SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 210, 228, 229, 239, 240, and 249

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RIN 3235–AG42

Proposed Amendments to Require Disclosure of Accounting Policies for Derivative Financial Instruments and Derivative Commodity Instruments and Disclosure of Qualitative and Quantitative Information About Market Risk Inherent in Derivative Financial Instruments, Other Financial Instruments, and Derivative Commodity Instruments

AGENCY: Securities and Exchange Commission.

ACTION: Proposed amendments.

SUMMARY: The Securities and Exchange Commission (''Commission'' or ''SEC'') today is soliciting comment on proposed amendments to Regulation S–X, Regulation S–K, and various forms, including Form 20–F. The proposed amendments are intended to clarify and expand existing requirements for financial statement footnote disclosures about registrants' accounting policies for derivative financial instruments, as defined, and derivative commodity instruments, as defined. In addition, the proposed amendments require disclosure outside the financial statements of qualitative and quantitative information about market risk inherent in derivative financial instruments, other financial instruments, as defined, and derivative commodity instruments. Also, the release reminds 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. In sum, these proposals are designed to make information about derivative financial instruments, other financial instruments, and derivative commodity instruments more useful to investors seeking to assess the market risk inherent in these instruments.

DATES: Comments on the proposed amendments should be received on or before May 7, 1996.

ADDRESSES: Comments should be submitted in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549. Comment letters should refer to File No. S7–35–95. All comments received will be available for public inspection and copying in the Commission's Public Reference Room, 450 Fifth Street, N.W., Washington, D.C. 20549.

FOR FURTHER INFORMATION CONTACT: Cathy J. Cole, Thomas J. Linsmeier, Russell B. Mallett, III, or Stephen M. Swad, at (202) 942–4400, Office of the Chief Accountant, Securities and Exchange Commission, 450 Fifth Street, N.W., Mail Stop 11–3, Washington, D.C. 20549, or Kurt R. Hohl, at (202) 942–2960, Division of Corporation Finance, Securities and Exchange Commission, 450 Fifth Street, N.W., Mail Stop 3–13, Washington, D.C. 20549.

SUPPLEMENTARY INFORMATION: The Commission is proposing to amend Rule 4–08 of Regulation S–X [1] and to add new Item 305 to Regulation S–K.[2] Additionally, the Commission is proposing amendments to Forms S–1, S–2, S–4, S–11, and F–4 [3] under the Securities Act of 1933,[4] and Rule 14a–3,[5] Schedule 14A,[6] and Forms 10, 20–F, 10–Q, and 10–K [7] under the Securities Exchange Act of 1934.[8]

I. Executive Summary

During the last several years, there has been substantial growth [9] in the use of derivative financial instruments, other financial instruments, and derivative commodity instruments.[10] The Commission recognizes that these instruments can be effective tools for managing registrants' exposures to market risk.[11] During 1994, however, some registrants experienced significant, and sometimes unexpected, losses in market risk sensitive instruments due to, among other things, changes in interest rates, foreign currency exchange rates, and commodity prices. In light of these losses and the substantial growth in the use of market risk sensitive instruments, public disclosure about these instruments has emerged as an important issue in financial markets.

During 1994 and 1995, to understand better this emerging issue and to assess current disclosure practice, the SEC staff reviewed annual reports filed with the Commission by approximately 500 registrants. The primary purposes of these reviews were to (i) assess the quality of disclosures pertaining to market risk sensitive instruments and (ii) determine what, if any, additional information is needed to improve disclosures about these instruments. The SEC staff observed that while disclosures reviewed in 1995 were more informative than those reviewed in 1994, in part, because of improved guidance by the FASB,[12] three

[1] 17 CFR 210.4–08. Item 310 of Regulation S–B, CFR 228.310, also would be amended to incorporate the changes to Item 4–08 of Regulation S–X.

[2] 17 CFR Part 229.

[3] 17 CFR 239.11, 12, 25, 18, and 34.

[4] 15 U.S.C. 77a *et seq.*

[5] 17 CFR 240.14a–3.

[6] 17 CFR 240.14a–101.

[7] 17 CFR 249.210, 220f, 308a, and 310.

[8] 15 U.S.C. 78a *et seq.*

[9] The worldwide notional/contract amounts for derivative financial instruments and derivative commodity instruments increased from $7.1 trillion in 1989 to $62.1 trillion in 1994. These notional amounts, while one way to measure derivative activities, do not represent a precise measure of the risk associated with these instruments. In many instances, the amount at risk is much smaller than the notional amount. *See Financial Derivatives: Actions Needed to Protect the Financial System*, United States General Accounting Office Report to Congressional Requesters (May 1994), and *Public Disclosure of the Trading and Derivatives Activities of Banks and Securities Firms*, Basle Committee on Banking Supervision (''Basle Committee'') and the Technical Committee of the International Organization of Securities Commissions (''IOSCO'') (November 1995).

[10] *See* section IV C, *infra*, for complete definitions of the terms derivative financial instruments, other financial instruments, and derivative commodity instruments. In brief, for purposes of this release: (1) derivative financial instruments include futures, forwards, swaps, options, and other financial instruments with similar characteristics, (2) other financial instruments include, for example, investments, loans, structured notes, mortgage-backed securities, indexed debt instruments, interest-only and principal-only obligations, deposits, and other debt obligations, and (3) derivative commodity instruments include, to the extent such instruments are not derivative financial instruments, commodity futures, commodity forwards, commodity swaps, commodity options, and other commodity instruments with similar characteristics that are reasonably possible to be settled in cash or with another financial instrument. In addition, for purposes of this release, the terms (1) ''derivatives'' refer to derivative financial instruments and derivative commodity instruments, together, and (2) ''market risk sensitive instruments'' refer to derivative financial instruments, other financial instruments, and derivative commodity instruments, collectively.

[11] Market risk is the risk of loss arising from adverse changes in market rates and prices, such as interest rates, foreign currency exchange rates, commodity prices, and similar market rate or price changes (*e.g.*, equity prices). *See* Group of Thirty, *''Derivatives: Practices and Principles''* (July 1993), and Financial Accounting Standards Board (''FASB''), *Statement of Financial Accounting Standards No. 105, ''Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk''* (''FAS 105'') (March 1990), for similar definitions of market risk.

[12] In October 1994, the FASB issued *Statement of Financial Accounting Standards No. 119, ''Disclosures about Derivative Financial Instruments and Fair Value of Financial Instruments''* (''FAS 119'') (October 1994), which requires disclosures about derivative financial instruments. FAS 119 is effective for fiscal years ending after December 15, 1994, except for entities

significant disclosure issues remain. Today, to address those disclosure issues:[13]

1. The Commission proposes amendments to Regulation S–X requiring enhanced descriptions in the footnotes to the financial statements of accounting policies for derivative financial instruments and derivative commodity instruments.[14] These disclosures would be required unless the registrant's derivative activities are not material. For this proposal, the materiality of derivatives activities would be measured by the fair values[15] of derivative financial instruments and derivative commodity instruments at the end of each reporting period and the fair value of those instruments during each reporting period.

2. The Commission proposes amendments creating a new Item 305 of Regulation S–K requiring disclosure outside the financial statements[16] of qualitative and quantitative information about derivative financial instruments, other financial instruments, and derivative commodity instruments. These disclosures would be required if any of the following items are material: (i) the fair values of market risk sensitive instruments outstanding at the end of the current reporting period or (ii) the potential loss in future earnings, fair values, or cash flows of market risk sensitive instruments from reasonably possible market movements.[17]

a. In complying with the proposed amendments requiring disclosure of quantitative information about market risk, registrants would be permitted to select any one of the following three disclosure alternatives:

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.

b. The proposed qualitative information about market risk would include a narrative discussion of (i) a registrant's primary market risk exposures[18] and (ii) how the registrant manages those exposures (*e.g.,* a description of the objectives, general strategies, and instruments, if any, used to manage those exposures).

3. The Commission is reminding registrants that when they provide disclosure about financial instruments, commodity positions, firm commitments, and other anticipated transactions[19] (''reported items''), such disclosure must include information 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. For example, when information is required to be disclosed in the footnotes to the financial statements about interest rates and repricing characteristics of debt obligations, registrants should include, when material, disclosure of the effects of derivatives. Similarly, summary information and disclosures in Management's Discussion and Analysis (''MD&A'') about the cost of debt obligations should include, when material, disclosure of the effects of derivatives.

Congress recently adopted the Private Securities Litigation Reform Act of 1995 that, among other things, amends the Securities Act and Securities Exchange Act to include a safe harbor for forward looking information. It is the Commission's intention that forward looking disclosures made pursuant to proposed Item 305 of Regulation S–K and Item 9A of Form 20–F be subject to an appropriate safe harbor. The Commission's staff is continuing to consider how best to craft an appropriate safe harbor in light of this recent legislation, and the Commission intends to issue a release shortly that would propose that the disclosures to be required by new Items 305 and 9A be made subject to safe harbor provisions.

The proposed amendments pertaining to qualitative and quantitative information about market risk would not apply to registered investment companies[20] and small business issuers.[21] However, to the extent market risk represents a material known trend, event, or uncertainty, small business issuers, like other registrants, would be required to discuss the impact of market risk on past and future financial condition and results of operations, pursuant to Commission rules relating to MD&A.[22]

The proposed amendments are designed to make disclosures about market risk sensitive instruments more useful to investors. They represent one step by the Commission to improve registrants' disclosures about market risk sensitive instruments. The Commission recognizes the evolving nature of market risk sensitive instruments and intends to continue considering how best to address disclosure issues relating to these instruments. In this regard, if the proposals in this release are adopted, the Commission would anticipate reconsidering the effectiveness of those rules, as well as the need for additional proposals, after a period of five years.

II. Initiatives Regarding Disclosures About Derivatives

Certain private sector entities have highlighted problems associated with

with less than $150 million in total assets. For those entities, FAS 119 is effective for financial statements issued for fiscal years ending after December 15, 1995.

[13] The FASB currently is working on a project to improve accounting recognition and measurement of derivatives. This release does not address accounting recognition and measurement of derivatives, but focuses solely on disclosure issues related to derivatives and other financial instruments.

[14] These disclosure requirements do not relate to, for example, other financial instruments. Accounting policy disclosure requirements for these other instruments are prescribed by existing generally accepted accounting principles and Commission guidance (*see, e.g., Accounting Principles Board Opinion No. 22, ''Disclosure of Accounting Policies''* (''APB 22'') (April 1972).

[15] For purposes of this release, the term ''fair value'' has the same meaning as defined by generally accepted accounting principles (*see, e.g.,* FASB, *Statement of Financial Accounting Standards No. 107, ''Disclosures about Fair Value of Financial Instruments''* (''FAS 107'') (December 1991), paragraph 5).

[16] *See* section III B3b, *infra,* for a discussion about where, outside the financial statements, these disclosures would appear.

[17] The proposed amendments regarding disclosure of qualitative and quantitative information about market risk do not relate solely to derivatives, but also to investments in other financial instruments. These disclosures would be required for registrants that have material investments in other financial instruments, even though they have no investments in derivatives.

[18] *See* note 63, *infra,* for a definition specifying how the term ''primary market risk exposures'' is used in this release.

[19] For purposes of this release, ''anticipated transactions'' means transactions (other than transactions involving existing assets or liabilities or transactions necessitated by existing firm commitments) an enterprise expects, but is not obligated, to carry out in the normal course of business (*see, e.g.,* ¶ 9 of *Statement of Financial Accounting Standards No. 80, ''Accounting for Futures Contracts''* (''FAS 80'') (August 1984)).

[20] The Commission currently is considering comments and suggestions on how to improve the descriptions of risk provided to investors by mutual funds and other investment companies. *See ''Improving Descriptions of Risk by Mutual Funds and Other Investment Companies,''* Securities Act Release No. 7153, 60 FR 17172 (April 4, 1995).

[21] The proposed amendments relating to accounting policies disclosures, however, would apply to both registered investment companies and small business issuers.

[22] *See, e.g.,* Item 303 of Regulation S–B, 17 CFR 228.303, and Item 303 of Regulation S–K, 17 CFR 229.303.

disclosures about market risk sensitive instruments, as identified by users of financial reports. For example, the Association for Investment Management and Research (''AIMR''), an organization of financial analysts, noted that users ''are confounded by the . . . complexity of financial instruments.'' [23] In addition, after considerable investigation into the needs of investors and creditors, the American Institute of Certified Public Accountant's (''AICPA'') Special Committee on Financial Reporting stated: [24]

Users are confused. They complain that business reporting is not answering important questions, such as: . . . 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 risks has the company transferred or taken on? [page 76]

Other organizations recently have made recommendations on how to improve such disclosures about market risk sensitive instruments. These organizations include regulators, such as the Group of 10 Central Bankers,[25] the Federal Reserve Bank of New York,[26] the Basle Committee and the Technical Committee of IOSCO,[27] and private sector bodies, such as the Group of Thirty [28] and a task force of the Financial Executives Institute (''FEI'').[29]

In general, these organizations have stressed the need to make more understandable the risks inherent in market risk sensitive instruments. In particular, they have called for additional quantitative and qualitative disclosures about market risk. For example, the Federal Reserve Bank of New York recommended a new financial statement providing quantitative information about the overall market risk of an entity.[30] In addition, the FEI task force recommended that companies ''disclose some type of information which conveys overall exposure to market risk.'' [31] In this regard, the FEI task force suggests two distinct approaches. One approach is to provide a high-level summary of relevant statistics about outstanding activity at period end. The second approach is to communicate the potential loss which could occur under specified conditions using either a value at risk or another comprehensive model to measure market risk.[32]

In October 1994, the FASB, responding in part to calls for improved disclosure, issued *Statement of Financial Accounting Standards No. 119, ''Disclosures about Derivative Financial Instruments and Fair Value of Financial Instruments''* (''FAS 119'') (October 1994).[33] FAS 119 prescribes, among other things, disclosures in the financial statements about the policies used to account for derivative financial instruments and a discussion of the nature, terms, and cash requirements of derivative financial instruments. FAS 119 also encourages, but does not require, disclosure of quantitative information about an entity's overall market risk.[34]

During 1994, in response, in part, to the concerns of investors, regulators, and private sector entities, the SEC staff reviewed the annual reports of approximately 500 registrants. In addition, during 1995, more recent annual reports were reviewed by the SEC staff to assess the effect of FAS 119 on disclosures about market risk sensitive instruments. As a result of these reviews, the SEC staff observed that FAS 119 had a positive effect on the quality of disclosures about derivative financial instruments. However, the SEC staff also concluded there was a need to improve disclosures about derivative financial instruments, other financial instruments, and derivative commodity instruments. In particular, the SEC staff identified the following three primary disclosure issues.

1. Footnote disclosures of accounting policies for derivatives often are too general to convey adequately the diversity in accounting that exists for derivatives. Thus, it often is difficult to determine the impact of derivatives on registrants' statements of financial position, cash flows, and results of operations;

2. Disclosures often focus on derivatives and other financial instruments in isolation. Thus, it may be difficult to assess whether these instruments increase or decrease the net market risk exposure of a registrant; and

3. Disclosure about financial instruments, commodity positions, firm commitments, and other anticipated transactions (''reported items'') in the footnotes to the financial statements, MD&A, schedules, and selected financial data may not reflect adequately the effect of derivatives on such reported items. Thus, without disclosure about the effects of derivatives, information about the reported items may be incomplete or perhaps misleading.

The proposals in this release are designed to address these issues. They reflect a significant amount of learning by the Commission and its staff over the past year and a half about (i) derivatives and related risk management activities, and (ii) alternative disclosure approaches to make those activities more understandable to investors. In addition, during this period, the Commission and its staff developed the following guiding principles, which provided the foundation for the proposed amendments described in this release:

- Disclosures should allow investors to understand better how derivatives affect a registrant's statements of financial position, cash flows, and results of operations;
- Disclosures should provide information about market risk;
- Disclosures should allow the investor to understand how market risk sensitive instruments are used in the context of the registrant's business;
- Disclosures about market risk should not focus on derivatives in isolation, but rather should reflect the risk of loss inherent in all market risk sensitive instruments;
- Disclosure requirements about market risk should be flexible enough to accommodate different types of registrants, different degrees of market risk exposure, and alternative ways of measuring market risk;
- Disclosures about market risk should highlight, where appropriate, special risks relating to leverage, option, or prepayment features; and
- New disclosure requirements should build on existing disclosure

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[23] *See* AIMR, *Financial Reporting in the 1990s and Beyond*, page 30 (1993).

[24] *See* AICPA Special Committee on Financial Reporting, *Improving Business Reporting—A Customer Focus: Meeting the Information Needs of Investors and Creditors* (1994).

[25] *See* Bank for International Settlements, *A Discussion Paper on Public Disclosure of Market and Credit Risks by Financial Intermediaries*, prepared by working group of the Euro-currency Standing Committee of the Central Banks of the Group of Ten Countries (September 1994).

[26] *See* Federal Reserve Bank of New York, *Public Disclosure of Risks Related to Market Activity: A Discussion Paper* (November 1994).

[27] *See* Basle Committee and the Technical Committee of IOSCO, *Framework for Supervisory Information about the Derivatives Activities of Banks and Securities Firms* (May 1995). *See also* Basle Committee and the Technical Committee of IOSCO, *Public Disclosure of the Trading and Derivatives Activities of Banks and Securities Firms* (November 1995).

[28] *See* Group of Thirty, *Derivatives: Practices and Principles* (July 1993).

[29] *See* FEI, *Derivative Financial Instruments Accounting and Disclosure Issues*, (''FEI Report'') prepared by FEI CCF/CCR Derivatives Disclosure Task Force (August 1994).

[30] *See* note 26, supra.

[31] *See* Attachment A, page 1 of FEI Report.

[32] *See* Attachment B, pages 5 and 6 of FEI Report.

[33] Similar standards were recently adopted or proposed by the International Accounting Standards Committee, the Canadian Institute of Chartered Accountants, and the Australian Accounting Standards Board. *See International Accounting Standards No. 32, ''Financial Instruments: Disclosure and Presentation''* (''IAS 32'') (March 1995), Section 3860 of the *Handbook of the Canadian Institute of Chartered Accountants*, and the Australian Accounting Standards Board's exposure draft entitled, *''Presentation and Disclosure of Financial Instruments''* (June 1995), respectively.

[34] *See* FAS 119 ¶ 12.

requirements, where possible, to minimize compliance costs of registrants.

III. Discussion of Proposed Amendments

A. Disclosure of Accounting Policies for Derivatives

1. Background

During the last several years, a significant number of issues relating to the accounting for derivatives have been raised. Although the FASB is working on a project that would address comprehensively the accounting for derivatives, currently there is very little authoritative literature on the accounting for options and complex derivatives, many of which are used frequently by registrants.[35]

In the absence of comprehensive literature, registrants are developing accounting practices for options and complex derivatives by analogy to the limited amount of literature that does exist. These analogies are complicated because existing derivative literature refers to at least three distinctly different methods of accounting for derivatives (*e.g.,* fair value accounting, deferral accounting, and accrual accounting)[36] and the underlying concepts and criteria used in determining the applicability of these accounting methods are not consistent.[37] As a result, during its 1994 and 1995 reviews of filings, the SEC staff observed that registrants may account for the same type of derivative in many different ways.[38] Thus, it was difficult to compare the financial statement effects of derivatives across registrants.

In order to provide a better understanding of the accounting for derivative financial instruments, paragraph 8 of FAS 119 requires disclosure of the policies used to account for such instruments, pursuant to the requirements of APB 22.[39] Specifically, FAS 119 emphasizes the disclosure of ''policies for recognizing (or not recognizing) and measuring derivative financial instruments . . . and when recognized, where those instruments and related gains and losses are reported in the statements of financial position and income.''[40] However, notwithstanding its helpful guidance, FAS 119 does not provide an explicit indication of what must be disclosed in accounting policies footnotes to make more understandable the effects of derivatives on the statements of financial position, cash flows, and results of operations, and it does not address disclosure of accounting policies for derivative commodity instruments. Thus, to facilitate a more informed assessment of the effects of derivatives on financial statements, the proposed amendments make explicit the items to be disclosed in the accounting policies footnotes for derivative financial instruments and derivative commodity instruments.

2. Proposed Disclosure Rule

The proposed amendments pertaining 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 (i) each method used to account for derivatives, (ii) types of derivatives accounted for under each method, (iii) the criteria required to be met for each accounting method used (*e.g.,* the manner in which risk reduction, correlation, designation, and/or effectiveness tests are applied), (iv) the accounting method used if the specified criteria are not met, (v) 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, (vi) the accounting for derivatives if the designated item matures, or is sold, extinguished, terminated, or, if related to an anticipated transaction, is no longer likely to occur, and (vii) where and when derivatives and their related gains and losses are reported in the statements of financial position, cash flows, and results of operations.[41]

The proposed amendments would require registrants to distinguish between accounting policies used for derivatives entered into for trading purposes from those that are entered into for purposes other than trading.[42] Disclosure of accounting policies for derivatives would be required unless the registrant's derivative activities are not material. For this proposal, the materiality of derivatives activities would be measured by the fair values of derivative financial instruments and derivative commodity instruments at the end of each reporting period and the fair value of those instruments during each reporting period.

In essence, the proposed amendments clarify the application of the accounting policy disclosure requirements set forth in FAS 119 for derivative financial instruments. They also extend those requirements to address the disclosure of accounting policies for derivative commodity instruments.[43]

[35] The authoritative accounting literature for options and complex derivatives generally is limited to a few consensuses from the FASB Emerging Issues Task Force (''EITF''), which by their nature address the accounting for very specific transactions. *See, e.g.,* EITF Issues 88–8, *''Mortgage Swaps,''* and 90–17, *''Hedging Foreign Currency Risks with Purchased Options.''*

[36] Under the fair value method, derivatives are carried on the balance sheet at fair value with changes in that value recognized in earnings or stockholders' equity (*see, e.g., Statement of Financial Accounting Standards No. 52, ''Foreign Currency Translation''* (''FAS 52'') (December 1981), and FAS 80. Under the deferral method, gains and losses from derivatives are deferred on the balance sheet and recognized in earnings in conjunction with earnings of designated items (*see, e.g.,* FAS 52 and FAS 80). Under the accrual method, each net payment/receipt due or owed under the derivative is recognized in earnings during the period to which the payment/receipt relates; there is no recognition on the balance sheet for changes in the derivative's fair value (*see, e.g.,* EITF Issue 84–36, *''Interest Rate Swap Transactions''*).

[37] For example, the risk reduction criterion in FAS 52 is different from the risk reduction criterion in FAS 80. FAS 52 specifies risk reduction on a transaction basis, while FAS 80 specifies risk reduction on an enterprise basis. In addition, FAS 80 permits the use of deferral accounting for futures contracts used to hedge probable, but not firmly committed, anticipated transactions, while FAS 52 prohibits deferral accounting for foreign currency forward exchange contracts used to hedge those same types of anticipated transactions.

[38] The Commission does not mean to imply by this statement that registrants may justify the use of any method of accounting for derivatives. Rather registrants must select appropriate accounting methods that are consistent with generally accepted accounting principles. In particular, generally accepted accounting principles require registrants using derivatives for trading, dealing, or speculative purposes to recognize those instruments on the balance sheet at fair value with changes in that value recognized immediately in earnings (*see, e.g.,* FAS 80 ¶ 3).

[39] APB 22 ¶ 12 states:

Disclosure of accounting policies should identify and describe the accounting policies followed by the reporting entity and the methods of applying those principles that materially affect the determination of financial position, cash flows or results of operations. In general, the disclosure should encompass important judgments as to the appropriateness of principles relating to recognition of revenue and allocation of asset costs to current and future periods; in particular, it should encompass those accounting principles and methods that involve . . . a selection from existing acceptable alternatives.

The Accounting Principles Board was the predecessor to the FASB. Unless superseded by FASB Statements, APB Opinions continue to be regarded as the highest level of generally accepted accounting principles followed by the accounting profession. *See generally* AICPA, *Statements on Auditing Standards No. 69, ''The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles in the Independent Auditor's Report,''* ¶ 5 (March 1992); AU § 411.05.

[40] *See* FAS 119 ¶ 60.

[41] FAS 119 ¶ 11(b) also requires a description of where gains and losses from derivative financial instruments held or issued for purposes other than trading are reported in the statements of financial position and income.

[42] For purposes of this release, the term ''trading purposes'' has the same meaning as defined by generally accepted accounting principles (*see, e.g.,* FAS 119 ¶ 9a).

[43] *See* note 14, *supra.*

3. Requests for Comment

1. The proposed amendments requiring disclosure of accounting policies for derivatives are designed to make it easier for investors to assess the financial statement effects of derivative financial instruments and derivative commodity instruments. Would the proposed disclosures accomplish this objective? If not, are there specific disclosures about accounting policies that should be added or deleted?

2. The proposed amendments relating to disclosures of accounting policies are limited to derivative financial instruments and derivative commodity instruments. These proposed disclosure requirements do not add to the accounting policies disclosure requirements for other financial instruments, which are addressed by generally accepted accounting principles (*e.g.,* APB 22). Is the scope of instruments covered by the proposed amendments requiring additional accounting policies disclosures appropriate? If not, which instruments should be included or excluded?

3. Under the proposed amendments, disclosure of accounting policies would be required unless the registrant's derivative activities are not material. For this proposal, the materiality of derivatives activities would be measured by the fair values of derivative financial instruments and derivative commodity instruments at the end of each reporting period and the fair value of those instruments during each reporting period. Is this disclosure threshold appropriate? If not, what other threshold could be specified to require disclosure of all information a reasonable investor would consider important to decision-making (*e.g.,* would it be more appropriate to use a disclosure threshold similar to the threshold for quantitative and qualitative disclosures about market risk proposed in section III B3a of this release)?

B. Disclosures of Quantitative and Qualitative Information About Market Risk

1. Quantitative Information About Market Risk

a. Background

Market risk is inherent in both derivative and non-derivative instruments, including:

• Derivative financial instruments—futures, forwards, swaps, options, and other financial instruments with similar characteristics;

• Other financial instruments—non-derivative financial instruments, such as investments, loans, structured notes, mortgage-backed securities, indexed debt instruments, interest-only and principal-only obligations, deposits, and other debt obligations;

• Derivative commodity instruments that are reasonably possible [44] to be settled in cash or with another financial instrument—commodity futures, commodity forwards, commodity swaps, commodity options, and other commodity instruments with similar characteristics, to the extent such instruments are not derivative financial instruments.

Generally accepted accounting principles and Commission rules require disclosure of certain quantitative information pertaining to some of these derivative financial instruments. For example, registrants currently are required to disclose notional amounts of derivative financial instruments and the nature and terms of debt obligations.[45] However, this information (i) often is abbreviated, (ii) is presented piecemeal in different parts of the financial statements, and (iii) does not apply to all market risk sensitive instruments. Thus, investors often are unable to assess whether or how particular financial and commodity instruments affect a registrant's net market risk exposure.

FAS 119 encourages, but does not require, disclosure of quantitative information about the overall market risk inherent in derivative financial instruments and other instruments subject to market risk.[46] However, the SEC staff has observed that registrants often do not make these disclosures.

b. Proposed Disclosure Rule

To allow investors to assess more easily overall market risk, the proposed amendments would create a new Item 305(a), which would require disclosure, outside the financial statements,[47] of quantitative market risk information for derivative financial instruments, other financial instruments, and derivative commodity instruments, to the extent it is material. This information would be furnished using one of the following three ways, at the election of the registrant.[48]

(i) Tabular Presentation

The first quantitative market risk disclosure alternative would permit registrants to provide a tabular presentation of terms and information related to derivative financial instruments, other financial instruments, and derivative commodity instruments. Such information would include, but is not limited to, fair values of instruments, expected principal or transaction cash flows, weighted average effective rates or prices, and other relevant market risk related information. These data are common inputs to market risk measurement methods and, therefore, may be useful in understanding a registrant's exposure to market risk.

This tabular information would be summarized by risk exposure category (*i.e.,* interest rate risk, foreign currency exchange rate risk, commodity price risk, and other similar price risks, such as equity price risk) and, within the foreign currency exchange rate risk category, by functional currency [49] (*e.g.,* U.S. dollar, Japanese yen). Within each of these risk exposure categories, instruments would be grouped based on common characteristics. At a minimum, instruments would be distinguished by the following characteristics: (i) Fixed rate or variable rate assets or liabilities, (ii) long or short forwards or futures, (iii) written or purchased put or call options, (iv) receive fixed or receive variable interest rate swaps, and (v) the currency in which the instruments' cash flows are denominated. Thus, for example, within the interest rate risk exposure category, a registrant might present the following list of instruments: fixed rate Mexican peso investments, variable rate U.S. dollar

[44] *See* note 65, *infra,* for a definition specifying how the term ''reasonably possible'' is used in this release.

[45] *See, e.g.,* FAS 119 ¶ 8b and Rule 5–02 of Regulation S–X, 17 CFR 210.5–02.

[46] In particular, FAS 119 ¶ 12 lists five possible quantitative methods of measuring and disclosing market risk. They are: (i) details about current positions and perhaps activity during the period, (ii) the hypothetical effects on equity, or on annual income, of several possible changes in market price, (iii) a gap analysis of interest rate repricing or maturity dates, (iv) the duration of the financial instruments, and (v) the entity's value at risk from derivative financial instruments and from other positions at the end of the reporting period and the average value at risk during the year.

[47] *See* section III B3b, *infra,* for a discussion about where, outside the financial statements, these disclosures would appear.

[48] At the current time, the Commission is not proposing to prescribe standardized methods and procedures specifying how to comply with each of these disclosure alternatives. To the extent registrants use one of these methods internally, they would be permitted, but not required, to report quantitative measures of market risk using the same method externally. To facilitate comparison across registrants, the Commission proposes, below, that registrants provide descriptions of the model and assumptions used to prepare quantitative market risk disclosures.

[49] For purposes of this release, functional currency means the currency of the primary economic environment in which the entity operates; normally, that is the currency of the environment in which an entity primarily generates and expends cash. This definition is the same as the definition of functional currency in FAS 52, Appendix E.

debt obligations, long U.S. Treasury futures, and Mexican peso receive variable interest rate swaps. Derivatives used to manage risks inherent in anticipated transactions also would be disclosed separately.

For each instrument in the table, expected principal or transaction cash flow information would be presented separately for each of the next five years, with the remaining expected cash flows presented as an aggregate amount. The proposed amendments also would require disclosure of information on assumptions necessary to an understanding of a registrant's tabular market risk disclosures. In this regard, registrants would describe, at a minimum, the differing numbers reported in the table for various categories of instruments (*e.g.*, principal cash flows for debt, notional amounts for swaps, contract amounts for options and futures) and key prepayment and/or reinvestment assumptions relating to the timing of reported cash flow amounts. See the Appendix to the text of the proposed amendments for a sample disclosure.

(ii) Sensitivity Analysis

The second quantitative market risk disclosure alternative would permit registrants to provide disclosure of sensitivity analyses expressing the hypothetical loss in future earnings, fair values, or cash flows of market risk sensitive instruments over the next reporting period due to hypothetical changes in interest rates, currency exchange rates, commodity prices, and other similar market price changes (*e.g.*, equity prices).[50] For example, these disclosures may be similar to the interest rate ''sensitivity'' measures already required to be calculated for regulatory purposes for thrift institutions.[51] Under the proposed amendments, earnings, fair values, or cash flows sensitivity disclosures would be presented separately for interest rate sensitive instruments, currency exchange rate sensitive instruments, certain commodity price sensitive instruments, and other types of market risk sensitive instruments (*e.g.*, equity instruments).

The proposed amendments also would require disclosure of the assumptions and parameters underlying the registrant's sensitivity analysis model that are necessary to an understanding of the registrant's market risk disclosure. In this regard, registrants would specify, at a minimum, (i) how loss is defined by the model (*e.g.*, loss in earnings, fair values, or cash flows), (ii) a general description of the modeling technique (*e.g.*, change in net present values arising from parallel shifts in market rates or prices and how optionality is addressed by the model), (iii) the general types of instruments covered by the model (*e.g.*, derivative financial instruments, other financial instruments, derivative commodity instruments, and whether other instruments are included voluntarily in the model by the registrant, such as certain commodity instruments and positions, cash flows from anticipated transactions, and operating cash flows from non-financial and non-commodity instruments), and (iv) other relevant information on model parameters (*e.g.*, the magnitudes of parallel shifts in market rates or prices used for each category of market risk exposure, the method by which discount rates are determined, and key prepayment and/or reinvestment assumptions).

(iii) Value at Risk

The third quantitative disclosure alternative would permit registrants to provide value at risk disclosures expressing the potential entity-wide loss in fair values, earnings, or cash flows of market risk sensitive instruments that might arise from adverse market movements with a selected likelihood of occurrence over a selected time interval.[52] Additional separate value at risk disclosures would be required for interest rate sensitive instruments, currency exchange rate sensitive instruments, certain commodity price sensitive instruments, and other similar market risk sensitive instruments (*e.g.*, equities). In addition, to help place reported value at risk amounts in context, registrants would be required to report either (i) the average or range in value at risk amounts for the current reporting period, (ii) the average or range in actual changes in fair values, earnings, or cash flows from market risk sensitive instruments occurring during the current reporting period, or (iii) the percentage of actual changes in fair values, earnings, or cash flows from market risk sensitive instruments that exceeded the reported value at risk amounts during the current reporting period.

The proposed amendments also would require disclosure of the model assumptions and parameters underlying the registrant's value at risk model that are necessary to an understanding of the registrant's market risk disclosure. In this regard, registrants would specify, at a minimum, (i) how loss is defined by the model (*e.g.*, loss in fair values, earnings, or cash flows), (ii) a general description of the modeling technique (e.g., variance/covariance, historical simulation, Monte Carlo simulation, and how optionality is addressed by the model), (iii) the general types of instruments covered by the model (*e.g.*, derivative financial instruments, other financial instruments, derivative commodity instruments, and whether other instruments are included voluntarily in the model by the registrant, such as certain commodity instruments and positions, cash flows from anticipated transactions, and operating cash flows from non-financial and non-commodity instruments), and (iv) other material information on model parameters (*e.g.*, holding period, confidence interval, and the method used for aggregating value at risk amounts across market risk exposure categories, such as by assuming perfect positive correlation, independence, or by using actual observed correlations).[53]

(iv) Other Disclosure Requirements

The proposed amendments would require presentation of quantitative information about market risk at the end of the most recent fiscal year or at the end of the most recent reporting period for which a full set of financial statements is filed with the Commission. Under the proposed amendments, registrants would be required to provide separately quantitative information for market risk sensitive instruments that are entered into for trading purposes[54] and those

[50] The term ''sensitivity analysis,'' as used in this release, describes a general class of models that assesses the risk of loss in market risk sensitive instruments based on hypothetical changes in market rates or prices. The term sensitivity analysis is not meant to refer to any one model for quantifying market risk.

[51] *See* Office of Thrift Supervision, *Regulatory Capital: Interest Rate Risk Component*, 12 CFR 567.5(c)(4) (August 1993).

[52] The term ''value at risk,'' as used in this release, describes a general class of models that provide a probabilistic assessment of the risk of loss in market risk sensitive instruments. The term value at risk is not meant to refer to any one model for quantifying market risk. Value at risk models can be adapted to non-trading activities as well as trading activities and to non-financial institutions as well as financial institutions, depending on the model and assumptions selected by the registrant.

[53] The primary differences between the value at risk and sensitivity analysis disclosure alternatives are (i) value at risk analysis reports the potential loss arising from equally likely market movements across instruments, while sensitivity analysis reports the potential loss arising from hypothetical market movements with differing likelihoods of occurrence across instruments and (ii) value at risk explicitly adjusts the potential loss to reflect correlations between market movements, while sensitivity analysis is not designed explicitly to make such adjustments.

[54] *See* note 42, *supra*, for a definition specifying how the term ''trading purposes'' is used in this release.

that are entered into for purposes other than trading. In addition, in order to enable an investor to assess material changes in market risk information, the proposed amendments would require registrants to provide summarized information as of the end of the preceding fiscal year or comparable preceding period. Registrants also would be required to discuss the reasons for material changes in quantitative information about market risk when compared to the information reported in the previous period.[55] Registrants would be allowed to change methods of disclosing quantitative information about market risk (*e.g.*, changing from tabular presentation to value at risk). However, if they change methods, registrants would be required to (i) disclose the reasons for any such change and (ii) provide summarized comparable information, under the new disclosure method, as of the end of the period preceding the current reporting period.

(v) Encouraged Disclosures

In essence, the proposed amendments primarily are designed to make disclosures about market risk more comprehensive by requiring disclosure of quantitative information about market risk that are encouraged to be disclosed by FAS 119. The proposals apply to derivative financial instruments, other financial instruments, and derivative commodity instruments.[56]

The Commission recognizes that market risk exposures may exist in instruments, positions, and transactions other than in those derivative financial instruments, other financial instruments, and derivative commodity instruments that specifically would be subject to the proposed amendments. In particular, market risk, in its broadest view, also may be inherent in the following items:

• Derivative commodity instruments not reasonably possible to be settled in cash or with another financial instrument—such as a commodity forward contract that must be settled in the commodity;

• Commodity positions—such as investments in corn, wheat, oil, gas, lumber, silver, gold, and other commodity inventory positions;

• Cash flows from anticipated transactions[57]—such as cash flows from anticipated purchases and sales of inventory; and

• Operating cash flows from non-financial and non-commodity instruments— such as cash flows generated by manufacturing activities.

The Commission also recognizes, however, that the amount and timing of the cash flows inherent in such instruments, positions, and transactions often are difficult to estimate. In addition, most risk measurement systems currently do not include such instruments, positions, and transactions in their quantitative assessments of market risk. For these practical reasons, the Commission is not proposing at this time to require that these items be included in the proposed quantitative disclosures about market risk. However, registrants are encouraged, when practical, to include voluntarily these items in their quantitative market risk disclosures. If these instruments, positions, and transactions are not included voluntarily, registrants, nonetheless, should consider whether they must address this issue in their disclosures identifying limitations of the quantitative information, discussed below.[58]

(vi) Limitations

The proposed amendments would require that registrants discuss limitations that may cause the quantitative information about market risk not to reflect fully the overall market risk of the entity. This discussion would include (i) a description of each limitation and (ii) if applicable, a description of the instruments' features that are not reflected fully within the selected quantitative market risk disclosure alternative.

Two illustrative examples are provided. First, as just stated, the Commission is allowing certain instruments, positions, and transactions to be excluded from quantitative disclosures about market risk. The failure of a registrant to include such items in its disclosures, while permitted, is a limitation of the quantitative information provided. This limitation must be described if the registrant has material investments in these instruments, positions, and transactions that cause its disclosures not to portray fully the overall market risk of the entity.

Second, each of the quantitative disclosure alternatives may not alert investors of the degree of market risk inherent in instruments with leverage, option, or prepayment features (*e.g.*, structured notes, collateralized mortgage obligations, leveraged swaps, and swaps with embedded written options). Tabular information on expected future cash flows normally would not indicate that instruments have such features. Value at risk and sensitivity analysis models generally do not reflect the potential loss arising from all changes in market rates or prices. Thus, if leverage, option, or prepayment features are triggered by changes in market rates or prices outside those reflected in the value at risk and sensitivity analysis disclosures, the potential loss in these instruments may be significantly larger than would be implied by a simple linear extrapolation of the reported numbers. Thus, to make investors fully aware of the market risk inherent in instruments with such features, the proposed amendments would require a (i) discussion of this limitation of the quantitative disclosures and (ii) description of the leverage, option, or prepayment features of the instruments causing the limitation.

c. Requests for Comment

1. The proposed amendments are designed specifically to elicit disclosure of quantitative information to assist investors and others in making an overall assessment of market risk. The Commission recognizes that some investors may be unfamiliar with certain of the proposed quantitative disclosure methods. Thus, the Commission requests comment (a) on whether the proposed quantitative information is expected to improve investors' understanding of the market risk associated with business activities of a registrant and (b) on the extent to which investors will benefit from and understand the proposed quantitative market risk alternatives.

2. The proposed amendments relating to disclosure of quantitative information about market risk are limited to derivative financial instruments, other financial instruments, and derivative commodity instruments. In addition, when preparing these disclosures, registrants are encouraged to present information about all instruments,

[55] For transition purposes, the Commission is proposing that quantitative disclosures about market risk provided in the initial period after the rule is adopted would not contain comparable summarized information for the preceding period. Similarly, in the initial year after the rule is adopted, a discussion of the reasons for material changes in reported amounts as compared to the preceding period would not be necessary.

[56] These disclosures would be required for other financial instruments, even if a registrant does not enter into derivatives.

[57] *See* note 19, *supra.*

[58] In addition, registrants should review the requirements of Item 303 of Regulation S-K, 17 CFR 229.303, to ensure that disclosures are sufficient to inform readers of material risks to which a registrant is exposed. Thus, MD&A would need to discuss the risks relating to, for example, anticipated transactions or commodity positions, to the extent these transactions or positions have, or are reasonably likely to have, a material effect on the registrant's liquidity, capital resources, and results of operations.

positions, and cash flows subject to market risk. Is the scope of instruments covered by these proposed amendments sufficient? For example, should commodity positions with readily available market prices be required to be included in the quantitative disclosures? In addition, are there other instruments and positions that should be included or excluded?

3. The Commission is proposing to allow registrants to choose one of three alternatives to present quantitative information about market risk (*i.e.*, tabular presentation of expected future cash flows and terms, sensitivity analysis, or value at risk). Are these the most appropriate alternatives? If not, should some alternatives be added or deleted? For example, although the Commission has not proposed use of interest gap analysis and duration because these market risk measurement methods commonly are not used to describe the market risk inherent in non-interest rate sensitive instruments and non-fixed income instruments, respectively, should these methods also be allowed?

4. In this release, the Commission proposes amendments designed to allow investors to evaluate quantitatively the overall market risk inherent in derivative financial instruments, other financial instruments, and derivative commodity instruments. Although the proposals permit registrants to select one of three alternative quantitative disclosure methods, they require that the same general disclosure alternative (*i.e.*, tabular presentation of expected future cash flows and terms, sensitivity analysis, or value at risk) be used to describe quantitatively the market risk inherent (i) in each market risk exposure category (*e.g.*, interest rates, foreign currency exchange rates, and commodity prices) and (ii) in instruments entered into for trading and other than trading purposes. Is this approach practical? Should the Commission permit registrants to use different alternatives to report the market risk inherent (i) in different categories of market risk exposure and/or (ii) in instruments entered into for trading and other than trading purposes? If so, how will this affect the ability of investors to assess the overall market risk inherent in market risk sensitive instruments? Please explain.

5. The Commission recognizes that risk management methods are evolving, and no method is dominant in practice. The proposed amendments, therefore, do not require the use of a single measure or standardized procedures or assumptions for preparing quantitative market risk disclosures. As a result, quantitative information about market risk is not likely to be prepared in a uniform manner across registrants. However, to facilitate the analysis and comparison of quantitative market risk information among registrants, the Commission is proposing disclosure of the model and assumptions used to comply with the quantitative market risk amendments. Will the proposed disclosures about the model and key assumptions provide sufficient information for investors to compare market risk across registrants? Are there additional disclosures that might further investors' analysis and comparison? Is there a better approach to enhancing the comparability of the proposed disclosures? For example, despite the evolving risk management practices, should standardized procedures be developed for preparing disclosures across registrants? Alternatively, should minimum acceptable standards be set prescribing model parameters and assumptions?

6. The Commission recognizes that quantitative disclosures about market risk may be viewed as more meaningful for certain registrants than others. For example, because market risk is one of the primary business risks for financial institutions, quantitative information about market risk may be more meaningful when applied to financial institutions than the same information presented for registrants whose primary risks are not related to market risk.

In this regard, the Commission has proposed that registrants have the ability to choose among three disclosure alternatives. These alternatives reflect different degrees of sophistication in risk measurement methods, thereby permitting registrants flexibility to select a disclosure method which corresponds most closely to the degree of market risk inherent in their business activities. Are there better ways to address how information about market risk should be presented for the different types of registrants that file with the Commission? In particular, should financial institutions, such as bank holding companies, thrift holding companies, finance companies, investment banks, mortgage banks, broker-dealers, insurance companies, and similar types of registrants have a different set of disclosure requirements than other companies? If so, should financial institutions have more rigorous disclosure requirements than those proposed in this release or should non-financial institutions be exempted from certain of the proposed disclosures specified in this release?

7. In regard to the presentation of tabular information on the terms, cash flow amounts, and fair values of market risk sensitive instruments, the Commission has specified that information be disaggregated by risk exposure category and grouped further based on certain common instrument characteristics. Sample disclosures have been provided in the Appendix to the text of the proposed amendments to illustrate compliance with these requirements. Is the level of disaggregation specified in the requirements adequate? Is there a better way to present such information?

8. The proposed amendments requiring disclosure of quantitative information about market risk generally are designed to indicate the degree of market risk from normal market movements. The proposed disclosure alternatives do not specifically require estimates of the market risk inherent in unusual markets reflecting worst-case scenarios. Should the proposed amendments address specifically market risk in worst-case scenarios? If so, what would be a useful standard for determining and disclosing a worst-case scenario?

9. To help place the reported value at risk numbers in context, the proposed amendments require that registrants report either (i) the average or range in value at risk amounts for the current reporting period, (ii) the average or range in actual changes in fair values, earnings, or cash flows from market risk sensitive instruments during the current reporting period, or (iii) the percentage of actual changes in fair values, earnings, or cash flows from market risk sensitive instruments that exceeded the reported value at risk amounts during the current reporting period. Will this information be useful to investors and others? Since similar disclosures cannot be developed easily for the other disclosure alternatives for presenting quantitative information about market risk (*i.e.* tabular presentation of expected cash flows and terms and sensitivity analysis), should these disclosures be encouraged, rather than required?

10. To enable investors to assess material changes in market risk, the proposed amendments would require registrants to provide summarized quantitative information about market risk for the preceding fiscal year. In addition, registrants would be required to discuss the reasons for material changes in quantitative information about market risk when compared to the information reported in the previous period. Is this information necessary to an understanding of the current period market risk disclosures? If not, are there other types of information that would be

helpful to investors in assessing material changes in market risk?

11. Under the proposed amendments, registrants would be allowed to change methods of presenting quantitative information about market risk provided they (i) explain the reasons for the change and (ii) provide summarized comparable information under the new disclosure method for the period preceding the current reporting period. Should registrants be required to present comparable information for the period preceding the current reporting period when they change methods of presenting quantitative information about market risk?

12. The proposed amendments are focused on providing investors with improved disclosures about market risk sensitive instruments and the impact of market risk on a registrant's financial condition and results of operations. Other regulators and private sector entities have set forth proposals and made recommendations that would require disclosures about derivatives and similar instruments that go beyond the disclosures proposed under these proposed amendments.[59] Such recommendations relate to the disclosure of credit risk, liquidity risk, legal risk, and operational risk inherent in market risk sensitive instruments. The Commission notes that existing generally accepted accounting principles (*e.g.*, FAS 105) and Commission Regulations (*e.g.*, Items 101 and 303 of Regulation S–K, 17 CFR 229.101 and 229.303, respectively) already require some disclosures relating to these risks. Thus, at this time the Commission does not intend to propose additional disclosure requirements about these other risks inherent in market risk sensitive instruments. Is this decision appropriate?

13. Would any of the proposed amendments regarding quantitative disclosures about market risk require disclosure of information considered highly proprietary by registrants? Are there other methods of quantifying and disclosing market risk that would be useful to investors and present fewer proprietary concerns?

2. Qualitative Information About Market Risk

a. Background

A qualitative discussion of a registrant's market risk exposures and how those exposures are managed is important to an understanding of a registrant's market risk. Such qualitative disclosures help place market risk management activities in the context of the business and, therefore, are a useful complement to quantitative information about market risk.

FAS 119 requires that certain qualitative disclosures be provided about market risk management activities associated with derivative financial instruments held or issued for purposes other than trading. In particular, FAS 119 requires disclosure of ''the entity's objectives for holding or issuing the derivative financial instruments, the context needed to understand those objectives, and its general strategies for achieving those objectives.''[60] In addition, FAS 119 requires separate disclosures about derivative financial instruments used as hedges of anticipated transactions.[61] As indicated above, these requirements of FAS 119 only apply to certain derivatives held or issued for purposes other than trading.

b. Proposed Disclosure Rule

In essence, the proposed qualitative disclosure requirements would create a new Item 305(b) of Regulation S–K, which would expand certain FAS 119 disclosures to (i) encompass derivative commodity instruments, other financial instruments, and derivative financial instruments entered into for trading purposes and (ii) require registrants to evaluate and describe material changes in their primary risk exposures and material changes in how those exposures are managed. In particular, the proposed amendments would require narrative disclosure outside the financial statements[62] of (i) a registrant's primary market risk exposures[63] and (ii) how those exposures are managed (*e.g.*, a description of the objectives, general strategies, and instruments, if any, used to manage those exposures).

In preparing the proposed qualitative disclosures about market risk, the Commission expects that registrants would describe their primary market risk exposures as they exist at the end of the current reporting period and how those risks currently are being managed. Registrants also would be required to describe material changes in their primary market risk exposures and material changes in how these risks are managed as compared to what was in effect during the most recent reporting period and what is known or expected to be in effect in future reporting periods.

These proposed qualitative disclosure requirements would apply to derivative financial instruments, other financial instruments, and derivative commodity instruments. As in the case with respect to the quantitative disclosures about market risk, the qualitative disclosures should be presented separately for market risk sensitive instruments that are entered into for trading purposes and those that are entered into for purposes other than trading. In addition, qualitative information about market risk should be presented separately for those instruments used to manage risks inherent in anticipated transactions.

Finally, to help make disclosures about market risk more comprehensive, as is the case with the quantitative disclosures about market risk, the Commission also is proposing to encourage registrants to disclose qualitative information about market risk relating to other items, such as derivative commodity instruments not reasonably possible to be settled in cash or with another financial instrument, commodity positions, cash flows from anticipated transactions, and operating cash flows from non-financial and non-commodity instruments (*e.g.*, cash flows generated by manufacturing activities).[64]

c. Requests for Comment

1. The proposed amendments regarding qualitative disclosure about market risk are designed to put market risk management activities into the context of a registrant's overall business. Does this qualitative information allow investors to understand better the management of market risk inherent in the business activities of a registrant? If not, are there other disclosure alternatives that would be more effective?

[59] *See* notes 25 and 27, *supra*.

[60] *See* FAS 119 ¶ 11a. Footnote 4 of FAS 119 illustrates the qualitative disclosures required by ¶ 11a. That footnote states:

If an entity's objective for a derivative position is to keep a risk from the entity's non-derivative assets below a specified level, the context would be a description of those assets and their risks, and a strategy might be purchasing put options in a specified proportion to the assets at risk.

[61] *See* FAS 119 ¶ 11c.

[62] *See* section III B3b, *infra*.

[63] For purposes of this release, primary market risk exposures mean (i) the following categories of market risk: interest rate risk, foreign currency exchange rate risk, commodity price risk, and other similar market rate or price risks (*e.g.*, equity prices) and (ii) within each of these categories, the particular markets that present the primary risks of loss to the registrant. For example, if a registrant (i) has a material exposure to foreign currency exchange rate risk and (ii) is most vulnerable to changes in dollar/yen, dollar/pound, and dollar/peso exchange rates within this category of market risk, it would disclose these exposures.

[64] *See* section III B1b(v), *supra*, for a discussion as to why these instruments are encouraged, but not required, to be included in disclosures about market risk.

2. Would any of the proposed amendments regarding qualitative disclosures about market risk require the disclosure of information considered highly proprietary in nature? Are there other disclosures that would be useful to investors and present fewer proprietary concerns?

3. The proposed amendments relating to disclosure of qualitative information about market risk are limited to derivative financial instruments, other financial instruments, and derivative commodity instruments. In addition, when preparing these disclosures, registrants are encouraged, but not required, to present information about all instruments, positions, and cash flows subject to market risk. Is the scope of instruments covered by this proposed amendment sufficient? If not, which instruments should be included or excluded?

3. Implementation Issues Relating to Quantitative and Qualitative Disclosures About Market Risk

a. Disclosure Threshold

(i) Discussion

Under the proposed amendments, registrants would be required to make quantitative and qualitative disclosures about market risk when such risk is material. For purposes of making this materiality assessment, registrants would need to consider both (i) the materiality of the fair values of derivative financial instruments, other financial instruments, and derivative commodity instruments outstanding at the end of the current reporting period and (ii) the materiality of the potential loss in future cash flows, earnings, or fair values from reasonably possible market movements.[65] If either (i) or (ii) in the previous sentence are material, registrants would have to disclose qualitative and quantitative information about market risk.

In determining the fair values of market risk sensitive instruments outstanding at the end of the current reporting period, registrants generally should not net fair values, except to the extent allowed under *FASB Interpretation No. 39, ''Offsetting of Amounts Related to Certain Contracts''* (''Interpretation 39'') (March 1992).[66] For example, the fair value of assets generally should not be netted with the fair value of liabilities. Instead, the fair values of such instruments should be aggregated, without netting, for purposes of assessing materiality.[67]

In determining the materiality of the potential loss in future earnings or fair values from reasonably possible market movements, registrants should consider (i) the magnitude of past market movements, (ii) expectations about the magnitude of reasonably possible future market movements, and (iii) potential losses that may arise from leverage, option, and/or multiplier features.

(ii) Requests for Comment

In developing the proposed disclosure thresholds, the Commission was interested in establishing thresholds that considered the materiality of fair values of market risk sensitive instruments at the end of a reporting period and the potential for market risk in those instruments in future periods. The Commission believes an assessment of the materiality of the instruments held at period end is appropriate because investors are likely to be concerned about the market risk exposure of an entity whenever their financial statements indicate material investments in derivative financial instruments, other financial instruments, and derivative commodity instruments. Without such disclosure, investors likely would be unable to determine the magnitude of the combined market risk exposure inherent in these individual instruments. Similarly, the Commission believes an assessment of the risk of loss in earnings, cash flows, or fair values from reasonably possible future market movements is necessary to capture, for example, the potential exposure to market risk in instruments with leverage, written option, or prepayment features that may not be reflected fully in fair values at period end.

Are these proposed disclosure thresholds relating to quantitative and qualitative disclosures about market risk, including the guidance relating to netting of fair values of market risk sensitive instruments, appropriate? Are there other disclosure thresholds that would provide more meaningful information to investors? For example, for purposes of determining the materiality of fair values of market risk sensitive instruments at period end, would it be better to determine a disclosure threshold based on the materiality of the larger of the fair values of (i) assets, and ''off-balance-sheet'' unrecognized assets or (ii) liabilities and ''off-balance-sheet'' unrecognized liabilities? Alternatively, would the disclosure thresholds for MD&A be more appropriate?[68]

Finally, should the Commission take a different approach to materiality assessments by specifying quantitative indicators that provide a threshold for disclosure, such as ratios of certain notional amounts, contractual amounts, fair values, and/or potential future losses to either stockholders' equity, earnings from continuing operations, and/or some other amount? If so, what specific indicators should result in disclosure (*e.g.*, fair value amounts in excess of 10% of stockholders' equity, or some other percentage of stockholders' equity or some other amount; notional and contractual amounts in excess of a specified percentage of stockholders' equity; and/or potential loss in earnings or fair values in excess of a specified percentage of earnings from continuing operations)? If specific indicators are used, should netting of certain amounts be permitted?

b. Location of Quantitative and Qualitative Disclosures

(i) Discussion

The proposed qualitative and quantitative market risk disclosure amendments specify that these disclosures be placed outside the financial statements. Thus, for example, this information would be required to be included in the annual report to shareholders, but would be located outside the financial statements covered by the audit opinion. The proposed disclosures are designed to supplement and make complete existing information about market risk sensitive instruments (*e.g.*, information required to be disclosed by FAS 119) that currently appears in prospectuses, registration statements, reports, and other documents that are used to make investment and voting decisions and that are delivered to investors and shareholders. Thus, the Commission is

[65] For purposes of this release, the term ''reasonably possible'' is defined by ¶ 3 of FASB, *Statement of Financial Accounting Standards No. 5,* ''Accounting for Contingencies'' (''FAS 5'') (March 1975), which states that ''reasonably possible'' means the chance of a future transaction or event occurring is more than remote but less than likely.

[66] Interpretation 39 states that it is a general principle of accounting that the offsetting of assets and liabilities in the balance sheet is improper except where a right of set off exists. Interpretation 39 defines right of set off and specifies what conditions must be met to have that right. FAS 119 ¶ 15(d) in disclosing the fair values of instruments also prohibits the netting of fair values, except to the extent that the offsetting of carrying amounts in the statement of financial position is permitted under Interpretation 39.

[67] In general, the Commission is not proposing the netting of fair values for purposes of assessing materiality primarily because it believes the establishment of a set of netting rules for fair values would be complex and difficult to implement.

[68] *See* SEC Financial Reporting Policies § 501.02 for the interpretative release to Item 303 of Regulation S-K, which specifies the MD&A disclosure thresholds.

recommending that the proposed market risk disclosures be included in such documents delivered to investors and shareholders, rather than included in documents filed only with the Commission.

(ii) Request for Comment

The Commission recognizes that the proposed disclosures may be complex, especially given the requirement to describe, when appropriate, the model and key assumptions used to prepare the quantitative disclosures about market risk. Given this complexity, would it be better to disclose the proposed information about market risk in reports and statements filed with the Commission that are not required to be delivered to all shareholders and investors? If so, will investors be disadvantaged by the omission of such information from delivered documents if it is otherwise required to be included in Commission filings and made available for free electronically and immediately through the SEC's EDGAR system?

c. Relationship of Proposed Disclosures to MD&A

Market risk sensitive instruments often are used to manage known uncertainties in market rates and prices. Under Item 303 of Regulation S–K, registrants currently are required to disclose in MD&A, among other things, the impact on past and future financial condition and results of operations of known uncertainties. Thus, there is a potential for overlap between the proposed amendments under new Item 305 and current Item 303. To the extent that the disclosures in a registrant's MD&A comply with the proposed amendments, registrants would not need to repeat this information elsewhere in their filings. Likewise, if the proposed disclosures are provided in the footnotes to the financial statements, that information also would not need to be reported elsewhere.

d. Application to Registrants

(i) Discussion

New Item 305 would require that all registrants currently required to provide MD&A disclosures, pursuant to Item 303 of Regulation S–X, also would have to comply with proposed Item 305 of Regulation S–K. As a result, to the extent material, quantitative and qualitative information about market risk would be required explicitly for many different types of registrants, including, for example, commercial and industrial companies, financial institutions, broker dealers, service companies, business development companies, and companies registering insurance contracts, such as market-value adjusted annuities and real estate funds underlying annuity contracts.

(ii) Request for Comment

Should proposed Item 305 of Regulation S–K be required for all registrants that prepare MD&A pursuant to Item 303 of Regulation S–K? If not, which registrants should be exempted from proposed Item 305 of Regulation S-K? In particular, should business development companies and companies registering insurance contracts be exempted from proposed Item 305?

e. Safe Harbor Provision

As noted by the FASB, some have expressed concern that disclosing information about market risk may have legal ramifications for registrants if actual outcomes differ from the market risk amounts disclosed.[69] It is the Commission's intention that forward looking disclosures made pursuant to proposed Item 305 of Regulation S–K and Item 9A of Form 20–F be subject to an appropriate safe harbor.

Congress recently adopted the Private Securities Litigation Reform Act of 1995 [70] that, among other things, amends the Securities Act and Securities Exchange Act to include a safe harbor for forward looking information. The Commission's staff is continuing to consider how best to craft an appropriate safe harbor in light of this recent legislation. The Commission intends to issue a release shortly that would propose that the disclosures to be required by new Items 305 and 9A be made subject to safe harbor provisions. Comments received on that release will be considered in connection with the comments received on this release to enable the Commission to take appropriate action with respect to both releases at the same time.

IV. Applicability of Proposed Amendments

A. Application to Small Business Issuers

1. Discussion

The Commission believes that because of the newness and evolving nature of these disclosures, as well as the relative costs of complying with these disclosures for small business issuers,[71] that it is appropriate, at this time, to exempt small business issuers from the proposed disclosures of quantitative and qualitative information about market risk. Accordingly, at this time, the Commission is not proposing to amend Regulation S–B to incorporate an item similar to proposed Item 305 of Regulation S–K. Small business issuers, however, still would be required (i) to comply with the proposed amendment regarding accounting policies disclosures for derivatives, (ii) to comply with Rule 12b–20 and Rule 408 as described in section VI of this release, thereby being responsive to guidance reminding registrants to provide additional information about the effects of derivatives on information expressly required to be filed with the Commission, and (iii) to the extent market risk represents a known trend, event, or uncertainty, to discuss the impact of market risk on past and future financial condition and results of operations, pursuant to Item 303 of Regulation S–B, 17 CFR 228.303.

2. Request for Comment

Should small business issuers be excluded from either a portion or all of the proposed quantitative and qualitative disclosures about market risk? If not, should application of these proposed amendments to small business issuers be delayed to provide them more time to become familiar with and implement the amendments?

B. Application to Foreign Private Issuers

1. Discussion

The need for improved disclosures about market risk sensitive instruments is not an issue limited to domestic registrants. Standard setters throughout the world have recognized and have begun to address the need for improvement in such disclosures for foreign companies, including some foreign private issuers that have registered securities with the Commission.[72] The Commission is proposing to amend Form 20–F to require disclosure by all foreign private

[69] *See* FAS 119 ¶ 73. Under the Commission's current safe harbor rules, a statement made by or on behalf of an issuer is not deemed a fraudulent statement unless it can be shown that the statement was made or reaffirmed without a reasonable basis or was disclosed other than in good faith. *See* Rule 175 under the Securities Act of 1933 and Rule 3b–6 under the Securities Exchange Act of 1934. The Commission has been re-examining Rules 175 and 3b–6. *See* Securities Act Release No. 7101 (October 13, 1994), 59 FR 52723 (October 19, 1994).

[70] Private Securities Litigation Reform Act of 1995, Pub. L. No. 104–67 (December 22, 1995).

[71] ''Small business issuer'' is defined to mean any entity that (1) has revenues of less than $25,000,000, (2) is a United States or Canadian issuer, (3) is not an investment company, and (4) if a majority owned subsidiary, the parent corporation is also a small business issuer. An entity is not a small business issuer, however, if it has a public float (the aggregate market value of the outstanding securities held by non-affiliates) of $25,000,000 or more, 17 CFR 230.405.

[72] *See* note 33, *supra.*

issuers of quantitative and qualitative information about market risk.

In addition, those foreign private issuers that prepare financial statements in accordance with Item 18 of Form 20–F would be required to provide descriptions in the footnotes to the financial statements of the policies used to account for derivatives. In contrast, foreign private issuers that prepare financial statements in accordance with Item 17 of Form 20–F are not required to provide financial statement disclosures required by generally accepted accounting principles and Regulation S–X, including disclosures about accounting policies.[73] Thus, the proposed amendments requiring disclosures of accounting policies would not apply to foreign private issuers filing under Item 17 of Form 20–F. However, foreign private issuers filing under Item 17 of Form 20–F would need to consider the guidance presented in Staff Accounting Bulletin Topic 1:D (''SAB Topic 1:D'') to determine if information regarding accounting policies for derivatives should be provided in MD&A.[74]

2. Request for Comment

Should foreign private issuers be subject to the proposed amendments? In particular, are the proposed differences in disclosure that would be applicable to foreign private issuers that file under Items 17 and 18 of Form 20–F appropriate? For example, should foreign private issuers filing under Item 17 of Form 20–F be required to provide accounting policies disclosures? Should application of some or all of the proposed amendments to foreign private issuers be delayed to provide them more time to become familiar with and implement the amendments? If so, which portions of the proposed amendments should be delayed and what period of delay would be appropriate (six months, one year, or some other time period)?

C. Scope and Definition of Instruments

For purposes of this release, financial instruments, derivative financial instruments, other financial instruments, and derivative commodity instruments are defined as follows. ''Financial instruments'' have the same meaning as that set forth in paragraph 3 of FAS 107.[75] ''Derivative financial instruments'' are a subset of financial instruments and include futures, forwards, swaps, options, and other financial instruments with similar characteristics, as defined by paragraphs 5–7 of FAS 119.[76]

Other financial instruments include all financial instruments as defined in paragraph 3 of FAS 107, except for derivative financial instruments, as defined above. For example, other financial instruments include trade accounts receivable, investments, loans, structured notes, mortgage-backed securities, trade accounts payable, indexed debt instruments, interest-only and principal-only obligations, deposits, and other debt obligations. However, for purposes of this release, trade accounts receivable and trade accounts payable should not be considered other financial instruments when their carrying amounts approximate fair value.

Commodity derivative instruments include, to the extent such instruments are not derivative financial instruments, commodity futures, commodity forwards, commodity swaps, commodity options, and other commodity instruments with similar characteristics, that are reasonably possible to be settled in cash or with another financial instrument.[77]

Thus, the instrument definitions described above do not encompass (i) commodity positions, (ii) derivative commodity instruments that are not reasonably possible to be settled in cash or with another financial instrument (*e.g.*, a commodity forward contract that must be settled in the commodity), (iii) cash flows from anticipated transactions, and/or (iv) operating cash flows from non-financial and non-commodity instruments.[78]

D. Reporting Frequency

1. Discussion

The proposed amendments would apply to all registration statements filed under the Securities Act and all reports and proxy and information statements filed under the Exchange Act that are required to include or incorporate financial statements. However, for reports that only include interim financial statements (*e.g.*, Form 10–Qs), the proposed amendments would need to be complied with only to the extent there has been a material change in the information disclosed as of the preceding fiscal year end. Thus, for example, the quantitative and qualitative information about market risk required by the proposed amendments would be included in interim filings only if there was a material change in that information when compared to the information

[73] Foreign private issuers complying with Item 18 of Form 20–F must provide all information required by US generally accepted accounting principles and Regulation S–X. Disclosures required by US generally accepted accounting principles but not required by foreign generally accepted accounting principles on which the financial statements are prepared need not be furnished pursuant to Item 17 of Form 20–F. Compliance with Item 17 of Form 20–F is acceptable for registration statements or annual reports on Form 20–F. With certain exceptions, foreign private issuers offering securities must comply with Item 18 of Form 20–F.

[74] SAB Topic 1:D provides several examples of disclosures in MD&A that might be necessary to enable readers to understand the financial statements as a whole. One of those example disclosures includes significant accounting policies and measurement assumptions which may bear upon an understanding of operating trends or financial condition.

[75] FAS 107 ¶ 3 states:

A financial instrument is defined as cash, evidence of an ownership interest in an entity, or a contract that both:

a. Imposes on one entity a contractual obligation (1) to deliver cash or another financial instrument to a second entity or (2) to exchange other financial instruments on potentially unfavorable terms with the second entity.

b. Conveys to that second entity a contractual right (1) to receive cash or another financial instrument from the first entity or (2) to exchange other financial instruments on potentially favorable terms with the first entity.

[76] FAS 119 ¶¶ 5–7 state:

5. For purposes of this Statement, a *derivative financial instrument* is a futures, forward, swap, or option contract, or other financial instrument with similar characteristics.

6. Examples of other financial instruments with characteristics similar to option contracts include interest rate caps or floors and fixed-rate loan commitments. Those instruments have characteristics similar to options in that they provide the holder with benefits of favorable movements in the price of an underlying asset or index with limited or no exposure to losses from unfavorable price movements, generally in return for a premium paid at inception by the holder to the issuer. Variable-rate loan commitments and other variable-rate financial instruments also may have characteristics similar to option contracts. For example, contract rate adjustments may lag changes in market rates or be subject to caps or floors. Examples of other financial instruments with characteristics similar to forward contracts include various kinds of commitments to purchase stocks or bonds, forward interest rate agreements, and interest rate collars. Those instruments are similar to forwards in that they provide benefits of favorable movements in the price of an underlying asset or index and exposure to losses from unfavorable price movements, generally with no payments at inception.

7. The definition of *derivative financial instrument* in paragraph 5 excludes all on-balance-sheet receivables and payables, including those that ''derive'' their values or contractually required cash flows from the price of some other security or index, such as mortgage-backed securities, interest-only and principal-only obligations, and indexed debt instruments. It also excludes option features that are embedded within an on-balance-sheet receivable or payable, for example, the conversion feature and call provisions embedded in convertible bonds.

[77] The term ''reasonably possible'' as used in the proposed rulemaking amendments is consistent with ¶ 3 of FAS 5, which defines ''reasonably possible'' to mean the chance of a future transaction or event occurring is more than remote but less than likely.

[78] *See* section III B1b(v), *supra*, for a further description of the instruments, positions, and transactions described in this paragraph.

presented as of the end of the preceding fiscal year.

2. Request for Comment

Is the frequency of reporting proposed in the amendments adequate? Alternatively, given that market risk sensitive instruments allow a registrant to change rapidly its exposures to market risk, should the proposed disclosures be provided in all interim filings?

V. General Request for Comment

The Commission seeks comment from all interested persons wishing to address any aspect of the proposed amendments. In addition to the requests for comments listed throughout this release, the Commission also is requesting comment on whether the proposed amendments, if adopted, would have an adverse impact on competition or would impose a burden on competition that is neither necessary nor appropriate in furthering the purposes of the Securities Act and the Exchange Act. Comments in this regard will be considered by the Commission in complying with its responsibilities under Section 23(a) of the Exchange Act, 15 U.S.C. 78w(a).

VI. Disclosure of the Effects of Derivative Instruments on Reporting Financial Instruments, Commodity Positions, Firm Commitments, and Anticipated Transactions

In conjunction with the publication today of proposed rules to require specific additional disclosures concerning market risk sensitive instruments, including derivatives, the Commission is taking this opportunity to remind registrants of existing obligations that may already require certain disclosures about derivatives. The staff's 1994 and 1995 reviews of registrant filings suggested that some registrants may not be providing sufficient disclosure about how derivatives directly or indirectly affect reported items. As a result, those disclosures that are being made may not accurately reflect such matters as the effective terms or expected cash flows of the reported items.

It is fundamental that registrants must include in any filings or reports any material information that may be necessary to make statements made, in light of the circumstances under which they are made, not misleading.[79] That is, registrants must provide disclosure about derivatives that affect, directly or indirectly, the terms, fair values, or cash flows, of the reported items. This would include derivative transactions that are designated to reported items under generally accepted accounting principles.[80]

Thus, for example, information required to be disclosed in the footnotes to the financial statements about the interest rates and repricing characteristics of debt obligations should include, when material, the effects of derivatives. Similarly, summary information and disclosures in MD&A about the interest costs of debt obligations should include, when material, disclosure of the effects of derivatives. Likewise, when derivatives directly or indirectly affect the terms and cash flows of items such as securities held as assets, servicing rights, oil and gas reserves, loan receivables, deposit liabilities, and leases, disclosure about the terms and cash flows of these items should include, when material, disclosure of the effects of derivatives to the extent such disclosure is necessary to prevent the disclosure about the reported item from being misleading.

VII. Cost-Benefit Analysis

A. Background

To assist the Commission in its evaluation of the costs and benefits that may result from the proposed disclosure requirements discussed in this release, commenters are requested to provide views and data relating to any costs and benefits associated with the proposed amendments. In general, the proposed amendments clarify existing standards and rules, include additional instruments within existing standards, and provide alternatives for quantitative disclosures regarding market risk sensitive instruments. In particular, the proposed amendments provide:

1. Enhanced descriptions of accounting policies for derivative financial instruments and derivative commodity instruments;
2. Quantitative disclosures about market risk; and
3. Qualitative disclosures about market risk.

The Commission is proposing these amendments in response to requests from investors and others to provide more meaningful information about market risk sensitive instruments.[81] The expected benefits of these proposed amendments are to make information about market risk sensitive instruments, including derivative instruments, more understandable to investors and others. This increased understanding is expected to enhance the ability of investors to make investment decisions and also improve the efficiency of markets. The Commission believes these benefits will outweigh the related costs, which are discussed below.

B. Descriptions of Accounting Policies for Derivatives

FAS 119 was designed, in part, to help investors and others understand how derivative financial instruments are reported in the financial statements.[82] Thus, FAS 119 requires, among other things, disclosure of the policies used to account for derivative financial instruments, pursuant to the requirements of APB 22.[83] However, the scope of FAS 119 is limited to derivative financial instruments; therefore, it does not apply to other derivative instruments with similar characteristics, such as derivative commodity instruments. In addition, FAS 119 does not provide explicit guidance indicating what must be described in accounting policies footnotes to make the financial statement effects of derivatives more understandable. The SEC staff found that the accounting policies footnotes for derivatives often were too general in nature, not reflecting adequately the many choices made by registrants in their accounting for derivatives.

The current proposed amendments require descriptions of accounting policies for derivative financial instruments and derivative commodity instruments, unless the registrant's derivative activities are not material. Thus, the scope of the proposed amendments is broader than the scope of FAS 119. In addition, to help make clear the impact of derivatives on the financial statements, the proposed amendments make explicit the items to be disclosed in the accounting policies footnotes.

The proposed amendments are likely to result in a more focused and descriptive discussion of the accounting policies for both derivative financial instruments and derivative commodity instruments. This additional information is likely to result in additional preparation, audit, and printing costs. However, because accounting policies for these instruments are known by registrants and should be known by their auditors,

[79] *See, e.g.*, Rule 12b–20, 17 CFR 240.12b–20, under the Securities Exchange Act of 1934 (''Exchange Act'') and Rule 408, 17 CFR 230.408 under the Securities Act of 1933 (''Securities Act'').

[80] *See, e.g.*, FAS 52 ¶ 21a and FAS 80 ¶ 4a.

[81] *See* notes 23–29, *supra*, for examples of investors, regulators, and other private bodies endorsing or recommending improved quantitative disclosures about market risk.

[82] See FAS 119 ¶ 60.

[83] *See* FAS 119 ¶ 8. *See also* note 39, *supra*, for a discussion of the requirements of APB 22.

most of the preparation and audit costs are expected to relate to initial compliance with the proposed amendments. These costs, along with expected printing costs, are not estimated to be significant. Other costs, such as ongoing recordkeeping and compliance costs, also are not expected to be significant.

C. Quantitative Information About Market Risk

As discussed earlier in this release, under the proposed amendments, registrants would be required to present quantitative information about market risk. An important aspect of this requirement, from a cost perspective, is that registrants will have the flexibility to choose one of three disclosure alternatives (tabular presentation, sensitivity analysis, or value at risk) to provide such quantitative information about market risk.

The Commission believes that, for registrants electing to provide tabular disclosure, much of the required information is currently available. Thus, additional costs relating to recordkeeping are not expected to be significant. While increased reporting and compliance burdens may result, in many cases the information presented in the tabular disclosures is used in managing the business activities of the registrant and, therefore, may be available at relatively low incremental costs. Further, registrants complying with Securities Act Industry Guide 3,[84] principally financial institutions, already disclose a significant amount of the requested information.

Registrants that choose to use either the sensitivity or value at risk disclosure alternatives may incur significant additional costs if they currently do not use these methodologies to manage market risk. In contrast, if registrants currently use sensitivity or value at risk analyses to manage market risk, the Commission believes that any additional costs associated with complying with the proposed amendments are likely to be negligible. In addition, the Commission understands that some of the data and the systems needed to develop these analyses recently have been made available at a relatively moderate cost.[85] Moreover, some registrants are required to prepare such information for regulatory capital measurement purposes. In particular, thrift institutions are required to prepare fair value sensitivity analysis amounts for risk-based capital purposes.[86] Also, bank holding companies may be required, under a proposed rulemaking requirement, to prepare a value at risk analysis for risk-based capital purposes.[87] Thus, the costs associated with the sensitivity and value at risk analyses may vary depending on (i) whether the registrant currently engages in these analyses for other management or regulatory purposes and (ii) the particular model and assumptions used in the registrant's calculations. Any registrant that believes the cost of such analyses outweigh the benefits of disclosing them, however, may elect to provide tabular presentation of information about market risk sensitive instruments.

D. Qualitative Information About Market Risk

FAS 119 requires certain qualitative disclosures about the market risk management activities associated with derivative financial instruments held or issued for purposes other than trading. In particular, FAS 119 requires disclosure of ''the entity's objectives for holding or issuing the derivative financial instruments, the context needed to understand those objectives, and its general strategies for achieving those objectives.'' [88] However, as indicated above, these requirements of FAS 119 only apply to certain derivative financial instruments, and the SEC staff has observed that these disclosures typically have been general in nature, providing only limited insight into an entity's overall market risk management activities.

In essence, the proposed amendments expand certain disclosure requirements set forth in FAS 119 to (i) encompass derivative financial instruments entered into for trading purposes, other financial instruments, and derivative commodity instruments and (ii) require registrants to evaluate and describe material changes in their primary risk exposures and their market risk management activities. The Commission believes this should present a more complete discussion of a registrant's exposure to market risks and the way it manages those risks. Because this information is likely to be used by registrants as part of their risk management activities, incremental costs relating to such disclosure are not expected to be significant.

E. Small Business Issuers

As noted earlier, the Commission has determined not to amend Regulation S-B [89] to incorporate an item similar to Item 305 of Regulation S-K. Regulation S-B may be used by small business issuers [90] required to register their securities with the Commission. By excluding small business issuers from all but the accounting policies disclosures that would be required by the proposed amendments, the Commission has limited substantially the cost of these proposals for small entities.

The Commission will reassess reporting, recordkeeping, compliance requirements, and other cost-benefit issues in light of comments it receives in response to the proposed amendments.

VII. Summary of Initial Regulatory Flexibility Analysis

The Commission has prepared an Initial Regulatory Flexibility Analysis pursuant to the requirements of the Regulatory Flexibility Act,[91] regarding the proposed amendments to Rule 4–08 of Regulation S–X and to Regulation S–K to create Item 305. Additionally, the Commission is proposing amendments to Forms S–1, S–2, S–4, S–11, and F–4 under the Securities Act of 1933, and Rule 14a–3, Schedule 14A and Forms 10, 20–F, 10–Q, and 10–K under the Exchange Act. The analysis notes that the amendments would clarify existing disclosure requirements, include additional instruments within existing disclosure requirements, and provide disclosure alternatives for quantitative information regarding derivative financial instruments, other financial instruments, and derivative commodity instruments. These amendments are intended to provide investors with information that provides a clearer understanding of registrants' use of such instruments, and the market risks inherent in those instruments.

The analysis notes that, although the proposed amendments may increase the

[84] Securities Act Industry Guide 3, ''*Statistical Disclosure by Bank Holding Companies.*'' Exchange Act Industry Guide 3 is identical to the Securities Act guide. Detailed disclosures are required under Guide 3 of, among other things, the registrant's: (i) distribution of assets, liabilities and stockholders' equity; interest rates and interest differential; (ii) investment portfolio; (iii) loan portfolio (including types of loans, maturities and sensitivities of loans to changes in interest rates, risk elements, and loans outstanding in foreign countries); (iv) summary of loan loss experience; (v) deposits; (vi) return on equity and assets; and (vii) short-term borrowings.

[85] *See Wall Street Journal,* ''Morgan Unveils the Way It Measures Market Risk'' C1 (October 11, 1994).

[86] *See* note 51, supra.

[87] *See* Department of the Treasury, *Notice of Proposed Rulemaking, ''Risk-Based Capital Standards: Market Risk,''* 60 FR 38082 (July 25, 1995): *see also* Federal Reserve System, *Request of Comments, ''Capital Requirements for Market Risk,''* 60 FR 38142 (July 25, 1995).

[88] See FAS 119 ¶ 11a.

[89] 17 CFR 228.10 *et seq.*

[90] *See* note 71, *supra.*

[91] 5 U.S.C. § 603.

reporting burden for those registrants not currently providing comparable disclosures, there should not be a significant impact on recordkeeping or other compliance burdens. The analysis also indicates that the proposals do not conflict or overlap with existing requirements but rather tailor them for specific purposes.

As more fully discussed in the analysis and noted in the *Cost-Benefit Analysis* section of this release, the Commission has determined not to amend Regulation S–B to incorporate an item similar to proposed Item 305 of Regulation S–K. The Commission, therefore, has reduced the impact of the proposed amendments on small business issuers.

Request for Comment

Written comments are encouraged with respect to any aspect of the Initial Regulatory Flexibility Analysis. Such comments will be considered in preparation of the Final Regulatory Flexibility Analysis if the proposed amendments are adopted. A copy of the Initial Regulatory Flexibility Analysis may be obtained by contacting Robert E. Burns, Chief Counsel, Office of the Chief Accountant, at (202) 942–4400, Securities and Exchange Commission, 450 Fifth Street, NW., Mail Stop 11–3, Washington, DC 20549.

List of Subjects in 17 CFR Parts 210, 228, 229, 239, 240, and 249

Accounting, Reporting and recordkeeping requirements, Securities.

Text of Proposed Amendments

In accordance with the foregoing, Title 17, Chapter II of the Code of Federal Regulations is proposed to be amended as follows:

PART 210—FORM AND CONTENT OF AND REQUIREMENTS FOR FINANCIAL STATEMENTS, SECURITIES ACT OF 1933, SECURITIES EXCHANGE ACT OF 1934, PUBLIC UTILITY HOLDING COMPANY ACT OF 1935, INVESTMENT COMPANY ACT OF 1940, AND ENERGY POLICY AND CONSERVATION ACT OF 1975

1. The authority citation for Part 210 continues to read as follows:

Authority: 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 77aa(25), 77aa(26), 78*l*, 78m, 78n, 78o(d), 78w(a), 78*ll*(d), 79e(b), 79j(a), 79n, 79t(a), 80a–8, 80a–20, 80a–29, 80a–30, 80a–37a, unless otherwise noted.

2. By amending § 210.4–08 by adding paragraph (n) to read as follows:

§ 210.4–08 General notes to financial statements.

* * * * *

(n) *Accounting policies for certain derivative instruments.* In connection with the accounting policies disclosures required by generally accepted accounting principles, identify and describe all accounting principles and the methods of applying those principles that affect the recognition and measurement of derivative financial instruments and derivative commodity instruments, as defined in the instructions to this paragraph, unless the registrant's derivatives activities are not material. Materiality of derivative activities shall be measured by the fair values of derivative financial instrument and derivative commodity instruments at the end of each reporting period and the fair value of those instruments during each reporting period. This description shall include:

(1) A description of each method used to account for derivative financial instruments and derivative commodity instruments;

(2) The types of derivative financial instruments and derivative commodity instruments accounted for under each method;

(3) The criteria required to be met for each accounting method used (*e.g.,* the manner in which the type of risk reduction, correlation, designation, and/or effectiveness tests are applied);

(4) The accounting method used if the specified criteria are not met;

(5) The accounting for terminations of derivatives designated as hedges or used to affect directly or indirectly the terms, fair values, or cash flows of a designated item;

(6) The accounting for derivatives if the designated item matures, or is sold, extinguished, terminated, or, if related to an anticipated transaction, is no longer likely to occur; and

(7) Where and when derivative financial instruments and derivative commodity instruments and their related gains and losses are reported in the statements of financial position, cash flows, and results of operations.

Instructions to Paragraph 4–08(n). 1. In preparing the accounting policies disclosures under this paragraph 4–08(n), registrants should include those derivative financial instruments and derivative commodity instruments that are held during, or outstanding at the end of, each reporting period.

2. For purposes of this paragraph 4–08(n), derivative financial instruments and derivative commodity instruments are defined as follows:

(i) Derivative financial instruments have the same meaning as defined by generally accepted accounting principles (*see, e.g.,* Financial Accounting Standards Board (''FASB''), *Statement of Financial Accounting Standards No. 119, ''Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments,''* paragraphs 5–7, (October 1994) (''FAS 119'')), and includes futures, forwards, swaps, options, and other financial instruments with similar characteristics.

(ii) Derivative commodity instruments include, to the extent such instruments are not derivative financial instruments, commodity futures, commodity forwards, commodity swaps, commodity options, and other commodity instruments with similar characteristics that are reasonably possible to be settled in cash or with another financial instrument. For purposes of this paragraph, the term ''reasonably possible'' has the same meaning as defined by generally accepted accounting principles (*see, e.g.,* FASB, *Statement of Financial Accounting Standards No. 5 ''Accounting for Contingencies,'' paragraph 3 (March 1975)).*

3. For purposes of these instructions, ''anticipated transactions'' means transactions (other than transactions involving existing assets or liabilities or transactions necessitated by existing firm commitments) an enterprise expects, but is not obligated, to carry out in the normal course of business (*see, e.g.,* FASB, *Statement of Financial Accounting Standards No. 80, ''Accounting for Futures Contracts,''* paragraph 9, (August 1984)).

4. For purposes of paragraphs 4–08(n)(2), 4–08(n)(3), 4–08(n)(4), and 4–08(n)(7) registrants should distinguish derivative financial instruments and derivative commodity instruments entered into for trading purposes from those instruments that are entered into for purposes other than trading. For purposes of this paragraph, ''trading purposes'' has the same meaning as defined by generally accepted accounting principles (*see, e.g.,* FASB, *Statement of Accounting Standards No. 119, ''Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments,''* paragraph 9a, (October 1994)).

PART 228—INTEGRATED DISCLOSURE SYSTEM FOR SMALL BUSINESS ISSUERS

3. The authority citation for Part 228 continues to read as follows:

Authority: 15 U.S.C. 77e, 77f, 77g, 77h, 77j, 77k, 77s, 77aa(25), 77aa(26), 77ddd, 77eee, 77ggg, 77hhh, 77jjj, 77nnn, 77sss, 78*l*, 78m, 78n, 78o, 78w, 78*ll*, 80a–8, 80a–29, 80a–30, 80a–37, 80b–11, unless otherwise noted.

4. By amending the *NOTES* to § 228.310 by revising the first sentence of note 2 to read as follows:

§ 228.310 (Item 310) Financial Statements.

Notes—1. * * *

2. Regulation S–X [17 CFR 210.1–210.12] Form and Content of and Requirements for Financial Statements shall not apply to the preparation of such financial statements, except that the report and qualifications of the independent accountant shall comply with the requirements of article 2 of regulation S–X [17 CFR 210.2], articles

3–19 and 3–20 [17 CFR 210.3–19 and 210.3–20] shall apply to financial statements of foreign private issuers, the description of accounting policies shall comply with article 4–08(n) of regulation S–X [17 CFR 210.4–08(n)], and small business issuers engaged in oil and gas producing activities shall follow the financial accounting and reporting standards specified in article 4–10 of Regulation S–X [17 CFR 210.4–10] with respect to such activities.

* * *

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PART 229—STANDARD INSTRUCTIONS FOR FILING FORMS UNDER SECURITIES ACT OF 1933, SECURITIES EXCHANGE ACT OF 1934 AND ENERGY POLICY AND CONSERVATION ACT OF 1975—REGULATION S–K

5. The authority citation for part 229 continues to read in part as follows:

Authority: 15 U.S.C. 77e, 77f, 77g, 77h, 77j, 77k, 77s, 77aa(25), 77aa(26), 77ddd, 77eee, 77ggg, 77hhh, 77iii, 77jjj, 77nnn, 77sss, 78c, 78i, 78j, 78*l*, 78m, 78n, 78o, 78w, 78*ll*(d), 79e, 79n, 79t, 80a–8, 80a–29, 80a–30, 80a–37, 80b–11, unless otherwise noted.

* * * * *

6. By adding § 229.305 (Item 305) to read as follows:

§ 229.305 (Item 305) Quantitative and qualitative disclosures about market risk.

(a) *Quantitative information about market risk.* (1) To the extent material, registrants shall provide quantitative disclosures about market risk, as of the end of the latest fiscal year. Such disclosures should be provided using any one of the following three disclosure alternatives at the election of the registrant:

(i)(A)(*1*) Tabular presentation of terms and information related to market risk sensitive instruments; such information (*e.g.*, expected cash flows by maturity dates) should be categorized according to risk exposure category (*e.g.*, interest rate risk, foreign currency exchange rate risk, commodity price risk, and other similar market risks, such as equity price risk), and within the foreign currency exchange rate risk category, by functional currency (*e.g.*, U.S. dollar, Japanese yen).

(2) Within each of these risk exposure categories, instruments should be grouped based on common characteristics. At a minimum, instruments should be distinguished by the following characteristics:

(*i*) Fixed rate or variable rate assets or liabilities;

(*ii*) Long or short forwards or futures;

(*iii*) Written or purchased put or call options;

(*iv*) Receive fixed or receive variable interest rate swaps; and

(*v*) The currency in which the instruments' cash flows are denominated.

(*3*) For each instrument in the table, expected cash flow information should be presented separately for each of the next five years with the remaining expected cash flows presented as an aggregate amount. Derivatives used to manage risks inherent in anticipated transactions also should be disclosed separately; and

(*B*) A description of assumptions necessary to an understanding of the disclosures required under paragraph (a)(1)(i) (A) of this item 305 (see the appendix to this Item for a suggested tabular format for presentation of this information), or

(ii)(A) Sensitivity analyses that express the hypothetical loss in future earnings, fair values, or cash flows of market risk sensitive instruments resulting from at least one selected hypothetical change in interest rates, currency exchange rates, commodity prices, and similar market rates or prices over a selected time period. The magnitude of each selected hypothetical change in rates or prices may differ across risk exposures. Separate sensitivity analysis disclosures should be made for each category of risk exposure, *i.e.*, interest rate risk, foreign currency exchange rate risk, commodity price risk, and other similar market risks, such as equity price risk; and

(B) A description of the model assumptions and parameters necessary to an understanding of the disclosures required under paragraph (a)(1)(ii) (A) of this item 305; or

(iii)(A) Value at risk disclosures that express the potential loss in fair values, earnings, or cash flows from market movements (*e.g.*, changes in interest rates, foreign currency exchange rates, commodity prices, and other similar market rates or prices) over a selected time period with a selected likelihood of occurrence; value at risk disclosures should be made on an aggregate basis for all market risk sensitive instruments and for each category of market risk exposure, such as interest rate risk, foreign currency exchange rate risk, commodity price risk, and other similar market risks, such as equity price risk;

(B) For each risk exposure category either:

(*1*) The average or range in the value at risk numbers for the reported period;

(*2*) The average or range in actual changes in fair values, earnings, or cash flows of instruments occurring during the reporting period; or

(*3*) The percentage of time the actual changes in fair values, earnings, or cash flows of market risk sensitive instruments exceeded the reported value at risk amounts during the current reporting period; (The information in this paragraph (a)(1)(iii)(B) is not required for [the first fiscal year end for which this section is effective]), and

(C) A description of the model assumptions and parameters necessary to an understanding of the disclosures required under paragraphs (a)(1)(iii) (A) and (B) of this item 305.

(2) Registrants shall discuss material limitations that may cause the information required under paragraph (a)(1) of this item 305 not to reflect the overall market risk of the entity. This discussion shall include descriptions of:

(i) Each limitation; and

(ii) If applicable, the instruments' features that are not reflected fully within the selected quantitative market risk disclosure alternative.

(3) Registrants shall present summarized information for the preceding fiscal year. Registrants also shall discuss the reasons for material changes in quantitative information about market risk when compared to the information reported in the previous period. Information required by this paragraph (a)(3) of item 305, however, is not required if disclosure is not required pursuant to paragraph (a)(1) of this item 305 for the current fiscal year. Information required by this paragraph (a)(3) of item 305 is not required [for the first fiscal year end in which item 305 is effective].

(4) Registrants may change methods of presenting quantitative information about market risk (*e.g.*, changing from tabular presentation to value at risk). However, if such a change is made the registrants shall:

(i) Explain the reasons for the change; and

(ii) Provide summarized comparable information, under the new disclosure method, for the year preceding the current year.

Instructions to Paragraph 305(a).

1. In preparing the disclosures under paragraph 305(a), registrants are required to include derivative financial instruments, other financial instruments, and derivative commodity instruments, as specified in the General Instructions to Paragraphs 305(a) and 305(b).

2. In preparing disclosures under paragraph 305(a), registrants should distinguish derivative financial instruments, other financial instruments, and derivative commodity instruments entered into for trading purposes from those instruments that are entered into for purposes other than trading.

3. In preparing disclosures under paragraph 305(a), registrants may include

other market risk sensitive instruments, positions, and transactions that are not addressed in instruction 1. to paragraph 305(a). Such instruments, positions, and transactions might include commodity positions, derivative commodity instruments that are not reasonably possible to be settled in cash or with another financial instrument, cash flows from anticipated transactions, and operating cash flows from non-financial and non-commodity instruments (*e.g.*, cash flows generated by manufacturing activities). Registrants choosing to include voluntarily these instruments, positions, and cash flows for purposes of paragraphs 305(a)1(ii) and 305(a)1(iii) are required to state that they have included such instruments, positions, and cash flows.

4. Under paragraph 305(a)(1)(i):

(A) The examples of terms and information relating to market risk sensitive instruments that should be disclosed include, but are not limited to, the instruments' fair values, expected principal or transaction cash flows, weighted average effective rates or prices, and other relevant market risk related information;

(B) Functional currency means functional currency as defined by generally accepted accounting principles (*see, e.g.,* FASB, *Statement of Financial Accounting Standards No. 52, ''Foreign Currency Translation''*, (''FAS 52'') Appendix E (December 1981);

(C) Model assumptions that should be described include, but are not limited to, specification of the differing numbers reported in the table for various categories of instruments (*e.g.*, principal cash flows for debt, notional amounts for swaps, and contract amounts for options and futures) and key prepayment and/or reinvestment assumptions relating to the timing of reported cash flow amounts; and

(D) Market risk sensitive instruments that are exposed to rate or price changes in more than one market risk exposure category should be presented within the tabular information under each of those risk exposure categories.

5. Under paragraph 305(a)(1)(ii), model assumptions and parameters that should be described include, but are not limited to, how loss is defined by the model (*e.g.*, loss in earnings, fair values, or cash flows), a general description of the modeling technique (*e.g.*, change in net present values arising from parallel shifts in market rates or prices and how optionality is addressed by the model), the types of instruments covered by the model (*e.g.*, derivative financial instruments, other financial instruments, derivative commodity instruments, and whether other instruments are included voluntarily, such as certain commodity instruments and positions, cash flows from anticipated transactions, and operating cash flows from non-financial and non-commodity instruments), and other relevant information on the model's parameters, (*e.g.*, the magnitudes of parallel shifts in market rates or prices used, the method by which discount rates are determined, and key prepayment and/or reinvestment assumptions).

6. Under paragraph 305(a)(1)(iii), model assumptions and parameters that should be described include, but are not limited to, how loss is defined by the model (*e.g.*, loss in earnings, fair values, or cash flows), type of model used (*e.g.*, variance/covariance, historical simulation, Monte Carlo simulation, and how optionality is addressed by the model), the types of instruments covered by the model (*e.g.*, derivative financial instruments, other financial instruments, derivative commodity instruments, and whether other instruments are included voluntarily, such as certain commodity instruments and positions, cash flows from anticipated transactions, and operating cash flows from non-financial and non-commodity instruments), and other relevant information on model parameters, (*e.g.*, holding period, confidence interval, and the method used for aggregating value at risk amounts across market risk exposure categories, such as by assuming perfect positive correlation, independence, or actual observed correlation).

7. Under paragraph 305(a)(2), limitations that should be considered include, but are not limited to:

(A) The exclusion of certain market risk sensitive instruments, positions, and transactions from the disclosures required under paragraph 305(a)(1) (*e.g.*, derivative commodity instruments not reasonably possible to be settled in cash or with another financial instrument, commodity positions, cash flows from anticipated transactions, and operating cash flows from non-financial and non-commodity instruments, such as cash flows from manufacturing activities). Failure to include such instruments, positions, and transactions in preparing the disclosures under paragraph 305(a)(1) may be a limitation because the resulting information may not fully reflect the overall market risk of a registrant; and

(B) The ability of disclosures required under paragraph 305(a)(1) to reflect fully the market risk that may be inherent in instruments with leverage, option, or prepayment features (*e.g.*, structured notes, collateralized mortgage obligations, leveraged swaps, and swaps with embedded written options).

(b) *Qualitative information about market risk.* To the extent material, describe:

(1) The registrant's primary market risk exposures;

(2) How those exposures are managed (*e.g.*, a description of the objectives, general strategies, and instruments, if any, used to manage those exposures); and

(3) Changes in either the registrant's primary market risk exposures or how those exposures are managed when compared to what was in effect during the most recent reporting period and what is known or expected to be in effect in future reporting periods.

Instructions to Paragraph 305(b).

1. The disclosures required by this paragraph relate to the market risk exposures inherent in derivative financial instruments, other financial instruments, and derivative commodity instruments, as defined in the General Instructions to Paragraphs 305(a) and 305(b).

2. In preparing disclosures under paragraph 305(b), the qualitative information about market risk should be presented separately for derivative financial instruments, other financial instruments, and derivative commodity instruments that are entered into for trading purposes and those that are entered into for purposes other than trading. In addition, qualitative information about market risk should be presented separately for those instruments used to manage risks inherent in anticipated transactions.

3. Primary market risk exposures, for the purposes of this paragraph, mean:

(A) The following categories of market risk: interest rate risk, foreign currency exchange rate risk, commodity price risk, and other similar market rate or price risks (*e.g.*, equity prices); and

(B) Within each of these categories, the particular markets that present the primary risk of loss to the registrant. For example, if a registrant has a material exposure to foreign currency exchange rate risk and, within this category of market risk, is most vulnerable to changes in dollar/yen, dollar/pound, and dollar/peso exchange rates, the registrant would disclose these exposures. Similarly, if a registrant has a material exposure to interest rate risk and, within this category of market risk, is most vulnerable to changes in short-term U.S. prime interest rates, it would disclose this exposure.

4. For purposes of disclosure under paragraph (b) of this item 305, registrants should describe primary market risk exposures that exist at the end of the current reporting period, and how those exposures are managed.

General Instructions to Paragraphs 305(a) and 305(b).

1. The disclosure called for by paragraphs 305(a) and 305(b) is intended to clarify the registrant's exposure to market risks associated with activities in derivative financial instruments, other financial instruments, and derivative commodity instruments.

2. For purposes of paragraphs 305(a) and 305(b), derivative financial instruments, other financial instruments, and derivative commodity instruments (referred collectively as ''market rate sensitive instruments'' or ''instruments'') are defined as follows:

(A) Derivative financial instruments has the same meaning as defined by generally accepted accounting principles (*see, e.g.,* FASB, *Statement of Financial Accounting Standards No. 119, ''Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments,''* paragraphs 5–7, (October 1994)), and includes futures, forwards, swaps, options, and other financial instruments with similar characteristics;

(B) Other financial instruments means all financial instruments as defined by generally accepted accounting principles (*see, e.g.,* FASB, *Statement of Financial Accounting Standards No. 107, ''Disclosures about Fair Value of Financial Instruments,''* paragraph 3, (December 1991)), except for derivative financial instruments, as defined above;

(C) Other financial instruments include, but are not limited to, trade accounts receivable, investments, loans, structured notes, mortgage-backed securities, trade accounts payable, indexed debt instruments, interest-only and principal-only obligations, deposits, and other debt obligations. However, for purposes of this release, trade accounts receivable and trade accounts payable should not be considered other financial instruments when their carrying amounts approximate fair value; and

(D) Derivative commodity instruments include, to the extent such instruments are not derivative financial instruments, commodity futures, commodity forwards, commodity swaps, commodity options, and other commodity instruments with similar characteristics that are reasonably possible to be settled in cash or with another financial instrument. For purposes of paragraphs 305(a) and 305(b) and these general instructions, the term ''reasonably possible'' has the same meaning as defined by generally accepted accounting principles (*see, e.g.*, FASB, *Statement of Financial Accounting Standards No. 5, ''Accounting for Contingencies,''* paragraph 3 (March 1975)).

3. For purposes of paragraphs 305(a) and 305(b), disclosure is not required for:

(A) Commodity positions;

(B) Derivative commodity instruments that are not reasonably possible to be settled in cash or with another financial instrument;

(C) Cash flows from anticipated transactions; and/or

(D) Operating cash flows from non-financial and non-commodity instruments.

4. (A) For purposes of making a materiality assessment under paragraphs 305(a) and 305(b), registrants should consider both:

(i) The materiality of the fair values of derivative financial instruments, other financial instruments, and derivative commodity instruments outstanding at the end of the current reporting period; and

(ii) The materiality of the potential loss in future earnings, fair values, or cash flows from reasonably possible market movements.

(B) If either (i) or (ii) of instruction 4.(A) is material, then the disclosures under paragraphs 305(a) and 305(b) are required.

(C) In determining the materiality of the fair values of market risk sensitive instruments outstanding at the end of the current reporting period, registrants generally should not net fair values, except to the extent allowed under generally accepted accounting principles (*see, e.g., FASB Interpretation No. 39, ''Offsetting of Amounts Related to Certain Contracts''* (March 1992)). For example, under this instruction, the fair value of assets generally should not be netted with the fair value of liabilities. In determining the materiality of the potential loss in future earnings or fair values from reasonably possible market movements, registrants should consider both the magnitude of past market movements, as well as expectations about the magnitude of future market movements. In addition, in making the determination under this instruction about the materiality of the potential loss in future earnings, fair values, or cash flows, registrants should consider, among other things, potential losses that may arise from leverage, option, and/or multiplier features.

5. For purposes of presenting quantitative and qualitative information about market risk, registrants generally should provide the required information in one location. However, alternative presentation, such as inclusion of all or part of the information in the footnotes to the financial statements or in Management's Discussion and Analysis, may be used at the discretion of the registrant.

6. For purposes of the instructions to paragraphs 305(a) and 305(b), ''trading purposes'' has the same meaning as defined by generally accepted accounting principles (*see, e.g.*, FASB, *Statement of Financial Accounting Standards No. 119, ''Disclosure About Derivative Financial Instruments and Fair Value of Financial Instruments,''* paragraph 9a (October 1994)). In addition, ''anticipated transactions'' means transactions (other than transactions involving existing assets or liabilities or transactions necessitated by existing firm commitments) an enterprise expects, but is not obligated, to carry out in the normal course of business (*e.g.*, FASB, *Statement of Financial Accounting Standards No. 80, ''Accounting for Futures Contracts,''* paragraph 9 (August 1984)).

Appendix to Item 305—Tabular Disclosures

The tables set forth below are illustrative of the format that might be used when a registrant elects to present the information required by paragraph (a)(1)(i)(A) of Item 305 regarding terms and information about derivative financial instruments, other financial instruments, and derivative commodity instruments. These examples are for illustrative purposes only. Registrants are not required to display the information in the specific manner illustrated below. Alternative methods of display are permissible as long as the disclosure requirements of the section are satisfied. Furthermore, these examples were designed primarily to illustrate possible formats for presentation of the information required by the proposed section and do not purport to illustrate the broad range of derivative financial instruments, other financial instruments, and derivative commodity instruments utilized by registrants.

Interest Rate Sensitivity

The table below provides information about the Company's derivative financial instruments and other financial instruments that are sensitive to changes in interest rates, including interest rate swaps and debt obligations. For debt obligations, the table presents principal cash flows and related weighted average interest rates by expected maturity dates. Weighted average variable rates are based on implied forward rates in the yield curve at the reporting date. For interest rate swaps, the table presents notional amounts and weighted average interest rates by expected (contractual) maturity dates. Notional amounts are used to calculate the contractual payments to be exchanged under the contract. The information is presented in U.S. dollar equivalents, which is the Company's reporting currency. The instrument's actual cash flows are denominated in both U.S. dollar ($U.S.) and German deutschmarks (DMs), as indicated in parentheses.

[Dollar amounts in millions]

December 31, 19×1	Expected maturity date						Total	Fair value
	19×2	19×3	19×4	19×5	19×6	There-after		
Liabilities:								
Long-term Debt:								
Fixed Rate ($US)	$XXX	$XXX	$XXX	$XXX	$XXX	$XXX	$XXX	$XXX
Average interest rate	X.X%	X.X%	X.X%	X.X%	X.X%	X.X%	X.X%	
Fixed Rate (DMs)	XXX	XXX	XXX	XXX	XXX	XXX	XXX	XXX
Average interest rate	X.X%	X.X%	X.X%	X.X%	X.X%	X.X%	X.X%	
Variable Rate ($US)	XXX	XXX	XXX	XXX	XXX	XXX	XXX	XXX
Average interest rate	X.X%	X.X%	X.X%	X.X%	X.X%	X.X%	X.X%	

[Dollar amounts in millions]

Interest Rate Derivatives	Expected maturity date						Total	Fair value
	19×2	19×3	19×4	19×5	19×6	There-after		
Interest Rate Swaps:								
Variable to Fixed ($US)	$XXX	$XXX	$XXX	$XXX	$XXX	$XXX	$XXX	$XXX
Average pay rate	X.X%	X.X%	X.X%	X.X%	X.X%	X.X%	X.X%	
Average receive rate	X.X%	X.X%	X.X%	X.X%	X.X%	X.X%	X.X%	
Fixed to Variable ($US)	XXX	XXX	XXX	XXX	XXX	XXX	XXX	XXX
Average pay rate	X.X%	X.X%	X.X%	X.X%	X.X%	X.X%	X.X%	
Average receive rate	X.X%	X.X%	X.X%	X.X%	X.X%	X.X%	X.X%	

Exchange Rate Sensitivity

The table below provides information about the Company's derivative financial instruments, other financial instruments, and firmly committed sales transactions by functional currency and presents such information in U.S. dollar equivalents.[1] The table summarizes information on instruments and transactions that are sensitive to foreign currency exchange rates, including foreign currency forward exchange agreements, deutschmark (DM)-denominated debt obligations, and firmly committed DM sales transactions. For debt obligations, the table presents principal cash flows and related weighted average interest rates by expected maturity dates. For firmly committed DM-sales transactions, sales amounts are presented by the expected transaction date, which are not expected to exceed two years. For foreign currency forward exchange agreements, the table presents the notional amounts and weighted average exchange rates by expected (contractual) maturity dates. These notional amounts generally are used to calculate the contractual payments to be exchanged under the contract.

December 31, 19×1	Expected maturity date						Total	Fair value
	19×2	19×3	19×4	19×5	19×6	There-after		
	(US$ Equivalent in Millions)							
On-Balance Sheet Financial Instruments:								
$US Functional Currency[2] Liabilities								
Long-Term Debt (DM)	$XXX	$XXX	$XXX	$XXX	$XXX	$XXX	$XXX	$XXX
Average U.S. dollar/DM Exchange Rate	X.X	X.X	X.X	X.X	X.X	X.X	X.X	

	Expected maturity or transaction date						Total	Fair value
	19×2	19×3	19×4	19×5	19×6	There-after		
	(US$ Equivalent in millions)							
Anticipated Transactions and Related Derivatives[3]								
$US Functional Currency:								
Firmly committed transactions:								
Sales Contracts (DM)	$XXX	$XXX	....	....	....	....	$XXX	$XXX
Forward Exchange Agreements (Receive $US/Pay DM)								
Contract Amount	XXX	XXX	....	....	....	....	XXX	XXX
Average Exchange Rate	X.X	X.X	....	....	....	....	X.X	

[2] Similar tabular information would be provided for other functional currencies.
[3] Pursuant to Instruction 3 to proposed Item 305(a) of Regulation S–K, registrants may include cash flows from anticipated transactions and operating cash flows resulting from non-financial and non-commodity instruments.

Commodity Price Sensitivity

The table below provides information about the Company's corn inventory and futures contracts that are sensitive to changes in commodity prices, specifically corn prices. For inventory, the table presents the carrying amount and fair value at December 31, 19x1. For the futures contracts the table presents the notional amounts in bushels, the weighted average contract prices, and the total dollar contract amount by expected maturity dates, the latest of which occurs one year from the reporting date. Contract amounts are used to calculate the contractual payments and quantity of corn to be exchanged under the futures contracts.

[1] The information is presented in U.S. dollars because that is the registrant's reporting currency.

December 31, 19×1	Carrying amount	Fair value
	(In millions)	
On Balance Sheet Commodity Position and Related Derivatives:		
Corn Inventory	$XXX	$XXX [4]

	Expected maturity 1992	Fair value
Related Derivatives:		
Futures Contracts (Short):		
Contract Volumes (100,000 bushels)	XXX	
Weighted Average Price (Per 100,000 bushels)	$X.XX	
Contract Amount ($US in millions)	$XXX	$XXX

[4] Pursuant to Instruction 3 to proposed Item 305 of Regulation S–K, registrants may include information on commodity positions, such as corn inventory.

PART 239—FORMS PRESCRIBED UNDER THE SECURITIES ACT OF 1933

7. The authority citation for Part 239 continues to read, in part, as follows:

Authority: 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 77sss, 78c, 78*l*, 78m, 78n, 78o(d), 78w(a), 78*ll*(d), 79e, 79f, 79g, 79j, 79*l*, 79m, 79n, 79q, 79t, 80a–8, 80a–29, 80a–30 and 80a–37, unless otherwise noted.

* * * * *

8. By amending Form S–1 (referenced in 239.11) by redesignating items 11(j) through 11(m) as items 11(k) through 11(n) and adding item 11(j) to read as follows:

Note—The text of Form S–1 does not, and this amendment will not, appear in the Code of Federal Regulations.

Form S–1

Registration Statement Under the Securities Act of 1933

* * * * *

Item 11. Information With Respect to the Registrant

* * * * *

(j) Information required by Item 305 of Regulation S–K (§ 229.305 of this chapter), quantitative and qualitative disclosures about market risk.

* * * * *

9. By amending Form S–2 (referenced in § 239.12) by adding paragraph (9) to Item 11(b), removing ''and'' at the end of Item 12(a)(3)(vii), removing the period at the end of Item 12(a)(3)(viii) and in its place adding ''; and'', and adding paragraph (ix) to Item 12(a)(3) to read as follows:

Note—The text of Form S–2 does not, and this amendment will not, appear in the Code of Federal Regulations.

Form S–2

Registration Statement Under the Securities Act of 1933

* * * * *

Item 11. Information With Respect to the Registrant

(a) * * *

(b) * * *

(9) Furnish quantitative and qualitative disclosures about market risk required by Item 305 of Regulation S–K (§ 229.305 of this chapter).

* * * * *

Item 12. Incorporation of Certain Information by Reference.

(a) * * *

(3) * * *

(ix) quantitative and qualitative disclosures about market risk as required by Item 305 of Regulation S–K (§ 229.305 of this chapter).

* * * * *

10. By amending Form S–4 (referenced in § 239.25) by removing ''and'' at the end of Item 12(b)(3)(v) and the period at the end of Item 12(b)(3)(vi) and in its place adding ''; and'', adding paragraph (vii) to Item 12(b)(3), removing ''and'' at the end of Item 13(a)(3)(v) and the period at the end of Item 13(a)(3)(vi) and in its place adding ''; and'', adding paragraph (vii) to Item 13(a)(3), removing ''and'' at the end of Item 14(h) and the period at the end of Item 14(i) and in its place adding ''; and'', adding paragraph (j) to Item 14, and adding paragraph (10) to Item 17(b) to read as follows:

Note—The text of Form S–4 does not, and this amendment will not, appear in the Code of Federal Regulations.

Form S–4

Registration Statement Under the Securities Act of 1933

* * * * *

Item 12. Information With Respect to S–2 or S–3 Registrants

* * * * *

(b) * * *

(3) * * *

(vii) Item 305 of Regulation S–K (§ 229.305 of this chapter), quantitative and qualitative disclosures about market risk.

* * * * *

Item 13. Incorporation of Certain Information by Reference

* * * * *

(a) * * *

(3) * * *

(vii) Item 305 of Regulation S–K (§ 229.305 of this chapter) quantitative and qualitative disclosures about market risk.

* * * * *

Item 14. Information With Respect to Registrants Other Than S–3 or S–2 Registrants

* * * * *

(j) Item 305 of Regulation S–K (§ 229.305 of this chapter), quantitative and qualitative disclosures about market risk.

* * * * *

Item 17. Information With Respect to Companies Other Than S–3 or S–2 Companies

* * * * *

(b) * * *

(10) Item 305 of Regulation S–K (§ 229.305 of this chapter), quantitative and qualitative disclosures about market risk.

* * * * *

11. By amending Form S–11 (referenced in § 239.18) to redesignate Items 30 through 36 as Items 31 through 37 and to add Item 30 to Part I to read as follows:

Note—The text of Form S–11 does not, and this amendment will not, appear in the Code of Federal Regulations.

Form S–11

Registration Statement Under the Securities Act of 1933

* * * * *

Item 30. Quantitative and Qualitative Disclosures About Market Risk

Furnish the information required by Item 305 of Regulation S–K (§ 229.305 of this chapter).

* * * * *

12. By amending Form F–4 (referenced in § 239.34) to redesignate Item 12(b)(3)(vi) as Item 12(b)(3)(vi)(A), add new paragraph (B) to Item 12(b)(3)(vi), redesignate Item 14(g) as Item 14(g)(1), add new Item 14(g)(2), redesignate Item 17(b)(4) as Item 17(b)(4)(i), and add new Item 17(b)(4)(ii) to read as follows:

Note—The text of Form F–4 does not, and this amendment will not, appear in the Code of Federal Regulations.

Form F–4

Registration Statement Under the Securities Act of 1933

* * * * *

Item 12. Information With Respect to F–2 or F–3 Registrants

* * * * *

(b) * * *

(3) * * *

(vi)(A) * * *

(B) Item 9A of Form 20–F, quantitative and qualitative disclosures of market risk.

* * * * *

Item 14. Information With Respect to Foreign Registrants Other Than F–2 or F–3 Registrants

* * * * *

(g)(1) * * *

(g)(2) Item 9A of Form 20–F, quantitative and qualitative disclosures of market risk.

* * * * *

Item 17. Information With Respect to Foreign Companies Other Than F–2 or F–3 Companies

* * * * *

(b)(4)(i) * * *

(b)(4)(ii) Item 9A of Form 20–F, quantitative and qualitative disclosures of market risk.

* * * * *

PART 240—GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

13. The authority citation for Part 240 continues to read in part as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78i, 78j, 78*l*, 78m, 78n, 78o, 78p, 78q, 78s, 78w, 78x, 78*ll*(d), 79q, 79t, 80a–20, 80a–23, 80a–29, 80a–37, 80b–3, 80b–4 and 80b–11, unless otherwise noted.

* * * * *

14. By amending § 240.14a–3 by adding paragraph (b)(5)(iii) to read as follows:

§ 240.14a–3 Information to be furnished security holders.

* * * * *

(b) * * *

(5) * * *

(iii) The report shall contain the quantitative and qualitative disclosures about market risk required by Item 305 of Regulation S–K (§ 229.305 of this chapter).

* * * * *

15. By amending § 240.14a–101 to remove the word ''and'' at the end of Item 13(a)(4), redesignate Item 13(a)(5) as Item 13(a)(6), add Item 13(a)(5), add Instruction 6 to Item 13, remove ''and'' at the end of Item 14(b)(2)(i)(B)*(3)(vi)* and the period at the end of Item 14(b)(2)(i)(B)*(3)(vii)* and in its place add ''; and'', add paragraph *(viii)* to Item 14(b)(2)(i)(B)*(3)*, remove ''and'' at the end of Item 14(b)(2)(ii)(A)*(3)(v)* and the period at the end of Item 14(b)(2)(ii)(A)*(3)(vi)* and in its place add ''; and'', add paragraph *(vii)* to Item 14(b)(2)(ii)(A)*(3)*, remove ''and'' at the end of Item 14(b)(3)(i)(H) and the period at the end of Item 14(b)(3)(i)(I) and in its place add ''; and'', add paragraph (J) to Item 14(b)(3)(i), and add Instructions 8, 9, and 10 to Item 14 to read as follows:

§ 240.14a–101 Schedule 14A. Information required in proxy statement.

* * * * *

Item 13. Financial and Other Information

(a) *Information required.* * * *

(5) Item 305 of Regulation S–K, quantitative and qualitative disclosures about market risk; and

* * * * *

Instructions to Item 13.

* * * * *

6. A registered investment company need not comply with items (a)(2), (a)(3), and (a)(5) of this Item 13.

* * * * *

Item 14. Mergers, Consolidations, Acquisitions and Similar Matters

* * * * *

(*b*) *Information about the registrant and the other person*.

* * * * *

(*2*) *Information with respect to S–2 or S–3 registrants*.

(*i*) *Information required to be furnished*. * * *

(B) * * *

(*3*) * * *

(*viii*) Item 305 of Regulation S–K (§ 229.305 of this chapter), quantitative and qualitative disclosures about market risk.

(ii) *Incorporation of certain information by reference*.

* * * * *

(A) * * *

(*3*) * * *

(*vii*) Item 305 of Regulation S–K, quantitative and qualitative disclosures about market risk.

* * * * *

(*3*) *Information with respect to registrants other than S–2 or S–3 registrants*.

(i) * * *

(A) * * *

(J) Item 305 of Regulation S–K, quantitative and qualitative disclosures about market risk.

* * * * *

Instructions to Item 14.

* * * * *

8. A registered management company need not comply with Items (i), (iii), (iv), (v), (vi), and (viii) of paragraph (b)(2)(i)(B)(3) of this Item 14.

9. A registered management company need not comply with Items (i), (ii), (iii), (iv), (v), and (vii) of paragraph (b)(2)(ii)(A)(3) of this Item 14.

10. A registered management company need not comply with items (A), (B), (D), (F), (G), (H), and (J) of paragraph (b)(3)(i) of this Item 14.

* * * * *

PART 249—FORMS, SECURITIES EXCHANGE ACT OF 1934

16. The authority for Part 249 continues to read, in part, as follows:

Authority: 15 U.S.C. 78a, *et seq.*, unless otherwise noted.

17. By amending Form 10 (referenced in § 249.210) by revising Item 2 to read as follows:

Note—The text of Form 10 does not, and this amendment will not, appear in the Code of Federal Regulations.

Form 10

General Form for Registration of Securities

* * * * *

Item 2. Financial Information

Furnish the information required by Items 301, 303, and 305 of Regulation S–K (§§ 229.301, 229.303, and 229.305 of this chapter).

* * * * *

18. By amending Form 20–F (referenced in § 249.220f) by adding Item 9A to be inserted after Item 9 and before Item 10 in Part I to read as follows:

Note—The text of Form 20–F does not, and this amendment will not, appear in the Code of Federal Regulations.

Form 20–F

Registration Statement Pursuant to Section 12(b) or (g) of The Securities Exchange Act of 1934 or Annual Report Pursuant to Section 13 or 15(d) of The Securities Exchange Act of 1934 or Transaction Report Pursuant to Section 13 or 15(d) of The Securities Exchange Act of 1934

* * * * *

Part I

* * * * *

Item 9A. Quantitative and Qualitative Disclosures About Market Risk.

(a) *Quantitative information about market risk*. (1) To the extent material, registrants shall provide quantitative disclosures about market risk, as of the end of the latest fiscal year. Such disclosures should be provided using any one of the following three disclosure alternatives at the election of the registrant:

(i)(A)(*1*) Tabular presentation of terms and information related to market risk sensitive instruments; such information (*e.g.*, expected cash flows by maturity dates) should be categorized according to risk exposure category (*e.g.*, interest rate risk, foreign currency exchange rate risk, commodity price risk, and other similar market risks, such as equity price risk), and within the foreign currency exchange rate risk category, by functional currency (*e.g.*, U.S. dollar, Japanese yen).

(*2*) Within each of these risk exposure categories, instruments should be grouped based on common characteristics. At a minimum, instruments should be distinguished by the following characteristics:

(*i*) Fixed rate or variable rate assets or liabilities;

(*ii*) Long or short forwards or futures;

(*iii*) Written or purchased put or call options;

(*iv*) Receive fixed or receive variable interest rate swaps; and

(*v*) The currency in which the instruments' cash flows are denominated.

(*3*) For each instrument in the table, expected cash flow information should be presented separately for each of the next five years with the remaining expected cash flows presented as an aggregate amount. Derivatives used to manage risks inherent in anticipated transactions also should be disclosed separately; and

(*B*) A description of assumptions necessary to an understanding of the disclosures required under subparagraph (A) of this item 9A(a)(1)(i) (see the Appendix to this Item for a suggested tabular format for presentation of this information), or

(*ii)(A*) Sensitivity analyses that express the hypothetical loss in future earnings, fair values, or cash flows of market risk sensitive instruments resulting from at least one selected hypothetical change in interest rates, currency exchange rates, commodity prices, and similar market rates or prices over a selected time period. The magnitude of each selected hypothetical change in rates or prices may differ across risk exposures. Separate sensitivity analysis disclosures should be made for each category of risk exposure, *i.e.,* interest rate risk, foreign currency exchange rate risk, commodity price risk, and other similar market risks, such as equity price risk; and

(B) A description of the model assumptions and parameters necessary to an understanding of the disclosures required under subparagraph (A) of this item 9A(a)(1)(ii); or

(iii)(A) Value at risk disclosures that express the potential loss in fair values, earnings, or cash flows from market movements (*e.g.,* changes in interest rates, foreign currency exchange rates, commodity prices, and other similar market rates or prices) over a selected time period with a selected likelihood of occurrence; value at risk disclosures should be made on an aggregate basis for all market risk sensitive instruments and for each category of market risk exposure, such as interest rate risk, foreign currency exchange rate risk, commodity price risk, and other similar market risks, such as equity price risk;

(B) For each risk exposure category either:

(*1*) The average or range in the value at risk numbers for the reported period;

(*2*) The average or range in actual changes in fair values, earnings, or cash flows of instruments occurring during the reporting period; or

(*3*) The percentage of time the actual changes in fair values, earnings, or cash flows of market risk sensitive instruments exceeded the reported value at risk amounts during the current reporting period; (The information in this subparagraph (B) is not required for the first fiscal year end for which this rule is effective) and

(C) A description of the model assumptions and parameters necessary to an understanding of the disclosures required under subparagraphs (A) and (B) of this Item 9A(a)(1)(iii).

(2) Registrants shall discuss material limitations that may cause the information required under paragraph (a)(1) of this item 9A not to reflect the overall market risk of the entity. This discussion shall include descriptions of:

(i) Each limitation; and

(ii) If applicable, the instruments' features that are not reflected fully within the selected quantitative market risk disclosure alternative.

(3) Registrants shall present summarized information for the preceding fiscal year. Registrants also shall discuss the reasons for material changes in quantitative information about market risk when compared to the information reported in the previous period. Information required by this paragraph (a)(3) of item 9A, however, is not required if disclosure is not required pursuant to paragraph (a)(1) of this item 9A for the current fiscal year. Information required by this paragraph (a)(3) of item 9A is not required for the first fiscal year end in which this item 9A is effective.

(4) Registrants may change methods of presenting quantitative information about market risk (*e.g.,* changing from tabular presentation to value at risk). However, if such a change is made the registrants shall:

(i) Explain the reasons for the change; and

(ii) Provide summarized comparable information, under the new disclosure method, for the year preceding the current year.

Instructions to Paragraph 9A(a).

1. In preparing the disclosures under paragraph 9A(a), registrants are required to include derivative financial instruments, other financial instruments, and derivative commodity instruments, as specified in the General Instructions to Paragraphs 9A(a) and 9A(b).

2. In preparing disclosures under paragraph 9A(a), registrants should distinguish derivative financial instruments, other financial instruments, and derivative commodity instruments entered into for trading purposes from those instruments that are entered into for purposes other than trading.

3. In preparing disclosures under paragraph 9A(a), registrants may include other market risk sensitive instruments, positions, and transactions that are not addressed in instruction 1. to paragraph 9A(a). Such instruments, positions, and transactions might include commodity positions, derivative commodity instruments that are not reasonably possible to be settled in cash or with another financial instrument, cash flows from anticipated transactions, and operating cash flows from non-financial and non-commodity instruments (*e.g.*, cash flows generated by manufacturing activities). Registrants choosing to include voluntarily these instruments, positions, and cash flows for purposes of paragraphs 9A(a)1(ii) and 9A(a)1(iii) are required to state that they have included such instruments, positions, and cash flows.

4. Under paragraph 9A(a)(1)(i):

(A) The examples of terms and information relating to market risk sensitive instruments that should be disclosed include, but are not limited to, the instruments' fair values, expected principal or transaction cash flows, weighted average effective rates or prices, and other relevant market risk related information;

(B) Functional currency means functional currency as defined by generally accepted accounting principles (*see, e.g.,* FASB, *Statement of Financial Accounting Standards No. 52, ''Foreign Currency Translation''*, (''FAS 52'') Appendix E (December 1981);

(C) Model assumptions that should be described include, but are not limited to, specification of the differing numbers reported in the table for various categories of instruments (*e.g.,* principal cash flows for debt, notional amounts for swaps, and contract amounts for options and futures) and key prepayment and/or reinvestment assumptions relating to the timing of reported cash flow amounts; and

(D) Market risk sensitive instruments that are exposed to rate or price changes in more than one market risk exposure category should be presented within the tabular information under each of those risk exposure categories.

5. Under paragraph 9A(a)(1)(ii), model assumptions and parameters that should be described include, but are not limited to, how loss is defined by the model (*e.g.,* loss in earnings, fair values, or cash flows), a general description of the modeling technique (*e.g.,* change in net present values arising from parallel shifts in market rates or prices and how optionality is addressed by the model), the types of instruments covered by the model (*e.g.,* derivative financial instruments, other financial instruments, derivative commodity instruments, and whether other instruments are included voluntarily, such as certain commodity instruments and positions, cash flows from anticipated transactions, and operating cash flows from non-financial and non-commodity

instruments), and other relevant information on the model's parameters, (*e.g.,* the magnitudes of parallel shifts in market rates or prices used, the method by which discount rates are determined, and key prepayment and/or reinvestment assumptions).

6. Under paragraph 9A(a)(1)(iii), model assumptions and parameters that should be described include, but are not limited to, how loss is defined by the model (*e.g.,* loss in earnings, fair values, or cash flows), type of model used (*e.g.,* variance/covariance, historical simulation, Monte Carlo simulation, and how optionality is addressed by the model), the types of instruments covered by the model (*e.g.,* derivative financial instruments, other financial instruments, derivative commodity instruments, and whether other instruments are included voluntarily, such as certain commodity instruments and positions, cash flows from anticipated transactions, and operating cash flows from non-financial and non-commodity instruments), and other relevant information on model parameters, (*e.g.,* holding period, confidence interval, and the method used for aggregating value at risk amounts across market risk exposure categories, such as by assuming perfect positive correlation, independence, or actual observed correlation).

7. Under paragraph 9A(a)(2), limitations that should be considered include, but are not limited to:

(A) The exclusion of certain market risk sensitive instruments, positions, and transactions from the disclosures required under paragraph 9A(a)(1) (*e.g.,* derivative commodity instruments not reasonably possible to be settled in cash or with another financial instrument, commodity positions, cash flows from anticipated transactions, and operating cash flows from non-financial and non-commodity instruments, such as cash flows from manufacturing activities). Failure to include such instruments, positions, and transactions in preparing the disclosures under paragraph 9A(a)(1) may be a limitation because the resulting information may not fully reflect the overall market risk of a registrant; and

(B) The ability of disclosures required under paragraph 9A(a)(1) to reflect fully the market risk that may be inherent in instruments with leverage, option, or prepayment features (*e.g.,* structured notes, collateralized mortgage obligations, leveraged swaps, and swaps with embedded written options).

(b) *Qualitative information about market risk.* To the extent material, describe:

(1) The registrant's primary market risk exposures;

(2) How those exposures are managed (*e.g.,* a description of the objectives, general strategies, and instruments, if any, used to manage those exposures); and

(3) Changes in either the registrant's primary market risk exposures or how those exposures are managed when compared to what was in effect during the most recent reporting period and what is known or expected to be in effect in future reporting periods.

Instructions to Paragraph 9A(b).

1. The disclosures required by this paragraph 9A(b) relate to the market risk exposures inherent in derivative financial instruments, other financial instruments, and derivative commodity instruments, as defined in the General Instructions to Paragraphs 9A(a) and 9A(b).

2. In preparing disclosures under paragraph 9A(b), the qualitative information about market risk should be presented separately for derivative financial instruments, other financial instruments, and derivative commodity instruments that are entered into for trading purposes and those that are entered into for purposes other than trading. In addition, qualitative information about market risk should be presented separately for those instruments used to manage risks inherent in anticipated transactions.

3. Primary market risk exposures, for the purposes of this paragraph, mean:

(A) The following categories of market risk: interest rate risk, foreign currency exchange rate risk, commodity price risk, and other similar market rate or price risks (*e.g.,* equity prices); and

(B) Within each of these categories, the particular markets that present the primary risk of loss to the registrant. For example, if a registrant has a material exposure to foreign currency exchange rate risk and, within this category of market risk, is most vulnerable to changes in dollar/yen, dollar/pound, and dollar/peso exchange rates, the registrant would disclose these exposures. Similarly, if a registrant has a material exposure to interest rate risk and, within this category of market risk, is most vulnerable to changes in short-term U.S. prime interest rates, it would disclose this exposure.

4. For purposes of disclosure under paragraph (b) of this item 9A, registrants should describe primary market risk exposures that exist at the end of the current reporting period, and how those exposures are managed.

General Instructions to Paragraphs 9A(a) and 9A(b).

1. The disclosure called for by paragraphs 9A(a) and 9A(b) is intended to clarify the registrant's exposure to market risks associated with activities in derivative financial instruments, other financial instruments, and derivative commodity instruments.

2. For purposes of paragraphs 9A(a) and 9A(b), derivative financial instruments, other financial instruments, and derivative commodity instruments (referred collectively as ''market rate sensitive instruments'' or ''instruments'') are defined as follows:

(A) Derivative financial instruments has the same meaning as defined by generally accepted accounting principles (*see, e.g.,* FASB, *Statement of Financial Accounting Standards No. 119, ''Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments*,'' paragraphs 5–7, (October 1994)), and includes futures, forwards, swaps, options, and other financial instruments with similar characteristics;

(B) Other financial instruments means all financial instruments as defined by generally accepted accounting principles (*see, e.g.,* FASB, *Statement of Financial Accounting Standards No. 107, ''Disclosures about Fair Value of Financial Instruments,''* paragraph 3, (December 1991)), except for derivative financial instruments, as defined above;

(C) Other financial instruments include, but are not limited to, trade accounts receivable, investments, loans, structured notes, mortgage-backed securities, trade accounts payable, indexed debt instruments, interest-only and principal-only obligations, deposits, and other debt obligations. However, for purposes of this release, trade accounts receivable and trade accounts payable should not be considered other financial instruments when their carrying amounts approximate fair value; and

(D) Derivative commodity instruments include, to the extent such instruments are not derivative financial instruments, commodity futures, commodity forwards, commodity swaps, commodity options, and other commodity instruments with similar characteristics that are reasonably possible to be settled in cash or with another financial instrument. For purposes of paragraphs 9A(a) and 9A(b) and these general instructions, the term ''reasonably possible'' has the same meaning as defined by generally accepted accounting principles (*see, e.g.,* FASB, *Statement of Financial Accounting Standards No. 5, ''Accounting for Contingencies,''* paragraph 3, (March 1975)).

3. For purposes of paragraphs 9A(a) and 9A(b), disclosure is not required for:

(A) Commodity positions;

(B) Derivative commodity instruments that are not reasonably possible to be settled in cash or with another financial instrument;

(C) Cash flows from anticipated transactions; and/or

(D) Operating cash flows from non-financial and non-commodity instruments.

4. (A) For purposes of making a materiality assessment under paragraphs 9A(a) and 9A(b), registrants should consider both:

(i) The materiality of the fair values of derivative financial instruments, other financial instruments, and derivative commodity instruments outstanding at the end of the current reporting period; and

(ii) The materiality of the potential loss in future earnings or fair values from reasonably possible market movements.

(B) If either (i) or (ii) of instruction 4. (A) is material, then the disclosures under paragraphs 9A(a) and 9A(b) are required.

(C) In determining the materiality of the fair values of market risk sensitive instruments outstanding at the end of the current reporting period, registrants generally should not net fair values, except to the extent allowed under generally accepted accounting principles (*see, e.g., FASB Interpretation No. 39, ''Offsetting of Amounts Related to Certain Contracts''* (March 1992)). For example, under this instruction, the fair value of assets generally should not be netted with the fair value of liabilities. In determining the materiality of the potential loss in future earnings or fair values from reasonably possible market movements, registrants should consider both the magnitude of past market movements, as well as expectations about the magnitude of future market movements. In addition, in making the determination under this instruction about the materiality of the potential loss in future earnings, fair values, or cash flows, registrants should consider, among other things, potential losses that may arise from leverage, option, and/or multiplier features.

5. For purposes of presenting quantitative and qualitative information about market risk, registrants generally should provide the required information in one location. However, alternative presentation, such as inclusion of all or part of the information in the footnotes to the financial statements or in Management's Discussion and Analysis, may be used if such presentation would be more meaningful to investors.

6. For purposes of the instructions to paragraphs 9A(a) and 9A(b), ''trading purposes'' has the same meaning as defined by generally accepted accounting principles (*see, e.g.*, FASB, *Statement of Financial Accounting Standards No. 119, ''Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments,''* paragraph 9a, (October 1994)). In addition, ''anticipated transactions'' means transactions (other than transactions involving existing assets or liabilities or transactions necessitated by existing firm commitments) an enterprise expects, but is not obligated, to carry out in the normal course of business (*e.g.*, FASB, *Statement of Financial Accounting Standards No. 80, ''Accounting for Futures Contracts,''* paragraph 9, (August 1984)).

Appendix to Item 9A—Tabular Disclosures

The tables set forth below are illustrative of the format that might be used when a registrant elects to present the information required by paragraph (a)(1)(i)(A) of Item 9A regarding terms and information about derivative financial instruments, other financial instruments, and derivative commodity instruments. These examples are for illustrative purposes only. Registrants are not required to display the information in the specific manner illustrated below. Alternative methods of display are permissible as long as the disclosure requirements of the section are satisfied. Furthermore, these examples were designed primarily to illustrate possible formats for presentation of the information required by the proposed section and do not purport to illustrate the broad range of derivative financial instruments, other financial instruments, and derivative commodity instruments utilized by registrants.

Interest Rate Sensitivity

The table below provides information about the Company's derivative financial instruments and other financial instruments, which are sensitive to changes in interest rates, including interest rate swaps and debt obligations. For debt obligations, the table presents principal cash flows and related weighted average interest rates by expected maturity dates. Weighted average variable rates are based on implied forward rates in the yield curve at the reporting date. For interest rate swaps, the table presents notional amounts and weighted average interest rates by expected (contractual) maturity dates. Notional amounts are used to calculate the contractual payments to be exchanged under the contract. The information is presented in US dollar equivalents, which is the Company's reporting currency. The instrument's actual cash flows are denominated in both US dollar ($US) and German deutschmarks (DMs), as indicated in parentheses.

December 31, 19×1	Expected maturity date						Total	Fair Value
	19×2	19×3	19×4	19×5	19×6	There-after		
	(In millions)							
Liabilities:								
Long-term Debt:								
Fixed Rate ($US)	$XXX	$XXX	$XXX	$XXX	$XXX	$XXX	$XXX	$XXX
Average interest rate	X.X%	X.X%	X.X%	X.X%	X.X%	X.X%	X.X%	
Fixed Rate (DMs)	XXX	XXX	XXX	XXX	XXX	XXX	XXX	XXX
Average interest rate	X.X%	X.X%	X.X%	X.X%	X.X%	X.X%	X.X%	
Variable Rate ($US)	XXX	XXX	XXX	XXX	XXX	XXX	XXX	XXX
Average interest rate	X.X%	X.X%	X.X%	X.X%	X.X%	X.X%	X.X%	

	Expected maturity date						Total	Fair value
	19×2	19×3	19×4	19×5	19×6	There-after		
	(In millions)							
Interest Rate Derivatives:								
Interest Rate Swaps								
Variable to Fixed ($US)	$XXX	$XXX	$XXX	$XXX	$XXX	$XXX	$XXX	$XXX
Average pay rate	X.X%	X.X%	X.X%	X.X%	X.X%	X.X%	X.X%	
Average receive rate	X.X%	X.X%	X.X%	X.X%	X.X%	X.X%	X.X%	
Fixed to Variable ($US)	XXX	XXX	XXX	XXX	XXX	XXX	XXX	XXX
Average pay rate	X.X%	X.X%	X.X%	X.X%	X.X%	X.X%	X.X%	
Average receive rate	X.X%	X.X%	X.X%	X.X%	X.X%	X.X%	X.X%	

Exchange Rate Sensitivity

The table below provides information about the Company's derivative financial instruments, other financial instruments, and firmly committed sales transactions by functional currency and presents such information in U.S. dollar equivalents.[1] The table summarizes information on instruments and transactions that are sensitive to foreign currency exchange rates, including foreign currency forward exchange agreements, deutschmark (DM)-denominated debt obligations, and firmly committed DM sales transactions. For debt obligations, the table presents principal cash flows and related weighted average interest rates by expected maturity dates. For firmly committed DM-sales transactions, sales amounts are presented by the expected transaction date, which are not expected

[1] The information is presented in U.S. dollars because that is the registrant's reporting currency.

to exceed two years. For foreign currency forward exchange agreements, the table presents the notional amounts and weighted average exchange rates by expected (contractual) maturity dates. These notional amounts generally are used to calculate the contractual payments to be exchanged under the contract.

December 31, 19×1	Expected maturity date						Total	Fair value
	19×2	19×3	19×4	19×5	19×6	There-after		
	(US$ Equivalent in Millions)							
On-Balance Sheet Financial Instruments:								
$US Functional Currency[2] Liabilities								
Long-Term Debt (DM)	$XXX	$XXX	$XXX	$XXX	$XXX	$XXX	$XXX	$XXX
Average U.S. dollar /DM Exchange Rate	X.X	X.X	X.X	X.X	X.X	X.X	X.X	....

[2] Similar tabular information would be provided for other functional currencies.

	Expected maturity or transaction date					There-after	Total	Fair value
	19×2	19×3	19×4	19×5	19×6			
	(US$ Equivalent in millions)							
Anticipated Transactions and Related Derivatives[3]								
$US Functional Currency:								
Firmly committed transactions:								
Sales Contracts (DM)	$XXX	$XXX	....	....	....	....	$XXX	$XXX
Forward Exchange Agreements (Receive $US/Pay DM):								
Contract Amount	XXX	XXX	....	....	....	....	$XXX	$XXX
Average Exchange Rate	X.X	X.X	....	....	....	....	X.X	....

[3] Pursuant to Instruction 3 to proposed Item 9A of Form 20–F, registrants may include cash flows from anticipated transactions and operating cash flows resulting from non-financial and non-commodity instruments.

Commodity Price Sensitivity

The table below provides information about the Company's corn inventory and futures contracts that are sensitive to changes in commodity prices, specifically corn prices. For inventory, the table presents the carrying amount and fair value at December 31, 19x1. For the futures contracts the table presents the notional amounts in bushels, the weighted average contract prices, and the total dollar contract amount by expected maturity dates, the latest of which occurs within one year from the reporting date. Contract amounts are used to calculate the contractual payments and quantity of corn to be exchanged under the futures contracts.

December 31, 19×1	Carrying amount	Fair Value
On Balance Sheet Commodity Position and Related Derivatives:	(In millions)	
Corn Inventory	$XXX .	$XXX[4]

[4] Pursuant to proposed Instruction 3 to proposed Item 9A of Form 20–F, registrants may include information on commodity positions, such as corn inventory.

	Expected maturity 1992	Fair value
Related Derivatives:		
Futures Contracts (Short):		
Contract Volumes (100,000 bushels)	XXX	....
Weighted Average Price (Per 100,000 bushels)	$X.XX	
Contract Amount ($US in millions)	$XXX	$XXX

* * * * *

19. By amending Form 10–Q (referenced in § 249.308a) by removing references to ''Items 1 and 2 of Part I of this form'' and adding in their place references to ''Items 1, 2, and 3 of Part I of this form'' in paragraphs 1 and 2 of General Instruction F, adding paragraph 2.c. to General Instruction H and Item 3 to Part I to read as follows:

Note—The text of Form 10–Q does not, and this amendment will not, appear in the Code of Federal Regulations.

Form 10–Q

Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 or Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

* * * * *

General Instructions

* * * * *

H. Omission of Information by Certain Wholly-Owned Subsidiaries

* * * * *

2. * * *

c. Such registrants may omit the information called for by Item 3 of Part I, Quantitative and Qualitative Disclosures About Market Risk.

* * * * *

Part I—Financial Information

* * * * *

Item 3. Quantitative and Qualitative Disclosures About Market Risk

If there has been a material change in the information required by Item 305 of Regulation S–K (§ 229.305 of this chapter) from the end of the preceding fiscal year to the date of the most recent interim balance sheet provided, furnish the information required by Item 305 of Regulation S–K.

* * * * *

20. By amending Form 10–K (referenced in § 249.310) by adding Item 7A to be inserted after Item 7 and before Item 8 in Part II to read as follows:

Note—The text of Form 10–K does not, and this amendment will not, appear in the Code of Federal Regulations.

Form 10–K

Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 or Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

* * * * *

Part II

* * * * *

Item 7A. Quantitative and Qualitative Disclosures About Market Risk.

Furnish the information required by Item 305 of Regulation S–K (§ 229.305 of this chapter).

* * * * *

Dated: December 28, 1995.

By the Commission.

Jonathan G. Katz,

Secretary.

[FR Doc. 96–130 Filed 1–5–96; 8:45 am]

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