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REMARKS OF

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MANAGING DERIVATIVES USE IN THE 1990'S

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* The views expressed herein are those of Commissioner Beese and do not necessarily represent those of the Commission, other Commissioners, or the staff.

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As you heard this morning, derivatives are complex instruments, sometimes as complicated to understand as they are to use. Nowadays, with all of the recent negative press reports, it can even be hard to tell whether derivatives help market participants by enabling them to hedge risk, or harm them by exposing them to significant leverage and losses.

Complicating the debate is the problem that there is some disagreement on what the term "derivatives" actually means. Fenn Putman, of the Public Securities Association, contends that the term derivatives has been extended to cover almost everything that isn't conventional passbook savings. Whether or not you agree with that assertion, there's no question that lack of understanding about what these products are and how they can be used prudently is the main cause of many of the losses we've witnessed lately.

The real risk with derivatives is not in the products themselves, but in the public perception of how corporations use derivatives. Senior managers need to take the lead in controlling their company's derivatives risk exposure before the public perception of that risk controls them. One means of doing this is through better disclosure and accounting. Another means is if managers monitor the integrity of their company's internal risk control systems. This is the first line of defense--not regulation. Regulation can never take the place of good risk management practices at the individual firm level.

In a sense, derivatives are the Ferrari's of the 1990's marketplace. Sleek and fast-moving, these financial instruments are being created and traded at an Indianapolis 500 pace. But just like any other high performance vehicle, derivatives can only be operated with reasonable safety if speed limits and other rules of the road are observed. Regulators have a responsibility to reassess regulations to make sure that they are flexible and realistic for use in the current market, and that the rules of the road are suited to today's financial vehicles for managing market risk.

<u>The Role of Senior Management</u>

Scanning through the flurry of recent press releases, it's easy to get the impression that derivatives are a blight on the marketplace. Sophisticated end-users that would be expected to max-out on the benefits of derivatives usage have been getting burned lately. A few weeks ago, the press reported that Dell Computer would take a first-quarter charge against earnings because of derivatives trading losses. Toyota announced in February that it lost $935 million in foreign-exchange losses in the last half of 1993. Some press reports have *indicated that Cargill Asset Management may have lost about $100 million, or about one-third of the assets, in its Minnetonka Fund last March.*

The easy way for corporations to avoid getting singed from a derivatives-related loss is to avoid using derivatives altogether. The press reports that Ameritech has decided to take this tactic. It reportedly has stopped all derivatives use pending review by its board of directors next month.

But even while some of the press paints derivatives as accidents waiting to happen, some companies are getting hammered if they do not use derivatives to hedge risk. Compaq Computer, which derives over half of its revenues from overseas markets, has two shareholder suits currently pending against it in federal and state court. Compaq is being sued for failing to disclose that it did not have sufficient and adequate foreign exchange hedging mechanisms to protect the company from substantial foreign exchange risk.

So how are companies to deal with this Dr. Jekyll and Mr. Hyde aspect of derivatives? Studies estimate that over 75 percent of the largest companies in the U.S. today use derivatives. Are these end-users setting themselves up for a blind curve in the marketplace?

Derivatives have been used for years now. A significant risk with derivatives lies with end-users. Recent press reports suggest that most of the larger derivatives-related losses have resulted from transgressions of a corporation's internal controls, and senior management's failure to realize fully the risks of the derivatives it is using. The recent Group of 30 study bears this out. Of the dealers and end-users surveyed, approximately 36 percent had some concern that senior management had an insufficient understanding of derivatives. About 43 percent had some concern regarding over-reliance on a few specialists. Approximately 41 percent of those surveyed were concerned about the gap between front office and back office professionals. That gap raises serious questions about the integrity of the daily pricing process.

With over 1200 types of derivative products on the market, as estimated by the Controller of the Currency, senior managers have a vested interest in getting a better handle on the operation and risk of the derivatives their companies are using. They need to make sure they understand what products their companies are using, as well as *the general strategy for using derivatives. Part of this responsibility involves realizing that there may be variations in how derivatives are priced depending on the dealer and the model used by the dealer. By preparing reserves to account for these differences, senior managers can protect their companies from the potential pitfalls of relying too heavily on a given model.*

Many in the marketplace quantify their portfolio risk by "stress-testing" their models to two standard deviations. But models can have significantly different weighted-average assumptions. So some market participants are now modeling the models and then stress-testing that model. I am going through all of this simply to illustrate that all of that evaluation of risk didn't protect some corporations from sharp movements in the first quarter, or save global money market funds during black Wednesday last year.

Senior management's responsibility doesn't stop at selecting an investment strategy. Especially with these volatile markets, management has to review the actual results of their company's derivatives game plan. This includes assessing whether an intent to hedge risk hasn't changed into a speculative bet to improve profits. Senior managers need to ask tough questions. What's the ultimate downside exposure from using a particular derivative? Is the company keeping enough in reserves to cover potential losses from this exposure? Is it reasonable to continue using a particular derivative instrument given the current market climate? A red flag to any senior manager should be hearing that we made five million on our hedged portfolio last month.

George Soros' testimony before Congress last month underscored the importance of vigilant oversight by senior management. He testified that even the most sophisticated investors--including himself--may not understand all of the risks involved in using the more esoteric derivative products.

In spite of the potential perils of using derivatives, I think it's important to emphasize that many companies do use derivatives successfully. These success stories never make big headlines. Alan Greenspan made this same point last Friday. The recent volatility in the markets has provided a rich testing ground for the internal risk systems of various end-users. In his opinion, at least at this point, the risk management systems of most of the firms seem to have weathered the storm successfully.

Financial Disclosure

Once senior managers get firm control over their company's derivatives use, their next job is to make sure that their company's shareholders know what's going on. If you look at a balance sheet of a company with significant derivatives exposure, even if you read the footnotes, you can't ascertain the financial health of that company. Industry observers, such as Joe Kolman of Derivatives Strategy & Tactics, have been outspoken in the need for clear and straightforward disclosure that investors can actually understand.

There has been a lot of progress in this area since Gerry Corrigan sounded the first warning two years ago. To its credit, FASB has of late moved quickly to improve the financial disclosure of derivatives. Last month, it issued a proposal to require expanded disclosure of derivatives. The proposal also would require end-users to distinguish between derivatives held or issued for trading purposes and those held or issued for risk management or speculation.

MD&A

Derivatives disclosure needs to be improved not only on the accounting side of the equation, but also on the reporting side. However, companies are often unsure what to disclose in their SEC filings because the guidelines are not as clear as they should be. A panel discussion at the Spring Meeting of the ABA Section of Business Law last month highlighted this. The discussion focused on the need for better guidance for disclosing "soft," or forward-looking, information in a company's MD&A. For instance, issuers have to distinguish between the reasonably expected and the less predictable. Once they have identified a trend or uncertainty, they have to make a judgment as to whether it is likely or not reasonably likely to occur.

There is clearly a lot of gray area here, and when complex instruments with potentially large repercussions are involved, such as derivatives, clearer guidelines need to be set forth. Corporations have a responsibility to disclose their derivatives usage adequately and fairly to their investors, but regulators have a responsibility to make sure that these end-users have a roadmap with which to do so. We can and should have some G-30 type of guidelines regarding derivatives disclosure.

Congressional Action

It's particularly important for senior management to take the lead in improving risk management and disclosure before Congress and regulators dictate that there's only one road you can travel. As you know, both Representative Leach and Representative Gonzalez proposed bills earlier this year to regulate derivatives use. Under Representative Gonzalez's bill, banks would be required to provide more financial disclosures for their derivative instruments. Representative Leach's bill would establish federal guidelines for supervision of derivatives activities by all financial institutions, and create a Federal Derivatives Commission to oversee the industry. Recently, the press has reported that Rep. Leach's bill will probably be folded into Representative Gonzalez's bill. The results of this merger are expected to be introduced in the House shortly.

The report by the GAO, which is expected to be released on May 18, may be providing some of the impetus for this legislative action. According to the press, the report is expected to call for greater regulatory oversight of end-users by the SEC. If these rumblings are correct, the GAO report could set off a maelstrom of regulatory oversight, including proposing that the SEC regulate corporate treasury operations in the same fashion that we regulate broker-dealers.

Market players are starting to understand that they will benefit it they take action to police themselves before Congress does it for them. ISDA has been outspoken against legislation that would restrict derivatives use. It has announced its concern that legislation would "create inequities" in the derivatives market. The SIA recently sent a letter to the SEC on behalf of eight of the largest securities firms in the U.S. urging industry self-regulation of OTC derivatives. Under this proposal, securities firms would provide voluntary periodic reports on their derivatives activity with the SEC that would permit regulators to evaluate the risks faced by these firms, as well as the methods used to control these risks.

Regulatory Response

In addition to Congressional and industry action, we regulators are trying to make the regulatory scheme responsive to the needs of the market. Last month, for instance, the SEC proposed amendments *to ensure prudent levels of capital consistent with the current use of derivatives.*

The SEC is also trying to bring the benefits of a competitive marketplace to end-users by facilitating the introduction of derivatives products on the marketplace. The SEC's Division of Market Regulation is working towards developing generic standards to eliminate time-consuming product-by-product approval delays. The goal is to set forth a framework of general criteria to be satisfied, so that individual products that meet these guidelines can be approved upon filing, or maybe even without filing.

There is a big difference between regulation and legislation. Legislation does get set in statutory stone. There's a real danger in that when you are dealing with a rapidly developing and dynamic market. With regulation, if we get it wrong, we can change it within months. Changing legislation within a decade is usually optimistic.

Conclusion

As senior managers steer their corporations down the highway of prudent derivatives use, they need to make sure that they have a clear understanding of where they are going and what alternative routes might exist to get them to the same point. Some may make the route a bit longer, but also possibly safer, and eliminate some of the blind curves. Derivatives are complex instruments, and the models used to evaluate them can be equally complicated. Senior managers have a duty to monitor the investment strategy of their companies to make sure that their companies and shareholders are not unduly or unknowingly exposed to speculative risk.

At the same time, regulators need to do their part to make it possible for senior management to stay on course. Requiring more derivatives disclosure in financial statements is one way of doing this. Another significant contribution by regulators would be to place clear roadmarkers, such as better guidelines for MD&A disclosure, to guide senior managers.

This is a crucial crossroads for market participants and regulators alike. If we work together, we can help minimize any "accidents" in derivatives use, and make derivatives a AAA industry.