



**Government Finance Officers Association**  
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February 22, 2011

Mr. David A. Stawick, Secretary  
Commodity Futures Trading Commission  
Three Lafayette Centre  
1155 21st Street, N.W.  
Washington, D.C. 20581

**Re: Business Conduct Standards for Swap Dealers and Major Swap Participants With Counterparties**

**Proposed Rule FR 2010-31588; Federal Register Release 75 FR 80638**

Dear Mr. Stawick:

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 development of best practices. Our more than 17,000 members are dedicated to the sound management of government financial resources.

We are writing with serious concern about the Proposed Rule, and the impact this could have on the municipal securities market and state and local governments.

The GFOA has long supported the regulation of the derivatives market, swap advisors, and swap brokers. We are pleased that these provisions are included in the Dodd-Frank Act. However, as drafted, these proposed rules could adversely affect those governments that have outstanding derivative contracts, as well as those governments that properly use these financial instruments and are well equipped to understand use them.

While we support the requirement to have state and local governments and “special entities” use a swap advisor, we are concerned with the requirement to have the swap broker verify that the swap advisor being used by the entity is independent from the swap dealer. At the very least this could pose a serious conflict of interest problem, something that the Act and the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC) would want to avoid. If the swap dealer must verify the qualifications of the swap advisor, then too much power could be given to the swap dealer (counterparty), which ultimately could interfere with, prove more costly for, and be problematic to the state and local government.

Additionally, it remains unclear how incorporating “acting in the best interest of the government” under the business conduct rules will work for swap dealers. This standard applies whenever a swap dealer acts as an “adviser” to its “special entity” counterparty. The definition of “adviser” in the context of swap

dealers is so broad that it would often apply in the normal course of traditional interactions between dealers and their state and local government clients.

The swap advisor already has a fiduciary duty to the state and local government. As the counterparty, it is unlikely that the swap dealer can act in the best interest of the government. That duty of care is fundamentally at odds with an arm's length, counterparty relationship. We strongly believe that for both swap dealers and swap advisors, there should be some suitability standards in place so that those governments with the appropriate expertise and capabilities to engage knowledgeably in these transactions are able to do so, while protecting those governments that should not be engaged in these types of transactions. Requiring dealers to ensure that transactions are in the best interests of their counterparties would result in an unresolvable conflict between the roles of counterparty and adviser. As a result, we are concerned that most or all dealers now active in executing over-the-counter swaps with state and local governments would need to stop providing these products, eliminating access to the swap market for states and localities. This would be particularly harmful for governments with swap contracts outstanding who may need to revise or restructure existing transactions.

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 potential risks and rewards associated with these products. We emphasize the importance of education and advise 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 to our submission for your review.

Finally, the rules should be clear as to which regulatory body has authority over swap advisors. It is our interpretation that such authority rests with the Municipal Securities Rulemaking Board and not the CFTC.

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

Sincerely,

A handwritten signature in cursive script that reads "Susan Gaffney".

Susan Gaffney  
Director, Federal Liaison Center



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 financial 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)."<sup>1</sup> 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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<sup>1</sup> 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

### Introduction

*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.*

### General Information

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.

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

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**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?

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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 ___ |

**Counterparty/ies**

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 \_\_\_

**Credit Support**

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 \_\_\_

**Tax Issues**

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 \_\_\_

**Operations and Monitoring**

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*



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### **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 intermediaries or are taking a proprietary position 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.