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Restoring American Financial Stability Act: impact on swaps and state and local governments

On May 20, 2010, the Senate passed the Restoring American Financial Stability Act of 2010 (the "Act"). Since the House of Representatives has already passed its own separate version of a financial regulatory reform bill, the Wall Street Reform and Consumer Protection Act, on December 11, 2009 (the "House Bill"), the next stage in the legislative process is for the House and Senate conferees to meet to produce a single bill. The Act makes many changes to existing laws regarding derivative products and summarized below are a few of the changes of particular interest to municipal market participants.

Fiduciary duty—The Act provides that a swap dealer that provides advice regarding, or offers to enter into, or enters into a swap with a state, state agency, city, county, municipality, or other political subdivision of a state or a federal agency (a "Municipal Entity"), or a pension plan, endowment, or retirement plan shall have a fiduciary duty to such entity. This fiduciary duty would apply to interest rate and commodity swaps and could, for example, require that the counterparty act for the benefit of the Municipal Entity, foregoing the counterparty's own advantage if necessary. This required fiduciary duty is contrary to the typical contractual relationship between a swap dealer and a municipal counterparty. Most swap agreements contain specific language describing the relationship and duties between the swap provider and their municipal counterparty and such language typically states that each party is not acting as a fiduciary or advisor to the other party in order to limit the potential for future lawsuits where one party states that they were relying on advice from the other party. A swap transaction is typically looked at as an arm's length transaction between two parties where each of the parties assesses the risks and benefits of the transaction and determines whether or not to enter into the transaction based on such assessment. This provision of the Act that would impose a fiduciary duty on counterparties entering into swaps with Municipal Entities would significantly change the relationship between a swap dealer and a Municipal Entity and is very controversial. It could effectively reduce the financial benefit received by the Municipal Entity or, more likely, serve as a significant impediment to future swap transactions between a swap dealer and a Municipal Entity.

The House Bill does not contain a similar fiduciary duty requirement. It is possible that the House and Senate conferees will use an alternative approach such as that suggested by Senator Harkin. Senator Harkin's amendment would not impose a fiduciary duty on swap

counterparties but would impose new requirements, including the following: (1) a counterparty that "recommends" a swap to a municipal entity (or other protected entity) must have reasonable grounds to conclude that the swap is in the "best interests" of the municipal entity, and (2) the municipal entity would have to have a swap advisor who is independent of the counterparty "authorize" the swap. While this language is preferable to the language in the Act, certain modifications would be recommended for it to be more workable for municipal entities and their counterparties.

Ability of Municipal Entities to enter into swap transactions—The Act also makes significant changes in the rules that apply in order for a municipal entity to qualify to enter into a swap transaction without complying with the rules of an exchange. Current law requires that either (i) the municipal entity must have certain qualifying characteristics regarding the commodity in question; or (ii) the municipal entity must own and invest on a discretionary basis $25,000,000 or more in investments; or (iii) the transaction must be offered by and entered into with a broker, dealer, or other type of financial institution with certain qualifying characteristics. The Act contains two significant changes. First, a municipal entity must own and invest on a discretionary basis $50,000,000 or more in investments (in lieu of the current law $25,000,000 minimum). The increase to $50,000,000 may be difficult for many municipal entities to meet. Second, the Act contains a controversial provision that would prohibit swap dealers and major swap participants from receiving federal financial assistance (such as advances from a Federal Reserve credit facility or discount window, use of Federal Deposit Insurance Corporation insurance, etc.), which may result in financial institutions creating subsidiaries to enter into swap transactions so that the financial institutions can continue to receive federal financial assistance. These new subsidiaries may not have the characteristics required to allow municipal entities to enter into swap transactions without the use of an exchange. These changes will make it more difficult for a municipality to enter into a swap transaction without complying with the rules of an exchange and may result in a decrease in the amount of swap transactions entered into by municipalities or an increase in the cost of such swaps. The House Bill contains a similar increase from $25,000,000 to $50,000,000 in the minimum amount of discretionary investment by municipal entities.

Commercial end user exemption—The Act and the House Bill each contain a new rule that requires swaps to be cleared through an exchange. Both the Act and the House Bill provide an exception to this rule for "commercial end users." A commercial end user can elect not to clear the swap through a clearing agency and avoid having to execute the swap transaction on, or be subject to the rules of, a board of trade designated as a contract market, an exchange, or a swap execution facility. This is important to many municipal entities (as well as other end users) since the specifically tailored nature of many of the swaps are not conducive to being exchange-traded. Additionally, if the municipality qualifies as a commercial end user, the municipality can utilize the commercial end user clearing exemption under the Act to avoid being subject to initial and ongoing margin requirements for swaps.

The Act defines "commercial end user" as any person (other than a financial entity) who, as its primary business activity, owns, uses, produces, processes, manufactures, distributes, merchandises, or markets goods, services, or commodities (which shall include but not be limited to coal, natural gas, electricity, ethanol, crude oil, gasoline, propane, distillates, and other hydrocarbons) either individually or in a fiduciary capacity.

For additional information regarding this Alert, please contact any of the following individuals:

- Arthur McMahon at amcmahon@nixonpeabody.com or 212-940-3181
- Barry Rothchild at brothchild@nixonpeabody.com or 212-940-3187
- Elizabeth Columbo at ecolumbo@nixonpeabody.com or 212-940-3183
- Mitch Rapaport at mrapaport@nixonpeabody.com or 202-585-8305