Government Finance Officers Association
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October 31, 2011

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549–1090
via electronic submission

RE: File No. S7-25-11/Business Conduct Standards for Dealers of Security-Based Swaps and Major Security-Based Swap Participants

Dear Ms. Murphy:

The Government Finance Officers Association (GFOA) is the professional association of state, provincial and local finance officers in the United States and Canada. The GFOA has served the public finance profession since 1906 and continues to provide leadership to the government finance profession through research, education and the development of best practices. Our more than 17,000 members are dedicated to the sound management of government financial resources.

The GFOA has long supported the regulation of the derivatives market, including regulating swap advisors and swap dealers. We are pleased that this market and the professionals working in this market will now be regulated with the implementation of the *Dodd-Frank Act*.

While the proposed Securities and Exchange Commission (SEC) business conduct rules are written to regulate the security-based derivatives market, the drafted rules also should apply to interest rate swaps and other non-security based swaps entered into by special entities. We believe the SEC proposed rules could be more workable than rules proposed by the U.S. Commodity Futures Trading Commission (CFTC) for swaps. Furthermore, it is imperative for the agencies with regulatory authority over the derivatives market to work together and develop consistent rules and definitions in order to alleviate confusion with the regulatory framework of this market. The need for streamlined rules and definitions across various agencies should also take into account outstanding swap contracts who in the future may need to revise or restructure existing transactions.

We would like to comment on three specific areas of the SEC proposed rules:

1. The rules allow the swap dealer and the issuer to state that the swap dealer is not acting as an advisor to the governmental entity. The *Dodd-Frank Act* mandates the use of a swap advisor for any special entity entering this market. It is important to note that the swap advisor has a fiduciary responsibility to the special entity and is not affiliated with the swap dealer, who does <u>not</u> have a fiduciary responsibility to the special entity. Allowing the swap dealer and the issuer to state that a swap advisor has been retained ensures that the governmental entity has an advisor

and provides clarity for the roles of all involved. Additionally, the rules should ensure that there is some type of independent verification that the external swap advisor has registered with the appropriate regulatory authority and also has met some type of proficiency or professional experience standards that would ensure the external swap advisor is qualified to serve in this capacity. It is also important to ensure that the external swap advisor has true independence from a swap dealer and is in no way affiliated with a swap dealer.

2. The rules provide for the ability to use written representations by the special entity and its representative to enable swap dealers to determine that the qualified independent swap advisor requirement has been satisfied. While we agree that written representations should be sufficient for ensuring that a qualified independent swap advisor has been hired[, the rules need to also include within that written representation verification that the external swap advisor has registered with and met professional standards set by the appropriate regulatory body overseeing swap advisors.]This would create a reliance on an independent measure, which is not associated with the swap dealer or the special entity, thus minimizing any conflicts of interests. Earlier this year the CFTC proposed having the swap dealer perform substantial diligence in order to confirm that the swap advisor is qualified to serve on the issuer's behalf. We noted to the CFTC that having the swap dealer confirm the qualifications of the swap advisor could pose a serious conflict of interest. Requiring the swap dealer to verify the qualifications of the swap advisor gives too much power to the swap dealer (the counterparty to the issuer/swap advisor), which ultimately could interfere with, prove more costly for, and be problematic to a state or local government.

3. The SEC requested comment on whether internal staff employed by a special entity and serving in the role of a financial advisor, is considered to be acting as an independent advisor to the special entity/their employer. As the governmental entity has verified the qualifications of their employee through the hiring process we believe that internal staff should inherently be considered to be acting in the best interest of their employer, and further requirements do not need to be imposed upon such individuals.

The *Dodd Frank Act* gives the Municipal Securities Rulemaking Board (MSRB) authority to regulate swap advisors who work with state and local governments. The MSRB is busy developing these rules, and we support their efforts to implement numerous regulations over swap advisors, such as pay-to-play rules and qualification standards. It is imperative that the federal regulatory agencies rely on the MSRB's immense knowledge of the municipal securities market and derivatives transactions related to these securities when developing appropriate regulations over all municipal advisors, including swap advisors.

Additionally, we feel strongly that the SEC consider setting develop suitability standards for the types of financial products that can be sold to state and local governments, including those products in the swaps arena.

The GFOA has established an Advisory "Use of Debt-Related Derivatives Products and the Development of a Derivatives Policy" and a subsequent "Derivatives Checklists" as well as the Advisory "Use of Derivatives and Structured Investments for State and Local Governments for Non-Pension Fund Investment Portfolios" to help our members use appropriate caution and learn and understand the risks associated with these products. We emphasize the importance of education about these products and caution our members to only enter into these types of transactions if the government has a full, comprehensive understanding of these products and the market, as well as staff qualified to continually review the terms and market dynamics related to these instruments on an ongoing basis. These documents are attached for your review.

The rules being developed by the federal agencies over the derivatives market will help protect state and local governments that use these financing tools from undue risk and against unsavory or unwise business practices.

Thank you very much for the opportunity to comment on this important issue.

Sincerely,

Susan Gaffney

Susan Gaffney
Director, Federal Liaison Center

ADVISORY

A GFOA ***advisory*** identifies specific policies and procedures necessary to minimize a government's exposure to potential loss in connection with its financial management activities. It is *not* to be interpreted as GFOA sanctioning the underlying activity that gives rise to the exposure.

Use of Debt-Related Derivatives Products and the Development of a Derivatives Policy (2003, 2005 and 2010) (DEBT)

Background. In recent years, the use of derivative products became more prevalent in the debt and risk management programs of state and local governments and other issuing authorities. A derivative is a financial instrument created from or whose value depends upon (is derived from) the value of one or more separate assets or indices of asset values. As used in public finance, derivatives may take the form of interest rate swaps, futures and options contracts, options on swaps and other hedging mechanisms such as caps, floors, collars and rate locks.

Derivative products can be important interest rate management tools that, when used properly, can increase a governmental entity's financial flexibility, provide opportunities for interest rate savings, alter the pattern of debt service payments, create variable rate exposure, change variable rate payments to fixed rate and otherwise limit or hedge variable rate payments. Recent market experience has also shown, however, that derivatives, when used to hedge a particular bond issue, can limit an issuer's flexibility with respect to such bond issue.

Issuers are cautioned that recent economic turmoil and associated credit downgrades have resulted in many collateral calls and, in some cases, involuntary terminations at severe cost to governmental entities.

Governmental issuers must learn about and understand the potential risks and rewards of derivative products in order to evaluate them properly as financing tools. Issuers must understand fully the characteristics of derivative instruments, have the ability to determine a fair market price and be aware of the legal, accounting, credit and disclosure issues involved. These instruments should not be used for speculation, but only to manage risks associated with an issuer's assets or liabilities and only in conformity with financial policies that reflect the risk tolerances and management capabilities of the issuer.

Advisory. The Government Finance Officers Association (GFOA) advises that state and local governments exercise great caution in the use of derivative instruments and use them only when the issuers have developed:

1. A sufficient understanding of the products. The GFOA encourages all financial officers to learn about the potential risks and benefits of using derivatives. A decision whether or not to use derivatives should be made on an informed basis. Training is essential both in evaluating the use of derivatives and in managing their use.

2. The internal staffing and expertise to manage, monitor and evaluate these products properly, either on their own or in combination with a swap or financial advisor, tax counsel and/or monitor. Issuers must have in place:
    a. Methods for measuring, evaluating, monitoring and managing risks associated with derivative products, including:
        i. Basis risk – the mismatch between variable rate debt service and the variable rate index used to determine swap payments. This risk can be managed through the creation of an interest rate reserve fund or conservative budgeting strategies.
        ii. Tax risk - the risk created by potential tax events that could affect swap payments. Careful attention should be paid to tax event triggers in the underlying swap documents.
        iii. Interest rate risk – how the movement of interest rates over time affects the market value of the instrument.
        iv. Collateralization risk – the risk that market movements or an issuer downgrade will cause the market value of the swap to decrease enough that the issuer has to post collateral under a Credit Support Annex (CSA). Issuers should be mindful of the different rating standards applied to corporate and municipal credits when evaluating collateralization thresholds and understand that this is a negotiable requirement. Termination and collateral requirements should reflect relative comparable credit strengths of the parties determined on a corporate equivalent or global rating basis.
        v. Counterparty risk – the risk that the counterparty fails to make required payments, experiences rating downgrades, or files for bankruptcy protection. This is particularly important if an issuer has more than one swap with a counterparty and the documents contain cross-default provisions. This can be addressed through the establishment of ratings thresholds, guidelines for exposure levels and, particularly, collateralization requirements.
        vi. Termination risk – the need to terminate the transaction in a market that dictates a termination payment by one of the counterparties. Market practice allows governmental issuers to limit the instances in which this can occur. This risk can also be mitigated through the identification of revenue sources for and budgeting of potential termination payments, structuring the swap so that refunding bond proceeds can be used for termination payments and subordinating the lien status of potential payments. Issuers are cautioned to ensure that counterparties do not impose excessive or unnecessary fees at termination in excess of amounts allowed for in the swap documents.
        vii. Market-access risk – the risk that the markets may be closed or that an issuer may not be able to enter the credit markets due to its own credit quality deteriorating or that credit may become more costly. For example, to complete a derivative's objective, a new money bond issuance or a refunding may be planned in the future. If at that time the markets are not functioning or an issuer is unable to enter the credit markets, expected cost savings may not be realized while the issuer will continue to be subject to its obligations required by the derivative contract.
        viii. Rollover or amortization risk – the mismatch of the maturity of the swap and the maturity of the underlying bonds or a mismatch in the amortization of the swap and bonds. This should be eliminated by making the maturity and amortization of the swap coterminous with those of the bonds.
        ix. Credit risk – the occurrence of an event modifying the credit rating of the issuer or its counterparty. This should be addressed through minimizing cross defaults and the favorable negotiation of credit event triggers in the underlying documentation.
    b. Methods for selecting and procuring derivative products, including when competitive bids and negotiated transactions are warranted, and knowledge of pricing conventions and documentation standards.

c. Guidelines governing the proper disclosure of material information relating to executed derivative products to the issuer's governing body, in financia1 statements, to the rating agencies, to investors in connection with bond offerings, and through secondary market disclosure. Internal disclosure should include information about legal authority, risks, guidelines and market value. The Official Statement and secondary market disclosure should comport with current market practice.
d. Procedures and personnel responsible for internally managing and monitoring the issuer's (i) obligations (also known as operational risk), such as monitoring rates, calculating and making payments, managing collateral, and budgeting and accounting for derivatives appropriately and (ii) exposure, such as counterparty credit, collateral posting levels, variable rate exposure levels and basis risk. Pursuant to applicable accounting requirements, these procedures must include the development of a methodology for providing periodic termination value analyses.

3. A comprehensive derivatives policy. A derivatives policy should include:
   a. Evidence of clear legal authorization to enter into such arrangements and guidelines for how derivative products fit within the overall debt management program.
   b. A list of the types of derivative products that may be used or are prohibited.
   c. The conditions under which these types of products can be utilized *(i.e.* bidding procedures, minimum benefit thresholds, terms of master agreements).
   d. The maximum amount of derivatives contracts, or a means of determining such amount, *e.g.*, by reference to floating rate assets.
   e. Guidelines for selecting counterparties of high credit quality and addressing the risks presented under item 2 above.

The GFOA recommends that all derivative transactions be documented using standardized forms, as standardized terms make it easier for market participants to analyze transactions, which minimizes costs. "Documentation in the municipal swap market is almost universally accomplished through the negotiation and execution of the forms of documents published by the International Swaps and Derivatives Associations, Inc. (ISDA)."[1] The GFOA also advises that many provisions in such forms are subject to negotiation and therefore recommends that finance officers have advisors familiar with such forms and amend ISDA documents as changing market conditions warrant, provided that such changes benefit the issuer. Specifically, the provision of collateral by one or both parties to a swap under certain circumstances is determined at the time the swap is executed. The form of that potential collateral may also be decided at the point of execution or may be postponed until such collateral is required. Collateral is identified in a Credit Support Annex (CSA), and while it will add legal costs to the original transaction and has the potential of never being used, the GFOA recommends it be completed simultaneous with the execution of the swap to avoid having to negotiate collateral arrangements under distressed circumstances.

Once an issuer has adopted a derivatives policy and executed a derivatives transaction, the issuer should monitor and, to the extent possible, take action to limit its exposure to the risks described above. Because opportunities in the derivatives market change frequently, the GFOA encourages finance officers to keep abreast of such market conditions.

It is also recommended that issuers read and understand the most current material regarding the effect of derivatives on ratings prior to execution of a derivatives contract.

References.

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[1] National Federation of Municipal Analysts, *White Paper on Disclosure for Swaps* (February 2004)

- GFOA Best Practice, *Debt Management Policy*, 2003.
- GFOA, *Elected Official's Guide to Debt Issuance*, Patricia Tigue and J.B. Kurish, 2005.
- *Understanding Municipal Derivatives*, David Taub, *Government Finance Review*, 2005.
- GFOA *Derivatives Checklist*, 2010.
- Fitch Ratings, Guidelines for Interest Rate Swaps and Variable-Rate Debt, May, 2005.
- Moody's Investors Service, Swaps and the Municipal Market: The Impact of Swaps and FASB 133 on Municipal Credit Quality, October 2002.
- Standard & Poor's, *Public Finance Criteria: Municipal Swaps*, November, 2004.

Approved by the GFOA’s Executive Board, March 5, 2010.

DERIVATIVES CHECKLIST

<u>Introduction</u>

This checklist is a supplement to the Advisory on "Use of Debt-Related Derivatives Products and the Development of a Derivatives Policy (2003, 2005 and 2010) (DEBT)" and is designed to be an attachment to a government issuer's derivatives policy. It is designed to be used prior to entering into any derivatives transaction. This checklist presumes an issuer's compliance with the Advisory—to wit, that the issuer has adopted a derivatives policy and that the issuer's staff has been trained in the evaluation and use of derivative products. An issuer that cannot answer the questions in this checklist is advised to continue its training prior to completing a derivatives transaction.

While the principles enunciated in the Advisory are generally applicable to all derivatives transactions, it is impracticable to create a "one size fits all" checklist to address the specific issues of all derivatives transactions. First, over-the-counter derivatives transactions are not uniform. Each is customized to fit the needs of the parties. Second, the derivatives market and the products being used in that market change over time, sometimes quite quickly, in response to changes in the broader financial markets. Third, the experience and sophistication of users of derivative products varies. Many experienced users of derivatives will already have developed their own means of assuring that all relevant issues in a derivatives transaction have been considered and addressed. Therefore, this checklist is intended mostly to assist issuers that meet the presumptions described above but are relatively new to the derivatives market. The issues addressed in this checklist are broadly applicable, but the form of the checklist is one that issuers are encouraged to adapt to their particular circumstances.

Many of the capitalized terms used in this checklist are used as defined in International Swaps and Derivatives Association, Inc. ("ISDA") documents, and this checklist presumes that an issuer is familiar with such documents.

<u>General Information</u>

1. Name of Governmental Issuer: ____

2. Date of most recent update to Issuer's Derivatives Policy: __________________

3. (a) Names of Official and Backup(s) Responsible for Procurement of Derivative:
____

   (b) Names of Official and Backup(s) Responsible for Monitoring Derivative:
____

   (c) Have all of them satisfied the training standards prescribed in the Issuer's Derivatives Policy? Yes ___ No ___

4. Independent Derivatives Advisor, if any: ____

5. Independent Derivatives Monitor, if any: ____

Authority

1. Will the Issuer's counsel deliver an unqualified opinion on the Issuer's authority to enter into the derivative? Yes ___ No ___

General Terms

1. Type of Derivative: ____

2. Counterparty/ies: ____

3. (a) Expected Trade Date: __________________
   (b) Effective Date: ___________________
   (c) Scheduled Termination Date: _________________
   (d) If derivative is an option, Exercise Date(s): _______________________________

4. Notional Amount: _________________________

5. Identify debt, or assets, with which the derivative is associated:
   ____

Financial Terms

1. (a) Basis for calculating Issuer's payments: _______________________________
   (b) Frequency of calculation: ___________________________
   (c) Frequency of payment: _______________________
   (d) Can the passage of time or future market conditions cause the basis for calculating these payments to change? Yes ___ No ___
   If yes, explain: ____
   ____
   ____

2. (a) Basis for calculating Counterparty's/ies' payments: ________________________
   (b) Frequency of calculation: ___________________________
   (c) Frequency of payment: _______________________________
   (d) Can the passage of time or future market conditions cause the basis for calculating these payments to change? Yes ___ No ___
   If yes, explain: ____
   ____
   ____

3. Identify any embedded options in the derivative: __________________________________
   ____
   ____

4. Will either party make an upfront payment upon execution of the derivative?

Yes ___ No ___

Purpose

1. State the reason(s) for entering into the derivative.
____
____
____

2. Were other means considered for achieving such purpose(s)? Yes ___ No ___
If yes, why was the derivative chosen? ____
____
____

Risks

1. Has the Issuer evaluated the extent to which each of the following risks will be assumed upon execution of the derivative?

(a)	Basis Risk	Yes ___	No ___
(b)	Tax Risk	Yes ___	No ___
(c)	Interest Rate Risk	Yes ___	No ___
(d)	Collateralization Risk	Yes ___	No ___
(e)	Counterparty Risk	Yes ___	No ___
(f)	Termination Risk	Yes ___	No ___
(g)	Market-access Risk	Yes ___	No ___
(h)	Rollover Risk	Yes ___	No ___
(i)	Credit Risk	Yes ___	No ___

2. Are the risks to be assumed within the risk parameters of the Issuer's Derivatives Policy?
Yes ___ No ___

3. Has Issuer run, or had run for it, stress tests on how the derivative could affect Issuer's budget and financial position under various market conditions? Yes ___ No ___

4. How do the benefits of entering into the derivative outweigh the risks being assumed?
____
____
____
____

5. Upon execution of this derivative,
(a) How many derivatives will Issuer have outstanding? __________________
(b) What is the total notional amount of those derivatives? ________________
(c) What percent of Issuer's long-term debt will be associated with derivatives? ________

Documentation

1. Is Issuer's counsel experienced in derivatives transactions? Yes ___ No ___

2. Has Issuer discussed with its counsel:
   - (a) Required consents and approvals? Yes ___ No ___
   - (b) Relation of derivative payments to bond payments? Yes ___ No ___
   - (c) Default provisions? Yes ___ No ___
   - (d) Termination provisions? Yes ___ No ___
   - (e) Other remedies? Yes ___ No ___

<u>Counterpartv/ies</u>

1. On what basis did Issuer select Counterparty/ies?
   - ❑ Competitive
   - ❑ Negotiated

2. If competitive,
   - (a) Who was bidding agent? ________________________
   - (b) How many firms were invited to bid? ______________
   - (c) How many firms bid? __________________________
   - (d) Is bidding agent providing a closing certificate? Yes ___ No ___

3. If negotiated,
   - (a) State reasons for negotiating derivative: _________________________________
     ____
   - (b) State reasons for choosing Counterparty/ies: _____________________________
     ____
   - (c) Estimated spread relative to mid-market or benchmark rate? _______________
   - (d) Is Derivatives Advisor providing a certificate as to fair market valuation?
     Yes ___ No ___
     If no, what comfort will Issuer receive that the terms for the derivative are commercially reasonable? ____

4. What are ratings of Counterparty/ies? ____

5. Does Counterparty/ies meet credit criteria of Issuer's Derivatives Policy? Yes ___ No __

6. What percentage of Issuer's total notional amount of derivatives will be with the same Counterparty/ies?______________

7. If Issuer will have more than one derivatives transaction with Counterparty or any of the Counterparties, will there be netting between or among separate derivatives transactions? Yes ___ No ___

<u>Credit Support</u>

1. Credit Support will be provided for:
   - (a) Issuer Yes ___ No ___
     If yes, name of provider: ____
   - (b) Counterparty/ies Yes ___ No ___
     If yes, name of provider: ____

2. Has Issuer's counsel reviewed Issuer's credit support obligations? Yes ___ No ___

3. Has Issuer established procedures sufficient to:
   (a) Comply with any such obligations? Yes ___ No ___
   (b) Renew or replace Credit Support, if required? Yes ___ No ___
   (c) Monitor the credit level of the Counterparty/ies? Yes ___ No ___
   (d) Receive the benefit of, and comply with any obligations relating to, any credit support obligations of Counterparty/ies? Yes ___ No ___

<u>Tax Issues</u>

1. Tax counsel reviewing the documentation: ____

2. Has Issuer discussed with tax counsel:
   (a) Integration of the derivative with a bond issue? Yes ___ No ___
   (b) Whether yield monitoring is required? Yes ___ No ___
   (c) Whether the derivative's performance or mark-to-market value should be included in arbitrage compliance calculations? Yes ___ No ___

3. Will tax counsel deliver an opinion in connection with the derivative? Yes ___ No ___

<u>Operations and Monitoring</u>

1. If the Expected Trade Date and the Effective Date are different, is the derivative part of a series of transactions? Yes ___ No ___
   If yes,
   (a) Describe the subsequent transactions being considered: _____________________
   ____
   ____
   (b) Has Issuer established procedures or mechanisms to:
      (i) Determine how and when any subsequent transaction will occur? Yes ___ No ___
      (ii) Evaluate and handle risks to completion of any subsequent transaction? Yes ___ No ___
      (iii) Complete, and pay expenses of, any subsequent transactions? Yes ___ No ___

2. Has Issuer discussed the appropriate accounting treatment for the derivative with its independent auditor? Yes ___ No ___

3. Does the Issuer intend to use hedge accounting? Yes ___ No ___
   If yes, has the issuer received or made arrangements to receive confirmation of hedge effectiveness? Yes ___ No ___
   If yes, from: ____

4. Who is responsible for confirming payment amounts and making necessary payments? ____

5. What is the source for Issuer's regular payments? _________________________________

6. How are such payments budgeted? ____

7. Who is responsible for monitoring credit ratings of Counterparty/ies? ____

8. Who is responsible for monitoring mark-to-market valuations? ____________________

9. What is the frequency of such monitoring? ________________________

10. Who is responsible for monitoring collateralization requirements of Issuer and Counterparty/ies? _____________________

11. If Issuer must post collateral, what will be the source? __________________

12. If Counterparty/ies must post collateral, who will monitor? _______________

13. What is the frequency of:
    (a) Reporting monitoring results to Chief Executive Officer/Chief Financial Officer? ________________________
    (b) Sharing monitoring results with independent auditor? ______________________

14. Has Issuer discussed this derivative with the rating agencies? Yes ___ No ___

15. Who is responsible for delivery of future documents required by the derivative's documentation? ___________________________

16. Who is responsible for answering investors' questions about Issuer's derivatives exposure? ____
____

Information Provided By:

____
signature

ADVISORY

A GFOA ***advisory*** identifies specific policies and procedures necessary to minimize a government's exposure to potential loss in connection with its financial management activities. It is *not* to be interpreted as GFOA sanctioning the underlying activity that gives rise to the exposure.

Use of Derivatives and Structured Investments by State and Local Governments for Non-Pension Fund Investment Portfolios (1994, 2002, and 2010) (TIM)

Background. A derivative product is a financial instrument created from, or the value of which depends on (is derived from), the value of one or more underlying assets or indices of asset values. Derivatives may include forwards, futures, options, swaps (currency and interest rate), caps, floors, collars and rate locks.

Structured investments are financial instruments that are created (structured) through pooling or redistributing assets, tranching liabilities (backed by pools of assets) and/or separating the credit risk of the collateral assets from the originating entity. Examples of such instruments commonly used by governmental entities may include asset backed securities, mortgage backed securities, various collateralized obligations and credit derivatives among others.

Advisory. The Government Finance Officers Association (GFOA) advises state and local government finance officers to exercise **extreme caution** in the use of derivatives and structured finance products. Governmental entities must learn about and understand the potential risks and rewards of derivative and structured products, before deciding if they should be used. Governments must understand fully the characteristics of these instruments and have the ability (internal staff and expertise) to determine the fair market price and be aware of the legal, accounting, credit and disclosure risks involved.

Governments should consider the following factors in determining whether to use derivatives and structured investment products:

1. **Legality.** Governmental entities should understand that state and local laws may not specifically address use of these products. Factors to consider include:
   - the constitutional and statutory authority of the governmental entity to execute derivative contracts or to buy structured finance products,
   - the potential for violating constitutional or statutory provisions limiting the governmental entity's authority to incur debt resulting from the transaction, and
   - the application of the governmental entity's procurement statutes specifically to derivative transactions.

2. **Appropriateness.** Governmental entities must observe the objectives of principal preservation, liquidity, and return within legally allowable investments. Judicious asset and liability management policies help achieve these objectives while managing risk. Characteristics of some derivatives and structured investment products that may preclude their use and make them inappropriate include high price volatility, illiquid markets, valuation difficulties, insufficient market history, high degree of leverage, keen monitoring and modeling system requirements, and

the need for a high degree of sophistication to manage risk. Governmental entities should be aware of all the risks associated with the use of derivatives and structured investment products, including credit, counterparty, market, prepayment, liquidity, settlement, custodial and operating risk.

Regarding the difficulty in valuing derivatives and structured investment products, governmental entities should understand that there may be little or no pricing information or standardization for some derivatives and structured investment products. Competitive price comparisons are recommended before entering into a transaction. Even in cases of competitive pricing, because valuations of such products are based on highly sensitive models and not on actual markets, changes in the underlying assumptions may severely impact asset values.

In addition to determining legality and appropriateness, governmental entities should analyze the materiality of a transaction to determine if it might affect a bond or other credit-related rating of such entity. Rating agencies should be notified if required.

3. **Procedures and Internal Controls.** Governmental entities should establish internal controls for use of derivatives and structured investment products to ensure that risks involved with these are adequately managed. Such procedures should include:

- Creating an oversight board and establishing upfront criteria for use of derivatives and/or structured securities;
- Comprehensive derivatives and structured securities policy (evidencing legal authority, listing authorized and prohibited types of derivatives and structured investments, identifying guidelines for counterparty selection, limiting maximum permissible amounts and specifying means of determining such maximums);
- Review with ratings agency(ies) impact of derivatives use on governmental entity;
- Written statement of purpose and objectives for derivative use,
- Written procedures for monitoring of derivative instruments and structured investment products, including how often they will be priced and what pricing services will be used:
- Periodic training for managers and access to technical resources to oversee derivative and structured investments:
- Sufficiently detailed recordkeeping to allow governing bodies, auditors, and examiners to determine if the program is functioning in accordance with established objectives. Managers should report regularly on the use of derivatives to their governing body and appropriate disclosure should be made in official statements and other disclosure documents:
- Reporting on derivative use in accordance with generally accepted accounting principles. Because of the complexity of these instruments, governments should consult with public accountants at an early point to determine if specialized reporting may be required:
- Required documentation of stress testing and scenario analysis of derivatives and structured investment products. Every possible effort should be made to determine worst case scenarios when using derivatives or structured products, as well as likelihood or probability of these outcomes and the government’s ability to weather them; and
- Procedures for evaluation and review on a periodic basis.

4. **Role of External Parties.** Governmental entities should know if their broker-dealers are merely acting as an intermediaries or are taking a proprietary positions in derivatives or structured investment product transactions. Possible conflicts of interest should be taken into consideration before entering into a transaction.

   Governmental entities should exercise caution in the selection of broker-dealers or investment advisers. They should confirm that these vendors are knowledgeable about, understand and provide disclosure regarding the use of derivatives and structured investment products, including benefits and risks.

   Governmental entities are responsible for ensuring appropriate safeguards are in place when derivative or structured investment product transactions are conducted by a third party acting on behalf of the governmental entities.

The GFOA reiterates the need for governments to exercise extreme caution when considering derivative products for their investment portfolio. It is important to emphasize that these instruments should not be used for speculation.

Governmental entities must learn about and understand the risks and rewards of derivative and structured investment products in order to properly evaluate and manage. Governmental entities should consider the use of derivatives and structured investment products **only** when they have attained a sufficient understanding of the products and the expertise to manage them. Certain derivative products and structured investment products may not be appropriate for all governmental entities.

Ultimately, it is the responsibility of each governmental entity to determine what constitutes a derivative and/or a structured investment, and what is allowable by statute and policy.

References.

- *A Public Investor's Guide to Money Market Instruments*, Second Edition, edited by M. Corinne Larson, GFOA, 1994.
- GFOA Best Practice: Use of Debt-Related Derivatives and Development of Derivatives Policy, 2010, GFOA’s Committee on Governmental Debt Management.
- GFOA Derivatives Checklist, 2010, GFOA’s Committee on Governmental Debt Management.

Approved by the GFOA’s Executive Board, March 5, 2010.