SEC's Long-Delayed Plan on Derivatives Would Make Companies Disclose Risks

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The Securities and Exchange Commission plans to require that companies tell shareholders about the riskiness of their derivatives holdings, a move some businesses worry will be costly and difficult to implement.

The long-delayed proposal, which would carry the most stringent disclosure rules yet involving derivatives contracts held by publicly traded companies, is expected to be issued before the end of the year, SEC officials said.

The SEC had expected to issue the proposal months ago, but problems in resolving tricky questions about derivatives trading caused a delay, Steven Wallman, an SEC commissioner, said.

Derivatives are financial instruments whose returns are linked to, or derived from, the performance of underlying assets such as bonds, currencies or commodities. In the last two years, their use resulted in major losses at some companies and investment funds, most notably that of Orange County, Calif.

Michael Sutton, the SEC's chief accountant, said that compliance with the proposed new rule would be mandatory for 1996 financial reports and that the proposal itself should be considered as guidance for 1995 reports. Speaking at a recent meeting of financial executives here, he said the proposal will be open for 60 to 90 days for comment. The SEC hopes to issue the final rule in mid-1996, he added.

The official said the proposed rule would require companies using derivatives to provide the following information, mainly in the annual report's management discussion and analysis section:

- A table of cash flows listed by maturity dates of the derivatives. Banks already provide similar information for interests rates on their assets and liabilities.
- A statement of how earnings or the fair value of the derivatives would change if interest rates moved up or down one percentage point.
- A calculation of possible losses – and their likelihood – resulting from unfavorable market moves over time, called "value at risk." The information needed could be figured in various ways, including calculating future cash flows based on maturities of the instruments.

Some companies say that creating a computer software program for this work would be unnecessary and could cost hundreds of thousands of dollars to develop. "It could be very expensive and simply marking derivatives to market might be an easier solution," said Shawn O'Keefe, chief financial officer of DHL Systems Inc., Burlingame, Calif., a unit of the Brussels-based shipping company, DHL International Ltd. Marking to market is stating the current value of an instrument.

Phillip Ameen, vice president and controller of General Electric Co., Fairfield, Conn., said that "while the SEC has valid concerns [about derivatives trading], some financial executives would have preferred that it took more time and wait to see what FASB will do with derivatives disclosure."

The new SEC rule would be tougher than a derivatives-accounting rule that the Financial Accounting Standards Board, the chief private-sector rule-making body for accountants, issued late last year. The FASB rule encourages, rather than requires, companies using derivatives as a hedging device to quantify the risks of holding the contracts if certain market conditions develop.

But the FASB recently disclosed that it is considering additional proposals on derivatives that some business executives say would make it difficult for companies to hedge financial positions. Under one FASB view, companies buying currency futures to lock in the costs of purchasing equipment abroad would be required to mark such futures to market every quarter. Most hedgers would prefer to figure the gain or loss from hedging into the cost of the machinery, to be depreciated on the balance sheet over future years.

Separately, federal bank regulators are working on derivatives-trading guidelines to ensure that bank derivatives officers don't expose their employers to excessive risk for their own short-term gain. The Office of the Comptroller of the Currency said last week that traders' compensation, which is usually linked to short-term performance, also should be tied to the long-

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