

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 [E]ven changes in statutory income tax rates can be hedged against [C]orporations 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

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

¹ Henry T.C. Hu, *Hedging Expectations: "Derivative Reality" and the Law and Finance of the Corporate Objective*, 73 TEX. L. REV. 985, 986 (1995).

² *Body Blow to Barings*, FIN. TIMES (London), Feb. 27, 1995, at 17.

³ Floyd Norris, *Orange County Crisis Jolts Bond Market: From a Bankruptcy, Fears About Losses*, N.Y. TIMES, Dec. 8, 1994, at D17.

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").

⁵ G. Bruce Knecht, *P&G Amends Lawsuit Naming Bankers Trust: Second Derivative Action Is Added and Company Alleges U.S. Violations*, WALL ST. J., Feb. 7, 1995, at A3 (describing increased demands and allegations by Proctor & Gamble ("P&G")); Steven Lipin, *Bankers Trust Says P&G Deal Wasn't Unique*, WALL ST. J., Nov. 22, 1994, at C1 (reporting BT's response to P&G's complaint); Michael Quint, *Gibson Suit on Trades Is Settled: Bankers Trust Gets 30% of Debt Claimed*, N.Y. TIMES, Nov. 24, 1994, at D1 (settling suit with BT charging that BT led Gibson into risky investments).

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.⁷ 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.⁸ In spite of losses, public concern,⁹ and Congressional threats,¹⁰ derivatives use continues unabated due to superior profit potential and risk management flexibility.¹¹ Because the

Determined Loser, ECONOMIST, Apr. 16, 1994, at 82 (reporting that Kashima Oil lost \$1.5 billion in currency transactions); Michael Siconolfi, *Kidder Discloses Seam in Bonds, Fires Top Trader: It Sets \$350 Million Charge, Says Scheme Involved Government-Strip Deals*, WALL ST. J., Apr. 18, 1994, at A3 (reporting Kidder, Peabody losses of \$350 million in "phantom" derivatives trades); Jeffrey Taylor & Allanna Sullivan, *German Firm Finds Hedges Can Be Thorny*, WALL ST. J., Jan. 10, 1994, at C1; Peter Truell, *Wisconsin Has Big Loss in Derivatives: Officials Play Down Deficit of \$95 Million*, N.Y. TIMES, Mar. 24, 1995, at D1.

⁷ Saul Hansell, *G.A.O. Seeks Sweeping Rules for Derivatives*, N.Y. TIMES, May 19, 1994, at D1.

⁸ Arguing against legislation, Cathy Minehan, the president of the Federal Reserve Bank of Boston, said "[o]ld-fashioned management controls, attention to separation of powers and the use of reasonable conflict-of-interest standards would have spotted every one of those derivative collapses." James Srodes, *Warning Labels*, FIN. WORLD, Jan. 2, 1996, at 16. However, "spotting" is not preventing. See Bryan H. Booth, Note, *Prudence or Paranoia: Considering Stricter Regulation of the International Over-the-Counter Derivatives Market*, 5 DUKE J. COMP. & INT'L L. 499, 526 (1995) (concluding that systemic risk is exaggerated and regulation will do more harm than good).

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.

¹¹ Jay Light, Professor of Finance at Harvard Business School, describes derivatives as the "fastest-growing financial instrument of our time, as measured either by the rate of growth of new contracts or by the amount of existing contracts" and points out that the futures volume trading is several times greater than the trading on the New York Stock Exchange. Jay Light, *The Use of Derivatives*, in Cathy E. Minehan & Katerina Simons, *Managing Risk in the '90s: What Should You Be Asking About Derivatives?*, NEW ENG. ECON. REV., Sep.-Oct. 1995, at 3, 5. "The worldwide notional/contract amounts for [derivatives] increased from \$7.1 trillion in 1989 to \$62.1 trillion in 1994." 61 Fed. Reg. 578, 578 n.6 (1996) (to be codified at 17 C.F.R. pts. 210, 228, 229, 239, 240, and 249) (proposed Jan. 1996). In the United States alone, a low estimate of the derivatives market is \$12 trillion, "more than three times the total assets of all US banks." Richard Evans, *Future Imperfect*, MGMT. TODAY, July 1995,

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.¹² These “underlyings” include stocks, bonds, commodities, interest rates, foreign currency exchange rates, financial product indices,¹³ and other assets, including other derivatives.¹⁴ 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).

¹² Adam R. Waldman, Comment, *OTC Derivatives & Systemic Risk: Innovative Finance or the Dance into the Abyss*, 43 AM. U. L. REV. 1023, 1026 (1994).

¹³ An example of one of these indices is the Standard and Poor 500.

¹⁴ 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.¹⁵ Although these instruments have grown increasingly complex,¹⁶ the basic types of derivatives are forwards, futures,¹⁷ options, and swaps.¹⁸ 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.¹⁹ Option-based derivatives are one-sided because only the holder has the opportunity to exercise the option and benefit from favorable price movements.²⁰ Therefore, the option holder has limited risk while the option writer has unlimited exposure.²¹ 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" price²² 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.*

¹⁹ Roger H.D. Molvar & James F. Green, *The Question of Derivatives: There May Be More Questions than Answers*, J. ACCT., Mar. 1995, at 55, 57.

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,²³ and embedded written options.²⁴

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.²⁵ 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.²⁶ Also, there is typically no payment at contract inception.²⁷ 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.²⁸ The importer may wish to lock in a U.S. dollar cost for the equipment in its machinery budget.²⁹ 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.³⁰ The importer will avoid a loss if the dollar cost of German currency increases by the date of delivery.³¹ Commonly used forward-based derivatives include futures, forwards, and swap contracts.³² The aforementioned building blocks of forward and option-based derivatives are

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." CHARLES W. SMITHSON ET AL., *MANAGING FINANCIAL RISK: A GUIDE TO DERIVATIVE PRODUCTS, FINANCIAL ENGINEERING, AND VALUE MAXIMIZATION* 24 (rev. ed. 1995).

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.

²⁸ *See* GENERAL ACCT. OFF. REP., *supra* note 14, at 26.

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.³³ Unique features of derivatives often include little or no cash flows at inception,³⁴ 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,³⁶ and heavily regulated and controlled.³⁷ Exchange-traded derivatives are standard as to amount and duration and include “futures, certain options, and other standardized contracts.”³⁸ These derivatives can be purchased by simply contacting a broker and are guaranteed by the exchange or a related clearinghouse.³⁹ However, the most complex, fastest growing, and potentially disastrous derivatives are privately traded over-the-counter (“OTC”),⁴⁰ with a counterparty who is not an organized exchange.⁴¹ OTC derivatives have no clearinghouse, largely escape regulation, and contain no guarantees of contract performance.⁴² 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.

³⁹ Henry T.C. Hu, *Misunderstood Derivatives: The Causes of Informational Failure and the Promise of Regulatory Incrementalism*, 102 YALE L.J. 1457, 1465 (1993) (book review). Hu notes that exchange-traded derivatives must be standardized and “generate enough trading to support a liquid market.” *Id.*

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,⁴³ using variations on terms or combining derivatives.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.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,⁴⁶ as well as the fluctuation of underlying indicators, the value of derivatives is difficult to measure and more volatile than traditional financial instruments.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"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.⁴⁹ Generally, end-users seek counterparty

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.

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.

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.*

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.

⁴⁷ *See id.*

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.

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 non-profit 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.

⁵⁵ See Saul S. Cohen, *The Challenge of Derivatives*, 63 FORDHAM L. REV. 1993, 2003 (1995).

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.⁵⁹ 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 risk⁶⁰ or in hedging⁶¹ 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.⁶²

2. Lower Funding Costs

Another important use of derivatives involves the reduction of transaction

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 [H]edging 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.⁶³ 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.⁶⁴ 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.⁶⁵ 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.⁶⁶ Derivatives are often the most cost-effective method for users to achieve their goals because of the reduced transaction costs and leverage offered.⁶⁷ Instead of purchasing or selling the actual underlying asset, synthetic financial instruments⁶⁸ are created which achieve the same results without encountering the transaction costs or regulatory limitations.⁶⁹ 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.⁷⁰

3. *Derivatives for Profit*

Speculation⁷¹ and arbitrage⁷² opportunities in derivatives are primarily

⁶³ See SMITHSON ET AL., *supra* note 24, at 61–66, 271.

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.⁷³ Tax and regulatory “arbitrage”⁷⁴ “enables the firm to earn a risk-free profit by exploiting differences in tax and/or regulatory environments.”⁷⁵ Tax and regulatory avoidance is also facilitated by derivatives which escape definitional schemes of governing rules.⁷⁶

B. Risks of Derivatives

Categories of derivatives-related risks include credit,⁷⁷ market,⁷⁸ legal,⁷⁹

14, at 25.

⁷² 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.

⁷³ 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.

⁷⁴ Tax and regulatory arbitrage differs from traditional arbitrage between markets. *See supra* notes 72–73.

⁷⁵ 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.

⁷⁶ 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.

⁷⁷ 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.

⁷⁸ Market risk accounts for “economic losses due to adverse changes in the fair

control,⁸⁰ and systemic.⁸¹ 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.”⁸² 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.⁸³ 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.”⁸⁴ 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.*

⁷⁹ 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).

⁸⁰ Control risk reflects loss exposure resulting from inadequate (or nonexistent) “internal controls to prevent or detect problems . . . hinder[ing] 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.*

⁸¹ At least thirteen types of risks have been associated with derivatives. *See* Cohen, *supra* note 55, at 2006–13.

⁸² Singher, *supra* note 50, at 1343.

⁸³ *See* GENERAL ACCT. OFF. REP., *supra* note 14, at 15.

⁸⁴ *Id.* at 7.

market, and to other players involved—including federally insured banks and the financial system in its entirety.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.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.”⁸⁷

Derivatives’ supporters downplay the risks involved, insisting that derivatives actually make the markets more stable⁸⁸ and efficient because of their volatility and interconnectedness.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.”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.⁹¹

⁸⁵ *Id.*

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.

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.

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. DEPOSIT INS. CORP., DERIVATIVE PRODUCT ACTIVITIES OF COMMERCIAL BANKS, IN JOINT STUDY CONDUCTED IN RESPONSE TO QUESTIONS POSED BY SENATOR RIEGLE ON DERIVATIVE PRODUCTS 4, 18 (Jan. 27, 1993).

⁸⁹ During testimony before a House subcommittee, Chairman Greenspan called the risk of a taxpayer bailout “negligible.” *See* Saul Hansell, *Derivatives Get a Key Supporter*, N.Y. TIMES, May 26, 1994, at D1.

⁹⁰ Booth, *supra* note 8, at 519.

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,⁹² making it problematic for a standardized exchange or clearinghouse to be created without destroying the fundamental advantage of the products.⁹³

Legislative or regulatory action concerning derivatives is complicated by a number of factors.⁹⁴ 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.⁹⁵ 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).

⁹² 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).

⁹³ See Carrie R. Smith, *OTC Derivatives: Clearing Away the Risk*, *WALL ST. & TECH.*, Feb. 1994, at 48 (discussing the pros, cons, and future potential of clearinghouse mechanisms for certain derivative products).

⁹⁴ 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.

⁹⁵ 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.⁹⁶ 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.⁹⁷ 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 dealers⁹⁸ 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").⁹⁹ Although this is a welcome and much needed step, the guidelines are only voluntary and many derivatives dealers are not members of this group.¹⁰⁰ 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

⁹⁶ See Roy C. Smith, *Risk and Volatility*, WASH. Q., 117, 117 (Autumn, 1995) (discussing recent international crises and regulatory weaknesses).

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.¹⁰¹ Despite early efforts,¹⁰² Congress now appears unlikely to pass any significant legislation restricting derivatives activity or creating a new regulatory agency.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,¹⁰⁴ clearinghouse proposals,¹⁰⁵ new regulatory agencies, suitability requirements,¹⁰⁶ and registration and new rules for

¹⁰¹ See *infra* Part III.B for a discussion of reporting and accounting regulations.

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.

¹⁰³ See Pamela Atkins & Niles S. Campbell, *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.*

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.

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.

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, 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

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,¹⁰⁷ 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.¹⁰⁸ 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.¹⁰⁹ 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.¹¹⁰ 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.¹¹¹ 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.¹¹²

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 directors¹¹³ or a committee thereof.¹¹⁴ 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

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.

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.

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).

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.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.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.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,

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

¹¹⁶ See *supra* note 115.

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, 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.¹¹⁸ 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,¹¹⁹ 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

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").

¹¹⁹ *Integral Development Corporation Announces RiskNet, World's First Derivatives Management System Delivered On-Line*, BUS. WIRE, July 6, 1995, at 10.

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

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 CREDITORS 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

Accounting Standards No. 52, § 162 (Financial Accounting Standards Bd. 1996); ACCOUNTING FOR FUTURES CONTRACTS, Statement of Financial Accounting Standards No. 80, § 15 (Financial Accounting Standards Bd. 1996).

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.

¹²⁷ *See* ACCOUNTING FOR DERIVATIVE AND SIMILAR FINANCIAL INSTRUMENTS AND FOR HEDGING ACTIVITIES, Statement of Financial Accounting Standards No. 162-B, §§ 44-48 (Financial Accounting Standards Bd. 1996) [hereinafter FASB Statement No. 162-B].

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.¹³³ Inconsistent reporting of similar transactions and dissimilar reporting of similar transactions abounds.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.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.¹³⁶

The FASB's hedging and derivatives accounting project has been four years in the making but is still only a work-in-progress.¹³⁷ The project manager for the FASB admits that there still exists a "knowledge gap" between accountants and the derivatives markets.¹³⁸ Thus, considerable inconsistency exists in accounting for derivatives and, according to some cynics, "in the prospects for improvement."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.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.¹⁴¹ The complexity of many derivatives also creates problems in timing and measurement issues of recognition.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

¹³³ See *id.* at ¶ 46.

¹³⁴ See GENERAL ACCT. OFF. REP., *supra* note 14, at 93.

¹³⁵ See *id.* at 94.

¹³⁶ See FASB Statement No. 162-B, *supra* note 127, at ¶ 48.

¹³⁷ See June F. Li, *FASB's Project on Financial Instruments*, OHIO CPA J., Apr. 1995, at 14.

¹³⁸ See Halsey Bullen, *Accounting Treatment of Derivatives*, in Minehan & Simons, *supra* note 11, at 17.

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.

¹⁴⁰ See Todd E. Petzel, *Derivatives: Market and Regulatory Dynamics*, 21 J. CORP. L. 95, 108 (1995).

¹⁴¹ See GENERAL ACCT. OFF. REP., *supra* note 14, at 94-99.

¹⁴² See *id.*

resolve these issues,¹⁴³ the FASB issued an exposure draft in June of 1996 regarding consistent accounting standards for all derivatives.¹⁴⁴

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.¹⁴⁵ Prompted by continued SEC insistence,¹⁴⁶ the FASB has gradually improved required disclosures of derivatives activity.¹⁴⁷ The 1994 issuance of FASB Statement No. 119 offered an important increase in required disclosures to assist investors in making informed decisions.¹⁴⁸ This statement was necessary to supplement FASB Statement No. 105, which did not include derivatives without off-

¹⁴³ These scenarios include: (1) mark-to-market all sides of the hedge; (2) defer recognition of all gains and losses or only to the extent that the hedge is effective; (3) mark derivatives to market with realized gains and losses to earnings and defer unrealized gains of risk management derivatives in a special equity component, a combination of the last two; and (4) derecognition—when an asset is taken off the balance sheet and sold or securitized. See Minehan & Simons, *supra* note 11, at 4.

¹⁴⁴ See Steve Burkholder, *FASB Makes Tentative Decisions on Scope, Definition for New Derivatives Approach*, BNA's Banking Rep., at 162 (Feb. 5, 1996); see also *infra* Part III.B.3.b.

¹⁴⁵ Besides the two important releases described in this section, other agencies are increasing disclosures as well. Beginning in March of 1995, banks have new requirements to be included in their call reports. See Christine Tate, *Derivatives Accounting & Disclosure: What's Next?*, BANK MGMT., May-June 1995, at 16, 24. The new Call Report disclosures are consistent with FASB Statement No. 119 and GAAP, but go one step further by "requir[ing] banks to disclose the income-statement effect of derivatives they use for non-trading purposes." *Id.* This new step is in addition to banking agencies "requiring additional disclosures" for "structured notes and High-Risk Mortgage Securities." *Id.*

¹⁴⁶ See Jay Mathews, *Levitt Pushes Accounting Board on Derivatives Rule*, WASH. POST, Dec. 13, 1995, at F1.

¹⁴⁷ The three most recent disclosure statements include: DISCLOSURE OF INFORMATION ABOUT FINANCIAL INSTRUMENTS WITH OFF-BALANCE-SHEET RISK AND FINANCIAL INSTRUMENTS WITH CONCENTRATIONS OF CREDIT RISK, Statement of Financial Accounting Standards No. 105, (Financial Accounting Standards Bd. 1990); DISCLOSURES ABOUT FAIR VALUE OF FINANCIAL INSTRUMENTS Statement of Financial Accounting Standards No. 107 (Financial Accounting Standards Bd. 1991) (requiring fair value disclosures for some financial instruments, unless not practicable, in which case descriptive information essential to estimating fair value must be disclosed); DISCLOSURES ABOUT DERIVATIVE FINANCIAL INSTRUMENTS AND FAIR VALUE OF FINANCIAL INSTRUMENTS, Statement of Financial Accounting Standards No. 119 (Financial Accounting Standards Bd. 1994).

¹⁴⁸ See FASB Statement No. 119, *supra* note 147.

balance-sheet risk of accounting loss.¹⁴⁹ 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.¹⁵⁰

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.¹⁵¹ 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.¹⁵² 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.¹⁵³ A recent study by the FASB reviewing derivatives disclosures after FASB Statement No. 119 demonstrates some compliance but is largely inconclusive

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 deb[t], . . . 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.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.¹⁵⁵ The SEC acted after concluding that current disclosures were insufficient and users were still "confounded by the . . . complexity of financial instruments."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."¹⁵⁷

The proposed amendments have three major thrusts. First, they require enhanced footnote description of accounting policies for material derivatives activity.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

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.

¹⁵⁵ See *SEC Issues Derivative Accounting Rule*, THE MORTGAGE MARKETPLACE, Jan. 15, 1996, at 1.

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)).

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

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,¹⁵⁹ 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.¹⁶⁰

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.¹⁶¹ The quantitative data may be presented using one of three proposed alternatives¹⁶² and should "include the actual dollar investment in derivatives, performance projections and the risk to earnings, fair value and cash flow."¹⁶³ This move was prompted by the failure of most companies to

¹⁵⁹ See discussion, *infra* Part III.B.3.b.

¹⁶⁰ See 61 Fed. Reg., *supra* note 11, at 579.

¹⁶¹ 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 The three disclosure alternatives include:

- i. Tabular presentation of expected future cash flow amounts and related contract terms categorized by expected maturity dates;
- ii. Sensitivity analysis expressing the possible loss in earnings, fair values, or cash flows of market risk sensitive instruments from selected hypothetical changes in market rates and prices; or
- iii. Value at risk disclosures expressing the potential loss in earnings, fair values, or cash flows of market risk sensitive instruments from market movements over a selected period of time with a selected likelihood of occurrence.

Id.

¹⁶³ 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

¹⁶⁴ See 61 Fed. Reg., *supra* note 11, at 579 (footnote omitted).

¹⁶⁵ *Id.* at 579.

¹⁶⁶ *Id.*

¹⁶⁷ Opposition to the proposal includes Big 6 accounting firms, banks, corporations, and numerous other groups. See *Second Thoughts on SEC Proposal: Revamping Disclosures*, 6 CFO ALERT 9, Mar. 4, 1996, at 1; Paul G. Barr, *Companies Slam Derivatives Disclosure Plan*, PENSIONS & INVESTMENTS, July 8, 1996, at 43; Louis Bisgay, *Trends in Financial Management*, 78 MANAGEMENT ACCOUNTING PRACTICES 1, July 1, 1996, available in 1996 WL 9578183; Joanne Morrison, *Regulation: TMA Tells SEC to Hold Off on Derivatives Disclosure Rules*, BOND BUYER, June 18, 1996, at 31.

¹⁶⁸ See *SEC Deliberating on Final Issues in Derivatives Disclosures Proposals*, 9 CFO ALERT, Sept. 30, 1996, No. 37.

¹⁶⁹ See *id.*

¹⁷⁰ See Morrison, *supra* note 167.

that the risks do not warrant this high-level treatment.¹⁷¹ 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.¹⁷² 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.¹⁷³

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. 11⁵, voluntary disclosures and reporting have increased with market demand, a trend that will continue absent SEC involvement.¹⁷⁴ Furthermore, regulation will only stifle innovation in risk management and reporting, as firms will have no incentive to develop better models.¹⁷⁵ 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.¹⁷⁶

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.¹⁷⁷ On the other hand, noted derivatives expert Professor Hu concludes “[i]n terms of liability, on the whole, disclosing more probably helps you”¹⁷⁸ and these disclosures provide management with the argument that “the public can’t argue they didn’t know.”¹⁷⁹ 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 1995.¹⁸⁰ Critics also agree that the SEC should work jointly with the FASB and coordinate efforts before final issuance.¹⁸¹ 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.¹⁸² 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.¹⁸³ 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).

¹⁸⁰ Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified as amended in scattered sections of 15 & 18 U.S.C. (1995)).

¹⁸¹ See Morrison, *supra* note 167.

¹⁸² See *SEC Seeks Comments on Proposals Concerning Derivatives Accounting*, 23 Pens. & Benefits Rep. (BNA) 100, 101 (Jan. 8, 1996).

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,

tendency to report good news and bury bad. See Jaret Seiberg, *Capital Briefs: U.S. Should Force Derivatives Disclosure Series*, AMERICAN BANKER, Oct. 15, 1996, at 8.

¹⁸⁴ See FASB Statement No. 162-B, *supra* note 127, at ¶ 32. If adopted in its current form, the proposed statement would be effective for fiscal years beginning after Dec. 15, 1997.

¹⁸⁵ See *id.* at ¶¶ 3 & 10. Transition adjustments resulting from adoption are reported in net income or other comprehensive income as the effect of a change in accounting principle. See *id.* at ¶¶ 33-34. The FASB returned to basics by finding in derivatives the essential characteristics of assets and liabilities as defined in FASB Concept Statement No. 6. See *id.* at ¶¶ 53-54.

¹⁸⁶ See *id.* at ¶ 54.

¹⁸⁷ See *id.* at ¶ 55.

cash flow hedge, or a hedge of foreign currency exposure.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.¹⁸⁹ The FASB considered and rejected mark-to-market accounting for all derivatives,¹⁹⁰ perhaps the simplest approach to implement because it would treat all derivatives equally in a formal sense.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.¹⁹² If a derivative does not qualify, however, as a hedge, any gain or loss is recognized in earnings in the period of change.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"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."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

¹⁸⁸ See *id.* at ¶¶ 3 & 11.

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. See *id.* at Summary.

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, *supra* note 145, at 22.

¹⁹¹ See *id.*

¹⁹² See *id.*

¹⁹³ 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).

¹⁹⁴ FASB Statement No. 162-B, *supra* note 127, at ¶ 42.

¹⁹⁵ *Id.*

statement applying to derivatives and hedging.¹⁹⁶ 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.¹⁹⁷ The definitional characteristics are broad enough to include financial instruments with embedded options as well as freestanding derivatives.¹⁹⁸

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.¹⁹⁹ 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.²⁰⁰ Additional disclosures are required based on each type of hedging activity and for derivatives not designated as hedges.²⁰¹ 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.²⁰² 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.

¹⁹⁶ 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.

¹⁹⁷ 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.

¹⁹⁸ 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.

¹⁹⁹ See *id.* at ¶ 31.

²⁰⁰ See *id.*

²⁰¹ 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).

²⁰² See *id.*

If the derivative is not designated as a hedge,²⁰³ 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.²⁰⁴ The business community prefers this approach to the single method required in the SEC's proposed disclosures.²⁰⁵ 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.²⁰⁶

The FASB has acknowledged the costs of its proposal and the dissension it has created.²⁰⁷ 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.²⁰⁸ Entities may have to incur the expense of changing their accounting systems and policies to comply with this statement.²⁰⁹ Much of the required information, however, is substantially the same as was previously required so it should be already available to financial statement preparers.²¹⁰ Also, the statement does not grant hedging treatment to certain types of risk management strategies, like macrohedging and rollover

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.*

hedging.²¹¹ 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.²¹² 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.²¹³

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.²¹⁴ 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.²¹⁵ 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

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.²¹⁶ Because of dramatic losses by companies,²¹⁷ investors, and governmental bodies, there has been a corresponding increase in litigation revolving around derivative activities.²¹⁸ 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,²¹⁹ contract,²²⁰ fraud,²²¹ and suitability claims.²²² 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 “[b]y 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 "[we] lure people into that calm and then just totally f--- 'em [sic]" (describing derivatives "business" as usual). *Id.* at 108, 110.

²²⁴ See *P & G Derivatives Case Hits a Snag: Racketeering Claims Blocked*, HOUS. CHRON., Apr. 6, 1996, at 8; see also, Saul Hansell, *Bankers Trust Settles Suit with P & G*, N.Y. TIMES, May 10, 1996, at D1.

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.

²²⁶ See *County of Orange v. Merrill Lynch & Co.*, Chapter 9 Adversary Proceeding No. 95-01045-JER (filed Jan. 12, 1995); *County of Orange v. Merrill Lynch & Co.*, Chapter 9 Adversary Proceeding No. 95-01045-JER (First Amended Complaint, filed June 6, 1995).

most legal action is BT and its subsidiary, BT Securities Corporation.²²⁷ BT has settled many claims by its customers and also been reprimanded by the federal regulators.²²⁸ BT recently won its first important victory in a London court, where it was deemed not liable for losses suffered by an Indonesian concern.²²⁹

The most critical derivatives-related case, involving P&G, was recently settled.²³⁰ 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.²³¹ P&G claimed that BT fraudulently lured it and other customers into unnecessarily complex derivatives.²³² BT countered that P&G's sophisticated management made a conscious, albeit risky, choice for which BT was not responsible.²³³ 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

²²⁷ 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.

²²⁸ *See* Waters, *supra* note 227, at 22.

²²⁹ *See id.*

²³⁰ *See* Hansell, *supra* note 224, at D1 (discussing *Proctor & Gamble Co. v. Banker's Trust Co.*, 925 F.Supp. 1270 (S.D. Ohio 1996)).

²³¹ *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).

²³² *See* Holland, *supra* note 223, at 108.

²³³ *See id.* at 109-10.

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

²³⁴ See Howard G. Chua-Eoan, *Going for Broke: The Ego of a 28-Year-Old Trader and the Greed of His 232 Year-Old Bank Combine to Destroy an Investment Empire, Stunning the Business World*, TIME, Mar. 13, 1995, at 40, 42.

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 unsupervised; in fact, were it not for the Kobe earthquake, he would probably still be trading from Singapore. *Id.* at 42–43, 46.

²³⁷ See Patrick Weever & Robert Tyerman, *The Futures that Finished Barings*, SUNDAY TELEGRAPH, Mar. 5, 1995, at 6.

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.

²⁴⁰ See Edith M. Lederer, *Bank's Brass Faces Reports of Misdeeds: Mounting Evidence Says Barings Management Ignored Warnings*, HERALD-SUN (Durham N.C.), Mar. 6, 1995, at A1.

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.

²⁴² See Saul Hansell, *A Bad Bet for P&G: Soap Giant Strays into Speculation*, N.Y. TIMES, Apr. 14, 1994, at D6.

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.

