**MEMO# 7539**

January 16, 1996

# SEC PROPOSAL ON ENHANCED FINANCIAL STATEMENT DISCLOSURE OF DERIVATIVE FINANCIAL INSTRUMENTS

1 In March of 1995 the SEC issued a concept release requesting comment on how to improve risk disclosure for investment companies. Among other things, the concept release considered application of various numerical risk measures to mutual funds. January 16, 1996 TO: ACCOUNTING/TREASURERS COMMITTEE No. 3-96 CLOSED-END FUND COMMITTEE No. 1-96 INVESTMENT ADVISERS COMMITTEE No. 2-96 SEC RULES COMMITTEE No. 2-96 RE: SEC PROPOSAL ON ENHANCED FINANCIAL STATEMENT DISCLOSURE OF DERIVATIVE FINANCIAL INSTRUMENTS ____________________________________________________________ The Securities and Exchange Commission has proposed amendments to Regulation S-X intended to clarify and expand existing requirements for financial statement footnote disclosures about "derivative financial instruments" and "derivative commodity instruments." The proposed amendments to Regulation S-X, which apply to all SEC registrants, including investment companies, augment existing disclosure requirements under generally accepted accounting principles. The proposed amendments list specific items to be disclosed in the accounting policies footnotes for derivative financial instruments and derivative commodity instruments. In addition, the Commission has proposed amendments to Regulation S-K that will require annual shareholder reports to contain disclosure of qualitative and quantitative information about market risk inherent in derivative financial instruments, derivative commodity instruments and other financial instruments (e.g. structured notes, mortgage backed securities, indexed debt instruments, and interest-only and principal only securities). The proposed amendments to Regulation S-K do not apply to investment companies. The release notes that the Commission is currently considering comments and suggestions on how to improve the descriptions of risk provided to investors by mutual funds and other investment companies.1 Finally, the proposing release reminds all registrants that when they provide disclosure about financial instruments, commodity positions, firm commitments, and other anticipated transactions ("reported items"), such disclosure must include disclosures about derivatives that affect directly or indirectly such reported items, to the extent the effects of such information are material and necessary to prevent the disclosure about the reported item from being misleading. A copy of the Commissions release proposing these amendments is attached. The proposed amendments are summarized below. Disclosure of Accounting Policies For Derivatives The proposed amendments relating to accounting policies would add a new paragraph (n) to Rule 4-08 of Regulation S-X to require disclosure in the footnotes to the financial statements of : each method used to account for derivatives, types of derivatives accounted for under each method, the criteria required to be met for each accounting

method used, the accounting method used if the specified criteria are not met, the accounting for the termination of derivatives designated as hedges or used to affect directly or indirectly the terms, fair values, or cash flows of a designated item, the accounting for derivatives if the designated item matures, or is sold, where and when derivatives and their related gains and losses are reported in the statements of position, cash flows, and results of operations. The disclosure must address accounting policies for both derivative financial instruments and derivative commodity instruments. The term derivative financial instruments has the same meaning as defined in Statement of Financial Accounting Standards No. 119 Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments ("FAS 119"). Derivative commodity instruments is defined in the proposed rule to include commodity futures, commodity forwards, commodity swaps, commodity options and other similar commodity instruments. FAS 119 requires disclosure of accounting policies for derivative financial instruments. The proposed amendments are intended to a) clarify the application of FAS 119 by requiring specific disclosures, and b) expand those disclosures to address derivative commodity instruments. Disclosure of Qualitative and Quantitative Information about Market Risk The proposed amendments create new Item 305 of Regulation S-K requiring disclosure of qualitative and quantitative information relating to derivative financial instruments, derivative commodity instruments and other financial instruments. In complying with the proposed amendments requiring disclosure of quantitative information about market risk, registrants would be permitted to select from one of three disclosure alternatives: 1. Tabular presentation of expected future cash flow amounts and related contract terms categorized by expected maturity dates; 2. 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 33. 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. The proposed qualitative information about market risk would include a narrative discussion of the registrants primary market risk exposures and how the registrant manages those exposures. As noted above, the proposed amendments to Regulation S-K do not apply to investment companies. The amendments will apply, however, to SEC registered entities in which investment companies may invest. Comments are due to the Commission on the proposed amendments by May 7. Please provide me with your comments on the proposals by February 29. My direct number is 202/326-5851 and the facsimile number is 202/326-5853. Gregory M. Smith Director - Operations/ Mutual Fund Accounting Attachment