SEC Is Seeking Data on Firms' Derivative Risk

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NEW YORK – The Securities and Exchange Commission is asking dozens of public companies, as part of their SEC filings, to provide details on their exposure to risk in holding derivatives.

The questions are being sent in letters to scores of major industrial companies, banks, insurance companies, airlines, oil producers and food companies, confirms an SEC official, who declines to identify the companies.

"There's been an increased sensitivity in the marketplace about derivatives and some worried parties are predicting dire consequences for financial markets," says the SEC official. While the agency queried about a half dozen registrants on their use of derivatives in early 1993, "the atmosphere has changed this year and, while we don't see the end of the world, we want a lot more disclosure," the official adds.

The letters ask companies to supply intricate details about their derivatives holdings. The SEC wants the companies not only to list specific derivatives they hold, but also their terms, maturities and how they would affect the company's income, on both a net and gross basis. More than a dozen companies contacted declined to comment on the letters.

Derivatives are financial agreements whose value is linked to – or derived from – changes in the value of some under-

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lying asset, such as stocks, currencies or commodities. Companies commonly use derivatives to manage their vulnerability to such as things as changing interest rates and raw materials prices. But because derivatives make it easy to make big market bets with little or no money down, they also can be used for speculation – a gambit that backfired earlier this year at several companies, causing millions of dollars in losses.

Companies' Internal Policies

In its current inquiry, the SEC is also asking about companies' internal policies of monitoring and controlling their derivatives use, as well as the off-balance-sheet risks posed by such instruments. What is especially troublesome to some companies are SEC questions about whether they are using "hedge" accounting for such derivatives.

Under hedge accounting, gains and losses from derivatives can be deferred and matched with the offsetting gain or loss from the item being hedged, says John Stewart, a partner of accountants Arthur Andersen. But accounting rules require that if the derivatives are held for speculative purposes, rather than hedging, they must be revalued at each financial-reporting period at prevailing market prices, or at estimated fair value for very exotic instruments. Speculators must include paper gains and losses on their derivatives positions in their earnings statements, he adds. In a rising or falling market, the revaluations would cause profits to be very volatile.

Because there are currently more than 1,200 derivative instruments available and because some derivative-based hedges for interest rates and other risks are so complex, derivatives issuers and users often disagree on which accounting treatment should apply.

Sweeping New Regulation

The General Accounting Office, the investigative arm of Congress, recently issued a report that calls for sweeping new regulation of companies that create derivatives, particularly those that deal in privately traded instruments. The GAO report notes that the progress of accounting rule-makers has been slowed "by the complexity and controversy associated with derivative products and related financial instruments." And several members of Congress have expressed concerns about the growing derivatives market and the dangers it may pose to the economy.

Several non-financial corporations have announced big losses in derivatives trading. Among them, **Procter & Gamble Co.**, a Cincinnati consumer-products maker, cited a $157 million pretax charge in its fiscal first quarter to close out two derivatives contracts. **Air Products & Chemicals Inc.**, the Allentown, Pa., maker of industrial gases, said it terminated three of five leveraged interest-rate swap agreements and took a $60 million charge to reflect their declining value.

While the SEC is sending out the inquiry letters, some agency officials aren't fulling convinced that a lot of new regulations are required for derivatives trading. "There are 15,000 public companies, of which 12,000 are active in the stock market, and so far only a dozen or fewer companies have announced problems with derivatives," says the SEC official. "The jury is still out on whether more drastic steps than better disclosure are required."

Walter Schuetze, the SEC's chief accountant, says the agency during the past month has been "getting a lot more phone calls asking questions about derivatives from registrants." With interest rates on the rise, Mr. Schuetze says many more companies are concerned that they are accounting properly for their derivatives holdings.

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