

HAWKINS ADVISORY

BUSINESS CONDUCT STANDARDS FOR SWAP DEALERS DEALING WITH STATE AND LOCAL GOVERNMENTAL SWAP COUNTERPARTIES

Pursuant to authority of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”), which includes amendments to the Commodity Exchange Act (the “CEA”) regarding over-the-counter swaps, regulations (the “Regulations”) were published by the Commodity Futures Trading Commission (the “CFTC”), effective on October 17, 2012, which regulate the business conduct of swap dealers with counterparties (the “counterparties”), including swap dealers engaged in swap transactions with state and local governmental counterparties (each termed a “Special Entity” in the Regulations). The CFTC made clear that the new “business conduct standards” will not apply to unexpired swaps executed before the effective date, but emphasized that a “material amendment” (which is not defined in the Regulations) to an existing swap may cause it to be treated as a new swap and subject to these Regulations. For Special Entities intending to engage in new swap activity after the October 17, 2012 effective date, certain of the requirements imposed on swap dealers will be met if the Special Entities agree to provide certain written representations to the swap dealer. It is presumed that swap dealers are refining the various representations, and mechanics for obtaining such representations, including amendment of existing ISDA master documentation. ISDA also is separately working on a project for standardized representations to be elected on an online system, as described below.

A fundamental feature of the requirements imposed on swap dealers in the Regulations is that the dealers have written policies and procedures reasonably designed to fulfill the purposes of the Regulations, and implement and monitor compliance with such policies and procedures. In addition,

- The policies and procedures must be designed to obtain and retain a record of “essential facts” concerning each counterparty (“know your counterparty”).
- Swap dealers must verify that a counterparty meets the eligibility standards for an “eligible contract participant” under the CEA and, if applicable, meets the standards for a Special Entity.
- Any communications between a swap dealer and a counterparty must be in a fair and balanced manner based on principles of fair dealing and good faith.
- A swap dealer must undertake diligence to determine the institutional suitability of a recommended swap for a counterparty.

- In transactions with Special Entities, swap dealers must determine whether each such Special Entity has engaged a swap advisor or other representative that is independent from the swap dealer.
- A swap dealer that acts as an advisor to a Special Entity has a duty to recommend swaps that are in the best interests of the Special Entity.
- It is unlawful for a swap dealer to engage in any activity that operates as a fraud or deceit of a Special Entity.

Pursuant to the Regulations, prior to entering into any swap, a swap dealer must provide to the counterparty information regarding risks, material economic terms of the swap, incentives or conflicts of interest the dealer may have and any compensation that may be due from any source other than the counterparty, and must upon request of the counterparty (unless the swap is ultimately listed for trading on a designated market or execution facility) provide scenario analyses to allow the counterparty to assess potential risk exposure in connection with the swap. Certain commenters to the Regulations expressed the intention to create standardized text for these analyses, but the CFTC declined to adopt standardized risk disclosures. Additional requirements in the Regulations include that, for uncleared swaps (and it is assumed that most Special Entities will be exempt from clearing requirements¹), swap dealers must provide the counterparty with a daily mid-market mark of the swap and disclose to the counterparty information relevant to evaluating the calculation of the mark. Finally, the Regulations have specific “pay to play” provisions prohibiting political contributions by swap dealers in specified circumstances.

A fundamental feature of the diligence and suitability requirements imposed on the swap dealers in the Regulations is that a swap dealer may rely on the written representations of the counterparty unless it has information that would cause a reasonable person to question the accuracy of the representations. For example, to avoid the determination that the swap dealer is acting as an advisor to a Special Entity and must therefore act in the best interests of the Special Entity, the dealer may disclose to the Special Entity that it is not undertaking to act in the best interests of the Special Entity and obtain

1 As discussed in the July 24, 2012 Special Edition of the *Hawkins Advisory* (available at Hawkins.com), the CFTC has stated its view that most state and local governmental swaps are exempt from Dodd-Frank clearing requirements.

the written representations of the Special Entity that (i) the Special Entity will not rely on recommendations provided by the swap dealer, and (ii) the Special Entity will rely on advice from its independent swap advisor or representative. Even if the dealer is determined to be an advisor to the Special Entity, its obligation to obtain information necessary to determine that the swap is in the best interests of the Special Entity (based on the Special Entity's financial and tax status, its hedging goals, its experience with swaps and its ability to withstand changes in market conditions) can be satisfied by the swap dealer through written representations from the Special Entity. Representations may be made by a Special Entity that apply to all of the swap transactions of that Special Entity (rather than on a transaction-by-transaction basis), and may be made effective for an extended period of time, provided that the Special Entity agrees to periodically update any material changes to the representations. Of course, any Special Entity can determine not to provide the representations that provide safe harbors for the swap dealer and the swap dealer would thereby assume the duties of investigation, disclosure and advice imposed on the swap dealer.

Special Entities that will continue swap activity after the October 17, 2012 effective date will likely execute swap confirmations under existing ISDA master documentation, and, to the extent the Special Entity intends to provide representations for regulatory safe harbors, that documentation will likely need to be amended to incorporate the various actions that satisfy the safe harbors. Such amendments could be undertaken swap by swap or on an aggregate bilateral basis with each swap dealer. ISDA is at work on a methodology for amendment (pursuant to ISDA protocols) that would require a single filing of representations by a particular Special Entity to an online site for all of its swaps, while similar online filings by swap dealers, available to all counterparties, would be matched up with the Special Entity's filing to create a portfolio of bilateral ISDA amendment agreements.

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