TESTIMONY

of the

GOVERNMENT FINANCE OFFICERS ASSOCIATION

presented by

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and
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on

State and Local Government
Cash Management Practices

presented to

Committee on Banking, Housing and Urban Affairs
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INTRODUCTION

Good morning. My name is Bonnie Ridley Kraft. I am City Manager of the City of Gresham, Oregon, and current President of the Government Finance Officers Association (GFOA). Previously, I was chair of GFOA's Committee on Cash Management for two years. GFOA is a professional association of state and local government officials whose responsibilities include all the disciplines related to public finance. Our Association is almost 100 years old, and our 10,000 members include both elected and appointed state and local government officials.

I am not going to focus on Orange County, California, this morning. Rather, I want to discuss with you how GFOA views the function of cash management, what activities we engage in to educate and assist our members in their management of the public's money, and to share with you some thoughts about how this important governmental function can be improved and the roles of the federal regulatory agencies and Congress in this process.

Cash management can be defined as all activities undertaken to ensure maximum cash availability and maximum investment yield on a government's idle cash. These twin goals sometimes conflict with each other. Where such conflicts exist, GFOA cautions in all its literature and educational programs that safety and liquidity have a higher priority than yield. In fact, we even have an acronym for this -- SLY -- Safety and Liquidity always come before Yield. Later in my testimony I will discuss in more detail some of our activities that are designed to provide a practical application of this important principle.

GFOA provides its members and other state and local officials with a full complement of cash management services, including publications, training programs, and technical assistance in response to inquiries. A listing of GFOA's cash management products is provided in Appendix A.

GFOA also works closely with other organizations to improve cash management. In response to the increased interest of state legislatures about the safety of public fund investments, we will offer a one-day seminar in three locations in February and March in cooperation with the National Conference of State Legislatures. This seminar will provide a forum for state and local officials to discuss the elements of state investment statutes as they apply to local governments; state involvement with, and oversight of, local government investment pools; and the elements of local investment policies.

OVERVIEW OF CASH MANAGEMENT PRACTICES

As a professional association, GFOA's mission is to enhance and promote the professional management of governmental financial resources. For many years, the Association has been the recognized leader in the area of cash management which encompasses such activities as:

- the receipt and deposit of cash and negotiable payments,
- custody of monies and securities of the state or local government entity,
- disbursement of funds upon proper authorization,
- selecting and dealing with financial institutions,
- investment of cash in instruments that are authorized under applicable statutes, policies and guidelines,
- cash budgeting and forecasting, and
- short-term borrowing to meet temporary cash-flow shortfalls.

One of the functions implicitly reserved to the states by the Constitution is that of management of a state's own public finance activities and those of its political subdivisions. No local government may organize, perform any function, tax its citizens, receive or spend money without the consent of the state. Thus, local governments, as political subdivisions of the states, look to state statutes and regulations for direction regarding permissible investments, debt financing, pension fund management, and other functions. With respect to cash management, state regulation sets the outer limits of local investment policies, authorized investments and concentrations in types of investments, as well as collateralization requirements and other procedures. Within state constraints, local government entities then formulate their own guidelines, many of which restrict authorized investments even further. See Appendix B for a listing of statutory local government investment authority by state. State laws also govern the creation and management of investment pools.

The role of the federal government has been regulator of those who trade with these entities -- primarily financial institutions and broker/dealers -- or regulator of many of the instruments themselves, but not the regulator of state or local government entities or their financial policies. Such intervention would be a drastic departure from the principles of federalism that reserve certain powers to the states and would be an encroachment on state sovereignty.

GFOA Model Legislation

In 1984, GFOA developed and approved Model Investment Legislation for State and Local Governments that provides a universe of appropriate investment instruments and outlines a series of considerations that should underlie the application of an investment policy at the state or local government level. These guidelines have since been updated as needed.

The GFOA model legislation, in addition to providing a list of appropriate instruments, also includes model legislation for local government investment pools. These are pools managed by the state consisting of funds from local governments placed in the custody of the state. While the model legislation refers specifically to state pools, the same operating principles should apply to pools administered locally as well. Local pools have in the past been viewed favorably as they allow otherwise small investors to gain the expertise and economies of scale generally available to only larger funds. The model legislation includes provisions relating to

- the method of establishing such a pool,

- creation of a local government investment board, including a member from the state treasurer's office, a representative of county officials, a representative of local government finance officers, a representative of school business officials, and a professional in the field of investment and finance who holds no other public office,

- board functions, including rules for prudent and necessary investment of funds, selection of an investment officer or agent, reporting to pool participants, budgeting and approval of expenditures for the fund's administrative costs, and contracting of legal or other professional assistance,

- adoption of rules and regulations necessary to administer the pool, including authorized investments, minimum amounts to be deposited for pool participation, payment of expenses, equitable distribution of earnings or allocation of losses to pool participants, procedures for deposit and withdrawal of funds, and procedures for custody and safekeeping of funds,

- authorized investments, and

- accounting and controls procedures.

The final section of the model legislation concerns collateral for public deposits.

Repurchase and Reverse Repurchase Agreements

Of the many investment instruments available, two that have attracted particular attention lately are repurchase agreements (repos) and reverse repurchase agreements (reverse repos). Briefly, repos are secured contractual transactions between an investor and a bank or securities dealer. The investor exchanges cash for temporary ownership or control of collateral securities, with an agreement between the parties that, on a future date, the bank or dealer will repurchase the securities. The investor customarily receives interest during the term of the repo. Repurchase agreements provide cash managers with an important short-term investment vehicle to supplement their portfolios of government securities, certificates of deposit and money market instruments. Repos provide a secured investment for those seeking safety, liquidity and yield. However, the losses resulting from the casual use of repurchase agreements in the 1980s demonstrate that care must be used with these instruments as well.

In some states, repos are authorized specifically by statutes that govern investment of public funds. In others, the authority for public investors to use repos derives from legal interpretations that regard the repo as a form of ownership of government securities that are specifically authorized elsewhere in their investment guidelines. GFOA recommends that governmental entities exercise special caution in selecting parties with whom they conduct repurchase transactions and undertake proper collateralization practices to protect public funds. GFOA also recommends the use of master repurchase agreements, such as that developed by the Public Securities Association (PSA), to eliminate uncertainty regarding ownership at various points in the process. The master agreement protects the investor seeking to liquidate collateral if a dealer or bank defaults.

In a reverse repurchase agreement, a dealer transfers cash in exchange for securities. This allows investors to use their portfolio securities for collateral as a means of raising cash. Reverse repos offer a source of liquidity for cash managers whose cash flow requirements mismatch their scheduled maturities. Using reverse repos may allow a cash manager to avoid liquidating the portfolio to meet an immediate, short-term cash requirement. Such use of a reverse repo is generally accepted as a legitimate cash management practice.

However, a more controversial use of reverse repos is to raise cash for arbitrage trades in government securities. Entities have used reverse repos against their original holdings in government securities and have reinvested the funds in additional securities at a higher rate. These are complicated transactions used for short-term needs but not for speculation and ought not to be undertaken by most public funds managers. There are also questions of legal authority involved, as such use of reverse repos might be considered to be unauthorized borrowing. As a general rule, borrowing short to lend

long can produce losses in adverse markets, such as occurred in the case of San Jose, California, in 1984, where losses of $60 million in leveraged transactions were financed in part by reverse repos. This is reportedly what occurred in Orange County as well.

Because of the liquidity needs of governments to pay operational expenses, payrolls, etc., instruments that are inherently risky, that may become illiquid, or that are long-term, are inappropriate for short-term cash management purposes, although they may be appropriate instruments for pension funds that traditionally and properly invest in long-term instruments of many types. Liquidity considerations impact yield as well, inasmuch as huge losses may be incurred and a low return realized if the instrument must be sold prior to maturity at a loss. Where interest rates impact the market for securities, yield is likely to suffer as well. No one, not even the experts, can be certain of the direction the markets or interest rates will take. If cash will be required, a jurisdiction ought not to be placing its funds in volatile or long-term instruments.

Why are derivatives and complex transactions such as reverse repos so attractive to state and local governments? Even small governments have significant amounts of money to invest, due to the timing of tax receipts or substantial borrowing needed to finance public facilities. The pressure for increased returns or reduced borrowing costs in times of tight budgets is a significant factor affecting decisions to use particular instruments. But finance officers, as custodians of public funds, have the continuing responsibility for balancing safety, liquidity and yield.

GFOA PRACTICES AND POLICIES ON DERIVATIVES AND OTHER ASPECTS OF CASH MANAGEMENT

Another aspect of GFOA's efforts to promote good cash management practices and procedures is the adoption of public-policy positions. In the cash management area, the Association has developed recommended practices for state and local governments and policy statements addressing federal legislative and regulatory activities that affect cash management.

Our recommended practices deal with such issues as:

- the appropriate use of repurchase agreements as an integral part of an investment program,
- support for collateralization of public deposits through the pledging of appropriate securities to fully guarantee the safety of funds and support for other risk control procedures,

- precautions to take when investing public funds in mutual funds,

- support for competitive bidding in securities purchases and the acquisition of written documentation of price mark-ups from securities dealers prior to the completion of a transaction that is not competitively bid,

- the selection of investment advisers,

- recommended investment instruments for public funds, and

- support for the creation of state-administered investment pools and other investment pools created through joint powers statutes and other intergovernmental agreement legislation.

Policy statements of the Association address such topics as:

- support for the Model Investment Legislation for State and Local Governments developed by the GFOA Cash Management Committee,

- endorsement of the National Association of State Treasurers' Statement in Favor of Full Disclosure for Local Government Investment Pools,

- support for federal legislation providing for sales practice rules for brokers and dealers of U.S. Government securities, and

- support for federal legislation providing for more frequent inspections and more thorough oversight of investment advisers.

In June 1994, our Association developed two prescient official positions in the area of derivatives in response to increased interest on the part of its membership in the use of derivatives products, reports of derivatives losses and the intense marketing of these products to state and local government finance officers by the broker/dealer community. These statements are attached to my testimony as Appendices C and D.

The first, a recommended practice which offers guidance to public entities thinking about using derivatives, continues GFOA's historic and ongoing efforts to educate its members, which I outlined earlier, and provides direction to insure prudent management of public funds. The GFOA's recommended practice on the use of derivatives was drafted by and approved unanimously by its members attending the annual meeting, many of whom are issuers of debt, cash managers or pension system administrators. The statement represents "best practices" for finance officers to gauge the appropriate use of derivative products for their jurisdictions. The

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recommended practice urges finance officers to ***exercise extreme caution*** in the use of derivatives instruments and to consider their use only when they have developed a sufficient understanding of the products and the expertise to manage them. The recommended practice provides eight factors that state and local governments considering derivatives should use to evaluate the appropriateness of such use for their jurisdictions. These deal with applicable statutes, risk awareness and establishment of internal controls, and it makes recommendations regarding relationships with brokers, dealers and investment managers dealing in derivative products.

GFOA supports the clarification or issuance of suitability rules for derivatives to assure that the products recommended by a broker or dealer are appropriate for the state or local government entity. This is similar to the GFOA position with respect to other financial markets. The policy also urges the accounting standard-setting process for derivative products to be accelerated by the Financial Accounting Standards Board so that those who depend on financial reports have reliable information on which to base their decisions. The policy also supports setting reasonable capital requirements for brokers and dealers, and urges that regulatory gaps related to securities firms and insurance companies that are dealers of derivatives products be closed.

SUITABILITY

One of GFOA's particular concerns in all financial markets is the issue of suitability. Suitability obligations on the part of broker/dealers arise in discerning the relationship between a particular instrument and a customer's constraints and affinity for risk. For example, because of the risk associated with some investment vehicles, a given instrument may not be appropriate for a specific investor. Loss alone does not determine unsuitability. A jurisdiction may invest, for example, in an instrument that results in a better-than-expected return, or it may have a mix of investments that include both winners and losers, resulting in no net loss. In either case, those investments may nevertheless have been unsuitable given the needs of the jurisdiction. Federal law now authorizes sales practice rules governing suitability, price mark-ups and churning.

Similarly, size alone is not determinative of knowledge or sophistication. Proposals are often made to exclude from suitability obligations on the part of a broker or dealer those investors, including governments, whose budget or investment portfolio exceeds a given level, based on the assumption that this entity is somehow deemed to be "sophisticated." Recent events confirm that size does not necessarily equal sophistication, and that whether there is a suitability issue depends not only on the level of expertise, knowledge and ability of the investor but on the facts and circumstances of a given case, including the fact that, as custodians of public funds

needed for public purposes, state and local government jurisdictions have a much lower risk tolerance than their private sector counterparts may.

As part of its continuing effort to encourage responsible cash management and appropriate investing, GFOA worked with the PSA in an attempt to reach consensus on a broker/dealer trading agreement that would provide guidelines for establishing a trading relationship between broker/dealers and governmental units. GFOA does not expect nor advocate that dealers become insurers against loss by customers that may result from market fluctuation or miscalculation by the investor. This agreement would assist all parties to a transaction in understanding the information to be disclosed by broker/dealers and governmental investors and recognizes the participants' respective responsibilities for dealing with the suitability of investments. The final version of this agreement failed to receive approval from PSA because the broker/dealer representatives considered it overly burdensome, but GFOA has issued the model agreement and many members are using it successfully in their arrangements with their brokers.

Furthermore, finance officers report that derivatives are being aggressively marketed to governments, which are assured in many cases by the sales force that the products are safe, government-guaranteed, and will protect principal. Based on these representations, finance officers may determine that an instrument falls within the parameters of a jurisdiction's investment policy, while remaining unaware of the risks associated with the instrument. If the value begins to decline, some finance officers have been assured that it will bounce back. In short, many cautious finance officers believe that they have been misled and that these products have been misrepresented, in part due to a lack of understanding by the broker/dealer trading them -- many of those selling these products played no part in creating them, and may have only limited knowledge themselves regarding the risks -- and in part because of the large commissions dealers earn. Unfortunately, there is a decided lack of unbiased information available to investors regarding specific derivatives, even from outside investment advisers or bond counsel, who are often called upon for advice, but who also may not be familiar with these complex instruments.

It is GFOA's view that the Government Securities Act Amendments of 1993 already provide for a regulatory structure to be developed that encompasses many of the troublesome derivative products now being used by investors. In comments submitted to the National Association of Securities Dealers, Inc. (NASD) regarding its proposed sales practice rules issued under the Act, GFOA criticized these rules as being outside the direction of the statute as passed and for shifting suitability obligations from the broker/dealer to the investor.

GFOA ACTIVITIES AT THE FEDERAL LEVEL

GFOA has long been in the forefront of federal activities related to state and local public finance issues, particularly with regard to investor protection issues. The Association took the initiative during the reauthorization process of the Government Securities Act in insisting that sales practice rules, which include suitability, for brokers and dealers be included in the reauthorization. GFOA testified several times before both House and Senate committees concerning this legislation. The Government Securities Act Amendments of 1993 as passed includes authority for rulemaking for both bank and non-bank regulators to write sales practice rules dealing with practices such as suitability, markups and churning. GFOA, as noted, submitted comments last fall regarding the proposed draft of the NASD sales practice rules, which focused particularly on the suitability obligation. The final NASD rules, subject to approval by the Securities and Exchange Commission (SEC), have not yet been issued. Financial institution regulators are currently drafting their versions of sales practice rules, and GFOA has been in contact with them as well. This is a priority issue for state and local government investors, and will continue to receive attention as well as the active involvement of the GFOA membership.

In addition, GFOA has worked to enact investment adviser legislation for each of the last several Congresses. This legislation, which would provide a mechanism for funding additional oversight by the SEC of the investment adviser and financial planning industry, is needed to address the explosive growth in this virtually unregulated industry. State and local government investors frequently engage such assistance to help them understand some of the more complex transactions they may undertake and to get professional advice that might not be available from their own staff. In addition to the well-documented losses of over $100 million which resulted from the advisory practices of Steven Wymer, recent news reports note the role such advisers have played in the current volatile market. Yet, despite passage by both houses of Congress, investment adviser legislation has not been enacted. GFOA has submitted comments to the SEC in support of its initiatives under its current statutory authority in this area.

GFOA also cooperated with the General Accounting Office (GAO) in its report on the use of derivatives and actions needed to be taken in this market, which was issued in May 1994 (*Financial Derivatives: Actions Needed to Protect the Financial System*, GAO/GGD-94-133). GFOA assisted in drafting the survey sent to public finance officers, and participated in follow-up meetings with the GAO and Congress regarding the results. GFOA also conducted its own survey regarding use of derivatives for debt issuance in conjunction with the Municipal Bond Investors Assurance Corporation (MBIA), which was released in June 1994.

Since issuance of the GFOA recommended practice and policy on derivatives, GFOA has not only testified before the House Committee on Banking, Finance and Urban Affairs, but has worked closely with a number of the federal regulators such as the Federal Reserve Board, the Commodity Futures Trading Commission, the Department of the Treasury, and the Securities and Exchange Commission on issues such as how state and local governments use derivatives; what the purposes of their use are; how derivatives are marketed to finance officers; what restrictions should or should not be placed on the use of derivative instruments, and by whom. GFOA recently submitted formal comments to the CFTC regarding proposed exemptions from regulations in the swaps markets.

Most recently, GFOA participated in meetings with the President's Working Group on Financial Markets and other state and local government organizations in examining what activities had occurred on behalf of these groups. A joint statement was issued by the participants indicating that, in this ongoing effort, we intend to continue to promote the use of sound investment policies by public entities through a number of methods.

In the private sector, GFOA has been contacted by several of the ratings agencies with regard to the implementation of volatility ratings to mutual funds. GFOA is studying this issue closely, but we look favorably on these important initiatives as a means of providing additional information to investors and will consider recommending that public investors request such information.

FINANCIAL INFORMATION ABOUT LOCAL GOVERNMENTS

As might be expected, recently there has been much discussion about the availability and adequacy of financial information about local governments and their investment portfolios. In particular, regulators, state and local officials and others are questioning whether better or more information might have brought the situation in Orange County into the open sooner. While this testimony concentrates especially on cash management practices, a discussion of financial information provision also is important. Three sources of information that have been the focus of such inquiries are information provided to investment pool participants, information contained in financial statements and the financial information and operating data provided in bond disclosure documents. These are the official statements prepared by governments in connection with the sale of securities in the municipal bond market and ongoing information provided to the secondary market while securities are outstanding.

The preparation and development of information in the public sector is a highly developed practice for which there is a significant body of guidance both with respect to the preparation of financial statements and bond disclosure documents. In addition,

as discussed below, there is considerable federal government involvement in the disclosure process through SEC rulemaking and through the development of guidance by the SEC relying on its interpretive authority under the antifraud provisions of the federal securities laws. State laws also govern the provision of certain information.

Information about Investment Pools

The provision of information to participants in an investment pool about the pool's policies and performance is typically a matter addressed by state law. Pools that are approved to accept and invest public funds are authorized and governed by state statutes, which establish general investment guidelines. In addition, they provide for controls to ensure that assets are properly safeguarded, managed and accounted for. This responsibility includes having policies and procedures in place to invest available cash to the greatest advantage and to avoid investments with an unacceptable degree of risk, to ensure transactions are properly authorized and to ensure data in financial reports are reliable.

Financial Statements

Groups such as citizens, legislative and oversight bodies, investors and creditors are all users of external financial reports because of their common interest in the finances of state and local governments even though the focus of their interest may vary. While it is not practical to design a single financial report that would completely satisfy all potential users of governmental financial information, it has been possible, in both the private and public sectors, to establish criteria for the preparation of a single annual financial report designed to meet the basic informational needs of a wide variety of potential users. These criteria have come to be known as generally accepted accounting principles (GAAP). For state and local governments, the primary source of GAAP is the Governmental Accounting Standards Board (GASB).

According to GAAP, the basic annual financial statements, including notes thereto, necessary for fair presentation of the financial position and results of operations of a government include a balance sheet; an "all inclusive" operating statement for governmental funds and expendable trust funds; a budget comparison statement for all governmental funds for which annual appropriated budgets are adopted; an "all inclusive" operating statement for proprietary funds, non-expendable trust funds and pension funds; and a statement of cash flows for proprietary funds and nonexpendable trust funds. The balance sheet presents the investments of the reporting jurisdiction and GAAP require substantial note disclosure about such investments. This note disclosure includes a list of investments by type as well as disclosure of the market value for each type of investment.

Recently, GASB developed a Technical Bulletin, which was formally approved in mid-December, that provides guidance to preparers of financial statements about the types of disclosures that should be presented for derivatives and similar debt and investment transactions such as mortgage-backed securities. The provisions of the newly issued bulletin are effective for financial statements for periods ending after December 15, 1994, but earlier application is encouraged by GASB. The GASB document makes quite clear that

> ...if derivatives have been used, held, or written (sold) during the period covered by the financial statements (regardless of whether the assets or liabilities resulting from these transactions are reported on the balance sheet), the nature of the transactions and the reasons for entering into them should be explained. This explanation should include a discussion of the entity's exposure to credit risk, market risk, and legal risk; however, the discussion of risk should be made only to the extent that these risks are above and beyond those inherent risks that are apparent in the financial statements or are otherwise disclosed in the notes to the financial statements.

It should be noted that the basic financial statements and notes required by GAAP are often part of a larger comprehensive annual financial report (CAFR). The CAFR supplements the basic financial statements with detailed information on individual funds of the government as well as statistical data on financial trends for the past 10 years and demographic data.

Disclosure in Connection with Securities Offerings

Another source of information about state and local governments is the disclosure documents prepared in connection with the issuance of securities. Rules promulgated by the Securities and Exchange Commission (Rule 15c2-12) require underwriters to obtain and review official statements for issues they are underwriting. Therefore issuers (or some other party) must prepare official statements if they are going to sell their securities in the market and these documents must contain financial information about the issuer and, if applicable, operating data about the facility being financed with the proceeds. These documents are filed in a central repository established by the Municipal Securities Rulemaking Board in Virginia and are available to the public through various nationally recognized municipal securities information repositories.

Ongoing information about issuers to the secondary market has frequently taken the form of annual financial reports which contain issuers' audited financial statements and are often available no later than six months after the close of a jurisdiction's fiscal

year. In response to market concerns about the availability of ongoing information about issuers, the SEC adopted modifications to its Rule 15c2-12 last November that call for the submission of ongoing information that will be available to investors and other users as long as an issuer has debt outstanding. In general, effective July 3, 1995, underwriters will not be permitted to underwrite securities unless the issuer or another person involved in the transaction agrees in a binding agreement to provide annual financial information and material events notices on a timely basis.

The annual financial information includes both financial information and operating data and must "mirror" the type of information provided by the issuer in the official statement prepared in connection with the bond issue. The information must be sent to repositories that will disseminate the information. Eleven material events are listed in the SEC rule about which notices must be filed once the issuer has discovered the occurrence of an event, assessed its materiality and prepared a notice. In addition to the adoption of these rule modifications, last March the SEC promulgated an Interpretive Release providing its views about disclosure obligations of participants in the municipal securities markets under the antifraud provisions of the federal securities laws both in connection with primary offerings and on a continuing basis with respect to the secondary market. These guidelines address several topics of current interest, including

- the adequacy of disclosure and the need to disclose information in official statements that would have been viewed by a reasonable investor as having significantly altered the "total mix" of information made available,

- the inclusion of information in official statements about financial and business relationships and arrangements among the parties involved in a transaction, and

- the statement that municipal issuers must consider disclosure issues arising from their activities as end-users of derivative products and the need for disclosure documents to discuss the market risks to which issuers are exposed, the strategies used to alter such risks and the exposure to both market risk and credit risk resulting from risk alteration strategies.

This guidance took effect on March 9, 1994, and applies retroactively to all municipal securities, including taxable and tax-exempt municipal securities issued prior to that date, because it represents the SEC's interpretation of the existing antifraud provisions in the federal securities laws. It is reported that the SEC is proceeding with its investigation of the Orange County matter under this existing authority.

GFOA also has provided guidance to issuers about such disclosures in its publication Disclosure Guidelines for State and Local Government Securities. (First published in 1976 and updated several times, most recently in 1991.) These

extensive voluntary guidelines have received widespread acceptance, and adherence with the Guidelines is recommended by the SEC. Among other things, the Guidelines call for the preparation of an official statement and recommend that there be a discussion of the principal factors that make an offering speculative or one of high risk and the possible consequences for investment risk. Among the examples of factors that the Guidelines gives are fiscal problems of the issuer or other parties that could interrupt or reduce revenues available for payment of debt service, the financial condition of the issuer, and the nature of activities or businesses in which the issuer is engaged or proposes to engage.

The Guidelines also recommends the provision of annual financial information that indicates important factors related to the financial condition and results of operations of the issuer and the release of information concerning major developments about the issuer as promptly as possible, including information about the likelihood of default in any outstanding indebtedness and relevant changes in assets, revenues, liquidity, and cash flow, among other things.

RESPONSE TO CURRENT ENVIRONMENT

GFOA believes that there are many ways that participants in financial markets, including federal regulators, state policy makers, state and local officials and others, can respond to current concerns regarding state and local government investment practices in general and concerns about derivatives in particular. Among these are the following:

Local Governments

Given the current level of concern among state and local elected officials regarding investment policies and portfolio holdings, local public officials should be undertaking a review of their authorized investments and an analysis of their portfolios. They should be looking particularly at their use of reverse repos and determining whether their policies should address derivatives only generically (such as providing authority for U.S. government agencies) or more specifically (by description of particular products themselves). Those jurisdictions without investment policies should reexamine their need for one, and those jurisdictions that have such policies should review them at this time.

State Governments

State governments should review their policies and holdings at the state level

for all state-administered funds as well as their state laws relating to local government investment policies and investment pools. States should also review their regulation of insurance company affiliates that are dealers of derivatives products to ensure that state insurance regulations are adequate with regard to these activities.

While GFOA believes such reviews are important, we caution state legislatures not to overreact to the current environment by passing overly restrictive legislation that may tie the hands of local finance officials to engage in prudent yet flexible investing appropriate for a specific local jurisdiction. We urge state governments to work closely with local public finance professionals in determining solutions to problems that may exist in their jurisdictions.

Federal Regulatory Agencies

Among the recommendations GFOA makes to federal regulators are the following:

- Expedited rulewriting on the part of the relevant regulators and strong enforcement of suitability rules, combined with education about suitability obligations, in addition to improved transparency, which is disclosure of information regarding not only pricing but also fees and mark-ups on these instruments.

- Adoption of rules requiring improved disclosure by brokers and dealers of derivatives products to all customers regarding the types of transactions being entered into and possible risks associated with those transactions. We suggest that recent requirements imposed on Bankers Trust Company by the Federal Reserve Board be applied routinely. These include getting prior approval to sell leveraged derivatives, disclosing to customers how the value of the contract will be affected by changes in the markets, ensuring that customers have the capability to understand the derivatives being marketed and agreeing not to sell complicated derivatives to unsophisticated customers, and disclosing to customers how profits and losses are calculated on each trade.

- Promotion of the use of volatility ratings and other evaluation tools.

- Monitoring municipal market disclosure practices in light of new SEC rules and the SEC Interpretive Release.

Congress

Among the recommendations GFOA makes to Congress are:

- Expeditious enactment of investment adviser legislation to provide for more frequent inspection and additional oversight of those who hold themselves out as investment advisers.

- Oversight of sufficiency of sales practice rules written by federal regulators under authority of the Government Securities Act Amendments of 1993 to ensure that such rules are consistent with the directives of the legislation and accompanying committee directives.

- Closing of regulatory gaps related to securities firms and their affiliates regarding derivatives activities in order for the activities of such affiliates to be subject to scrutiny as are their parent firms.

- Continued oversight of the derivatives market to determine if additional legislation is needed regarding the creation or marketing of derivatives products.

Rating Agencies

GFOA applauds projects already underway by the national rating agencies such as Fitch Investors Service and Standard and Poor's in establishing volatility ratings for mutual funds. We urge them to continue to examine instruments and work toward an industry standard in finding ways to provide additional and continuing information to investors regarding new and complex investment instruments.

In addition, the rating agencies have heightened their scrutiny of the investment practices of state and local governments, especially those involving pooled investment instruments. This heightened scrutiny will be an ongoing process of credit analysis. We urge rating agencies to closely review investment results, either positive or negative, that may be contrary to general market results and those of similar entities.

GFOA

Professional associations such as GFOA will continue to offer training, publications, recommended practices and policies that serve to educate their members. In addition to those activities already underway, GFOA standing committee members will be considering policies at their upcoming Winter Meeting later this month that deal with leveraged transactions such as reverse repurchase agreements and

improved information regarding market risk through ratings of derivatives products. We will continue to work with our membership in assessing their needs for additional training and guidance. As discussed earlier, GFOA will soon be participating with the National Conference of State Legislatures in several seminars designed to address issues relating to state investment statutes and local government investment pools and will continue to work with other elected official organizations.

Specifically, GFOA will be examining limitations on leveraging for the purpose of investment and considering whether investment pools should be subject to the same or similar requirements under which mutual funds now operate.

GFOA believes that by working together with federal, state and local governments, as well as the private sector, we will restore confidence in the investment practices of state and local governments and in the financial markets in general. We look forward to the opportunity to find new ways of strengthening investment practices and promoting investor protection.

APPENDIX A
GFOA CASH MANAGEMENT PRODUCTS

Publications

Investing Public Funds

An Introduction to Broker/Dealer Relations for State and Local Governments

An Introduction to External Money Management for Public Cash Managers

A Public Investor's Guide to Money Market Instruments

Cash Management for Small Governments

Considerations for Governments in Developing a Master Repurchase Agreement

Considerations for Governments in Collateralizing Public Deposits

An Introduction to Treasury Agreements for State and Local Governments

Banking Relations: A Guide for Government

A Treasury Management Handbook for Small Cities and Other Governmental Units

An Elected Officials Guide to Investments (forthcoming)

Training

Investing Public Funds

Public Cash Management

Annual Conference Sessions

Miscellaneous

Software programs for cash management

A monthly Public Investor newsletter

Timely articles on developments in cash management in other periodicals published by the Association, such as Government Finance Review

Representation in Washington, DC, to work for federal legislation and regulations that are consistent with the public-policy positions of the GFOA

TABLE 2
STATUTORY LOCAL GOVERNMENT INVESTMENT AUTHORITY

State	U.S. Treasury Obligations	U.S. Agency Obligations	Federal Instrumentalities	Repurchase Agreements (Explicit)	Commercial Bank CDs	Savings & Loan Deposits	Bankers Acceptances	Commercial Paper	Money Market Funds	State Investment Pool
Alabama	Yes	Yes	No	Yes	Yes	Yes	No	No	Yes	No
Alaska	HOME RULE									No
Arizona	Yes	Yes	Yes	Yes	Lmtd.	Yes	No	No	No	Yes
Arkansas	Yes	Some	No	Yes	Yes	Yes	No	No	Lmtd.	No
California	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Colorado	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Private
Connecticut	Yes	Yes	Some	Yes	Yes	Yes	Yes	Yes	No	Yes
Delaware	HOME RULE									No
Florida	Yes	Yes	Yes	Yes	Yes	Yes	No	No	Yes	Yes
Georgia	Yes	Yes	Yes	Yes	Yes	Yes	Yes	No	No	Yes
Hawaii	Yes	Some	Some	Yes	Yes	Yes	No	No	No	No
Idaho (cities)	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Illinois	Yes	Yes	Some	Yes	Yes	Yes	No	Lmtd.	Yes	Yes
Indiana	Yes	Yes	Some	Yes	Yes	Yes	No	No	No	No
Iowa	Yes	Yes	Yes	Lmtd.	Yes	Yes	Yes	Yes	Yes	Yes
Kansas	Yes	Some	Some	Lmtd.	Yes	Lmtd.	No	No	No	No
Kentucky	Yes	Yes	Some	Yes	Yes	Yes	No	No	Lmtd.	Private
Louisiana	Yes	Yes	Some	Yes	Yes	Yes	No	No	Lmtd.	No
Maine	Yes	Yes	Yes	Yes	Yes	Yes	Lmtd.	Lmtd.	Lmtd.	No
Maryland	Yes	Yes	Some	Yes	Yes	Yes	Yes	No	Yes	Yes
Massachusetts	Lmtd.	No	No	Lmtd.	Lmtd.	Lmtd.	No	No	No	Yes
Michigan	Yes	Yes	Yes	Yes	Lmtd.	Yes	Yes	Lmtd.	Yes	No
Minnesota	Yes	Yes	Yes	Lmtd.	Lmtd.	Lmtd.	Lmtd.	Lmtd.	Yes	Private
Mississippi	Yes	Yes	No	Yes	Yes	Yes	No	No	Yes	No
Missouri	Yes	Yes	Yes	Yes	Yes	Yes	No	No	No	No
Montana	Yes	Yes	No	Yes	Yes	Yes	No	No	Lmtd.	Yes
Nebraska	Yes	Yes	Some	No	Yes	No	No	No	No	No
Nevada	Yes	Some	Some	Yes	Yes	Yes	Lmtd.	Lmtd.	Yes	Yes
New Hampshire	Yes	Lmtd.	Lmtd.	Lmtd.	Yes	Yes	No	No	Lmtd.	Yes
New Jersey	Lmtd.	Some	No	Yes	Yes	Yes	No	No	No	Yes
New Mexico	Yes	Some	Some	Yes	Yes	Yes	Some	Some	No	Yes
New York	Yes	Lmtd.	Lmtd.	Lmtd.	Yes	No	No	No	No	No
North Carolina	Yes	Some	Some	Yes	Yes	Yes	Some	Lmtd.	Lmtd.	Yes
North Dakota	Yes	No	Some	No	Yes	No	No	No	No	No
Ohio	Yes	Yes	Some	Yes	Yes	Yes	No	No	No	Yes
Oklahoma	Yes	Yes	Some	Yes	Yes	Yes	Yes	Yes	No	Yes
Oregon	Yes	Yes	Yes	Yes	Lmtd.	Lmtd.	Lmtd.	Lmtd.	No	Yes
Pennsylvania	Yes	Some	Some	No	Yes	Yes	No	Lmtd.	Yes	Trust
Rhode Island	No	No	No	No	Yes	Yes	No	Yes	Yes	Private
South Carolina	Yes	Yes	Some	Yes	Yes	Yes	No	No	Lmtd.	Yes
South Dakota	Yes	Lmtd.	Yes	Lmtd.	Yes	Yes	Lmtd.	No	Lmtd.	No
Tennessee	Yes	Yes	Some	Lmtd.	Yes	Yes	Lmtd.	Lmtd.	Lmtd.	Yes
Texas	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Utah	Yes	Yes	Some	Yes	Yes	Yes	Yes	Yes	Some	Yes
Vermont	HOME RULE									No
Virginia	Yes	Yes	Yes	Yes	Lmtd.	Lmtd.	Lmtd.	Lmtd.	Yes	No
Washington	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Lmtd.	Yes	Yes
West Virginia	Yes	Some	Some	Yes	Yes	No	No	No	Yes	No
Wisconsin	Yes	Yes	Yes	Yes	Yes	Yes	Lmtd.	Lmtd.	No	Yes
Wyoming	Yes	Some	Some	No	Yes	Yes	No	No	No	Yes

APPENDIX C

GOVERNMENT FINANCE OFFICERS ASSOCIATION

Recommended Practice

Use of Derivatives by State and Local Governments

A derivative is a financial instrument created from or whose value depends on (is derived from) the value of one or more underlying assets or indexes of asset values. The term "derivative products" refers to 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 are potential users of derivatives in their roles as debt, cash, and pension fund managers.

The Government Finance Officers Association (GFOA) urges government finance officers to exercise extreme caution in the use of derivative instruments 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 considering derivatives should use these instruments only if they can evaluate the following factors, among others, to determine the appropriateness of derivative use for their jurisdiction:

1. Government 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 government entities should receive particular scrutiny. Certain derivative products may not be appropriate for all government 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. Government entities should understand that state and local laws may not specifically address the use of derivatives. Therefore, analysis should include an examination of considerations, such 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.

- The application of the government entity's procurement statutes to derivative transactions.

3. Government entities should be aware of the risks incurred as a result of use of derivatives. These include, in addition to legal risk, counterparty credit risk, custodial risk, market risk, settlement risk and operating risk.

4. Government entities should establish internal controls for each type of derivative in use to ensure that these risks are adequately managed. Examples include:

   - 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 have sufficient expertise and technical resources to oversee derivative programs. Periodic training should be provided.

   - 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.

   - Reporting on derivative use should be in accordance with generally accepted accounting principles. Because use of these instruments is a complex matter, early discussion with public accountants is essential. Specialized reporting may be required.

5. **Government entities should be aware if the broker or dealer with whom they are dealing is merely acting as an agent or intermediary in a derivative transaction or is taking a proprietary position. Any possible conflict of interest should be taken into consideration before entering into a transaction.**

6. **Government 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.**

Use of Derivatives by State and Local Governments

7. Government entities should exercise caution in their selection of brokers, 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 acknowledgement from the broker or dealer 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 government entity.

8. Government 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.

Adopted: June 7, 1994

APPENDIX D

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