A Guide to Narrow the Derivatives’ Understanding Gap and Reduce Losses: How to Increase Knowledge, Controls, and Reporting

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Derivatives allow corporations to insulate themselves from, amplify, or otherwise modulate the impact of changes in interest and exchange rates and commodity, equity, and real estate prices... Even changes in statutory income tax rates can be hedged against... Corporations can increasingly determine the market and legal environment in which they will operate. If clever and careful enough, a corporation can avoid the chaos of the real world... and enter a private “derivative reality,” a synthetic world purged of risks it deems undesirable.¹

Despite the risk-free nirvana described above, derivatives have played a role in the collapse of England’s most venerable bank,² the bankruptcy of the richest county in California,³ and a financial leader facing lawsuits and sanctions⁴ due to losses by its large, supposedly sophisticated clients.⁵ Why is there such a huge chasm between the ideal and the reality?⁶ Critics claim that

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¹ I would like to thank my parents for their unconditional support and Professor Morgan Shipman for his advice, assistance, and entertainment.


⁴ Saul Hansell, Bankers Trust and U.S. Set Pact on Disclosure of Derivatives’ Risk, N.Y. Times, Dec. 6, 1994, at A1 (describing an agreement with the Federal Reserve Bank to increase disclosures); Saul Hansell, Settlement by Bankers Trust Unit, N.Y. Times, Dec. 23, 1994, at D1 (reporting that Banker’s Trust (“BT”), the nation’s seventh largest bank, “agreed to pay a $10 million fine to settle charges that its securities unit hid the extent of a client’s losses from trading derivatives”).


⁶ Recently derivatives disasters have made numerous headlines. See, e.g.,
these breakdowns must be addressed or the entire financial system will be in jeopardy. Proponents claim that these losses were instead caused by knowledge and internal control breakdowns and do not indicate that derivatives are inherently dangerous or require legislative action. In spite of losses, public concern, and Congressional threats, derivatives use continues unabated due to superior profit potential and risk management flexibility.


9 The Orange County bankruptcy made it very clear that derivatives can affect citizens without substantial portfolios who neither knew nor cared about what new innovations Wall Street was concocting.

10 In 1994, Congress considered, but did not pass, a number of bills to regulate derivatives. See, e.g., *Markey Says Kidder Events Show Derivatives Oversight Needed*, 26 Sec. Reg. L. Rep. (BNA) No. 32, at 1112 (Aug. 12, 1994). Recently, however, there has been considerably less interest in legislative action. See discussion infra Part II.

creation and use of derivatives show no signs of slowing down, the most important issue to be resolved is how best to close the "understanding gap" and minimize losses and ensuing litigation. The purpose of this Note is to recommend immediate action to be undertaken mostly by the private sector to effectively utilize derivatives. A lesser role is envisioned for public and private regulating bodies to ensure consistency in reporting in order to protect the investing public and market stability.

Part I of this Note will begin by describing derivatives and why they are so valuable, as well as risky. The difficulties of legislative action and regulation will then be discussed in Part II, concluding that wide-scale regulation, though a desirable goal, may be premature. Part III will detail an immediate proposal to enhance the safety of derivatives with efforts by market participants and regulatory bodies. The major provisions of this proposal include: (1) increased participation and expertise by directors and senior management; (2) clear, properly enforced derivatives policies; (3) strengthened internal control systems; (4) adequate resources and training provided to personnel; (5) full disclosure of policies and methodologies to financial statement users; and (6) implementation of consistent accounting and disclosure standards by the appropriate private and public regulatory bodies. The legal consequences of participants' failure to act will also be briefly discussed. Finally, Part IV will apply this short-term solution to recent derivatives catastrophes to test whether it would have prevented or mitigated them.

I. BACKGROUND

A derivative is a financial contract whose value is derived from an underlying asset, rate, or index. These "underlyings" include stocks, bonds, commodities, interest rates, foreign currency exchange rates, financial product indices, and other assets, including other derivatives. Despite this rather abstract definition, a common example of a derivative contract occurs when a farmer, worried about what the price of his crop might be in six months when it

at 64, 64. However, estimates as to the size of the derivatives market are often misleading because the total value of all derivatives ignores that these contracts frequently are held by the same party in offsetting positions—so the risk is only the difference. Global Derivatives Study Group, Derivatives: Practices and Principles 28, at 53–54 (Group of Thirty Report eds., 1993).


An example of one of these indices is the Standard and Poor 500.

GENERAL ACCT. OFF. REP., FINANCIAL DERIVATIVES: ACTIONS NEEDED TO PROTECT THE FINANCIAL SYSTEM, 24 (May 1994) [hereinafter GENERAL ACCT. OFF. REP.].
is harvested, enters into a futures contract to lock in a price now. Although these instruments have grown increasingly complex, the basic types of derivatives are forwards, futures, options, and swaps. Further, all derivatives have characteristics of either option or forward contracts, or some combination thereof.

Option-based derivatives have elements of traditional option contracts. They provide the holder with the right “to buy or sell an underlying financial instrument, foreign currency or commodity” at a specified price in return for a premium paid to the counterparty, the option writer. Option-based derivatives are one-sided because only the holder has the opportunity to exercise the option and benefit from favorable price movements. Therefore, the option holder has limited risk while the option writer has unlimited exposure. For example, a manufacturing company which needs oil for its operations may desire an option to purchase a given quantity of oil at a certain “strike” price at some date in the future, in case of an oil embargo or conflict in the Middle East. In this way, the manufacturer is able to control a risk over which it otherwise would have no control and thus concentrate on the business at hand. If the price of oil decreases, the manufacturer will simply let the option expire; it has incurred the

15 Because futures are traded on an organized exchange, the Chicago Board of Trade, the farmer need not seek out a counterparty with needs counter to his or her own to make this transaction. However, the price of this contract will depend on the demand for a counter position, as well as other market factors. For example, another company which depends on the farmer’s crop for its livelihood—say a canning company—may also wish to lock in a certain price for the produce, guaranteeing a profit at a specified selling price. This company would “gain” if the market price of the produce rose above the futures price on the date of delivery.

16 One study found more than 1200 derivative products currently available. See Jerry W. Markham, “Confederate Bonds,” “General Custer,” and the Regulation of Derivative Financial Instruments, 25 SETON HALL L. REV. 1, 2 n.4 (1994).

17 Futures, like forwards, obligate the holder to buy or sell for a specific amount, but are primarily traded on organized exchanges in standardized contracts. See GENERAL ACCT. OFF. REP., supra note 14, at 5.

18 Swap contracts “are agreements between counterparties to make periodic payments to each other for a specified period.” Id.


20 See id.

21 Many option writers, however, usually hedge their positions by selling an opposite position to another end-user.

22 The strike price is the price at which the option is exercised. See FINANCIAL INSTRUMENTS TASK FORCE, AMERICAN INST. CERTIFIED PUB. ACCT., DERIVATIVES—CURRENT ACCOUNTING AND AUDITING LITERATURE 12 (1994) [hereinafter AMERICAN INST. CERTIFIED PUB. ACCT.].
premium paid on the option as its “insurance” cost. On the other hand, if the price of oil soars, the manufacturer will be able to purchase its much needed oil at well under the market price. Other commonly used option-based derivatives include interest rate caps, floors, collars, and embedded written options.

Forward contracts bind one party to buy and the counterparty to sell a “financial instrument, foreign currency, or commodity at a future date” and at a specified price. Forward-based derivatives contain traditional forward characteristics. Forwards are two-sided contracts because they provide the holder as well as the writer with both the benefits of favorable price movements and exposure to loss from unfavorable price movements. Also, there is typically no payment at contract inception. A forward contract may be used when an American importer contracts to purchase German machinery payable in German marks upon delivery one year from the contract date. The importer may wish to lock in a U.S. dollar cost for the equipment in its machinery budget. Thus, the importer “may enter [] into a foreign exchange forward contract to purchase the exact amount of marks needed to pay” for the equipment on the date of delivery. The importer will avoid a loss if the dollar cost of German currency increases by the date of delivery.

Commonly used forward-based derivatives include futures, forwards, and swap contracts. The aforementioned building blocks of forward and option-based derivatives are

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23 Interest rate caps, floors, and collars are combinations of individual interest rate options which enable holders to limit rate increases (capping the rate) or decreases (putting a floor on the rate) on floating rate instruments, or both, by using a “collar.” See id. at 12-13.

24 These options embedded in contracts may be exercised by the counterparty issuer if certain events occur, and may increase risks assumed by the end-user. Because embedded options and other variations may affect the amount, rate, or payments, there exists the “potential to produce higher cash inflows or outflows than similar instruments that do not contain the... feature.” Id. at 17. Typical examples are often termed hybrid securities, or “debt with embedded interest rate risk management derivatives.”


25 Molvar & Green, supra note 19, at 57.

26 See id.

27 That is, unlike in the case of an option contract, no premium for writing the instrument occurs at inception.


29 See id.

30 Id.

31 See GENERAL ACCT. OFF. REP., supra note 14, at 26-27.

32 See Molvar & Green, supra note 19, at 57. These derivatives include a myriad of derivations, like basis, foreign currency, and equity swaps.
often combined, resulting in more complex products like swaptions. Unique features of derivatives often include little or no cash flows at inception, no principal balance or other fixed amount to be paid or received, and "potential risks and rewards substantially greater than the amounts recognized in the statement of financial position."35

Many derivatives are relatively straightforward, traded on an exchange or a central clearinghouse, and heavily regulated and controlled. Exchange-traded derivatives are standard as to amount and duration and include "futures, certain options, and other standardized contracts." These derivatives can be purchased by simply contacting a broker and are guaranteed by the exchange or a related clearinghouse. However, the most complex, fastest growing, and potentially disastrous derivatives are privately traded over-the-counter ("OTC"), with a counterparty who is not an organized exchange. OTC derivatives have no clearinghouse, largely escape regulation, and contain no guarantees of contract performance. OTC derivatives are negotiated and

33 Primarily used for interest rate risk management, a swaption is an option on a swap which entitles the holder to "the right to enter into an interest rate swap in the future," and which can be exercised to either pay or receive a fixed interest rate. SMITHSON ET AL., supra note 24, at 368.

34 This feature makes the derivative attractive to end-users but also creates accounting problems because traditional accounting is cash-based, so many derivatives are not accounted for in the body of the financial statements where they are most useful for investors. See infra Part III.B.1.

35 AMERICAN INST. CERTIFIED PUB. ACCT., supra note 22, at 5.

36 Derivatives, however, are certainly not risk-free. See infra Part IV.A (discussing Barings Bank's collapse due to foreign currency trading).

37 The Commodity Futures Trading Commission ("CFTC") and the Securities Exchange Commission ("SEC") scrutinize the futures and options exchanges. In addition, they have "broad authority to monitor transactions," require registration and financial disclosures, and intervene in the marketplace to maintain fair, orderly trading if necessary. See Markham, supra note 16, at 2 n.6 and accompanying text.

38 AMERICAN INST. CERTIFIED PUB. ACCT., supra note 22, at 7.


40 In general, OTC derivatives, unlike those traded on an exchange, do not offer physical settlement, standardized terms, liquidity, or transparency. See SMITHSON ET AL., supra note 24, at 389.

41 OTC derivatives can be privately negotiated between two counterparties with a financial institution acting as an intermediary.

42 Hu, supra note 39, at 1465.
customized to meet the specific needs of the end-user,\textsuperscript{43} using variations on
terms or combining derivatives.\textsuperscript{44} Countless digressions are also possible,
requiring the end-user to take action or the derivative to change terms if certain
conditions or specified events occur.\textsuperscript{45} These modifications allow specific
tailoring to meet a user's planned needs and risk profile, but they make the
derivative much more difficult to value, assess for risk, properly account for,
and understand. Complex OTC derivatives comprise the primary focus of this
Note, although much of the discussion applies equally to exchange-traded and
“plain vanilla” derivatives. Because of the frequent lack of standardization and
liquidity,\textsuperscript{46} as well as the fluctuation of underlying indicators, the value of
derivatives is difficult to measure and more volatile than traditional financial
instruments.\textsuperscript{47} Indeed, many OTC dealers utilize a staff of mathematicians and
Ph.D.s with supercomputers to create and evaluate derivatives. Products named
“mambo combo,” “rambos,” “geishas,” “surf and turn,” and “death-backed
bonds”\textsuperscript{48} fail to give confidence in these financial rocket scientists’ sanity, let
alone competence.

A. Users and Uses

Derivatives are used to manage risk, to seek a profit, or to obtain lower
financing or transactions costs, although in practice it is sometimes difficult to
distinguish between these objectives.\textsuperscript{49} Generally, end-users seek counterparty

\textsuperscript{43} Noted derivatives expert and consultant Charles Smithson states that “OTC
products have expanded the number of tools available for hedging risk by offering
longer maturities, greater position size, cash settlement, and overall better customized
payoffs.” SMITHSON ET AL., supra note 24, at 389.

\textsuperscript{44} An example is the combination of a currency swap and an interest-rate swap,
which “allows the end-user to manage more than one risk simultaneously.” AMERICAN
INST. CERTIFIED PUB. ACCT., supra note 22, at 1.

\textsuperscript{45} See id. at 20. Examples of complicated variations which may be added to the
derivative contract include: increases or decreases in the notional amount based on
certain changes in interest rates, increases or decreases in interest rates based on a
multiplier, additional payments required under specified conditions, and settlement
payment required upon the expiration of a contract. See id.

\textsuperscript{46} Liquidity of derivatives depends on the size of their secondary markets, which
decreases as the products become more tailored and have longer terms. See Booth,
supra note 8, at 519. This lack of liquidity can be true for exchange-traded derivatives
as well as OTC derivatives.

\textsuperscript{47} See id.

\textsuperscript{48} Glenn Alan Cheney, FASB Wins for Speed, Not Scope, on Derivatives, ACCT.
TODAY, Nov. 7, 1994, at 12; see also Waldman, supra note 12, at 1027.

\textsuperscript{49} See SMITHSON ET AL., supra note 24, at 61–62.
broker/dealers to purchase or write derivatives to meet their specific needs. The OTC derivatives market is generally limited to large end-users,\(^{50}\) including not only commercial and financial institutions but also government entities,\(^ {51}\) nonprofit organizations,\(^ {52}\) and institutional investors like pensions plans and mutual or hedge funds.\(^ {53}\) OTC derivatives dealers include a short list of securities firms,\(^ {54}\) insurance companies, and large money-center banks.\(^ {55}\) This concentrated group of dealers provides some liquidity to the OTC market by its activity.\(^ {56}\) These dealers will have many of the same purposes as end-users, but also earn income by meeting the demand for derivatives.

1. Risk Management

Enterprises are exposed to, and attempt to control, a variety of risks.\(^ {57}\) Derivatives are largely used to manage interest rate, foreign exchange, and commodity price risks.\(^ {58}\) The heightened demand for derivatives accompanied fundamental changes in global financial markets and international trade. This

\(^ {50}\) A few years ago, the average contract size for interest rate swaps was $30 million. See Hu, supra note 39, at 1465 n.29. Therefore, private investors lack the capital, expertise, and clout to enter the OTC market by negotiating directly with dealers; however, there are certainly some very wealthy private individuals who fall into this category and invest in derivatives. See Thomas C. Singher, Regulating Derivatives: Does Transnational Regulatory Cooperation Offer a Viable Alternative to Congressional Action?, 18 FORDHAM INT'L L.J. 1397, 1403-04 (1995).

\(^ {51}\) See Singher, supra note 50, at 1403. Governmental entities include federal, state, and local governments and branches thereof.

\(^ {52}\) Although the discussion herein repeatedly refers to for-profit organizations, local governments and pension funds are of equal or even greater concern due to their potential detrimental effect on the noninvesting public. Thus, all principles discussed apply equally to nonprofit organizations.

\(^ {53}\) See Singher, supra note 50, at 1404.

\(^ {54}\) An affiliate is usually formed to conduct derivatives activity to avoid minimum capital and other regulatory requirements. See infra Part II for an explanation of the complex regulatory scheme and players.


\(^ {56}\) GENERAL ACCT. OFF. REP., supra note 14, at 5.

\(^ {57}\) Risks generally faced by all business organizations include interest rate, foreign exchange, commodity price, credit, liquidity, theft, catastrophe, competitive/strategic, and business cycle. See FINANCIAL ACCT. STANDARDS BD., A REPORT ON DELIBERATIONS, INCLUDING TENTATIVE CONCLUSIONS ON CERTAIN ISSUES, RELATING TO ACCOUNTING FOR HEDGING AND OTHER RISK-ADJUSTING ACTIVITIES (1993) [hereinafter FASB REPORT].

\(^ {58}\) See id.
was coupled with the relatively recent trend of increased volatility in interest and foreign exchange rates as well as stock and commodity prices. Confronted with such market movements, users of derivatives are primarily motivated by the desire to mitigate or capitalize upon this volatility. Attempts to alter risk may be made at a general or more specific level. Derivatives can be used to manage portfolio risk or in hedging against risk of loss from adverse price or rate fluctuations that may occur in owning or owing items (assets, existing liabilities, firm commitments to buy or sell, and anticipated, but not contractually committed, transactions such as purchases, sales, or the issuance or refinancing of debt) over a period of time.

2. Lower Funding Costs

Another important use of derivatives involves the reduction of transaction

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59 See GENERAL ACCT. OFF. REP., supra note 14, at 24. Foreign exchange rates became increasingly volatile after the Bretton Woods system of fixed currency rates was abandoned by the industrialized nations shortly after the United States ended the gold standard. See id. at 24 n.1. Today, currency rates fluctuate according to supply and demand. See id. at 24. Similarly, interest rate volatility has increased since the Federal Reserve changed its policy controlling interest rates. See id. at 24 n.2. Finally, price volatility exposures encountered by various organizations are partially attributable to the “growth in international commerce and finance.” Id. at 24.

60 See id. at 99. Hedging activities of groups of assets and liabilities is termed “dynamic portfolio management,” and “characterized by the continuous assessment and periodic adjustment of the risk in groups of assets, liabilities, and binding commitments of an enterprise.” Id. This cost-effective technique is commonly used because it takes “maximum advantage of naturally offsetting positions in the portfolio and . . . adjust[s] only for the portfolio’s net remaining exposure.” Id.

61 Hedging typically refers to a strategy of entering transactions or financial positions whose primary purpose and effect is to protect an enterprise from potential losses by reducing its exposure to price risk. An enterprise enters into a hedging relationship by acquiring or creating an instrument . . ., or combination of instruments, whose changes in value are expected to move inversely with the changes in value of the instrument or position being hedged . . .. Transactions or positions that reduce the risk of loss also may reduce the potential for gains.

FASB REPORT, supra note 57, at 6.

62 See John E. Stewart, The Challenges of Hedge Accounting: The Explosion of New Hedging Instruments Has Outpaced Accounting Guidance, J. ACCT., Nov. 1989, 48, 48 (defining hedging as “the act of taking a position in a hedging instrument—such as in the futures, forward, options or swap market—opposite to an actual position that’s exposed to risk”).
costs and tax burdens, and the avoidance of regulations. Some derivatives allow users to attain more desirable financing by working with other participants to take advantage of differences in the rates at which they can borrow money. This use may allow a company with a lower credit rating to swap its floating interest rate for a desired fixed rate which it could not have otherwise attained except at a premium. In addition, the use of hedging techniques described in Part I.A.1 can actually enhance the credit rating of a borrower, so banks will lend to them at lower rates. Derivatives are often the most cost-effective method for users to achieve their goals because of the reduced transaction costs and leverage offered. Instead of purchasing or selling the actual underlying asset, synthetic financial instruments are created which achieve the same results without encountering the transaction costs or regulatory limitations. Most important, these derivatives are often far less expensive, but herein also lies risk. An investor need only put down a fraction of the value of the underlying security given a certain capital base, encouraging overextension and increasing exposure in an attempt to recoup losses.

3. Derivatives for Profit

Speculation and arbitrage opportunities in derivatives are primarily

64 See GENERAL ACCT. OFF. REP., supra note 14, at 29.
65 See id.

For example, a company with a medium credit rating may wish to protect against rising interest rates by obtaining fixed rate borrowing but may not wish to pay the higher interest rate normally paid by companies of its credit quality. The company may be able to arrange lower fixed rate financing by first obtaining a floating rate loan and then entering into a swap contract with a higher rated counterparty.

Id.

66 See id. at 25.
67 See id.
68 Synthetic instruments are the result of a strategy linking two or more distinct instruments whose collective characteristics resemble those of a prototype instrument. See FASB REPORT, supra note 57, at 99.

69 Unlike exchange-traded derivatives, many hybrid derivatives securities escape collateral requirements and receive favorable accounting treatment, because they do not fit within the existing regulatory or accounting systems. See SMITHSON ET AL., supra note 24, at 426.

70 This leveraging feature can bring big profits or even larger losses. See Evans, supra note 11, at 65.
71 A market participant speculates by “assum[ing] risk in attempting to profit from anticipating changes in market rates or prices.” GENERAL ACCT. OFF. REP., supra note
undertaken by dealers and very sophisticated investors, who also employ hedging techniques to limit their loss exposure. Dealers earn fees and commissions by advising their clients on risk management and writing derivatives contracts to meet these needs. Tax and regulatory "arbitrage" enables the firm to earn a risk-free profit by exploiting differences in tax and/or regulatory environments. Tax and regulatory avoidance is also facilitated by derivatives which escape definitional schemes of governing rules.

B. Risks of Derivatives

Categories of derivatives-related risks include credit, market, legal, 

14, at 25.

Arbitrage capitalizes on price differentials in the same instruments between markets or exchanges, generating a modest profit for the trader while making the markets more uniform and efficient.

Thus, dealers can earn profits whether trading on their own account or simply facilitating transactions for various parties. The financial institution at the center of much of the legal debate about derivatives, Bankers Trust, derived the majority of its earnings from aiding its clients in managing financial risk and from its own trading of derivatives and other assets for its own account. See Bankers Trust N.Y. Corp., 1994 ANNUAL REPORT 15-16 (1995); see also discussion infra Part III.C.

Tax and regulatory arbitrage differs from traditional arbitrage between markets. See supra notes 72-73.

SMITHSON ET AL., supra note 24, at 253-55. This is usually accomplished by "an 'unbundling,' in effect, of currency and interest rate exposure from the tax rules." Id. However, this use of derivatives represents a very small portion of the derivatives market and has been curtailed by regulatory changes in the United States and abroad.

Avoidance of an entity's own policies is also possible in this fashion. For example, a fund manager whose portfolio guidelines limit him to the purchase of dividend-paying common stock may purchase an equity-based derivative whose value is contingent upon nondividend-paying stocks. See, e.g., Cohen, supra note 55, at 2005.

Credit risk, a familiar concept, is the loss which would occur if the counterparty "fail[ed] to meet its financial obligations under the contract." AMERICAN INST. CERTIFIED PUB. ACCT., supra note 22, at 5. This risk is often measured as the replacement cost or "current market value of an identical" derivative. Id. Credit risk is greatly reduced when derivatives are traded on an organized exchange where protections include margin requirements and daily settling of open positions, among others. See id. End-users of OTC derivatives, on the other hand, must fully research the counterparty's financial stability and be concerned with settlement risk, the exposure which arises when "a counterparty . . . fail[s] to perform under a contract after the end-user has delivered funds or assets." Id. Settlement risk may be limited by master netting agreements. Id. at 6.

Market risk accounts for "economic losses due to adverse changes in the fair
control, and systemic. This Note will primarily focus on control risk and systemic risk. Control risk is also termed operations risk and "broadly refers to the risk that losses will occur as a result of improper or undesired functioning of trading or management systems." Adequate understanding by management and internal controls can minimize control risk. The risk which most legitimates government involvement is systemic risk, the threat that financial markets may be undermined by derivatives activity.

Harsh critics of derivatives see them as a threat to the entire financial system because they act as bridges between the various markets, which have become increasingly volatile. A General Accounting Office ("GAO") report stressed that the United States OTC market is controlled by only "fifteen major U.S. dealers that are extensively linked to one another, end-users, and the exchange-traded markets." Because of these close interrelationships, the report concluded that "the sudden failure or abrupt withdrawal from trading of any one of these large dealers" could present serious risks to the liquidity of the

value" of derivatives, and encompasses price risk, liquidity risk, and valuation or model risk. Id. Price risk is driven by changes in the underlying interest rates, foreign exchange rates, and "other factors that relate to market volatilities." Id. Basis risk describes "the differing effects market forces have on the performance or value of two or more distinct instruments used in combination." Id. Liquidity risk is the risk that a holder may not be able to sell or close out a derivative position, thus affecting its value adversely. See id. This risk is higher with OTC derivatives because of the lack of standardization. Valuation or model risk relates to "the imperfections and subjectivity of models and the related assumptions used to value derivatives." Id.

Legal risk reflects the chance that a derivatives-related contract may be unenforceable due to legal or regulatory action. This risk might arise, for example, because of poor contract drafting, adverse tax law changes, or statutory action prohibiting derivative activity. See id. Although at one time this was a significant threat to many OTC derivatives, particularly regarding netting agreements, many industry experts, including the Federal Reserve, attacked the problem, and legal risks have been somewhat decreased. For a discussion, see David M. Lynn, Comment, Enforceability of Over-the-Counter Financial Derivatives, 50 Bus. Law. 291 (1994).

Control risk reflects loss exposure resulting from inadequate (or nonexistent) "internal controls to prevent or detect problems... hindering] an end-user from achieving its operational, financial reporting, or compliance objectives." AMERICAN INST. CERTIFIED PUB. ACCT., supra note 22, at 6. The understanding gap is included in internal control weaknesses, i.e., the end-user does not know enough about derivatives activity to design and monitor proper internal control systems. See id.

At least thirteen types of risks have been associated with derivatives. See Cohen, supra note 55, at 2006-13.

Singher, supra note 50, at 1343.

See GENERAL ACCT. OFF. REP., supra note 14, at 15.

Id. at 7.
market, and to other players involved—including federally insured banks and
the financial system in its entirety.\textsuperscript{85} Pointing to recent debacles and
uncontrolled incidents like the taxpayer bailout of the savings and loans and the
October crash of 1987, naysayers call for immediate and strong regulation.\textsuperscript{86} It
is interesting to note that despite concern about possible systemic breakdown,
"[t]he GAO did not propose restricting any derivative products or limiting their
use."\textsuperscript{87}

Derivatives’ supporters downplay the risks involved, insisting that
derivatives actually make the markets more stable\textsuperscript{88} and efficient because of
their volatility and interconnectedness.\textsuperscript{89} Another systemic advantage of
derivatives cited is that market linking may reduce financial disruptions by
simply “spreading the disturbance among more firms and markets.”\textsuperscript{90}

II. LEGISLATION AND REGULATION DIFFICULTIES

The following has been a typical pattern in the United States financial
community: after new, attractive financial instruments are developed which
make multi-millionaires out of some wise or lucky participants, the popularity
of these instruments grows absent complete understanding of risk potential.\textsuperscript{91}

\textsuperscript{85} Id.

\textsuperscript{86} See id. The GAO’s principal recommendation is to subject insurance companies
and brokers to the same strict examinations and regulations, including capital rules, as
federally insured banks. Other recommendations include enhancing accounting
standards, forcing end-end-users to have better controls, and fostering international
harmony and cooperation. See id. at 15–16.

\textsuperscript{87} Hansell, supra note 7, at D1, D9. After the Barings collapse, both Greenspan
and SEC Chairman Levitt defended derivatives and denied the need for regulation. See
Roger Fillion, Greenspan Calls for Calm on Derivatives, CHI. SUN-TIMES, Jan. 6,
1995, at 50.

\textsuperscript{88} The joint study by the Federal Reserve, the FDIC, and the Comptroller of the
Currency inferred that international and inter-market linkages may have a stabilizing
effect. Using the 1992 European currency crisis as an illustration, the study noted that
“it is unlikely that the underlying markets would have performed as well as they did in
September without the existence of related derivatives markets that enabled currency
positions to be managed, albeit with some difficulty in some instruments.” Fed.
DEPOT INS. CORP., DERIVATIVE PRODUCT ACTIVITIES OF COMMERCIAL BANKS, IN
JOINT STUDY CONDUCTED IN RESPONSE TO QUESTIONSPOSED BY SENATOR RIEGLE ON
DERIVATIVE PRODUCTS 4, 18 (Jan. 27, 1993).

\textsuperscript{89} During testimony before a House subcommittee, Chairman Greenspan called the
risk of a taxpayer bailout “negligible.” See Saul Hansell, Derivatives Get a Key

\textsuperscript{90} Booth, supra note 8, at 519.

\textsuperscript{91} For a discussion of futures and options—themselves derivatives—leading to the
What follows are significant financial crises through fraud or market movement which attract governmental attention. Finally, some type of response is formed, which usually results in an organized exchange or registered dealer associations and heavy regulation to protect the financial system and investing public. In this fashion, the instruments are then standardized and ceilings and floors are designed to moderate volatility and ensure adequate capital for losses, decreasing credit and legal risks. However, the impetus and primary benefit of most OTC derivatives is their flexibility and unique nature, making it problematic for a standardized exchange or clearinghouse to be created without destroying the fundamental advantage of the products.

Legislative or regulatory action concerning derivatives is complicated by a number of factors. Because many derivatives do not fall neatly under an existing definition or regulatory scheme, there are a myriad of public and private organizations currently involved in a part of the derivatives market, many of which have different regulatory philosophies as well as specific practices. Additionally, the derivatives market is international in scope, and any long-term solution must involve a transnational effort to be effective. Intra- and international jurisdictional issues would have to be settled to achieve creation of the Chicago Board, see Louis Engel & Henry Hecht, How to Buy Stocks 221-47 (8th ed. 1994).

Although OTC products necessarily involve heightened credit risk, the ability to customize the notional amount, strike price, maturity date, and exercise features without regard to margin requirements or position limits attracts end-users with individualized needs. See Robert J. Schwartz, Swaps and Other Derivative Instruments, in Swaps and Other Derivatives in 1995, at 9, 76 (Practicing Law Institute ed., 1995).


For a thorough examination of the various public and private agencies with roles in derivatives, as well as recent legislative proposals, see Singher, supra note 50, arguing against regulation and legislation.

As previously mentioned, OTC derivatives dealers are primarily large banks, securities or commodities dealers, and insurance companies. The banking institutions are regulated by the Federal Reserve ("Fed"), the Office of the Comptroller of the Currency ("OCC"), the FDIC, and the Office of Thrift Supervision ("OTS"). Only the Fed and the OCC have expressed interest in derivatives activity to date. The two regulatory bodies with primary responsibility for the regulation of financial instruments are the SEC and the CFTC, which regulate securities and commodities futures and options, respectively. It is often difficult to ascertain under which, if any, umbrella a new financial instrument belongs. See, e.g., Chicago Mercantile Exch. v. SEC, 883 F.2d 537, 539 (7th Cir. 1989). Finally, because insurance companies are regulated on a state-by-state basis, regulations may vary significantly.
uniform regulation. A related issue is that customized derivatives were invented in this country, and any regulation must attempt to maintain the competitive edge of the United States. Regulatory attempts that dampen financial creation and innovativeness will do so to the detriment of U.S. interests. The demand for these instruments will not lessen, so dealers will merely be driven offshore. The derivatives market is very new and some fallout is to be expected. Although there is legitimate concern that those who create these instruments do not fully understand the full range of possibilities associated with their creations, regulators can certainly not be immediately expected to fully appreciate the complexities either. Until the understanding gap is considerably narrowed, heavy-handed regulation might fail because of inability to keep up with the pace of new invention. Absent a thoughtful and comprehensive definition and scheme, financial wizards can find and capitalize upon loopholes in the same fashion as tax experts. Experience may be the best teacher concerning the new products.

This is not to say, however, that nothing should be or is being done to tackle the problem of derivatives. In an effort to avoid legislation, six of the largest Wall Street derivatives dealers have formed the Derivatives Policy Group and developed voluntary dealer guidelines in conjunction with the Securities Exchange Commission (“SEC”) and the Commodity Futures Trading Commission (“CFTC”). Although this is a welcome and much needed step, the guidelines are only voluntary and many derivatives dealers are not members of this group. In addition, the SEC, the Office of the Comptroller of the Currency (“OCC”), and the Financial Accounting Standard Board (“FASB”) have recently announced modest, new requirements—mostly focusing on

97 See Cohen, supra note 55, at 2027–28. Cohen contends that derivatives “evolve too quickly to be encompassed in any kind of regulatory net” and that their real challenge is “the difficulty they pose to the orthodox and increasingly irrelevant regulatory structure.” Id. Cohen concludes that because derivatives need no costly federal oversight, the patchwork of federal and state regulations of banking, securities, and insurance should be reconsidered and largely dismantled.
98 They are CS First Boston, Goldman Sachs, Morgan Stanley, Merrill Lynch, Salomon Brothers, and Lehman Brothers.
99 This report includes provisions for regular risk disclosure to counterparties and voluntary reporting to the requisite agencies on the management of the firms’ own derivatives risks. See DERIVATIVES POLICY GROUP, A FRAMEWORK FOR VOLUNTARY OVERSIGHT OF THE OTC DERIVATIVES ACTIVITIES OF SECURITIES FIRM AFFILIATES TO PROMOTE CONFIDENCE AND STABILITY IN FINANCIAL MARKETS (1995).
100 Most notably absent are the much beleaguered Bankers Trust and the entire insurance industry.
increased disclosures—but promise continued efforts.\textsuperscript{101} Despite early efforts,\textsuperscript{102} Congress now appears unlikely to pass any significant legislation restricting derivatives activity or creating a new regulatory agency.\textsuperscript{103} This reprieve may be only temporary, however, so derivatives market participants should continue and even increase voluntary action.

Despite large-scale losses, Congress and regulators should tread warily. Minimum capital requirements,\textsuperscript{104} clearinghouse proposals,\textsuperscript{105} new regulatory agencies, suitability requirements,\textsuperscript{106} and registration and new rules for

\begin{itemize}
  \item \textsuperscript{101} See infra Part III.B for a discussion of reporting and accounting regulations.
  \item \textsuperscript{102} After continued derivatives loss headlines, Congress appeared poised to enact some legislation in this area. See, e.g., Derivatives Limitations Act of 1995, S. 557, 104th Cong. (1995) (prohibiting banks and other federally insured financial institutions from engaging in speculative derivatives trading); Risk Management Improvement and Derivatives Oversight Act of 1995, H.R. 20, 104th Cong. (1995) (proposed by Congressman Leach, this bill would have created a Federal Derivatives Commission, strengthened powers of federal banking regulators, amended existing laws to encompass derivatives activity, and authorized the Federal Reserve to approve a derivatives self-regulatory agency of dealers). Perhaps due to recent elections, however, as well as Congressional testimony recommending caution, the prospect for passage is now doubtful. See infra note 103.
  \item \textsuperscript{103} See Pamela Atkins \& Niles S. Campbell, \textit{Congress Unlikely to Break New Ground with Banking Bills; Reg Review Rolls On}, [1996] Daily Rep. for Executives (BNA) No. 25, at C-1, C-3 (Feb. 7, 1996). House Banking Committee Chairman Leach noted that “recent efforts by the OCC and SEC have pushed financial derivatives legislation off the front burner for this year.” Id. Representative Leach also noted, however, that future “legislation still may be needed” particularly in the areas of accounting practices and “forming an interagency council to develop regulation applying to all financial institutions and derivatives products.” Id.
  \item \textsuperscript{104} Minimum capital requirements would require a derivatives dealer to be collateralized at a certain percentage of either the dealer’s notional amount of derivatives or value at risk.
  \item \textsuperscript{105} As discussed supra Part I, a clearinghouse mechanism facilitates strict regulation and daily settling and largely eliminates the risk of default because the clearinghouse itself is the counterparty to the transaction.
  \item \textsuperscript{106} Suitability requirements in the derivatives context would demand that dealers evaluate the capability of the counterparty to understand, independently evaluate, and bear the risks of a transaction. Legal scholars are currently divided as to whether suitability rules would be detrimental or are needed. See, e.g., Jennifer A. Frederick, \textit{Note, Not Just for Widows \& Orphans Anymore: The Inadequacy of the Current Suitability Rules for the Derivatives Market}, 64 FORDHAM L. REV. 97, 139 (1995) (“The duty to determine suitability should be placed on investment professionals who understand [these] complex derivatives,” and suitability requirements should be included in adopted versions of the Derivatives Oversight Act and the Derivatives Supervision Act, which “provide for cooperative regulation of the derivatives market[.]”); Geoffrey
\end{itemize}
derivatives dealers may eventually be necessary, but wide-scale action at this time may do more harm than good. Effective capital requirements require a more uniform and accepted method of calculating market value and risk than is currently the case. Various federal agencies, private think tanks, and industry groups have made considerable progress on potential solutions, but this work should be further developed before any legislation is enacted.

III. IMMEDIATE STOPGAPS TO IMPLEMENT

The most significant threat to derivatives dealers and users right now is the "understanding gap" between investors and market participants, and the requisite knowledge needed to successfully invest in derivatives. This understanding gap was the natural result of the phenomenal growth of derivatives products and technology, which outpaced management and investor knowledge, as well as the existing control and regulatory systems. Most, if not all, of the well-publicized derivatives disasters are attributable to a lack of understanding of the risks of the products and the market and an appreciation of the importance of internal controls. Furthermore, accounting for derivatives and disclosure requirements does not give financial statement users sufficient information with which to properly assess derivatives activity and management's capabilities. If this existing state of affairs continues, so will losses and litigation. This gap, however, can be closed voluntarily with a modest effort by participants in the derivatives market, along with some assistance from public and private governing bodies.

A. Internal Control Systems and Policy

1. Broker/Dealers

Although wide-scale regulation is as yet premature, certain actions can be

B. Goldman, Note, Crafting a Suitability Requirement for the Sale of Over-the-Counter Derivatives: Should Regulators "Punish the Wall Street Hounds of Greed?", 95 COLUM. L. REV. 1112, 1159 (1995) (advocating "a limited two-tier suitability requirement" to require of dealers disclosure only for "sophisticated investors" but "a stronger, affirmative suitability" duty of dealers vis-à-vis other end-users); Daniel G. Schmedlen, Jr., Note, Broker-Dealer Sales Practice in Derivatives Transactions: A Survey and Evaluation of Suitability Requirements, 52 WASH. & LEE L. REV. 1441, 1474 (1995) (stating that antifraud provisions apply under the Commodity Exchange Act and federal securities laws and are sufficient to protect investors; furthermore, suitability requirements are unnecessary due to market pressures and thus potentially harmful). 107 For example, some of the most well-respected and oft-cited research regarding derivatives has been done by Paul Volcker's Group of Thirty.
taken by sellers and traders of derivatives in order to limit losses, avoid litigation, and perhaps stave off legislation. Many of the largest derivatives dealers have “voluntarily” agreed to enhanced controls and disclosures to customers and regulatory agencies. The most important control over derivatives traders is to ascertain that their trades will be properly accounted for, so that performance can be properly monitored. This requires complete segregation of duties between the “front office,” where derivatives are created, traded, and sold to clients, and the “back office,” which records derivatives transactions and monitors positions. Clearly delineated roles, exposure and position limits, and proper supervision of traders should also be established and closely monitored on a continual basis.

Another peculiarity of traders which enhances the likelihood for over-aggressiveness is the compensation scheme. Traders are rewarded for short-term performance and seldom rewarded with long-term contracts. Thus, job security as well as bonuses are tied to short-term profits, which may actually encourage traders to sacrifice the long-term stability of their organization. Due to the highly leveraged nature and unparalleled upside potential of some derivatives, they are the most obvious choice for zealous traders seeking quick profits. One solution would be to reward long-haul performance and sign traders to longer-term contracts. In addition, the concern about federally insured deposits at banks and protecting customers’ accounts in case of derivatives losses is legitimate and calls for separate entities or subsidiaries for derivatives trading.

Despite the fact that internal control improvements are in the dealers’ best interests, excessive optimism may be misplaced despite recent proposals due to the lengthy history of faulty controls at many of the largest and most respected Wall Street firms and banks. Whether this refusal to learn from past mistakes

108 See Richard Lapper, Report Calls for Broad Reform of Derivatives: Barings Collapse Triggers Proposals for Big Changes by Futures Industry Group, FIN. TIMES (London), June 20, 1995, at 25. This proposal is aimed at improving internal controls and increasing transparency in the exchange-traded markets. Id. For discussion of private activity on the OTC front, see supra note 95 and accompanying text.

109 Id.

110 In fact, the OCC is currently drafting a set of rules which “would tie traders’ compensation packages to long-term performance by the institution, rather than to quarterly profits and losses.” James Srodes, Warning Labels, FIN. WORLD, Jan. 2, 1996, at 16. However, this agency’s jurisdiction is currently limited to banks.

111 See Kurt Eichenwald, Learning the Hard Way How to Monitor Traders, N.Y. TIMES, Mar. 9, 1995, at D1, D5 (describing the Barings incident as indicative of an industry’s lax practices). Noted failures which were or should have been apparent to management included incidents at E.F. Hutton, Drexel Burnham Lambert, Salomon Brothers, Prudential-Bache Securities, and Kidder Peabody. See id.
is an unfair characterization or simply an unavoidable symptom of the unbridled, high-pressure competition associated with financial markets is moot. Some type of regulatory assurance that internal controls are adequate is essential and not overly intrusive.

2. End-Users

A fundamental premise of this Note is that nonfinancial companies as end-users should never enter into derivatives for speculation or any purpose other than risk management. Particularly in the case of public companies, investors and creditors make investment decisions on the basis of the particular core operations of organizations. If investors wish to speculate in the derivatives market, they may do so with their own funds. Investors view derivatives as a cost and are skeptical, as they should be, of management’s ability to run a derivative profit center. Corporate treasurers usually do not have the expertise necessary to speculate successfully on derivatives, nor is this their function, particularly in light of losses by so-called experts. Finally, heavy involvement in derivatives may divert and impede management’s focus on its central areas of operations, particularly in the case of important financial personnel.\footnote{112 This idea is from the commentary of Paul J. Isaac, a noted investor and former chief economist at a major securities firm. See Paul J. Isaac, Using Derivatives: What Senior Managers Must Know, HARV. BUS. REV., Jan.–Feb. 1995, at 33, 40.}

Decisions to use derivatives for risk management must be made from the top of the organization, including the chief executive officer, senior management, and the board of directors\footnote{113 This term includes their counterparts in not-for-profit and governmental organizations, although for illustrative purposes this Note will focus on profit-seeking organizations.} or a committee thereof.\footnote{114 For a summary outline of suggestions from various public and private bodies regarding derivatives controls, see Brandon Becker & Francois Mazur, Risk Management and Internal Controls, in 1 27TH ANNUAL INST. ON SEC. REG. 351 (Practicing Law Institute ed., 1995).} This is not to say that senior management must actually calculate the numbers themselves, but they must accept responsibility to research fully and review the company’s investments and risk management. In order to generate profit, risk is a necessary evil of capitalism. Some risks, however, may be so removed from the industry, expertise, and control of a company and its customers that it behooves the company to work to minimize these peripheral risks, such as foreign currency volatility.

The first step is to assess and attempt to quantify risk in light of the company’s overall strategic objectives. Next, management should decide which risks warrant attempts at mitigation, keeping in mind that there are other means
besides derivatives to manage risk. Industry experts recommend using relative probabilities and ranges rather than single value estimates, and stress determining what drives the risk.\textsuperscript{115} Risks which are driven from the same parameters should be grouped together so that organizations may internally net out the minimal risk number requiring external risk management devices.\textsuperscript{116} Because the decision to utilize derivatives requires a serious commitment and potential loss exposure, derivatives should be used only if they are necessary and will be beneficial. Although this is often true, the process of deciding whether derivatives will work and at what amount must not be short-circuited or the consequences may be devastating. In addition, initial and continued risk analysis is beneficial from an overall business standpoint, as well as helpful, in understanding the goal of derivative use as merely supportive of the organization's central operations.

After deciding to use derivatives, senior management and the board should implement clear, written guidelines demarcating policies of the company, lines of authority, and levels of review. The policy must be clearly explained and fully enforced. The board of directors may decide to appoint a special committee or perhaps independent experts to assess and review underlying derivative policies, control procedures, changing market conditions, and the potential risk exposure therefrom, as well as portfolio balance and activity. Involvement leading to informed decisions by the board of directors and senior management is likely to improve performance or, if losses occur, serve as evidence in support of top management in case of litigation.\textsuperscript{117}

The internal controls are of the utmost importance and must include proper segregation of duties, education, and training of the finance department, communication and review by senior management, and maintenance of computer systems capable of recording, tracking, and valuing derivatives.

The financial staff should be responsible on a daily basis for the derivatives portfolio and is vital to the successful use of derivatives to manage the company's risk. Therefore, hiring decisions, communication, and training are important. Essential characteristics include education, technical competency,

\textsuperscript{115} Many ideas in this section were considered after reviewing suggestions in two valuable sources. See Isaac, \textit{supra} note 112, at 33; J. Carter Beese Jr., \textit{The CEO's Guide to Derivatives}, CHIEF EXECUTIVE, Mar. 1994, at 92.

\textsuperscript{116} See \textit{supra} note 115.

\textsuperscript{117} In general, the business judgment rule states that as long as a director acts in good faith and with due care in the procedural sense, the director will not be found liable even though the decision itself was not that of the ordinarily prudent person. The procedural due care test will be met if the director takes appropriate steps to become informed about the derivatives and the company's activity in particular. See, \textit{e.g.}, Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).
knowledge of the organization’s overall objectives, and integrity. Although big decisions are made from the top, the financial staff should be involved as much as possible so as to understand its role in the strategic goals of the company. Better decisions will be made if traders and others understand the reasons behind their hedging activity, such as facilitating entry into a new, international market. If the financial staff sees the big picture, it may be able to think creatively and devise better solutions. Personnel must be given adequate resources as well, including training or consultation with experts about the risks and opportunities of derivatives.

The most important resource may be a computer system which can record, track, and value the portfolio on a daily basis. A recent study has shown that end-users are woefully lacking in technical as well as managerial expertise. Technology has increased so that various scenarios can be run by the system and analyzed. In this fashion, the company can examine its portfolio given the worst case, as well as more likely scenarios, to ascertain that the company is aware of and willing to live with the downside potential. This function may be performed in-house, on-line, or contracted to outside experts, similar to actuaries who service pension plans for companies.

Although this proposal may be objected to because the counterparty dealers have the state-of-the-art computer systems to price and assess portfolio risk, end-users must understand the inherent conflict of interest between themselves and their counterparties. End-users must recognize that dealers have their own profit motives which are usually served, regardless of whether the end-users’ “needs” are met. By increasing the derivatives complexity and customizing it to the end-user’s needs, a dealer may decrease competition and increase its profit margin. Furthermore, there are times when a dealer needs to cover an exposed position and has an incentive to write a derivative which may or may not be the wisest choice for the end-user. Only by maintaining an independent pricing, valuation, and risk measurement system can end-users ensure that their needs are met. Additionally, daily tracking of the portfolio can minimize losses by allowing early recognition, adjustment, and, if necessary, exit from exposed positions.

As previously stated, prudent end-users are not involved in derivative activity to turn a profit. Thus, significant gains as well as losses should be

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118 See Joanne Morrison, News and Trends: Survey Finds Corporations are Lagging Financial Firms in Gauging Value at Risk, THE BOND BUYER, Dec. 12, 1995, at 24 (reporting a survey that concluded that 66% of respondents did not “have an adequate understanding or the necessary in-house expertise to effectively measure value at risk”).

avoided. If either sharp gains or losses occur, top management should investigate existing controls, making sure there is no speculation or guidelines which have been violated. Reassessment of types of derivatives and positions held should also be reexamined to ascertain that any unforeseen risks are closed.

Furthermore, it is crucial that the compensation schemes of the company’s finance department and traders responsible for derivatives do not contain profit incentives which would undermine the company’s risk management policies. In other words, trading profits on derivatives should never result in a bonus or raise. Perhaps a risk-conscious compensation plan could be developed instead, basing bonuses on how well the risk was managed or how close to estimates the derivatives portfolio ended.

Finally, the control structure must be routinely monitored by both internal and external auditors. The audits should include internal control testing of computer systems and compliance with the end-users’ policies. The results of these audits should be reported to the audit committee of the board of directors and the results of the external audit should be included in the organization’s annual report.

B. Financial Reporting, Disclosure, and Audit Guidelines

Investors, creditors, and other financial statement users rely upon consistent accounting and disclosure standards to ensure the reliability, consistency, and comparability of financial statements. Financial statement uses include: evaluation of management, assessment of borrowing power, and selection of investment opportunities. Indeed, one of the fundamental protections for investors to select and monitor their investments is uniform financial reporting.120 Unfortunately, current financial accounting standards do not provide sufficient information about derivatives activity to financial statement users.121 Recent proposals, however, by the SEC and the FASB purport to

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120 See GENERAL ACCT. OFF. REP., supra note 14, at 92. The GAO concluded that the “[e]ffective functioning of our economy depends upon financial information that is widely used being reliable and clearly understood.” Id.

121 See SPECIAL COMM. ON FIN. REPORTING, AMERICAN INST. CERTIFIED PUB. ACCT., IMPROVING BUSINESS REPORTING—A CUSTOMER FOCUS: MEETING THE INFORMATION NEEDS OF INVESTORS AND CREDIDORS 76 (1994):

[U]sers are confused. They complain that business reporting is not answering important questions .... What [innovative financial] instruments has the company entered into, and what are their terms? How has the company accounted for those instruments, and how has that accounting affected the financial statements? What
improve and unify disclosure and accounting standards. This Note concludes that these proposals would make the financial statements more complete and informative and should be adopted immediately. Unlike wide-scale regulation, these proposals would not dictate a code of conduct nor limit any type of product or transactions. Providing relevant information about exactly what type of risk management or profit strategies are being utilized and their impact on an entity will allow statement users to make informed decisions. By increasing transparency and the free flow of information, the derivatives market may develop even further.

1. Flaws, Gaps, and Conflicts in Current Accounting Guidelines for Derivatives

Readability and confidence in the reliability of financial statements is based upon preparers' conformance with generally accepted accounting principles ("GAAP") promulgated by the FASB.122 GAAP includes both accounting for transactions123 within the body of the financial statements and disclosure requirements.124 A primary objective of GAAP is to accurately portray an entity's financial position and activity. Although the accounting guidelines for standardized foreign currency forward and futures contracts have been fairly consistent for some time,125 accounting for options, swaps, and other forward-risks has the company transferred or taken on?

Id.

122 The FASB is an “independent” private authority whose pronouncements have the force of law because compliance with generally accepted accounting principles is necessary to illicit an unqualified audit opinion. Public companies must have annual audits and many private companies must have independent audits as well in order to obtain financing. However, the FASB serves two “clients”; (1) the government or some arm thereof, which threatens to take over the regulation of accounting and auditing if the FASB moves too slowly; and (2) the FASB’s more conservative, private-sector constituents, who pay the bills. The FASB is funded by contributions “from public accounting firms, banks and others in the end-user community, along with corporate gifts,” while document sales and publication subscriptions also generate some revenues. FASB Makes Tentative Decisions on New Approach for Derivatives, 23 Pens. & Benefits Rep. (BNA) 401, 402 (Feb. 5, 1996).

123 See GENERAL ACCT. OFF. REP., supra note 14, at 93. Accounting standards “define how...transactions...should be recognized, measured, and reported in...the financial statements.” Id.

124 See id. Disclosure requirements provide additional quantitative and qualitative data, including information about financing or contractual arrangements, relevant to the interpretation of financial statements in the footnotes to the financial statements. See id.

125 See, e.g., FOREIGN CURRENCY TRANSLATION, Statement of Financial
based derivatives remains dreadfully inconsistent and has been improving at a slow pace. \(^{126}\) Therefore, financial statement users cannot accurately gauge the use or impact of derivative activity on an entity.

Existing accounting guidance is incomplete, inconsistent, and complex, resulting in financial statements in which the effects of derivative transactions are not transparent. \(^ {127}\) Accounting standards only directly apply to a limited number of derivatives and transactions. \(^ {128}\) Thus, entities must turn to a variety of sources, \(^ {129}\) including nonauthoritative literature, to "determine how to account for specific instruments or transactions." \(^ {130}\) Because of this lack of authoritative guidance, "accounting by analogy" is the informal industry standard, as gaps are filled by accounting practitioners based on their own creativity. \(^ {131}\) Basically, this means that financial statement preparers subjectively account for derivatives based on common industry practices or by attempting to analogize limited, existing standards.

Under this ad hoc approach, a number of analogies are utilized and are indeed defensible, although subject to later challenge; therefore, they are not as reliable as many preparers would like. Of course, entities may utilize the method which most favorably states their financial position. Therefore, many derivatives are carried "off-balance-sheet" regardless of their use, giving financial statement users inadequate and inconsistent information. \(^ {132}\) Even if there is authority on point, the accounting guidance reveals inconsistent

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\(^ {126}\) An SEC accountant has chastised the FASB for the lack of "guidance at all in many areas," and particularly noted that "the accounting literature for swaps is badly outdated." SEC Accountant Sutton Calls for Action on Derivatives, ACCT. TODAY, Dec. 11, 1995, at 14 (citation omitted). The GAO found that no specific accounting rules existed for swaps and options, let alone the multitude of complex hybrid derivatives. See GENERAL ACCT. OFF. REP., supra note 14, at 93.


\(^ {128}\) Foreign exchange contracts and exchange-traded futures contracts are granted hedging treatment by Statements 52 and 80. See id. at ¶ 45; see also supra note 126 and accompanying text.

\(^ {129}\) The only authority on other products is issued by the FASB's Emerging Issues Task Force on an ad hoc basis.

\(^ {130}\) FASB Statement No. 162-B, supra note 127, at ¶ 47.

\(^ {131}\) See id.

\(^ {132}\) See id. at ¶ 45.
treatment for similar hedges, for valuing derivatives, and for assessing risk and measuring hedge effectiveness.\textsuperscript{133} Inconsistent reporting of similar transactions and dissimilar reporting of similar transactions abounds.\textsuperscript{134} Due to these problems, the nature and effects of derivatives are not apparent to financial statement users. The natural result of "accounting by analogy" is reported results which are misleading and lack the transparency needed to provide users with relevant information for decisions.\textsuperscript{135} Entities may or may not have recognized derivative activity in the financial statements; disclosures about the derivatives' rights, obligations, and effects are often omitted or not discernible.\textsuperscript{136}

The FASB's hedging and derivatives accounting project has been four years in the making but is still only a work-in-progress.\textsuperscript{137} The project manager for the FASB admits that there still exists a "knowledge gap" between accountants and the derivatives markets.\textsuperscript{138} Thus, considerable inconsistency exists in accounting for derivatives and, according to some cynics, "in the prospects for improvement."\textsuperscript{139} Part of the problem is that many accounting standards are based on the classic distinctions between assets, liabilities, and equity, which derivatives tend to blur so that they do not fit neatly into the traditional framework.\textsuperscript{140} Derivatives accounting is also complicated by existing hedging criteria which are difficult to apply, and the varying nature of the products and objectives of the users.\textsuperscript{141} The complexity of many derivatives also creates problems in timing and measurement issues of recognition.\textsuperscript{142} Some assert that outdated accounting guidance may actually have an adverse effect on the innovation and effective use of the derivatives market, thus inefficiently stunting the market's growth. After exploring several scenarios to

\textsuperscript{133} See id. at ¶ 46.

\textsuperscript{134} See GENERAL ACCT. OFF. REP., supra note 14, at 93.

\textsuperscript{135} See id. at 94.

\textsuperscript{136} See FASB Statement No. 162-B, supra note 127, at ¶ 48.


\textsuperscript{138} See Halsey Bullen, \textit{Accounting Treatment of Derivatives}, in Minehan & Simons, \textit{supra} note 11, at 17.

\textsuperscript{139} Id. at 18. Bullen notes that although the FASB project began in 1986, fundamental problems still exist due to the double entry nature of an accounting system designed primarily for cash instruments, not those which can fluctuate between asset and liability or debt and equity status. See id. at 17.


\textsuperscript{141} See GENERAL ACCT. OFF. REP., supra note 14, at 94-99.

\textsuperscript{142} See id.
resolve these issues, the FASB issued an exposure draft in June of 1996 regarding consistent accounting standards for all derivatives.

2. Current Required Disclosures: The Next Best Thing?

Despite, or maybe due to, the lack of uniform accounting standards, there has been significant progress in disclosures regarding derivatives. Prompted by continued SEC insistence, the FASB has gradually improved required disclosures of derivatives activity. The 1994 issuance of FASB Statement No.119 offered an important increase in required disclosures to assist investors in making informed decisions. This statement was necessary to supplement FASB Statement No. 105, which did not include derivatives without off-
balance-sheet risk of accounting loss. In addition, FASB Statement No. 119 amended FASB Statement No. 107 to insist that fair value information be presented in a clearer fashion to financial statement users.

The major provisions of FASB Statement No. 119 require the following disclosures: (1) the distinction between instruments held or issued for trading purposes and those for purposes other than trading, (2) the contractual (or notional) amount and nature and terms of all derivative financial instruments—as defined narrowly in the statement; (3) the average fair value of derivatives held or issued for trading purposes during the period should be reported; (4) the net gains or losses from trading activities must be disaggregated and the classes of instruments giving rise to those gains and losses identified; (5) a description of the objectives and strategies for holding and issuing derivatives, identifying the classes of derivatives used in achieving those objectives; (6) the accounting policies for derivatives, and specific disclosures about anticipated transactions hedged with derivatives; and (7) fair value information for "financial instruments" (which excludes some derivatives) presented on the face of the balance sheet or in the footnotes.

The narrow scope of the statement is problematic. To expedite issuance, the FASB chose to focus only on disclosures, rather than substantive accounting policies. FASB Statement No. 119 also applies only to its narrow definition of "derivative financial instruments"; it does not apply to instruments with similar characteristics, like commodity derivatives. Furthermore, the FASB failed to define "such key terms as speculation, risk management, and even hedging," leaving the door open for conflicting interpretations by preparers. A recent study by the FASB reviewing derivatives disclosures after FASB Statement No. 119 demonstrates some compliance but is largely inconclusive.

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149 FASB Statement No. 119 also amended statements Nos. 105 and 107 to require additional disclosures which had previously been optional, mainly whether the derivative is entered into for trading or other purposes, i.e., risk management. Id.

150 Specifically, FASB Statement No. 119 provides that fair value information be presented without aggregating or netting the value of derivatives with nonderivatives, and that assets and liabilities be clearly identified and distinguished. The amendment also demands that disclosures be located in either the body of the financial statements or in the same footnote, along with the carrying amount of related assets and liabilities.

151 See Cheney, supra note 48, at 12.

152 See Steven Woodward, et al., FASB 119 & Derivative Financial Instruments: Disclosure & Fair Value, NAT'L PUB. ACCT., Jan. 1996, at 18, 19. Nor does FASB Statement No. 119 apply to "on-balance sheet items like mortgage-backed securities, interest only and principal only debt[i], . . . instruments indexed to the price of gold, silver or equity securities, . . . and optional features that are embedded in an on-balance sheet receivable or payable." Id.

153 Id.
about the quality of the disclosures.\textsuperscript{154}

3. Recent Proposals for Improving Reporting for Derivatives

Because of the aforementioned inconsistency and incomprehensible nature of derivatives reporting, both the SEC and the FASB have issued proposals addressing disclosures and accounting. Although the SEC's dictates are supreme to those of the FASB, the SEC has traditionally respected the FASB's role in promulgating accounting standards, which have the full backing of the business community even if not the force of law. It remains to be seen how these two proposals will be melded together.

a. SEC Release on Enhanced Disclosures

After a review of company filings which it found deficient, the SEC addressed the deficiencies of FASB Statement No. 119 in a recent proposal.\textsuperscript{155} The SEC acted after concluding that current disclosures were insufficient and users were still "confounded by the . . . complexity of financial instruments."\textsuperscript{156} The goal of this release was to "clarify and expand accounting regulations S-X and S-K" relating to footnote disclosure in interim and annual reports, allowing users "to analyze the potential impact of derivatives to the company's bottom line and shareholder value."\textsuperscript{157}

The proposed amendments have three major thrusts. First, they require enhanced footnote description of accounting policies for material derivatives activity.\textsuperscript{158} As previously described, inconsistency abounds in accounting for derivatives, resulting in a severe lack of comparability among financial reports. Although the SEC has left uniform accounting recognition and measurement

\textsuperscript{154} See Jeffrey P. Mahoney & Yoshinori Kawamura, Financial Acct. Standards Bd., Special Rep. No. 156-A, Review of 1994 Disclosures About Derivative Financial Instruments and Fair Value of Financial Instruments, (1995). The fiscal year ending December 31, 1994 was the first year of implementation of this standard for companies with total assets of $150 million or more; however, most companies involved in derivatives will meet this requirement and were well aware of the impending pronouncement.


\textsuperscript{156} 61 Fed. Reg., supra note 11, at 580 n.23 (quoting Association for Inv. Mgmt. & Res., Financial Reporting in the 1990s and Beyond, at 30 (1993)).

\textsuperscript{157} Dominic Bencivenga, Derivative Disclosure: SEC Rules on Data Required in Annual Reports, N.Y. L.J., Jan. 11, 1996, at 5.

\textsuperscript{158} The materiality of derivatives activities would be measured by their fair values during and at the end of each reporting period. See 61 Fed. Reg., supra note 11, at 579.
standards to be developed by the FASB, required disclosure of accounting methodology should provide users with the information to assess the financial statement impact of derivatives activities and compare various companies' financial reports. The SEC proposal also extends FASB Statement No. 119 disclosures to commodity as well as financial derivatives.

Second, the SEC has addressed FASB Statement No. 119's biggest shortcoming, its failure to require entities to disclose quantitative information about the risks of derivatives. Despite cries from preparers regarding excessive costs and the lack of uniformity in pricing and other models, every organization entering into derivatives uses some models to assess their risks internally. Although consistent risk measurement may not be a reality at this point, entities should disclose their risk calculations along with information about the assets, liabilities, or operations underlying the risk that is being managed. Quantified information regarding the market risks of derivatives would enable users to assess the success of the risk management strategy given the stated objectives. Therefore, the SEC proposal calls for additional disclosures of quantitative and qualitative information outside the financial statements, most notably concerning the all-important market risk, deemed by some the most relevant figure to investors. The quantitative data may be presented using one of three proposed alternatives and should "include the actual dollar investment in derivatives, performance projections and the risk to earnings, fair value and cash flow." This move was prompted by the failure of most companies to

\[^{159}\text{See discussion, infra Part III.B.3.b.}\]
\[^{160}\text{See 61 Fed. Reg., supra note 11, at 579.}\]
\[^{161}\text{See id. Again, however, these disclosures are only "required if any of the following items are material: the fair values of market risk sensitive instruments outstanding at the end of the current reporting period or the potential loss in future earnings, fair values, or cash flows of market risk sensitive instruments from reasonably possible market movements." Id.}\]
\[^{162}\text{The three disclosure alternatives include:}\]
\[^{163}\text{Id.}\]
\[^{164}\text{Bencivenga, supra note 157, at 5.}\]
follow FASB Statement No. 119's recommendation and to provide market risk information, or to do so in a piecemeal fashion in different parts of the financial statements.164 “The . . . qualitative information about market risk [must] include a narrative discussion of . . . a registrant's primary market risk exposures” and how these exposures are managed, including strategies, objectives, and instruments utilized.165

Third, the SEC was kind enough to “remind” registrants that disclosures about “financial instruments, commodity positions, firm commitments, and other anticipated transactions” must be accompanied by “information about derivatives that affect directly or indirectly such reported items, to the extent . . . material and necessary to prevent the disclosure about the reported item from being misleading.”166

Critics of the proposal argue that the disclosures will prove costly, impractical, irrelevant or confusing to users, and detrimental to their businesses by forcing disclosure of competitive advantages.167 Large, decentralized organizations, which may utilize different monitoring systems, claim the quantitative disclosures are too burdensome and would force system changes to accommodate the new requirements.168 Furthermore, the SEC’s view of risk management on a product basis conflicts with a line of business approach taken by many banks.169 End-users claim the required disclosures do not track actual risk management methods used by entities. Specifically because nonderivatives risk management techniques are often used internally but excluded by the SEC proposal, the resulting disclosures may be incomplete or materially misleading.170

The narrative disclosures also draw criticisms from preparers, who claim that it is difficult to put this type of information into a clear format for users and
that the risks do not warrant this high-level treatment. Preparers assert the
proposal would add too much information and disclosures in an already
overburdened financial reporting system, and the required level of detail may
make it harder for investors to understand the company's derivatives use. The
lack of relative ease of a disclosure, however, does not mitigate heavily against
its adoption: if an entity cannot logically explain its derivatives use to investors,
perhaps its policies are in need of review.

Another concern is that the disclosures will give a distorted view of
derivatives activity because of their sheer length. Emphasizing derivatives
exposure may de-emphasize their primary role as risk management tools,
causing derivatives activity to appear riskier and investors to discriminate
against firms which utilize derivatives. More important risks may exist which
should also be discussed in the Management Discussion and Analysis
section. This information may not make statements comparable because
portfolios and positions held vary. The scope of the proposal is also a subject of
contention in the opinion of some end-users, who believe current disclosure
requirements are sufficient, and only financial institutions and derivatives
traders should be required to disclose such information. Nonetheless, an
overwhelming number of experts and investors in these end-user companies
believe this information is crucial for informed investment decisions, as well as
shaping internal policies and attitudes.

Many claim the SEC action was a premature overreaction to a few isolated
abuses. This camp claims that since the implementation of FASB Statement No.
119, voluntary disclosures and reporting have increased with market demand, a
trend that will continue absent SEC involvement. Furthermore, regulation
will only stifle innovation in risk management and reporting, as firms will have
no incentive to develop better models. The most important criticism leveled
against the disclosure of risk valuation methodology is that it will stifle market
innovation and place entities at a competitive disadvantage.

171 This may be particularly challenging for smaller organizations who are not used
to disclosing this type of information.
172 See Bisgay, supra note 167.
173 See id.
174 See Morrison, supra note 167.
175 See id.
176 Although sophisticated derivatives dealers and users maintain internal risk
evaluation and pricing systems, they argue that forced disclosure will destroy their
competitive edge. This zero-sum game, however, between competitors can have very
high stakes even to parties who do not wish to play. Entities using faulty or inferior
models (particularly if not disclosed) can create financial disasters for investors, bank
customers, and all taxpayers. There is a higher marginal utility for society to
disseminate better information, equalize competitive playing fields, and avoid financial
Protesters also assert that the proposed disclosures will place additional burdens on corporations and securities attorneys by introducing a "wave of complex information into the marketplace" and a corresponding wave of shareholder litigation, particularly from increased disclosure and projections in the Management Discussion and Analysis section of the report. On the other hand, noted derivatives expert Professor Hu concludes "[i]n terms of liability, on the whole, disclosing more probably helps you" and these disclosures provide management with the argument that "the public can't argue they didn't know." Furthermore, the SEC has announced its intention to provide a "safe harbor" for forward-looking disclosures along the lines of provisions in the recently enacted Private Securities Litigation Reform Act of 1995. Critics also agree that the SEC should work jointly with the FASB and coordinate efforts before final issuance. Harsher cries can be heard to let the FASB do its own work. However, it was precisely because the FASB was not acting that the SEC intervened in the first place.

In some respects, even this proposal might not go far enough. Registered investment companies and small business companies are exempt from disclosing the qualitative and quantitative information about risk management policies and market risk, although they must disclose their accounting policies for derivatives activity. Therefore, a major class of small investors in mutual funds still would lack important data relevant to investment decisions.

On the whole, the SEC action represents important improvements in derivatives reporting, and should be formally enacted. There is a risk that havoc. Moreover, this is not like forcing one to reveal trade secrets like the Coke formula. Although some pricing and risk strategies may give competitive advantages, issuers and traders still make their money by researching and anticipating market movements, and end-users earn profits in their essential lines of business.

177 See Bencivenga, supra note 157, at 5–6.

178 Id. at 6 (quoting derivatives expert Professor Hu). According to Hu, "[t]he additional disclosure could help companies in shareholder litigation." Id.

179 Id. (quoting attorney Robert Todd Lang, chairman of the American Bar Association's Task Force on Hedge Accounting).


181 See Morrison, supra note 167.


183 The SEC is supported in its efforts by at least one important player. A Federal Reserve Bank of Chicago study concluded that regulators should intervene if companies fail to reveal derivatives holdings and policies willingly. The study concludes that market discipline is insufficient to force voluntary disclosure. Furthermore, controls must be built in to ensure that the disclosures are unbiased and accurate because of the
flooding users with voluminous disclosures may be overwhelming to all but the most sophisticated investor. The most valuable information has always been and should continue to be contained within the financial statements themselves. However, until financial accounting standards are formally improved, these disclosures are the only consistent and reliable information presented to investors, and as such are essential.

b. FASB Responds: A Proposal to Unify Derivatives Accounting

The SEC may have done the FASB a favor by absorbing all of the above criticism. While the business community’s ire was directed at the SEC, the FASB finally issued an exposure draft intended to clarify and standardize accounting for derivatives.¹⁸⁴ This proposed statement concludes that all derivatives are assets or liabilities and requires they be recognized at fair value in the statement of financial position.¹⁸⁵ As previously discussed, many derivatives are reported off-balance-sheet, the rationale given is that they are only a mutual exchange of promises (an executory contract) without any initial transfer of tangible assets or consideration.¹⁸⁶ If historical cost is used to measure and report derivatives, their value is nothing. Using cost, however, is irrelevant and even misleading because derivative positions are rights or obligations that may be settled for cash at any time. Derivatives clearly have a market value, and their volatility argues for inclusion on the balance sheet, not invisibility from the statements. The FASB deemed fair value the most relevant measure for financial instruments in general and “the only relevant measure for derivatives.”¹⁸⁷ Adjustments to the carrying amount of hedged items should reflect offsetting changes in their fair value (gains and losses) arising while the hedge is in effect.

The statement compromised by permitting favorable hedge accounting treatment if a derivative is intended for and designated as a fair value hedge,
cash flow hedge, or a hedge of foreign currency exposure.\textsuperscript{188} Gains and losses resulting from changes in the value of the derivative are accounted for based on these designations and, logically, tied closely with the item being hedged in terms of recognition and timing.\textsuperscript{189} The FASB considered and rejected mark-to-market accounting for all derivatives,\textsuperscript{190} perhaps the simplest approach to implement because it would treat all derivatives equally in a formal sense.\textsuperscript{191} This method was opposed by many financial statement preparers who charged that it would distort earnings and equity and fail to match derivatives with the assets or liabilities they are designed to hedge.\textsuperscript{192} If a derivative does not qualify, however, as a hedge, any gain or loss is recognized in earnings in the period of change.\textsuperscript{193} The FASB acknowledges that its proposal is but an interim step “to address the immediate problems about the recognition and measurement of derivatives while the Board’s vision of carrying all financial instruments at fair value”\textsuperscript{194} on balance sheets continues to be pursued. The draft will be “reconsidered as the Board continues to address the issues in its broad project on financial instruments.”\textsuperscript{195}

The scope of the exposure draft is broad. It applies to all entities and is expanded from past pronouncements, superseding or amending nearly every

\textsuperscript{188} \textit{See id. at ¶ 3 & 11.}

\textsuperscript{189} Changes in the value of derivatives used as fair value hedges for assets, liabilities, or firm commitments are recognized as gains or losses in earnings in the period of change along with the offsetting change in the hedged item. The basis of the hedged item is adjusted accordingly. Cash flow hedges are designed to protect against exposure due to a forecasted transaction's variable cash flows; changes in the hedge's value are recognized in earnings on the projected date of the transaction as part of other comprehensive income. Changes in value of derivatives which hedge against foreign currency exposure of a net investment in a foreign operation may be split. The portion of the change equivalent to a foreign currency transaction gain or loss is reported as part of the cumulated translation adjustment, i.e., reported outside of earnings in other comprehensive income. If there is any remaining change, it is recognized in earnings. \textit{See id. at Summary.}

\textsuperscript{190} One FASB proposal would require that “change in fair value for derivatives classified as a trading activities would be recognized in earnings in the period they occur. Unrealized changes in the fair value of derivatives held for risk management purposes would be recorded as a separate component of equity until realized. All realized gains and losses would be recognized in earnings.” Tate, \textit{supra} note 145, at 22.

\textsuperscript{191} \textit{See id.}

\textsuperscript{192} \textit{See id.}

\textsuperscript{193} \textit{See FASB Statement No. 162-B, supra} note 127, at Summary (stating that nonprofit organizations must recognize changes in the fair value of derivatives as a change in net assets in the period of change).

\textsuperscript{194} FASB Statement No. 162-B, \textit{supra} note 127, at ¶ 42.

\textsuperscript{195} \textit{Id.}
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statement applying to derivatives and hedging. This proposed statement avoids the limited definition of financial instruments previously utilized in FASB pronouncements. Derivatives are deliberately defined using flexible, common characteristics to avoid circumvention by creators of instruments and to anticipate and accommodate future derivative products. The definitional characteristics are broad enough to include financial instruments with embedded options as well as freestanding derivatives.

The proposed statement requires certain disclosures relating to derivatives activity and would completely supersede FASB Statement No. 119. Entities who hold or issue derivatives must disclose their objectives for doing so and any context needed to understand these objectives, as well as their strategies for achieving them. Specific disclosures must include the face or contract amount when necessary to enable investors to understand what the entity is trying to accomplish with its derivatives use; the entity must distinguish between types of hedges and other derivatives. Additional disclosures are required based on each type of hedging activity and for derivatives not designated as hedges. For all hedging activity, the entity must describe the risk management policy, the item being hedged, the classes of derivatives and how they are being used to hedge. Most important, the entity must disclose gains or losses on derivatives and hedges, as well as those gains and losses not recognized, and how these transactions are reflected in the financial statements.

If adopted, the statement would amend FASB Statement No. 52 to permit special accounting for foreign currency forecasted transaction derivatives hedges, and FASB Statement No. 107 to comply with its measurement and disclosure provisions. FASB Statements No. 80, No. 105, and No. 119 would be completely superseded, and the proposed statement would nullify or modify to compliance any conclusions reached by the FASB's Emerging Issues Task Force, a committee designed to deal with emerging accounting issues in a timely fashion but whose pronouncements lack the mandatory character of FASB Statements. See FASB Statement No. 162-B, supra note 127, at Summary.

The distinguishing characteristic of a derivative is that a holder can settle the contract with only a net cash payment, which is determined by reference to changes in the price of an underlying.

See FASB Statement No. 162-B, supra note 127, at ¶ 6 & 69. However, certain instruments or contracts with some derivatives are excluded, e.g., insurance contracts. See id. at ¶ 7.

See id. at ¶ 31.

See id.

See id. (listing the required disclosures for fair value hedges, cash flow hedges, hedges of currency exposure of a net investment in a foreign operation, and nonhedging derivatives).

See id.
If the derivative is not designated as a hedge, the entity must describe the purpose of the activity and disclose the amount of gain or loss recognized during the period and again demonstrate where the resulting amounts are reported in the financial statements. This information must be disaggregated by class, business activity, risk, or other category consistent with the management of that activity. The business community prefers this approach to the single method required in the SEC's proposed disclosures. The SEC apparently is considering adopting more flexible guidelines for qualitative disclosures, perhaps permitting the "management approach" of disclosures based on how companies view their business lines.

The FASB has acknowledged the costs of its proposal and the dissension it has created. As opposed to Congress and the many federal regulatory bodies, the FASB will not promulgate standards unless there is a significant need to do so where the expected benefits would exceed the perceived costs of the additional information provided. Entities may have to incur the expense of changing their accounting systems and policies to comply with this statement. Much of the required information, however, is substantially the same as was previously required so it should be already available to financial statement preparers. Also, the statement does not grant hedging treatment to certain types of risk management strategies, like macrohedging and rollover.

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203 Some synthetic derivatives which may be designed to manage risk do not receive hedging treatment under this proposal.

204 This is somewhat of a retreat from FASB Statement No. 119.

205 See Focus on FASB: SEC Approach to Swaps May Clash with FASB’s, 6 INSURANCE ACCOUNTANT, Mar. 11, 1996, at 10.

206 See id.

207 Compare FASB Statement No. 162-B, supra note 127, at ¶¶ 189–94, with id. at ¶¶ 195–205. Two FASB members dissented because they believed derivatives should be classified only with respect to risk management, using the comprehensive income approach and deferring gains or losses until recognized. The FASB, however, concluded that this approach would make comprehensive income very volatile, perhaps dissuading risk management strategies. On the other hand, the FASB feared that earnings and per share information would be too easily manipulated under this approach because of the liquidity of the derivative market. Management could buy or sell very similar products to generate gains or losses without changing its position. See id. at ¶¶ 195–205.

208 See id. at ¶ 189. Organizations subject to GAAP and financial statement end-users often vehemently disagree as to the relative costs and benefits of the FASB's actions. The FASB also attempts to adhere to a principle of neutrality in promulgating standards, which are to reflect economic realities rather than favor or discourage certain types of transactions. Id.

209 See id. at ¶ 191.

210 See id.
Although comments were received that this statement will further complicate accounting treatment, the FASB seems confident that replacing the existing structure of a variety of statements and other sources of authority used by analogy with a unified standard greatly simplifies accounting. Unsaid is the fact that this standardization stops entities from analogizing to the most favorable financial statement treatment. The FASB finally notes that the proposed statement would actually decrease many of the disclosure requirements previously in effect. The proposal discontinues the need to assess risk at an entity-wide level, which many complained was expensive and difficult. Furthermore, the statement expands hedge accounting treatment to more types of derivatives if certain conditions are met.

This statement eliminates inconsistencies in existing guidelines and should meet its goals by establishing consistent recognition and measurement guidance for all derivative and hedging activities. The result is increased visibility, comparability, and understandability of the risks associated with derivatives while accommodating a reasonable range of hedging accounting practices.

Finally, derivatives are truly a global phenomenon—used, sold, and exchanged in every major market in the world. To achieve comparability and transparency, an eventual goal must be international harmony of accounting reporting standards. Inconsistent practices across jurisdictions can lead to vastly divergent results. For example, Metallgesellschaft showed a profit under American accounting standards but German accounting guidance on the same data and period yielded a loss in the hundreds of millions. The international community should work to agree on a single, practical method of reporting derivatives activity to prevent confusion. Although this is a daunting, long-term project given the various cultures, politics, and varying practices involved, minimum disclosures of reporting methodology would be an easy first step.

C. Legal Risks of Internal Control Failures and Insufficient Disclosure

In addition to business risks which should scare organizations into improving disclosures, internal controls, and policies, another potent motive

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211 See FASB Statement No. 162-B, supra note 127, at ¶ 192.
212 See id. at ¶ 193.
213 See id. at ¶ 194.
214 See id. at ¶ 43. The FASB recognizes this and in 1995 it coauthored a report with representatives of the accounting bodies of the UK, Canada, Australia, as well as the International Accountant Standards Committee. See Jane B. Adams & Corliss J. Montesi, Major Issues Related to Hedge Accounting, FASB SPECIAL REPORT, Oct. 1995.
215 See Petzel, supra note 140, at 108–09.
also exists: the threat of an equally unpredictable loss exposure due to litigation. Because of dramatic losses by companies, investors, and governmental bodies, there has been a corresponding increase in litigation revolving around derivative activities. The defendants in these lawsuits are both end-users and dealers in derivatives. One legal expert has identified the four principal theories driving derivatives litigation as ultra vires, contract, fraud, and suitability claims. After uncovering incriminating tapes by

216 This should be of particular concern to directors of companies. See Meredith M. Brown & James H. Cheek III, Director Liability Under the Federal Securities Laws, 27TH ANNUAL INST. ON SEC. REG. 443 (Practicing Law Institute ed., 1995).

217 Harvard Law Professor Hal S. Scott noted that “by some accounts, at least 30 multi-million-dollar lawsuits involving derivatives are currently in various stages of disposition.” Hal S. Scott, Theories of Legal Liability in Derivative Transactions, in Minehan & Simons, supra note 11, at 19.

218 This should not, however, chase organizations out of the derivatives market, particularly given the realities of a fluctuating, risky marketplace. In Brane v. Roth, 590 N.E.2d 587, 591–92 (Ind. Ct. App. 1992), members of a grain co-operative were awarded damages for management’s alleged failure to hedge adequately the co-op’s position. To be sure, there is a significant distinction between relatively simple, exchange traded commodity positions and more complex OTC derivatives, but this may signal that there eventually might be placed upon management a “duty to hedge” potential loss exposures within certain parameters. For a thorough discussion on hedging and the role of corporate management, see Hu, supra note 1.

219 Ultra vires claims usually assert “that the customer was prohibited by law from engaging in a particular transaction and therefore is not bound by that contract.” Minehan & Simons, supra note 11, at 19. Ultra vires theories have notably been advanced in the Orange County bankruptcy (the California constitution prohibited the transaction because the county’s debt would have exceeded its revenue for the year) and an action by a Chinese company against Lehman Brothers Commercial Corporation (Chinese law prohibited the transaction). See id.

220 According to Professor Scott, contract claims are generally of two varieties. The first type of contract claim is where the party is not bound by the contract due to some factor like economic duress. See id. The second line of contract claims attempts to include prior oral agreements in the contract; if these understandings were not included in the contract, there was no meeting of the minds and thus no contract. See id.

221 Fraud claims in this matter are based both on common law or statutory securities and commodities law.

222 Rules of suitability for derivatives depend substantially on the rules of self-regulatory organizations such as the National Association of Securities Dealers and the New York Stock Exchange. Suitability claims are also based on Rule 10b-5 or a violation of fiduciary duty, and have four elements: (1) the defendant recommended or purchased the investment for the plaintiff; (2) the investment was unsuitable for the plaintiff; (3) the defendant either knowingly or recklessly, thus fraudulently, recommended said unsuitable investment; and (4) reasonable reliance by the plaintiff on
callous Bankers Trust ("BT") employees, Proctor & Gamble ("P&G") upped the ante in its suit against BT by adding racketeering claims under RICO, raising the possibility of triple damages.223 P&G may have lost steam and thus agreed to settle once the judge blocked these claims until after the trial on the original fraud ended.224

In order to prevent litigation or mount an adequate defense, both sellers and end-users of derivatives must be cognizant of this developing area of law and all of its intersections. By implementing the internal controls suggested earlier, including a standing independent committee of the board to vote on highly risky transactions, management may be able to use the business judgment shield or a consent theory in its defense.225 In addition, full disclosure has traditionally been a defense to many actions, most notably fraud. Management should provide investors with all relevant risk strategies, quantified data, and independent audit reports.

Dealers as well must be aware of their responsibilities, even to supposedly sophisticated users. Because they tout expertise and the ability to customize for specific risks as selling features, dealers would be wise to investigate and communicate underlying risks to investors who do not have the state-of-the-art technology of the dealers. Although dealers deny any duty to investors, a number of recent lawsuits demonstrate the risk of litigation. For example, the role of Merrill Lynch in selling Orange County the highly leveraged derivatives portfolio, the losses on which drove the county into bankruptcy, is being questioned in court.226 The dealer which to date has been the subject of the

the recommendation of the defendant in making the investment. Minehan & Simons, supra note 11, at 19.

223 See Kelley Holland et al., The Bankers Trust Tapes, Bus. Wk., Oct. 16, 1995, at 106, 108-09. Excerpts from BT employees discussing the leveraged derivatives sold to P&G include: "we set 'em up [sic]'"; "[t]his could be a massive huge future gravy train"; "they [(P&G)] don't [sic] understand the leverage"; and "[w]e lure people into that calm and then just totally f- 'em [sic]'" (describing derivatives "business" as usual). Id. at 108, 110.


225 Most states impose fiduciary duties of care and loyalty on directors, see, e.g., Smith v. Van Gorkum, 488 A.2d 858, 873 (Del. 1985), although under Delaware law, the standard for finding liability is one of gross negligence. See supra discussion of business judgment rule at note 117 and accompanying text.

most legal action is BT and its subsidiary, BT Securities Corporation.\footnote{BT has been involved with some of the most significant losses and legal actions concerning derivatives, resulting in settlements, fines, sanctions, continuing litigation, and one victory. See, e.g., Gibson Greetings, Inc. v. Bankers Trust, No. C-1-94-620 (S.D. Ohio 1994); In the Matter of BT Securities Corporation, [1994–1995 Decisions] Fed. Sec. L. Rep. (CCH) ¶ 85,477 (Dec. 22, 1994) (SEC); In the Matter of BT Securities Corporation, 1994 CFTC LEXIS 340 (Dec. 22, 1994). See also Kenneth N. Gilpin, $67 Million Settlement by Bankers Trust: Air Products Wins Dispute over Money-Losing Derivatives Deals, N.Y. TIMES, Jan. 25, 1996, at D8; Richard Waters, Bankers Trust Wins High Court Ruling, FIN. TIMES (London), Dec. 4, 1995, at 22.} BT has settled many claims by its customers and also been reprimanded by the federal regulators.\footnote{See Waters, supra note 227, at 22.} BT recently won its first important victory in a London court, where it was deemed not liable for losses suffered by an Indonesian concern.\footnote{See id.}

The most critical derivatives-related case, involving P&G, was recently settled.\footnote{See id. at 109–10.} This case had the potential to go far in defining the responsibilities of derivatives dealers to their customers, including whether suitability requirements would be applicable.\footnote{See Hansell, supra note 224, at D1 (discussing Proctor & Gamble Co. v. Banker’s Trust Co., 925 F.Supp. 1270 (S.D. Ohio 1996)).} P&G claimed that BT fraudulently lured it and other customers into unnecessarily complex derivatives.\footnote{See Saul Hansell, British Court Supports Bankers Trust in Derivatives Case, N.Y. TIMES, Dec. 2, 1995, at 37 (derivatives expert Henry Hu noting the lack of precedent in the area of derivatives litigation and speculating as to the influence BT’s British victory may have upon the litigation).} BT countered that P&G’s sophisticated management made a conscious, albeit risky, choice for which BT was not responsible.\footnote{See Holland, supra note 223, at 108.} The judgment on this issue did not go far enough in shaping derivatives law, practices, and the relative duties of involved parties. Although both sides have claimed victory, it appears that derivatives dealers have again escaped. Nonetheless, this issue is far from resolved, so both end-users and dealers would be wise to commit to writing the explicit terms and understandings of their dealings.

IV. APPLICATION OF ENHANCED INTERNAL CONTROL AND REPORTING TO EXAMPLES

To demonstrate that the above proposal is not just costly, academic nonsense, two of the most significant and publicized derivatives scares will be reviewed and tested. Realizing that hindsight is usually acute, every attempt will
be made to be realistic in application.

A. Barings Bank PLC

Beginning with perhaps the most disastrous and easiest in terms of prevention, Barings appears to have been brought down by one rogue trader. It is naïve, however, to merely blame the chief trader of Barings' Singapore branch, Nick Leeson, rather than examine the astonishingly lax control environment in which he was permitted to operate.\(^{234}\) Although these losses were via exchange-traded derivatives, and thus ostensibly safer, the numerous internal control issues are the same as with OTC derivatives. First and most blatantly, the trading involved was only to be arbitrage, not speculation on the Nikkei.\(^{235}\) The foundation of the internal control system should have been designed to assure that only arbitrage trading occurred. Large losses and gains are uncharacteristic of arbitrage and should have been reviewed by the trader's supervisor and the practice halted.

In addition, trading and loss limits were ignored not only by the trader but apparently by his supervisors as well.\(^{236}\) The handsome bonuses Leeson and his supervisors received for previously successful trades were increased incentive for risk-taking.\(^{237}\) Barings violated the cardinal segregation-of-duties principle by allowing Leeson to perform both the front-office trading function and the back-office recording function.\(^{238}\) Therefore, it was much easier for Leeson to conceal his overrides of management controls.\(^{239}\) Finally, Barings ignored and failed to make public an audit which evidenced the dangerous control environment at the bank.\(^{240}\) Proper internal controls may not have prevented


\(^{235}\) See id. at 44–45. An earthquake in Kobe brought the Nikkei crashing down, at which point Leeson began “doubling down” on his bets in an attempt to recoup his losses. See id. at 45.

\(^{236}\) See id. at 46. Leeson appeared to have operated virtually un-supervised; in fact, were it not for the Kobe earthquake, he would probably still be trading from Singapore. Id. at 42–43, 46.


\(^{238}\) See Chua-Eoan, *supra* note 234, at 46.

\(^{239}\) Apparently, Leeson concealed his losses in a discrepancy account which he set up. THE STRAIGHTS TIMES (Singapore), Sept. 12, 1995, at 25.

Leeson's initial fraud, but they would have detected and halted trading practices and losses. Had it implemented these controls, the bank which helped finance Columbus's expedition would still exist.

B. Procter & Gamble's Big Gamble

Certainly not an investing newcomer, the significant losses sustained by P&G surprised many and resulted in actions by shareholders against management as well as a lawsuit against and countersuit by a derivatives' industry leader, BT.\(^{241}\) Lured into leveraged derivatives by a desire to minimize financing costs in its domestic and international operations, P&G entered into interest rate swaps to convert its fixed rates to floating rates, apparently believing (as did most experts) interest rates would fall.\(^{242}\) Although interest rate swaps are commonly used, the P&G swaps were variations on the "plain vanilla" contract because "[e]very six months, the variable rate it paid would be adjusted according to a very highly complex formula" devised by BT.\(^{243}\) This formula resulted in sharp increases in interest payments.\(^{244}\) Therefore, when the Federal Reserve began raising rates to slow the economy and halt predicted inflation, P&G, like many who bet the same way, lost big.

P&G need not have sustained heavy losses in this case for a number of reasons. First, if P&G had adequate systems to analyze the terms of the derivatives at the inception of the contract, it would have at least recognized the multiplier involved with rate increases. The risk may have exceeded numerical or percentage maximums of company policy following the proposal in Part III of this Note. This information would also have been communicated to senior management and perhaps to the board or an independent committee thereof for a vote. Furthermore, if full reporting and disclosure were required, this information would be presented on the financial statements, and thus to shareholders and creditors. It is plausible, if not certain, that if P&G's top management had been more involved and fully recognized the loss potential, they may have rejected or modified the derivative. Second, even if P&G had not been dissuaded, periodic evaluation of the derivative position would have presented the company with the information to attempt to exit the position early and minimize losses. Third, if P&G relied on the expertise of BT, as they claim, they would make certain that all such agreements were formalized in a written, properly executed agreement. Finally, if P&G had in place the controls

\(^{241}\) See supra note 230.


\(^{243}\) Id.

\(^{244}\) See id.
suggested earlier, they might have been able to mount a solid defense to any shareholder action using the business judgment shield, having fully disclosed the transaction to shareholders and the board.

V. CONCLUSION

Derivatives are an essential tool for the transfer of risks from those unwilling or able to assume them to those more willing or able to do so. Given the realities of volatile domestic and international markets, the proper use of derivatives presents invaluable and unparalleled vehicles for modern entities. While systematic regulation of the derivatives market must continue to be studied and considered, caution is essential in order to preserve U.S. competitiveness and ensure that any regulatory scheme is both effective and efficient.

In the interim, however, immediate steps should be taken to assist and protect financial institutions and end-users of derivatives. Full disclosure, increased understanding and involvement by top management and the board of directors, consistent reporting, and enhanced internal control systems will provide a short-term solution to facilitate informed decisions about risk management and investing. Although the proposed controls are essential to every organization involved in derivatives, many will consider them an unwarranted, costly intrusion into the private realm of management. Nonetheless, because of the need for protection of the investing public, the SEC and other bodies should continue to demand improved accounting and disclosure standards, as well as the issuance of an internal control letter as part of an independent audit. Absent systemic breakdown, future financial disasters can be avoided.