker-dealers trading OTC derivative products in registered entities. Our goal is to revise completely the application of the net capital rule to OTC derivatives transactions in a manner that both reflects modern financial theory and contemporary risk reducing techniques, while still providing the safe capital base necessary to protect our markets.[51] I am confident that working together, the Commission and the industry can, in the near future, fashion capital charges that realistically and adequately address the risks in OTC derivatives.

While our efforts in implementing the risk assessment program and revising the net capital rule have been effective and responsive in ensuring the financial integrity of broker-dealers subject to its rules, we share GAO's concern regarding the activities conducted in unregulated affiliates of broker-dealers. Specifically, we believe more can, and should, be done to address the following areas:[77]

- Capital standards that deal with market and credit risks and leverage concerns. In particular, such standards should specifically address the ability of a firm to withstand "volatility shocks" and valuation uncertainties in times of market stress;
- Suitability standards that specifically address OTC derivatives transactions;
- Risk management controls that will enable firms to monitor adequately OTC derivatives activities and the risks arising therefrom, including their cash market relationships;
- Approaches for addressing legal uncertainties regarding enforceability of netting arrangements;
- Recordkeeping and reporting requirements, including audits by independent public accountants; and
- Examination and enforcement by the Commission and, if appropriate, a SRO.
- More generally, in addition to issues related to the integrity of individual firms, we also must be cognizant of the potential interaction between the trading activity by derivatives dealers and the cash markets.

Implementation of any such regulatory plan may require legislative or regulatory action, or some combination of the two. At this time, we are not submitting a legislative request to Congress. We believe that the Commission has appropriate tools for existing oversight. The Commission also has experienced a high level of cooperation by both registered broker-dealers and their unregistered affiliates in discussing how to improve oversight, and we have every expectation that we can work with the industry to develop such a regulatory plan. It, however, may become necessary to come back to Congress with a request for specific legislative action and we will not hesitate to do so. For the time being, I intend to explore with the industry and others the best methods of accomplishing these regulatory goals. I look forward to working through these challenges and call on market participants to join the Commission and others, particularly the CFTC, in a serious, committed effort to tackle these complex issues.

Finally, any effective solution ultimately will require coordination with banking and other domestic regulators, as well as the international community. It is critical, however, to bring the securities dealers under prudent standards quickly, even while addressing the complex task of more harmonized standards across markets and institutions.

F. Netting

Aside from more comprehensive coverage of dealers' activities and improved accounting and disclosure standards, there is a need for further action in several other areas involving derivatives. One of these involves the need for greater certainty and coordination in the bankruptcy treatment of derivative products in order to reduce systemic risk. By reducing settlement risk as well as credit exposure, netting contributes to the reduction of systemic risk in the derivatives market by decreasing the number and value of daily settlement obligations and by permitting participants to execute more transactions before reaching their credit limits.

The Commission has been active in efforts to eliminate uncertainty over the enforceability of netting arrangements. In this regard, the Commission supported the passage of the netting provisions in the FDICIA,[53] which expressly affirms the enforceability of netting arrangements between financial institutions. The Commission also has worked with the Board of Governors of the Federal Reserve System on a proposal that would expand the pool of institutions qualified to rely on the netting provisions under FDICIA to include swaps dealers meeting certain financial thresholds.

Despite the many efforts that have been made to eliminate uncertainty in this area, there continues to be concern about certain scenarios where there may be questions regarding the enforceability of netting provisions. The Group of Thirty Report identifies certain circumstances where the current regulatory scheme leaves an element of uncertainty.[54] For example, if the transaction is not expressly enumerated under the Financial Institutions Reform, Recovery and Enforcement Act of 1989 ("FIRREA") or the Bankruptcy Code, such as spot foreign exchange agreements, and FDICIA does not apply, then an element of uncertainty remains in the process. The Commission continues to work with other regulators and with industry representatives, including the Commission's Market Transactions Advisory Committee, toward revising the laws to eliminate this netting uncertainty.

The establishment of a properly structured and regulated clearinghouse could help to reduce the legal, operational, and credit risks for OTC derivatives dealers and end-users. A clearinghouse for swaps transactions, for example, would benefit dealers by improving data collection, trade matching, and risk management, by enhancing the potential for multilateral netting and mutualization of risks, and by providing centralized management of relations with and dissemination of information to regulators, banks, and market participants. In addition, a swaps clearinghouse would help reduce the credit exposure of end-users by shielding them from the default of a particular counterparty. This protection may become more important as the OTC market expands. Finally, in the Commission's experience, clearinghouses provide dealers and end-users with operational efficiencies that can result in savings to dealers, even if they are not direct participants in the clearinghouse, which could be passed on to end-users.[55] Although many issues need to be resolved before a swaps clearinghouse could be established, the Commission staff will work with other regulators and industry participants to resolve legal or regulatory impediments to the development of a clearinghouse.[56]

G. Suitability

Another area worthy of consideration is the suitability of recommendations in derivative products. The customer base of the derivatives market, which began with only the largest, most sophisticated institutions, will expand over time. The use of derivatives by a wider range of potential end-users raises different suitability concerns depending on the end-user. For example, the concerns created by the use of derivatives by highly sophisticated multi-national companies to manage their business exposures differ from those raised when the end-user is a pension fund or a foundation seeking to protect its financial assets. When retail investors are added to this mix, additional concerns are raised.

Highly sophisticated end-users may understand derivatives products and trading strategies. Less sophisticated institutional and retail customers simply may not understand these products and strategies as well. This situation makes it necessary to ensure that suitability standards take into account the differences among derivatives users. In all cases, however, end-users should have adequate information to evaluate the risks inherent in the product being purchased.

Securities SRO rules already require broker-dealers to make suitability determinations before recommending customer trades. Their rules generally require that broker-dealers have reasonable grounds for believing that their recommendations are suitable for a customer based on information regarding the customer's financial situation and needs. Broker-dealers effecting transactions in options, whether such securities are traded on an exchange or in the OTC market, are subject to additional requirements. For example, NASD rules require specific approval of customer accounts for OTC options trading.

The Commission's staff will work with the SROs to evaluate whether broker-dealers are making suitable recommendations to customers engaging in derivatives transactions. We will request a meeting with a group of representatives of the SROs to hear their thoughts and suggestions on the issue as well as on the development of suitability standards for OTC derivative products. Such discussions are part of the process of implementing the agenda for oversight of the OTC derivatives market specified in the recently issued joint statement by the Commission, the CFTC, and the U.K. Securities and Investments Board ("SIB"). In addition, I think it is particularly important to develop suitability standards that specifically address recommendations in OTC derivatives transactions.

H. Regulatory and International Coordination

Aside from the areas of concern to the Commission's program, we recognize that derivative products and dealers cross product, regulatory, and international boundaries. For this reason, we strongly support interagency -- and international -- cooperation as a means of addressing areas of concern regarding derivative products. Accordingly, the Commission and staff regularly meet with banking and futures regulators to discuss a broad range of structural and policy issues, including developments in, and various risks posed by, the derivatives market. These meetings provide the participants with a valuable opportunity to draw upon each agency's experience and expertise. The Working Group has been revived and is expressly dealing with the issue of derivative products. Over the past few months, the Working Group has held a number of meetings to discuss a broad range of structural and policy issues concerning OTC derivative markets.

In addition, the Commission coordinates with foreign regulators in the regulation of risks associated with OTC derivative products. Specifically, the Commission is an active participant in working groups and committees of the International Organization of Securities Commissions ("IOSCO") and working groups of the Basle Committee on Banking Supervision ("Basle Committee"). Both organizations have been discussing capital standards for equity and debt securities positions, including derivative positions.

Finally, on March 15, 1994, the Commission, the CFTC, and the SIB issued a joint statement setting forth an agenda for the oversight of the OTC derivatives market. Recognizing the size and the global nature of the OTC derivatives market, the joint statement identifies ways in which these three agencies can cooperate in their respective regulatory approaches to OTC derivatives and is intended to provide a framework for enhanced international regulatory cooperation. The staff of the Commission, the CFTC and the SIB have held discussions on the actions necessary to implement the joint statement, including, among others matters, the development of mechanisms for exchanging information on the operations of significant derivative dealers, addressing the legal uncertainties of netting arrangements, and stress testing major dealers' proprietary models for capital charges.

One of the goals of the joint statement was to promote wider regulatory cooperation by taking the joint statement to other regulators, both domestic and international.

Accordingly, Andrew Large, the Chairman of the SIB, and I sent a letter to Mr. Sohei Hidaka, the Director-General of the Securities Bureau of the Ministry of Finance in Japan, expressing our hope that the joint statement would provide a basis for further multilateral issues in this area. We are happy to say that the Japanese Ministry of Finance has agreed in principle to work with other regulators in the area of OTC derivatives oversight.

The Commission agrees with GAO's recommendation for the U.S. regulators to exhibit leadership in harmonizing international standards for derivative products. We believe that because of the global nature of the OTC derivatives market, any effective regulatory framework must include international cooperation and coordination. The joint statement provides an excellent basis for this type of relationship. Our goal is to involve the Group of 10 countries in discussions regarding the implications of derivatives for the global financial system. It is important to remember, however, that international cooperation and harmonization does not mean lowering regulatory standards to the lowest common denominator.

CONCLUSION

To conclude, I would like to emphasize that the U.S. securities markets remain the most vibrant and healthy markets in the world. One of the assets of our markets is their ability to assimilate technological innovations and new products. The development of the OTC derivatives markets has provided benefits to our marketplace and its participants -- but any new development must be watched closely. We have done so, and under the approach we have set forth today, will continue to move forward. The Commission remains committed to ensuring that our markets continue to be the national resource they are globally recognized to be.

1. United States General Accounting Office, Pub. No. 94-133, Financial Derivatives: Actions Needed to Protect the Financial System (1994) [hereinafter GAO Report].

2. The term "derivative" can be used to refer to any financial product that derives its value from other assets. Derivative products, therefore, encompass not only standardized financial products such as options and futures, which have been traded on exchanges for many years, but also customized products such as swaps and forwards, which are traded by dealers in the OTC market.

3. In response to the growing OTC market for stock index options, the Chicago Board Options Exchange developed an OTC-type of stock index options contract for trading on an exchange. These Flexible Exchange Options, or "FLEX Options," are large-sized, customized index options. In addition, the Philadelphia Stock Exchange has proposed establishing a FLEX framework for foreign currency options. The Commission believes that FLEX Options benefit market participants who effect transactions in the OTC marketplace in numerous ways.

4. In general, concerns expressed regarding the growth of derivatives are directed at the more exotic OTC derivative products, which are sold and intermediated for the most part by the major banks and securities dealers. These concerns arise, in part, because of large exposures created by these products for the major financial institutions. In addition, because OTC derivative products often are complex in design, they can be difficult for dealers and end-users to manage.

5. *Concerning Safety and Soundness Issues Related to Bank Derivatives Activities: Hearing Before the House Committee on Banking, Finance and Urban Affairs*, 103rd Cong., 1st Sess. 103-88 (1993) (testimony of J. Carter Beese, Jr., Commissioner, U.S. Securities and Exchange Commission).

6. Procter & Gamble and Gibson Greetings announced in April 1994 that they had lost $102 million and $19.6 million, respectively, on interest rate swaps. On May 12, 1994, Air Products & Chemicals Inc. announced that it lost $60 million on interest rates swaps. In addition, Marion Merrell Dow announced in April 1994 that it expected to take a charge of between $11.9 million and $13.9 million from investments lost as part of Askin Capital Management hedge funds liquidation. The ARCO pension fund announced in April 1994 that it lost $22 million, which accounts for 5.3% of its principal, from derivatives activities.

7. *See e.g.*, GAO Report, *supra* note 1; Financial Accounting Standards Board, Proposed Statement of Financial Accounting Standards, "Disclosure About Derivative Financial Instruments," (Apr. 14, 1994) [hereinafter Exposure Draft]; House Banking Committee Minority Staff, 103rd Cong., 1st Sess., Report on Financial Derivatives (November 1993); Group of Thirty, "Derivatives: Practices and Principles," (July 1993) [hereinafter Group of Thirty Report].

8. Group of Thirty Report, *supra* note 7.

9. Exposure Draft, *supra* note 7.

10. The exposure draft suggests ways of reporting quantified information including the disclosure of: (1) more details about current positions and, perhaps, activities, (2) the hypothetical effects on equity or annual income of various changes in market prices, (3) a gap analysis of interest repricing on maturity dates, (4) the duration of financial instruments,

or (5) the entity's largest value at risk level during the reporting period and as of the end of the reporting period from derivative financial instruments and from other positions. Exposure Draft *supra* note 7.

11. *See* Accounting Series Release ("ASR") No. 123 (Mar. 23 1972), 37 FR 6850; In re McKesson & Robbins, Inc., ASR No. 19 (December 5, 1940), [1937-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 72,020.

12. ASR No. 123, (March 23, 1972), 37 FR 6850.

13. *See* SEC Division of Corporation Finance, Staff Report on Corporate Accountability, printed for use by the Senate Committee on Banking, Housing and Urban Affairs, 96th Cong., 2d Sess., 486-510 (September 4, 1980).

14. Item 7(e) of Schedule 14A, 17 C.F.R. § 240.14a-101.

15. Item 304 of Regulation S-K, 17 C.F.R. § 229.304.

16. *See, e.g.*, In re Theodore Hofmann, Accounting and Auditing Enforcement Release ("AAER") No. 513, (January 4, 1994); SEC v. Software Toolworks, Inc., AAER No. 495 (September 30, 1993); SEC v. American Biomaterials Corporation, AAER No. 187 (April 19, 1988); SEC v. Gemcraft Inc., et al., AAER No. 107 (July 31, 1986).

17. *See, e.g.*, The Institute of Internal Auditors Research Foundation, Improving Audit Committee Performance: What Works Best (A Research Report Prepared by Price Waterhouse, 1993).

18. *See* Form N-SAR, Item 77B, 17 C.F.R. § 274.101.

19. *See* Exchange Act Rule 17a-5(g) and (j), 17 C.F.R. § 240.17a-5(g) and (j). The reporting requirements for broker-dealer rules require that any "material inadequacies" be disclosed. A "material inadequacy" would include any condition that has contributed substantially to or, if appropriate corrective action is not taken, could reasonably be expected to (i) inhibit a broker-dealer from promptly completing securities transactions or promptly discharging its responsibilities to customers, other broker-dealers, or creditors, (ii) result in material financial loss, (iii) result in material misstatements in the broker-dealer's financial statements, or (iv) result in violations of the Commission's recordkeeping or financial responsibility rules to an extent that could reasonably be expected to result in one of the three conditions described herein. *Id.*

20. *See* Exchange Act Rule 17Ad-13, 17 C.F.R. § 240.17Ad-13.

21. 15 U.S.C. § 78m(b)(2).

22. Accounting Series Release No. 278 (June 6, 1980).

23. Securities Act Release No. 6789 (July 19, 1988), 53 FR 28009 (July 26, 1988).

24. Securities Act Release No. 6935 (April 24, 1992), 57 FR 18421 (Apr. 30, 1992). In addition, the Commission has since noted that "mandatory auditing of internal controls" could result in "enormous costs with relatively few real benefits." Statement of Richard C. Breeden, Chairman, Securities and Exchange Commission, Before the Subcommittee on

Telecommunications and Finance of the House Committee on Energy and Commerce, Concerning H.R. 574, The Financial Fraud Detection and Disclosure Act (Feb. 18, 1993) at 35.

25. The Federal Deposit Insurance Corporation Improvement Act, Pub. L. 102-242, § 112.

26. GAO, Failed Banks: Accounting and Auditing Reforms Urgently Needed (GAO/AFMD 91-43, April 1991) at 8 and 34.

27. Committee of Sponsoring Organizations of the Treadway Commission, Internal Control - Integrated Framework (August 1992).

28. 12 C.F.R. §§ 363.2(b) and 363.3(b), and FDIC, Guidelines and Interpretations Concerning Annual Independent Audits and Related Requirements of Insured Depository Institutions, Appendix to Part 363, Chapter III, Title 12, Code of Federal Regulations, ¶¶ 9 and 10 (May 1993), which indicate that the internal control policies should include the safeguarding of assets. The American Institute of Certified Public Accountants has adopted relevant guidance in Statement on Standards for Attestation Engagements No. 2, "Reporting on an Entity's Internal Control Structure Over Financial Reporting" (May 1993).

29. AICPA, Statement on Auditing Standards No. 53, "The Auditor's Responsibility to Detect and Report Errors and Irregularities," ¶ 5 (effective January 1989).

30. Investment Company Institute, Derivative Securities Survey, February 1994. Survey respondents included 52 fund complexes with 1,728 long-term funds (52% of industry long-term funds) holding aggregate net assets of $958 billion (76% of industry long-term assets).

31. *See, e.g., Bond Fund Sets Disclosure Pact on Derivatives,* Wall St. J., Apr. 18, 1994, at C1; *Paying the Piper,* Barron's, Apr. 11, 1994, at 15; *Derivatives Undo a Popular Paine Webber Fund, Triggering 4% One-Day Drop in Its Value*, Barron's, May 16, 1994, at MW12; *Sinking Funds,* Barron's, May 16, 1994, at MW12.

32. *See Derivatives Undo a Popular Paine Webber Fund, Triggering 4% One-Day Drop in Its Value,* Barron's, May 16, 1994, at MW12.

33. McGough, Robert, *Piper Jaffray Acts to Boost Battered Fund,* Wall St. J., May 23, 1994, at C1. *The Wall Street Journal* reported that the Piper Jaffray Companies have taken the unusual action of investing $10 million in the fund, the Piper Jaffray Institutional Government Income Portfolio.

34. Letter from Carolyn B. Lewis to Registrants (Feb. 25, 1994).

35. Section 18 of the Investment Company Act prohibits mutual funds from issuing any "senior security" other than a borrowing from a bank. Such borrowings cannot exceed one-third of a fund's assets. Investment Company Act of 1940, § 18, 15 U.S.C. § 80a-18.

36. The Commission staff has taken the position that some derivative investments are, in effect, senior securities because they create a fund obligation senior to the claims of fund shareholders. The staff has permitted such investments if they are "covered" or if fund assets are earmarked to collateralize the fund's obligation. For example, a put option obligates the writer to purchase the "underlying" on exercise. Therefore, a mutual fund

may write a put option only if the fund either covers the position (*e.g.*, sells short the "underlying" at a price no less than the option strike price) or segregates cash, U.S. government securities, or other high grade debt securities in an amount equal to the option strike price. *See, e.g.*, Securities Trading Practices of Registered Investment Companies, Investment Company Act Release No. 10666 (Apr. 18, 1979); Dreyfus Strategic Investing and Dreyfus Strategic Income (pub. avail. June 22, 1987).

The Investment Company Act generally does not limit fund use of a derivative unless it creates a fund obligation to a third party.

37. An illiquid asset is any asset that may not be sold or disposed of in the ordinary course of business within seven days at approximately the value at which the mutual fund has valued the investment. *See* Guidelines for Form N-1A, Guide 4.

38. *See* Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, Remarks at the Investment Company Institute Annual Conference, Washington, D.C. (May 18, 1994).

39. These instruments include capped floaters (whose floating rates will not adjust above a stated level), "CMT floaters" (whose floating rates are tied to longer term rates and which will not return to par if the relationship between short- and long-term rates changes), leveraged floaters (whose floating rates move at multiples of market interest rate changes), dual index floaters (whose interest rates are tied to two indexes and which will not return to par if the relationship between the two indexes changes), and COFI floaters (whose floating rates are tied to the Cost of Funds Index, which substantially lags market rates).

40. Investment Company Act Release No. 19959 (Dec. 17, 1993), 58 FR 68585, 68601-68602 (Dec. 28, 1993). Rule 2a-7 allows the maturity of adjustable rate instruments to be determined by reference to interest rate adjustment dates if the instrument "can reasonably be expected to have a market value that approximates its par value" upon adjustment of the interest rate. The proposed rule would clarify that the board of directors or its delegate must have a reasonable expectation that, upon adjustment of an instrument's interest rate at any time until the final maturity of the instrument or until the principal amount can be recovered through demand, the instrument will return to or maintain its par value.

41. Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, Mutual Fund Directors: On the Front Line for Investors, Remarks at Mutual Funds and Investment Management Conference, Scottsdale, Arizona (Mar. 21, 1994).

42. The Commission's resources for mutual fund inspections have lagged far behind the growth of the industry in recent years. *See* Testimony of Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, Concerning Appropriations for Fiscal Year 1995, Before the Subcommittee on Commerce, Justice, and State, the Judiciary, and Related Agencies of the Senate Committee on Appropriations (May 5, 1994) at 4-6.

43. Exchange Act Release No. 30929 (July 16, 1992), 57 FR 32,159 (July 21, 1992); Rules 17h-1T and 17h-2T and Form 17H.

44. The Market Reform Act also gave the Commission authority to promulgate rules that would establish an identification, recordkeeping, and reporting system for large trader accounts and transactions. In January of this year, the Commission proposed its Large Trader Reporting System, which will provide us with another information source regarding the relationship between the derivatives and cash markets. *See* Exchange Act Release No.

33915 (Apr. 19, 1994), 59 FR 19685 (Apr. 25, 1994); Exchange Act Release No. 33608 (Feb. 9, 1994), 59 FR 7917 (Feb. 17, 1994).

45. The SEC, CFTC and SIB recently issued a joint statement setting forth an agenda for the oversight of OTC derivatives. The joint statement included an agreement by these three regulatory agencies to work together and with appropriate industry groups and participants to promote the development of sound management controls for the risk management of OTC derivative products by securities and futures firms. Specifically, the joint statement listed the following seven concepts that management controls should embrace:

> (1) Policies about derivative activities should be promulgated by the board of directors and should be reviewed as business and market circumstances change;
>
> (2) Execution of these policies should be supported by valuation procedures and techniques, and risk management and information systems designed to ensure the adequacy of both management information and external reporting;
>
> (3) Responsibility for implementing the policies should be clearly delineated and the board of directors should define appropriate levels of and delegated authority for those responsible for implementing board policies for supervising OTC derivatives activities;
>
> (4) Information systems should be designed to achieve full compliance with the policies and principles, assist in the active management of derivatives activities, and provide an adequate flow of relevant information about the derivatives activities not only of the firm but also of its related entities on a world-wide basis;
>
> (5) Appropriate expertise should be maintained at all levels of a firm;
>
> (6) Internal controls should include units, which are independent of trading personnel and report directly to senior management, dedicated to the evaluation of.credit, market, and legal risks; and
>
> (7) Appropriate use should be made of risk reduction techniques, such as master agreements and credit enhancements, including collateralization.

Statement of the Securities and Exchange Commission, the Commodity Futures Trading Commission and the Securities and Investments Board (March 15, 1994).

46. Group of Thirty Report, *supra* note 7.

47. *See supra* note 19.

48. Exchange Act Rule 15c3-1, 17 C.F.R. § 240.15c3-1.

49. Securities Exchange Act Release No. 32256 (May 4, 1993), 58 FR 27486 (May 10, 1993). *See* Letter from Michael A. Macchiaroli, Associate Director, Division of Market Regulation, Securities and Exchange Commission to Mary L. Bender, The Chicago Board Options Exchange and Timothy Hinkas, The Options Clearing Corporation, dated March 15, 1994.

50. Securities Exchange Act Rel. No. 33761 (March 15, 1994), 59 FR 13275 (March 21, 1994).

51. While I believe these proposals would provide broker-dealers with an objective, and reasonable method of assessing capital charges on derivative instruments, the securities dealers have argued that we should forego fixed standards and instead allow broker-dealers to use their own internal proprietary models to calculate capital requirements. Before such an approach can be approved, the Commission first must be certain that it would be able to rely upon such models to yield consistent and independently verifiable results.

52. As discussed in the text, efforts also are underway by FASB and the Commission in the development of accounting recognition measurement and disclosure standards that will result in financial statements that achieve greater market transparency and adequate information for the users of those statements.

53. Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. 102-242.

54. For a detailed analysis of the issues surrounding OTC derivatives and netting under the Bankruptcy Code, FIRREA, and FDICIA, see "Over-the-Counter Derivatives Transactions: Netting under the U.S. Bankruptcy Code, FIRREA and FDICIA," Memorandum of Law for the International Swaps and Derivatives Association, Inc. prepared by Cravath, Swaine & Moore (June 22, 1993).

55. A swaps clearinghouse also might increase the liquidity of the market.

56. In order for a clearinghouse to manage effectively the risks swaps create, it must be able to obtain accurate historical measures of price and volatility. Currently, however, there is a lack of publicly reported data to permit pricing of rights and obligations to protect against potential price volatility. In addition, it would be necessary to determine whether a sufficient number of OTC derivatives had achieved an adequate level of fungibility to make an OTC derivatives clearinghouse practicable.