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OFFICERS ASSOCIATION

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OFFICE OF THE SECRETARIAT

October 13, 1998

COMMENT

COMMODITY FUTURES TRADING COMMISSION
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Jean A. Webb, Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 - 21st Street, NW
Washington, DC 20581

RE: Over-the-Counter Derivatives Concept Release

Dear Secretary Webb:

The enclosed comments represent the views of the Government Finance Officers Association (GFOA) regarding the Over-the-Counter Derivatives Concept Release issued by the Commission on May 12, 1998. The GFOA is a 14,000-member professional association of state and local government finance officials and other public finance specialists whose responsibilities include debt, cash and pension fund management.

GFOA appreciates the opportunity to provide comments and looks forward to continuing to work with the Commission on issues of mutual interest. Questions concerning these comments should be addressed to Betsy Dotson, Director, GFOA Federal Liaison Center, at 202/429-2750.

Sincerely,

Betsy Dotson

Betsy Dotson
Director
Federal Liaison Center

Enclosure

These comments address the Concept Release on over-the-counter (OTC) derivatives issued on May 12, 1998, by the Commodity Futures Trading Commission (CFTC). Because of the extensive nature of the Concept Release, GFOA's comments do not attempt to address all areas or all questions included in the release. The comments will instead focus on some of those areas particularly applicable to state and local government investors and which are addressed by long-established GFOA policies and practices. Specifically, these comments will be limited to two key areas of the concept release: eligible participants and sales practices. Copies of the recommended practices and policy statements cited within the comments are attached.

Eligible Participants

The concept release requests comment regarding whether the current list of eligible participants and appropriate persons for whom swap agreement exemptions may be granted under Sections 4(c)(2) and 4(c)(3) of the Commodity Exchange Act should be modified; that is, whether some persons who are currently excluded should be included or whether some persons currently included should not be active in the current market, and whether additional protections might be necessary.

GFOA has previously commented on the eligible participant/appropriate person issue. In December 1994, GFOA submitted comments to the Commission concerning a CFTC proposed rule regarding which entities should be included as "eligible participants" for Section 4(c) contract market transactions. The Commission at that time requested comment on whether municipalities should be excluded from participation in these transactions. In its comments, GFOA expressed its support for maintaining the eligibility of local governments to engage in such transactions. It believed that any attempt by the CFTC to exclude such entities would have been an inappropriate intrusion into and preemption of what is properly a state and not a federal function -- that is, the regulation of the investment functions and decisions of a state or its political subdivision. GFOA pointed out that the proper role of federal regulators was that of regulating those who deal with investors, including state and local governments.

In 1997, GFOA approved a policy statement opposing legislative proposals to relax standards for exchange-traded derivatives and related proposals to create a "professional trading market" (Deregulation of Futures Exchanges). The Association stated its policy that deregulation of commodities futures exchanges could put public pension funds and other state and local government funds at risk.

In comments submitted to the CFTC in November 1997, GFOA opposed a proposed rule which would have amended CFTC Rule 1.55, removing the requirement that futures commission merchants and introducing brokers furnish certain disclosure information to specific categories of customers. The proposed rule included "any governmental entity (including...any state...) or political subdivisions thereof,...or department of any of the foregoing" in these categories of customers. GFOA opposed any change to the existing rule regarding the provision of risk disclosure statements to state and local investors prior to opening a commodities futures account, and in its final rule published in February 1998, the Commission adopted the GFOA position.

Without commenting on whether the current list of eligible swap participants should be expanded or contracted in any other way, GFOA believes that state and local governments should continue to be eligible participants in the OTC derivatives markets. The Association believes that all OTC derivatives investors could benefit from additional protections. The types of protections GFOA believes are appropriate will be discussed later in these comments.

Definition of Sophisticated Investor

GFOA is aware of attempts to establish a single definition of "sophisticated investor" whenever that concept arises under the Commission's regulations. For example, in June 1998 the National Futures Association (NFA) petitioned the CFTC to establish such a uniform definition for those types of customers who are considered sophisticated and therefore authorized to engage in certain types of transactions or excluded from particular regulatory requirements. Under the NFA proposal, these would be considered "enumerated persons." It is GFOA's understanding that attempts to create such a definition also include plans to attempt to expand it to other regulatory structures such as those in the securities and banking areas. The Association opposes all attempts at such uniformity.

In the November 1997 comments to the CFTC discussed above, GFOA outlined its opposition to such a plan. In the proposed rule under consideration at that time, the Commission seemed to adopt the concept of "sophisticated investor" without specifically endorsing or defining it. GFOA viewed the inclusion of state and local government entities in the list of those exempted from the required receipt of risk disclosure information as an indication that the CFTC considered these entities to be "sophisticated." The proposed NFA amendment specifically lists "any governmental entity (including the United States, any state, or any foreign government) or political subdivision thereof, or...any instrumentality, agency, or department of any of the foregoing" as a so-called "enumerated person."

Previous attempts by the CFTC, the National Association of Securities Dealers (NASD), financial institution regulators and Congress to determine who is a "sophisticated" investor have all encountered difficulties. Some have tried to employ an asset-based test, which is impracticable due to the differences in how governments measure assets in comparison to private entities. In addition, such asset-based or, similarly, investment portfolio-size measurement tests have proved to be ineffective as predictors of problems. Large entities and investors, both public and private, have been the victims of misrepresentation and other misconduct just as small ones have. Experience has shown that even investors presumed to be "sophisticated" -- by whatever measure -- require protections.

Under the NFA proposal, even the smallest municipal government or government agency would be treated as "sophisticated," as would townships, boroughs, special districts, school districts and all other state and local governmental entities. Finance officers in many of the smallest jurisdictions often have additional responsibilities as far removed from finance as handling public works projects and supervising public safety officers. These small jurisdictions often rely on public servants who may have little expertise with commodities or derivative instruments.

GFOA believes that whether or not a particular investor is "sophisticated" under a given regulatory regime ought to be determined on a case-by-case basis and opposes proposals to establish a uniform definition.

Sales Practices

As a sign of its commitment to responsible investing, GFOA has long advised its members to exercise caution in the investment of public funds. It is a GFOA recommended practice, for example, that investors obtain competitive bids and proposals from securities dealers, or verify through other means that the prices being offered are reasonable, and that finance officers secure acknowledgment from their depositories and dealers of receipt of written copies of their investment policies, risk constraints, and trading requirements. Governmental investors are also advised to be aware of reasonably foreseeable risks of market price loss, illiquidity, nonmarketability, or default of investment instruments prior to purchase (Governmental Relationships with Securities Dealers).

GFOA has also recommended that state and local governments exercise caution in their selection of investment advisers and implement an ongoing risk control program (Selection of Investment Advisers). The Association has urged state and local government finance officers to exercise extreme caution in the use of derivatives and to consider their use only when they have developed a sufficient understanding of the products and the expertise to manage them. GFOA has provided public investors with a detailed, eight-point set of factors to use in order to evaluate the appropriateness of derivatives for their jurisdiction (Use of Derivatives by State and Local Governments).

GFOA has also approved a recommended practice supporting the use of written investment policies for state and local governments and at that time issued a sample investment policy that is intended to serve as a guide for the preparation of state and local government investment policies (Use and Application of Voluntary Agreements and Guidelines and Support for Written Investment Policies for State and Local Governments).

The above summary represents only a portion of the educational efforts undertaken by GFOA to make sure that state and local government investors understand their investments. Clearly, GFOA does not expect or advocate that dealers become insurers against loss by customers that may result from market fluctuation or poor choices by the investor. However, not even the adoption of GFOA's investment guidelines nor the use of an investment policy can protect a jurisdiction against dealers who either are not subject to or do not follow sales practice standards.

For this reason, GFOA has historically supported sales practice rules for financial markets. The concept of rules for fair dealing is not a new one. Underwriters of municipal debt are required to review disclosure documents before offering the securities for sale. In addition, before recommending a municipal security for purchase, a broker-dealer must have procedures in place to assure that he will receive notice of designated material events affecting the issuers whose securities are traded. Broker-dealers in the U.S. government securities market -- considered by many to be the safest, most efficient and generally most transparent financial market in the world -- are now subject to sales practice rules (Regulation of U.S. Government Securities Dealers' Sale Practices, Reauthorization of the Government Securities Act).

While some have argued that sales practice rules are unnecessary as long as antifraud statutes apply, it is clear that there are egregious practices that may fall short of fraud, or where, by their very nature, intent to defraud is difficult to prove. Such misconduct, even where it does not rise to the level of fraud, must be deterred. The Concept Release itself cites the 1997 General Accounting Office report (*OTC Derivatives: Additional Oversight Could Reduce Costly Sales Practice Disputes,* GAO/GGD-98-5, October 1997) regarding losses in OTC derivatives. GFOA members report that many new and complex instruments that have proven to be risky are being aggressively marketed to state and local governments. If the value begins to decline, some finance officers have been assured that the instrument will bounce back. In short, some cautious finance officers believe they have been misled by dealers and that these products have been misrepresented, in part due to a lack of understanding by those trading them and in part because of the incentives to sell because of the large commissions dealers earn. There is a decided lack of information available to finance officers regarding specific instruments, even from outside investment advisers or bond counsel, who are often unfamiliar with these instruments.

In 1994, GFOA issued a policy statement supporting the promulgation of sales practice rules in the OTC derivatives markets (Regulation of Derivatives Products). Although that policy statement did not specifically address what the rules should provide nor what body or bodies should have implementation and enforcement authority, GFOA has consistently supported sales practice rules that are appropriately similar to those in other markets.

Since the adoption of that policy, the Association has also continued to support efforts to increase the flow of information to OTC end-users and opposed those guidelines or approaches that served to restrict the flow of information. For example, in 1995 GFOA and other state and local government organizations criticized the guidelines set forth under the name of "Principles and Practices for Wholesale Financial Market Transactions" which sought to establish a framework for OTC transactions. First, an underlying concept of the document was the presumed equality between dealers and end-users regarding access to information, a presumption that most market participants understand to be false. In that regard, GFOA recommended that dealers should recognize an affirmative duty to provide information material to a particular transaction instead of requiring the end-user to request it.

Second, GFOA objected to the document's failure to even suggest that a dealer ought to undertake any kind of inquiry about a potential counterparty of the "know-your-party, know-your-counterparty" nature prior to making recommendations on OTC derivatives. Instead, the Association suggested that a model such as the Bankers Trust/Federal Reserve Board settlement might be appropriate. That 1994 agreement required Bankers Trust to obtain prior approval to sell leveraged derivatives; disclose to customers how the value of the contract would be affected by changes in the markets; ensure that customers have the capability to understand the derivatives being marketed; agree not to sell complicated derivatives to unsophisticated customers; and disclose to customers how profits and losses are calculated on each trade. For the reasons discussed earlier, GFOA clearly favors disclosure of risk information to state and local government entities. GFOA continues to believe that these factors would permit investors to exercise better judgment regarding possible investment transactions in OTC derivatives.

Conclusion

GFOA urges the Commission to carefully consider the Association's comments as it continues its examination of the regulatory regime governing OTC derivatives markets, and looks forward to working with the Commission in this effort.

GOVERNMENT FINANCE OFFICERS ASSOCIATION

Policy Statement

Deregulation of Futures Exchanges

Background

The Futures Trading Practices Act of 1992 authorized the Commodity Futures Trading Commission (CFTC) to permit less regulated "professionals only" futures trading in the United States. For this purpose, professionals are considered to be entities and individuals with assets that tend to exclude the general public from participation. In 1993, the CFTC exempted a number of "professionals only" markets from its regulatory structure, including the over-the-counter (OTC) derivatives market. The futures exchanges were not exempted.

While trading in derivatives occurs both on exchanges and in OTC transactions, there are differences between these markets. Exchanges are organized public marketplaces in a centralized environment. The exchanges are noted for the following characteristics: open and competitive trading; publicly available price transparency; clearing firm financial requirements; and clearing systems that eliminate counterparty risk. OTC transactions involve privately negotiated contracts between institutional customers. Each party to the transaction must take the credit risk of the counterparty and the price of the trade is confidential. In many cases, OTC products may prove to be better risk management tools than standardized exchange-traded products. OTC dealers frequently hedge their risks using exchange-traded products.

Recent legislative proposals would amend the Commodities Exchange Act to permit the futures exchanges to operate a "professional market." This would be a largely unregulated market designed for trading by "appropriate persons." Federal regulators would retain their anti-fraud and anti-manipulation authority, but this authority would be limited by their inability to enforce certain recordkeeping and reporting requirements that exist under current law. Futures exchanges point to competitive pressures from the deregulated OTC market in urging a similar relaxation of rules for the commodities exchanges.

While most state and local governments are precluded from trading directly in futures, this option is available for public pension funds. In addition, state and local governments often use derivative products for risk management purposes. For example, debt and investment transactions often involve swaps based on futures products prices and might include interest rate derivatives that are used to hedge against interest rate movements. Although used less frequently, debt and investment transactions also might involve currency derivatives used to hedge against changes in foreign exchange rates and commodity derivatives that are used to hedge against future price changes.

GFOA Policy

The Government Finance Officers Association (GFOA) opposes legislative proposals to relax standards for exchange-traded derivatives and those provisions that would create a "professional trading market." It is clear that even a market composed primarily of institutional investors or those with a particular asset threshold must have a means of ensuring market integrity, price dissemination and adequate protections against fraud, manipulation, and other trading abuses. GFOA believes that deregulating commodities futures exchanges could put public pension funds and other state and local government funds at risk. GFOA urges Congress to consider carefully the potentially negative effects that the deregulation of futures exchanges could have on the integrity of the financial markets, including the perception that they are less safe or stable than under the current environment.

Adopted: June 3, 1997

GFOA Recommended Practice

Governmental Relationships with Securities Dealers (1986 and 1988)

Background. State and local governments represent one of the largest sources of investment funds available to purchase U.S. Government Securities. Without broad participation by state and local government investors, the government securities market would lack liquidity and the U.S. Treasury's cost of borrowing would increase. At the same time, governmental investors are expected to protect public funds from losses arising from default and to ensure that securities are purchased and sold at the best price available in the competitive marketplace.

Recommendation. The Government Finance Officers Association (GFOA) makes the following specific recommendations to state and local government investors in selecting depositories and securities dealers for the purpose of investment transactions in government securities:

1. Select or qualify depositories, custodians, and dealers through competitive procedures, including requests for proposals for banking services. All securities purchases should be made through competitive bidding. In the event that a governmental unit does not obtain competitive price bids, investors are urged to obtain written documentation of price markups prior to completing the transaction.

2. Require securities dealers conducting transactions with governmental entities to comply with the Federal Reserve Bank of New York's capital adequacy guidelines as a condition of doing business. Before investing public funds, governmental investors should obtain compliance certifications from the dealer and an independent auditor.

3. Secure acknowledgment from depositories and dealers that they have received written copies of their investment policies, portfolio risk constraints, and investment trading requirements.

4. Be aware of reasonably foreseeable risks of market price loss, illiquidity, nonmarketability, or default of investment instruments before they are purchased. Additionally, securities dealers have a responsibility to disclose unreasonable risks.

References

- *An Introduction to Broker/Dealer Relations for State and Local Governments,* M. Corinne Larson, GFOA, 1994.
- *Investing Public Funds*, Girard Miller, GFOA, 1986.

GFOA Recommended Practice

Selection of Investment Advisers (1992)

Background. Some state and local governments have augmented their investment programs by retaining investment advisers to perform various portfolio services, ranging from advice-only consultation to fully discretionary management. In many cases, the results of these engagements have been favorable but there also have been cases of reported investment losses resulting from governmental units transacting business with certain investment advisers. Unlike the highly regulated bank trust and mutual fund sectors, federal regulatory inspection of independent investment advisers is infrequent and relatively superficial.

Recommendation. The Government Finance Officers Association (GFOA) has recommended consistently that state and local governments exercise caution in their selection of investment advisers and implement an ongoing risk control management program. The Association urges state and local governments considering or retaining independent investment advisers to carefully review the credentials, procedures, and controls of firms offering investment advisory services. Recommended precautionary measures include

- delivery versus payment,
- third-party custody arrangements,
- prohibitions against self-dealing,
- independent audits,
- timely reconciliations, and
- other appropriate internal control measures.

References

- *An Introduction to External Money Management for Public Cash Managers,* GFOA, 1991.
- *An Elected Official's Guide to Investing,* M. Corinne Larson, GFOA, 1995.
- GFOA Sample Investment Advisory Agreement, 1995.
- *An Introduction to Investment Advisers for State and Local Governments*, M. Corinne Larson, GFOA, 1996.

GFOA Recommended Practice

Use of Derivatives by State and Local Governments (1994)

Background. Derivative products are financial instruments created from or whose value depends on (is derived from) the value of one or more underlying assets or indexes of asset values. Derivatives include instruments or features such as collateralized mortgage obligations (CMOs), interest-only (IOs) and principal-only (POs), forwards, futures, currency and interest rate swaps, options, floaters/inverse floaters, and caps/floors/collars. State and local governments may use derivatives in their roles as debt, cash, and pension fund managers.

Recommendation. The Government Finance Officers Association (GFOA) urges state and local government finance officers to exercise extreme caution in the use of derivatives and to consider their use only when they have developed a sufficient understanding of the products and the expertise to manage them. Because new derivative products are increasingly complex, state and local governments should use these instruments only if they can evaluate the following factors, among others, to determine their appropriateness:

1. Governmental entities must observe the objectives of sound asset and liability management policies that ensure safety, liquidity, and yield. Because of the risks involved, the use of derivatives by governmental entities should receive particular scrutiny. Certain derivative products may not be appropriate for all governmental investors. Characteristics of such products can include high price volatility, illiquid markets, products that are not market-tested, highly leveraged products, products requiring a high degree of sophistication to manage, and products that are difficult to value.

2. Governmental entities should understand that state and local laws may not specifically address the use of derivatives and examine such considerations as

   - the constitutional and statutory authority of the governmental entity to execute derivative contracts,
   - the potential for violating constitutional or statutory provisions limiting the entity's authority to incur debt resulting from the transaction, and
   - the application of the governmental entity's procurement statutes to derivative transactions.

3. Governmental entities should be aware of all the risks associated with use of derivatives, including counterparty credit, custodial, market, settlement, and operating risk.

4. Governmental entities should establish internal controls for each type of derivative in use to ensure that these risks are adequately managed. For example,

   - the entity should provide a written statement of purpose and objectives for derivative use;

- written procedures should be established that provide for periodic monitoring of derivative instruments;
- managers should receive periodic training and have sufficient expertise and technical resources to oversee derivative programs;
- recordkeeping systems should be sufficiently detailed 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; and
- reporting on derivative use should be in accordance with generally accepted accounting principles, and because use of these instruments is a complex matter, early discussion with public accountants is essential to determine if specialized reporting may be required.

5. Governmental entities should be aware if their broker/dealer is merely acting as an agent or intermediary in a derivatives transaction or is taking a proprietary position. Possible conflicts of interest should be taken into consideration before entering into a transaction.

6. Governmental entities should be aware that there may be little or no pricing information or standardization for some derivatives. Competitive price comparisons are recommended before entering into a transaction.

7. Governmental entities should exercise caution in the selection of broker/dealers or investment managers and ensure that these agents are knowledgeable about, understand and provide disclosure regarding the use of derivatives, including benefits and risks. The entity should secure written acknowledgment from broker/dealers that they have received, read, and understood the entity's debt and investment policies, including whether derivatives are currently authorized under the entity's investment policy and that the broker/dealer or investment manager has ascertained that the recommended product is suitable for the governmental entity.

8. Governmental entities are responsible for ensuring this same level of safeguards when derivative transactions are conducted by a third party acting on behalf of the governmental entity.

References

- *A Public Investor's Guide to Money Market Instruments, Second Edition,* edited by M. Corinne Larson, GFOA, 1994.
- An Elected Official's Guide to Investing, M. Corinne Larson, GFOA, 1995.

GFOA Recommended Practice

Use and Application of Voluntary Agreements and Guidelines and Support for Written Investment Policies for State and Local Governments (1995)

Background. Various participants in the investment process are seeking to clarify the relationship of parties in an investment transaction by undertaking voluntary efforts to develop model agreements and guidelines. Some of these documents contain legal assumptions that might affect the validity of a transaction. Others would require certain statements to be in writing in order to be effective. Although the enforceability of such guidelines is uncertain, state and local government investors should be aware of their existence and the possibility that their counterparties may be operating under these or similar guidelines.

Recommendation. The Government Finance Officers Association (GFOA) recommends that state and local governments consider carefully any agreement or guideline presented for their use because many of these documents affect a public entity's rights and responsibilities in a given transaction. Furthermore, GFOA recommends that:

1. Governmental investors be aware of the federal, state, and local laws that govern investment contracts and agreements, as well as statutes and regulations affecting suitability obligations of broker/dealers, which require that a broker/dealer should only recommend a product after that broker/dealer has taken steps to determine that it is suitable for the customer.

2. Governmental investors use the GFOA-developed Broker/Dealer Request for Information, Sample Agreement for Securities Service and (Optional) Statement of Work in dealing with broker/dealers, modified as necessary, which have been formulated specifically by and for state and local government investors.

3. Governmental investors use the GFOA-developed Sample Agreement for Investment Advisory Services when contracting for investment advisers.

4. Governmental investors protect their existing statutory and regulatory rights by ensuring that such rights are not inadvertently waived through the use of "boiler-plate" language in contracts with counterparties.

5. Governmental investors develop written investment policies using the GFOA-developed Sample Investment Policy.

References

- *An Introduction to Treasury Agreements for State and Local Governments,* Linda Sheimo, GFOA, 1993.
- *An Introduction to Broker/Dealers Relations for State and Local Governments,* M. Corinne Larson, GFOA, 1994.
- GFOA Sample Custodial Trust Agreement, 1995.
- GFOA Sample Investment Advisory Agreement, 1995.
- GFOA Sample Security Agreement, 1995 (short and long version).
- GFOA Sample Investment Policy, 1996.

GOVERNMENT FINANCE OFFICERS ASSOCIATION

Policy Statement

Regulation of U.S. Government Securities Dealers' Sales Practices

State and local governments represent one of the largest sources of investment funds available to purchase U.S. Government securities. Without broad participation by state and local government investors, the government securities market would lack liquidity and the Treasury's cost of borrowing would increase.

In 1986, Congress created the Government Securities Dealer Act, Public Law 99-571, which imposed a regulatory structure and net capital requirements for all dealers in U.S. Government securities. The 1986 Act, however, did not establish regulatory authority to control the sales practices of government securities brokers/dealers. As a result, state and local government entities have not been protected from aggressive or unscrupulous sales practices and price markups.

Ironically, a federal regulatory structure governing dealer sales practices has been imposed in the tax-exempt market for state and local government securities while the federal government has failed to police the market in its own securities.

The Government Finance Officers Association (GFOA) encourages competitive bidding in all securities purchases. In the event that a governmental unit does not obtain competitive price bids, investors are urged to obtain written documentation of price markups prior to completing the transaction.

The GFOA will work in cooperation with other interested groups to encourage development of investor-protection guidelines regarding standards of practice, securities selection suitability, and price markups.

The GFOA supports federal legislation to facilitate self-regulation and surveillance of sales practices of all securities dealers who conduct transactions involving U.S. Government securities and money market instruments.

Adopted: May 3, 1988

GOVERNMENT FINANCE OFFICERS ASSOCIATION

Policy Statement

Reauthorization of the Government Securities Act

In order to achieve adequate investor protection in the government securities market, the Government Finance Officers Association (GFOA) supports federal legislation amending the Government Securities Act (GSA) to include sales practice rules for government securities dealers. The Association supports the adoption of sales practice rules that are appropriately similar to those in other regulated securities markets. The GFOA further recommends the granting of explicit enforcement authority to bank and non-bank regulators including self-regulatory organizations (SROs) and a meaningful role for the Securities and Exchange Commission. A sunset provision should be included in the Government Securities Act to provide an opportunity to review the rules and the regulatory structure.

Adopted: June 4, 1991

GOVERNMENT FINANCE OFFICERS ASSOCIATION

Policy Statement

Regulation of Derivative Products

Changes in global financial markets have led both the private and public sectors to search for new methods to protect against risks associated with foreign exchange and interest rates as well as equity and commodity prices. In order to address this demand, many institutions are using derivative products. Derivatives are financial instruments created from, or whose value depends on (is derived from) the value of an underlying asset, reference rate or index.

Participants in the derivatives markets are dealers and end-users. End-users include financial institutions, businesses, mutual and pension funds and government entities. Dealers are usually large commercial banks or securities firms and insurance companies and their affiliates. Derivatives can be traded through established exchanges. Derivatives can also be traded through contracts negotiated privately between two parties, called over-the-counter (OTC) derivatives. While payments between counterparties of exchange-traded derivatives are guaranteed, those between counterparties of OTC derivatives are not.

Recent reports about losses by some derivatives end-users have raised numerous issues of concern to state and local government finance officers. These include concerns about the risks incurred with the use of derivatives, such as legal, credit, market, settlement, interest rate, and operating risks, as well as concerns regarding the appropriate use of derivative products and the marketing of these products. Indeed, some public jurisdictions have already experienced losses because of their use of derivative products.

The Government Finance Officers Association (GFOA) is concerned about the increasing complexity of new derivative products used for debt, cash and pension management purposes. There are various vehicles available to address these concerns, including legislation, regulation, better enforcement of existing rules, improved oversight and educational initiatives. Accordingly, GFOA supports appropriate federal action that would accomplish the following:

- Close regulatory gaps related to securities firms and insurance companies that are dealers of derivative products. While financial institutions are subject to periodic regulatory examinations regarding their use of derivatives, there are no federal regulations regarding derivative activities by securities and insurance firm affiliates, and there is little or no state oversight of derivatives activities of insurance company affiliates.

  In addition, while banks and affiliates of securities firms are required to submit reports to regulators on their derivatives activities, there is no independent reporting requirement for insurance company affiliates. Closing these gaps will result in greater assurance that potential problems will be identified and addressed on a timely basis.

- Ensure investor protection by clarifying suitability rules for derivatives brokers, dealers, and investment managers and promulgating new rules as necessary. State and local governments must be assured that the product recommended for their use is appropriate and that the broker or dealer has disclosed his or her own position with regard to the derivatives contract.

- Accelerate the Financial Accounting Standards Board (FASB) accounting standard-setting process for derivative products and disclosure by derivatives brokers and dealers. Investors, creditors, regulators and other users of financial reports must be able to rely on consistent reporting of material information. Lack of accounting rules can result in inconsistent and misleading reporting on derivative products.

- Examine and set reasonable capital requirements for derivative brokers and dealers. Capital requirements are imposed to provide protection from unexpected losses, reduce the likelihood of failure of an institution or firm, and protect clients and creditors. Currently, only banks have capital requirements. There are no capital requirements for securities firms or insurance companies affiliate derivative dealers.

GFOA believes that greater federal government involvement in the regulation of derivative products is warranted to avoid market disruption and the loss of scarce taxpayer funds.

Adopted: June 7, 1994