Statement of Kenneth Gibbs
Member, Board of Directors and Chair, Municipal Securities Division
Securities Industry and Financial Markets Association

Before the

Subcommittee on Capital Markets and Government Sponsored Enterprises
Committee on Financial Services
U.S. House of Representatives

July 20, 2012

Hearing on the Impact of the Dodd Frank Act on Municipal Finance

Chairman Garrett, Ranking Member Waters and other subcommittee members, thank you for the opportunity to be here. I am Kenneth Gibbs and I am President of the Municipal Securities Group at Jefferies & Company, Inc. in New York. I appear here today not on behalf of Jefferies, but in my capacity as a member of the Board of Directors of the Securities Industry and Financial Markets Association ("SIFMA"),[1] where I also serve as Chairman of the Municipal Securities Division. I am pleased to be here to discuss the impact of the Dodd-Frank Act ("DFA") on municipal finance.

The $3.7 trillion municipal bond market is a vital sector of our capital markets. Our federal system of government places a number of responsibilities on states and localities, including education, development of public infrastructure and promoting health care and affordable housing, among others. Many of these functions require significant long-term capital investments, and much of that capital is raised in the municipal bond market. One of the extraordinary features of the market is the breadth of issuers that are able to access the marker efficiently. Issuers from the largest states and cities to the smallest towns and school districts are able to access capital with maturities of up to 30 years or more at low fixed rates, and with a diversity and flexibility of structure and credit. This degree of market access is unheard of in other countries or even in other sectors of our own financial markets. The median size of a municipal bond issuance last year was under $6 million, and thousands of issuers sold bonds of less than $10 million. At the same time, the municipal market continues to be one of the safest available to

[1] The Securities Industry and Financial Markets Association brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association. For more information, visit www.sifma.org.

investors, with a default rate well under 0.5 percent, while uniquely respecting the sovereignty of its issuing constituents.

It is important for the municipal market to function soundly and efficiently in order to protect investors and other market participants and to ensure the lowest possible cost of financing for state and local governments and their citizens. Efficient and effective regulation is a vital component of a sound market.

The DFA includes a number of provisions that are having, or will have, an effect on municipal finance, the municipal bond market, and municipal market participants. Now that it has been two years since the enactment of the DFA, it is appropriate for Congress to review the effects and consequences of the Act. In that regard, we commend Chairman Garrett for calling this important hearing and we are grateful to participate.

My testimony today will focus on four general areas:

- Section 975 of the DFA relating to the registration and regulation of municipal advisors (“MA”), including H.R. 2827, legislation to amend those provisions;
- The “Volcker Rule” as it relates to municipal securities;
- Section 978 of the DFA related to funding for the Government Accounting Standards Board; and
- Provisions of Title VII of the DFA in the context of swaps used in relation to municipal finance.

Regulation of Municipal Advisors

Section 975 of the DFA includes provisions that establish a regulatory framework for MAs. MAs are consultants that provide advice to state and local governments with regard to financial transactions such as bond issuance, use of derivatives, investment of bond proceeds and other activities. Before the DFA, MAs who were not broker-dealers were wholly unregulated, one of the last unregulated parties active in the financial markets. Regulations that apply to broker-dealers and municipal securities dealers who provide MA services, on the other hand, have encompassed MA activities for many years. It was appropriate, therefore, for Congress to bring MAs under the regulatory umbrella. SIFMA supported and actively advocated for the inclusion of MA regulation in the DFA because we believe it is important to level the regulatory treatment for dealer and non-dealer MAs and to ensure that non-dealer MAs are appropriately policed with respect to competency, conflicts of interest, interaction with bond issuers and other areas.

In its work leading to the enactment of the DFA, the Financial Services Committee examined the issue of unregulated municipal advisors. In a hearing on May 21, 2009, the Committee heard testimony on H.R. 2550 (111th Congress), the Municipal Advisers Regulation Act. At the hearing, both then-Chairman Frank and Ranking Member Bachus expressed support, at least conceptually, for regulating MAs, with then-Ranking Member Bachus stating “Mr. Chairman, of the measures that are the subject of today’s hearing, the legislation, your legislation to regulate unregulated municipal financial advisors is one that I could accept, with some changes. We are in agreement with the basic premise that the SEC should require

individuals who advise municipalities to register as investment advisors."[2] Key elements of H.R. 2550 were eventually incorporated into the DFA.

On September 1, 2010, after the enactment of the DFA, the Securities and Exchange Commission ("SEC") published an interim final temporary rule to implement the MA registration requirements of Section 975 of the Act.[3] The interim final temporary rule is much broader in scope than what was intended by Congress in enacting the MA provisions of the DFA and goes far beyond simply regulating previously unregulated advisors. It also left many key questions unanswered in terms of what constitutes "advice" provided to municipal entities, the scope of the fiduciary duty of MAs, and the scope of the "investment strategies" provision of the DFA, among others. Because the SEC has not yet completed work on the final municipal advisor registration rule, key elements of the interim final temporary rule are still in force.

One illustration of the breadth of the interim final temporary rule in relation to Congress' original intent with regard to MA regulation is the number of entities that have registered with the SEC as MAs since the rule took effect. In testimony before the U.S. Senate Committee on Banking, Housing and Urban Affairs in March 2009—before the enactment of the DFA and before the SEC's temporary municipal advisor registration rule—the Municipal Securities Rulemaking Board ("MSRB") indicated that 260 non-dealer municipal financial advisors participated in at least one municipal securities transaction in 2008.[4] As of July 17, 2012, under the SEC's temporary municipal advisor registration rule, 1,132 firms have registered as municipal advisors.[5] One reason the number of registered municipal advisors so far exceeds the number of advisory firms actually active in the market is that the SEC's temporary rule is so much broader, and farther-reaching than Congress considered in 2009 when the DFA was being conceived.

On December 20, 2010, the SEC published a proposed rule on Registration of Municipal Advisors[6] (the "Proposed Final Rule"). The SEC's Proposed Final Rule goes much farther than Congress intended when the DFA was being drafted. Rather than being limited to previously unregulated municipal advisors, the Proposed Final Rule would encompass in the definition of MA a wide breadth of entities and activities that are outside Congress' intent, outside the scope of the statute, and outside the scope of what

---

[2] Committee on Financial Services, U.S. House of Representatives, One Hundred Eleventh Congress, hearing transcript on "Legislative Proposals to Improve the Efficiency and Oversight of Municipal Finance," May 21, 2009, Serial No. 111-37, page 3.
[3] Securities and Exchange Commission, "Temporary Registration of Municipal Advisors," Release No. 34-62824, September 1, 2010.
[4] Testimony of Ronald A. Stack, Chair, Municipal Securities Rulemaking Board, before the Committee on Banking, Housing and Urban Affairs, United States Senate, March 26, 2009, page 27.
[5] U.S. Securities and Exchange Commission, "Municipal Advisor Temporary Registration Forms Received," at https://tts.sec.gov/MATR/. The MSRB also has a parallel registration rule. It is interesting to note that not all firms that registered as MAs registered with both the SEC and the MSRB.
[6] U.S. Securities and Exchange Commission, "Registration of Municipal Advisors," Release No. 34-63576, December 20, 2010.

market participants generally understand to be MA activities. Some examples of activities and entities covered by the SEC's Proposed Final Rule but outside the scope of the statute include, among others:

- Certain appointed, unpaid members of issuer governing bodies, such as, for example, volunteer members of a local government board or commission;[7]
- Banks providing "traditional banking services" or "investment advisory services" such as deposit accounts or trustee services;[8]
- Investment advisors or others who provide advice regarding the investment of not only the proceeds of municipal securities, as provided in the statute, but virtually any public funds such as pension funds or Section 529 college savings plans;[9] and
- Broker-dealers or banks serving as or seeking business as underwriters with respect to many services and functions typically performed by investment bankers.[10]

SIFMA provided extensive comments to the SEC on its Proposed Final Rule, which outline numerous other areas where the proposal goes beyond congressional intent or statutory authority.[11] The SEC has received over 1,000 comment letters on the Proposed Final Rule, many from state or local officials, with the overwhelming majority opposed to all or part of the proposal.

Focusing on the role of underwriters and the bond issuance process, Congress in the DFA explicitly excluded from the definition of MA "a broker, dealer, or municipal securities dealer serving as an underwriter." However, the SEC's proposed implementation of that exclusion is too narrow and would be detrimental for bond issuers. In a "negotiated" bond sale, a bond issuer typically selects one or more dealer firms to serve as underwriter, often through a competitive "request for proposals" process. Sometimes before the selection process begins, investment bankers present ideas or suggestions that may or may not result in transactions. After the selection, the selected underwriter typically provides many services to the issuer leading up to the pricing and sale of bonds and sometimes after the closing. These services can include help with structuring, sizing or timing the capital program or sale, performing calculations or analysis regarding the credit terms or other features, interaction with rating agencies, pre-marketing the bonds to investors and other functions. Underwriters are generally not compensated separately for these services, but rather these services are part of the overall process of underwriting bonds in a negotiated sale. Congress would not have included an underwriter exclusion to the MA definition in the statute if their intention was to cover investment banking activities such as recommendations and suggestions on the structure, timing, terms and other similar matters in the definition of MA.

---

[7] *Id.*, page 41.
[8] *Id.*, page 42.
[9] *Id.*, page 26.
[10] *Id.*, page 31.
[11] Letter from Leslie M. Norwood, SIFMA, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, February 22, 2011.

The SEC has interpreted the underwriter exclusion from the MA definition narrowly to encompass only the function of price negotiation and purchase of the bonds by the underwriters. The proposed interpretation of the underwriter exclusion would not cover all the other services and functions provided by an underwriter in the context of serving a negotiated issuer. If adopted as proposed, the Proposed Final Rule would limit the ability of state and local governments and other municipal securities issuers to obtain services necessary for, and typically provided in the context of, the bond issuance process. The result would be higher costs and poorer transaction execution for state and local borrowers.

Moreover, treating the value-added services typically provided by underwriters in the context of negotiated underwritings as MA services is incompatible with the role of underwriter for two reasons. First, the DFA imposes a fiduciary duty on MAs with respect to their issuer clients. While a fiduciary relationship is acceptable for MAs—indeed, MAs have had a fiduciary duty to their issuer clients under state laws for many years—it is at odds with the role underwriters play in bond sales. Underwriters are arm's-length counterparties, particularly in the context of the price negotiation and sale. A "buyer-seller," counterparty relationship is fundamentally incompatible with the role of a fiduciary, which generally entails a duty of loyalty and the requirement to place the needs of the client first. Underwriters, on the other hand, serve as a bridge between issuers and investors and must consider the needs and requirements of both parties when negotiating the price of a new bond issue.

The SEC's Proposed Final Rule would also potentially result in a confusing array of standards of conduct, which is particularly troubling in the context of a rule designed to clarify roles. A firm hired as an underwriter on a negotiated transaction would declare itself an underwriter under MRSB rules. That dealer could bear a fiduciary duty to the issuer with respect to advice leading up to the pricing. That fiduciary duty would end when the price negotiation began.

Most important, the SEC has not provided any justification or basis for treating investment banking services as MA activity. Nowhere in the legislative history associated with the MA provisions in the DFA is there any indication that Congress intended the definition of MA to include investment banking services. Indeed, Congress explicitly excluded underwriters from the definition. The SEC has simply interpreted that exclusion inappropriately narrowly.

Now that the DFA is two years old and the SEC's Proposed Final Rule has been out for 19 months, we are hopeful that the SEC will act quickly to finalize the rule in a manner that respects Congress' intent and the scope of the SEC's authority under the statute.

H.R. 2827

On August 26, 2011 Rep. Bob Dold (IL-10) introduced H.R. 2827, legislation which would amend the DFA to ensure that the statutory definition of MA incontrovertibly reflects Congress' original intent. The bill now has 35 cosponsors, both Republicans and Democrats. The bill includes several tailored, sensible amendments to the DFA that would prevent any regulatory misinterpretation:

- The bill would specify that a party is a MA when that party "is formally engaged, in writing and for compensation, by a municipal entity to provide advice." This is the generally accepted means of defining the advisory role among market participants, and MSRB rules mandate a written agreement for advisory services.
- The bill would exclude from the definition of MA parties that either are already excluded under the statute currently or were already regulated before the DFA, such as broker-dealers and banks, among others.
- The bill would exclude from the MA definition "any elected or appointed member of a governing body of a municipal entity."
- The bill would clarify the definition of "investment strategy" so that it encompasses only the proceeds of bond issues, as Congress intended, and would exclude from the definition of MA certain activities and services such as serving as custodian or acting as a broker without providing advice, again consistent with Congressional intent.
- The bill would ensure that certain communications between a municipal entity and a pooled investment fund would not cause the fund's manager to be treated as a MA; and

In short, H.R. 2827 would clarify language in Section 975 of the DFA to ensure, as Congress intended, that the statute encompasses those activities performed by municipal financial advisors who were unregulated before the DFA was enacted, and excludes those parties and activities that are already heavily regulated. SIFMA supports H.R. 2827 and urges Congress to act on the bill quickly.

The Volcker Rule and Municipal Finance

Section 619 of the DFA creates a new Section 13 of the Bank Holding Company Act ("BHCA"), known as the "Volcker Rule," generally prohibiting any banking institution from engaging in certain proprietary trading activities or from acquiring or retaining an ownership interest in, sponsoring, or having certain relationships with "hedge funds" and "private equity funds". Federal regulators including the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Securities and Exchange Commission and the Commodity Futures Trading Commission (the "Agencies") have since issued proposed rules to implement Section 619[12] (collectively, the "Volcker Rule Proposal"). SIFMA has raised significant, substantive concerns with various aspects of the Volcker Rule Proposal, especially with the "market making" exception to the rule. Our general comments are embodied in a letter we filed together with other associations on February 13, 2012.[13] In addition, SIFMA's Municipal Securities Division filed a letter focusing on the effects of the

---

[12] Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 76 Fed. Reg. 68,846 (proposed Nov. 7, 2011) and Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Covered Funds (proposed Jan. 13, 2012).

[13] SIFMA, The Clearing House Association, The Financial Services Roundtable and the American Bankers Association, "Comment Letter on the Notice of Proposed Rulemaking Implementing the Volcker Rule – Proprietary Trading," February 13, 2012.

Volcker Rule Proposal on municipal finance.[14] Those statements describe our views on the Volcker Rule Proposal in considerable detail.

In sum, with respect to the effects of the Proposed Volcker Rule on municipal finance, there are two general areas of concern. The first relates to a provision in Section 13(d)(1)(A) of the BHCA that exempts from Volcker Rule restrictions trading in, among others, "obligations of any State or of any political subdivision thereof." Congress included this exemption in the DFA in recognition that municipal securities are extraordinarily safe investments and generally do not pose substantial risks for banks and in order to help maintain a liquid and active market for municipal securities, thereby keeping state and local financing costs low. Unfortunately, the Agencies have proposed to interpret "obligations of any State or of any political subdivision thereof" too narrowly.[15] Congress clearly intended to exclude the full municipal securities market from Volcker Rule restrictions, and the proposed rule violates that intent. The proposed interpretation would also artificially bifurcate the market by excluding bonds issues directly by state and local governments but not excluding bonds issued by state and local agencies and authorities.

The MSRB estimates, based on information from Thompson Reuters, that in calendar year 2011, 41.4 percent of municipal securities issued were sold by agencies and authorities[16] and would not be excluded from Volcker Rule restrictions. Many of these agency and authority bonds are for vital government functions such as water and sewer systems, public power systems, hospitals and universities and similar types of facilities. In many cases, bonds issued by agencies and authorities are no riskier, and may even be less risky, than bonds issued directly by governments. In other circumstances, the choice of whether to issue bonds by a government directly or through an agency or authority is based on convention or local statute and has no bearing on credit or other risk or on how the bonds are considered by the market.

Excluding one segment of the municipal market from Volcker Rule restrictions while subjecting another to the restrictions would cause substantial confusion. It is not always obvious from looking quickly at a security whether it is issued by a government directly or by an agency, and there is a significant "grey area" between government and agency bonds. We are concerned that some banks, rather than facing the risk of violating the Volcker Rule by trading restricted municipal securities, would simply avoid the municipal market altogether, reducing liquidity. Moreover, banks are one of the few remaining sources of institutional demand in the municipal market, and discouraging their participation in the market could result in higher borrowing costs for municipal bond issuers. Most important, we believe Congress intended for municipal securities generally to be excluded from Volcker Rule restrictions. Hence, we

---

[14] Letter from David L. Cohen, SIFMA, to the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency and the Securities and Exchange Commission on "Comments on Volcker Rule Proposed Regulations," February 13, 2012.
[15] Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 76 Fed. Reg. 68,846, page 68,878, footnote 165.
[16] Letter from the Municipal Securities Rulemaking Board Re: Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds, January 31, 2012, page 2.

have urged the Agencies to exclude from Volcker Rule treatment all municipal securities as defined in Section 3(a)(29) of the Securities Exchange Act of 1934.

Our second area of concern relates to the treatment of tender option bonds ("TOBs") under the Proposed Volcker Rule. TOBs are financial products created by dealers or other market participants by depositing fixed-rate municipal securities in a pass-through trust and selling interests in the trust to investors. The TOB interests generally are floating-rate securities and are supported by a feature where investors can sell their interests to a remarketing agent or bank at face value periodically. Creating a TOB also generally results in creating a residual class of TOB interests that is almost always retained by the bank or dealer that sponsored the transaction. The residual interests generally entail no more risk to the holder than the underlying securities themselves. TOBs' features combined often make them compliant with SEC Rule 2a-7 and eligible for investment by money market mutual funds. They also satisfy investor demand for short-term-like municipal investments, which tend to be in short supply in the market, particularly in current conditions. TOBs actually give investors greater security than the underlying bonds because they are fully supported by liquidity facilities. Moreover, TOBs provide a source of demand for municipal securities that has the effect of lowering borrowing costs for borrowers. TOB volume can run into the hundreds of billions of dollars, depending on market conditions, and can represent an important source of demand. In addition, TOBs are an important means for bond dealers to finance their inventories, which improves liquidity for investors. The TOB market has existed for over 20 years, and TOBs generally performed well during the financial crisis.

The Proposed Volcker Rule would prohibit bank investment in "covered funds." As proposed by the Agencies, covered funds would functionally include TOB trusts, effectively prohibiting banks from holding TOB residual interests. The proposed rule would effectively bar banks from establishing TOB programs. Those hurt by this prohibition would include state and local government borrowers, which would lose an important source of demand for their securities, and money market mutual funds and their shareholders, which would lose an important source of low-risk, high-quality investments. We have urged the Agencies to treat TOB interests in the same manner as municipal securities and exclude TOBs from Volcker Rule restrictions.

Funding for the Governmental Accounting Standards Board

Section 978 of the DFA authorizes the SEC to require the Financial Industry Regulatory Authority ("FINRA") to collect a fee from its members to fund the Governmental Accounting Standards Board ("GASB"). On May 11, 2011 the SEC issued such a direction to FINRA[17] and on February 23, 2012 the SEC approved FINRA's Rule to implement a new tax on dealers to fund GASB[18] ("FINRA Rule"). Unfortunately, the new fee structure effectively represents a "blank check" for GASB, which is particularly troubling given that there is little oversight over GASB's budget or activities.

---

[17] U.S. Securities and Exchange Commission, "Order Directing Funding for the Governmental Accounting Standards Board," Notice No. 33-9206, May 11, 2011.
[18] Financial Industry Regulatory Authority, "GASB Accounting Support Fee," Regulatory Notice 12-15, March 2012.

GASB is the accounting standards setter for state and local governments and government agencies and authorities. Unlike the Financial Accounting Standards Board ("FASB"), however, GASB does not fall under the oversight of the SEC, and there is no statutory or regulatory requirement that governments comply with GASB Generally Accepted Accounting Principles ("GAAP"). According to the U.S. Government Accountability Office ("GAO"), over the period 2006-2009, GASB was funded through a combination of "voluntary financial contributions" and the sales of subscriptions and publications by FASB and GASB.[19] Since the adoption of the FINRA Rule, dealers have received invoices for the funding of GASB, and the tax on dealers has become GASB's principal funding source. The fee imposed by the FINRA Rule is based on each FINRA dealer's municipal securities trading activity as reported to the MSRB's Real-time Trade Reporting System ("RTRS"). While we support and appreciate the role that GASB plays in the market, we feel strongly that requiring FINRA's dealer members to fund GASB is wholly inappropriate:

- The fee imposed by the FINRA Rule is an unfair tax on broker-dealers and municipal bond investors who should not be mandated to subsidize the entire expense of financially supporting GASB.
- There are many other end users of GASB's accounting and financial reporting standards, such as non-debt issuing municipalities, financial advisors, banks, bank dealers, insurance companies, rating agencies, mutual funds, legislative/governmental staff, and taxpayer organizations that get a "free ride" under FINRA's fee.
- The fee imposed by the FINRA Rule provides virtually unlimited funding for GASB. GASB simply tells FINRA how much funding they need for a given year, and FINRA structures the tax to raise that much revenue. There is no direct or indirect independent budget oversight – in effect "taxation without representation" with no incentive for transparency or fiscal discipline.
- Many municipal bond obligors are not GASB reporting entities. Many municipal bond obligors are private non-profit corporations, and thus are subject to the rules of FASB, not GASB. The fee imposed by the FINRA Rule makes no distinction between bonds issued by GASB obligors, bonds issued by FASB obligors and bonds with obligors who follow neither set of standards. It would be inappropriate to tax transactions in bonds issued by obligors that do not utilize GASB standards.
- The fee imposed by the FINRA Rule unfairly burdens certain dealers and is not allocated equitably. Any accounting support fee should be business model/operationally neutral, and FINRA's fee is not. Not all trades reportable to the RTRS involve customers. Additionally, under certain circumstances multiple assessments are charged from a single purchase and sale. Supply chains that involve multiple dealer trades are more heavily impacted. Finally, the municipal securities transactions of bank dealers'–who comprise a significant portion of trading activity–are not covered by FINRA's proposal, as they are not FINRA members.

---

[19] U.S. Government Accountability Office, "Dodd-Frank Wall Street Reform Act: Role of the Governmental Accounting Standards Board in the Municipal Securities Markets and Its Past Funding," Briefing for offices of the Committee on Banking, Housing, and Urban Affairs, United States Senate, and the Committee on Financial Services, House of Representatives, January 12 and 13, 2011, page 29.

The breadth of our concerns regarding the FINRA Rule is outlined in our comment letter on the proposed rule filed with the SEC.[20]

While we recognize that the SEC and FINRA are bound by the restrictions of the statute, we maintain that imposing a fee on dealers to fund GASB is inappropriate. FASB is funded primary by fees paid by corporate securities issuers. This approach is appropriate since corporations and other businesses are the primary users and beneficiaries of FASB's work. We urge Congress to consider a statutory amendment to the GASB funding provision of the DFA to change the way GASB is funded, perhaps based on the FASB model, as well as to impose independent oversight of GASB's budget.

Derivatives Regulation and Municipal Finance

Title VII of the DFA includes substantial new regulations relating to products and participants in the market for over-the-counter swaps. These new regulations cover a wide range of products and activities, many of which have implications for state and local governments that use swaps as a component of their financing and swap dealers who transact with states and localities. SIFMA's Municipal Securities Division has focused mostly on two areas, the business conduct standards in Section 731 of the DFA and the mandatory clearing requirements in Section 723.

Section 731, related to business conduct standards, imposes significant new regulatory obligations on swap dealers and major swap participants with respect to swap counterparties. These obligations are heightened in the context of swaps executed with "special entities," a term that includes state and local governments. Swap dealers are now required to make disclosures to counterparties covering such areas as, among others, information about the material risks and characteristics of the swap and any material incentives or conflicts of interest that the swap dealer or major swap participant may have in connection with the swap. The obligations for swap dealers executing swaps with special entities under Title VII are even stricter and include, among others, a requirement that the swap dealer has a reasonable basis to believe that the counterparty has an independent representative that has sufficient knowledge to evaluate the transaction and risks; is independent of the swap dealer; and undertakes a duty to act in the best interests of the counterparty it represents as well as other factors. If the swap dealer is also serving as an "advisor" to a special entity counterparty, that dealer has a duty to act in the best interests of the counterparty, among other requirements.

On February 17, 2012, the Commodity Futures Trading Commission ("CFTC") published the final rules implementing the business conduct standards in Section 731.[21] SIFMA had urged the CFTC in general to construct the business conduct rules in such a way as to preserve the ability of state and local governments to execute swap contracts when appropriate. We have some concerns with the final

---

[20] Letter from David L. Cohen, SIFMA, to Elizabeth M. Murphy, SEC on SEC File No. SR-FINRA-2011-073: Notice of Filing of Proposed Rule Change Relating to Establishing a Governmental Accounting Standards Board Accounting Support Fee, January 30, 2012.
[21] Commodity Futures Trading Commission, "Business Conduct Standards for Swap Dealers and Major Swap Participants With Counterparties," *Federal Register*, Vol. 77, No. 33, February 17, 2012, page 9734.

business conduct rule, which we continue to raise with the CFTC. However, the rule in general, while imposing substantial new obligations on swap dealers, will allow state and local governments to continue to execute swaps when warranted.

Section 723 of the DFA generally requires swaps to be cleared through derivatives clearing organizations ("DCOs"), a function that will require counterparties to a swap contract to maintain margin accounts at the DCOs. Rules and practices governing states and localities effectively prohibit governments from tying up public funds in margin accounts. Fortunately, the DFA includes a provision exempting "end users" from the mandatory clearing requirements if the end user is not a financial entity, is using swaps to hedge or mitigate commercial risk, and notifies the Commission, in a manner set forth by the Commission, how it generally meets its financial obligations associated with entering into non-cleared swaps. Earlier this month the CFTC finalized its rules implementing the end user clearing exception.[22] We had urged the CFTC during the consideration of the rule to ensure that states and localities are not "financial entities" and that interest rate and other risks generally hedged and managed by states and localities would be included in "commercial risk." The final rule appears to have addressed those concerns.

While the new regulations governing municipal swaps are not unmanageable, a key question is whether swap dealers and state and local governments will bear the additional regulatory obligations required to continue to use derivative products. We continue to monitor other areas of swap regulation, such as the anticipated rules governing margin requirements for uncleared swaps, to ensure that the new rules preserve the ability of state and local governments to execute swaps when appropriate.

Conclusion

The DFA includes a number of provisions which will have a significant effect on the municipal securities market. Among these are regulation of municipal advisors, the Volcker Rule, a new funding scheme for GASB, and regulation of over-the-counter swaps. We have been working with regulators to help ensure that implementation of these elements of the DFA will allow the market to function smoothly while ensuring that Congress' intent is fully realized. However, important issues remain unresolved:

- The SEC has not yet finalized its municipal advisor registration rule, and the proposed final rule includes numerous provisions that would go against congressional intent and statutory authority, including issues related to the underwriter exclusion. H.R. 2827 would help address these issues by clarifying key provisions in the statute.
- The Volcker Rule, as proposed by the financial regulatory agencies, would take too narrow an approach to the municipal securities exclusion in the statute and, if adopted as proposed, would bifurcate the market and increase borrowing costs for states and localities with no benefit to bank safety and soundness.

[22] Commodity Futures Trading Commission, "End-User Exception to the Clearing Requirement for Swaps," available at www.cftc.gov/LawRegulation/DoddFrankAct/Rulemakings/DF_11_EndUser/ssLINK/federalregister071012.

- The GASB funding provision in the DFA is misguided because it imposes the funding obligation on FINRA-member dealers, parties that have little to do with GASB's activities. The FINRA rule related to GASB funding provision is also unfairly implemented because it fails to tax non-FINRA dealers and is inappropriately based on trading activity. It also provides a virtually unlimited funding source for GASB with little oversight over its budget or activities. We urge Congress to revisit the entire approach to GASB funding.

SIFMA looks forward to continuing to work with regulators and Congress to help ensure that the reforms embodied in the DFA are fairly and efficiently implemented. Thank you for the opportunity to present our views.