

The elimination of tax-exempt advance refunding bonds in the Tax Cuts and Jobs Act of 2017¹ prompted municipal securities issuers to consider alternative structures to refinance outstanding municipal bonds or lock-in debt service costs associated with a future refinancing of outstanding municipal bonds prior to their first call date. The use of over-the-counter (OTC) derivatives—which were largely exempt from regulation prior to the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“Dodd-Frank Act”)²—has been cited as a potential alternative for municipal securities issuers. In light of this development, other uses of derivatives by municipal securities issuers and the nexus between these products and the underlying municipal securities, the Municipal Securities Rulemaking Board (MSRB) is publishing this document as a resource to help all market participants understand the regulatory framework for swaps and other derivatives under the Dodd-Frank Act, and to highlight where that framework intersects with the MSRB’s regulatory framework for municipal advisors.

The Dodd-Frank Act and Related Regulations

Title VII of the Dodd-Frank Act granted the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC) primary regulatory authority over swaps and security-based swaps (SBS), respectively,³ and introduced a comprehensive regulatory framework for the OTC derivatives market, including the regulation of swap dealers, security-based swap dealers (“SBS dealers”), major swap participants (MSPs) and major security-based swap participants (MSBSP).⁴ After the Dodd-Frank Act was enacted, the CFTC adopted rules that apply to swap dealers and MSPs, while the SEC adopted largely parallel rules for SBS swap dealers and MSBSPs that become effective once the SEC’s rulemaking is completed.

The derivative products most commonly used in the municipal securities market are regulated by the CFTC,⁵ which established business conduct standards and reporting and recordkeeping requirements for swap dealers and MSPs applicable to their communications, dealing activities and, in some cases, advisory activities. Notably, some of these regulatory requirements are more stringent for swap dealers and MSPs dealing with “special entities,” which include, among other entities, states, state agencies, cities, counties,

¹ Pub. L. No. 115-97, 131 Stat. 2054.

² Pub. L. No. 111-203, 124 Stat. 1376.

³ For mixed swaps, which are both swaps and SBS, the CFTC and the SEC share authority and may jointly issue rulemaking.

⁴ MSPs and MSBSPs are non-dealers that transact in such significant volumes as to potentially create systemic risk. See 7 U.S.C. 1a(32)-(33); see also 7 U.S.C. 1a(42), (49) (defining “security-based swap dealer” and “swap dealer”).

⁵ For simplicity, unless otherwise noted herein, all references to requirements related to swap transactions are to CFTC rules. For example, the swap dealer requirements outlined in this and the following paragraph are provided in CFTC rules. See 17 CFR 23.200 *et seq.*, .400 *et seq.*

municipalities, certain pension funds and other governmental entities. Specifically, when acting as counterparties to special entities, CFTC rules require swap dealers and MSPs to have a reasonable basis to believe that the special entity has a qualified independent representative (QIR) or fiduciary (an individual or entity that has sufficient knowledge to evaluate the transaction and risks of the swap, and is independent of the swap dealer or MSP),⁶ among other requirements. Because of these requirements, prior to engaging in discussions regarding derivative structures with a municipal entity, a swap dealer usually will require that certain representations are made by the municipal entity with respect to the use of a QIR or fiduciary, and policies and procedures around the use of derivatives.

In addition, if a swap dealer is acting as an “advisor” by making swap or swap trading “recommendations” to a municipal entity (as such terms are described by the CFTC in its regulations), the swap dealer must reasonably determine that the swap or strategy it is recommending, is in the best interests of the municipal entity and tailored to its needs or characteristics. A swap dealer can avoid this requirement through a safe harbor to the regulation that generally is met if the special entity represents to the swap dealer that, among other things, it will not rely on recommendations of the swap dealer and will rely on the advice of its designated QIR. The swap dealer also must disclose to the municipal entity that it is not undertaking to act in municipal entity’s best interests. The swap dealer also must refrain from providing “opinions” as to whether the special entity should enter into the recommended swap or strategy.

A QIR that advises municipal entities on swaps transactions often will be a municipal advisor that is subject to registration with the SEC and the MSRB. However, certain swap dealers are exempted from registering as municipal advisors and certain commodity trading advisors are excluded from the definition of “municipal advisor” under the SEC’s municipal advisor registration rule⁷ and, therefore, not subject to the MSRB’s regulatory framework for municipal advisors. For firms that do not qualify for an exemption or exclusion, and are engaged in municipal advisory activities, MSRB rules require them to meet professional qualification requirements, deal fairly with clients and not engage in any deceptive, dishonest or unfair practice. Additionally, municipal advisors’ recommendations must be suitable, and their compensation must not be excessive. MSRB rules also address gift-giving and political contributions related to their business activities, and require disclosure to clients, in writing, of all material conflicts of interest, and any legal or disciplinary event that is material to the client’s evaluation of the municipal advisor or the integrity of its management or advisory personnel. Importantly, most, if not all, QIRs are subject to a robust regulatory regime, either under CFTC, SEC and/or MSRB rules, affording meaningful protections to the municipalities that hire them.

⁶ In general, a QIR is independent of a swap dealer or MSP if it has not been associated with the swap dealer or MSP within the past year and was not recommended to the special entity by the swap dealer or MSP.

⁷ See 17 CFR 240.15Ba1-1(d)(2)(iii), (3)(v). See also [Registration of Municipal Advisors](#), Exchange Act Release No. 70462 (Sept. 20, 2013), 78 FR 67467 (Nov. 12, 2013).

While the provisions of, and the regulations promulgated under, the Dodd-Frank Act primarily apply to swap and SBS dealers, there are various mandatory clearing, reporting and recordkeeping requirements that apply to swap counterparties that are not registered swap or SBS dealers, including municipalities and other special entities, who use swaps to, among other things, hedge or mitigate their commercial risks, or make investments.⁸ To comply with reporting rules, all swap counterparties must acquire a Legal Entity Identifier (LEI) under the Global Legal Entity Identifier System⁹ so the swap can be reported, but they typically can rely on swap dealers to satisfy the reporting requirements. Further, to satisfy recordkeeping requirements, swap counterparties must keep complete and systematic records with respect to each swap during the life of the swap and for at least five years thereafter, and such records must be retrievable within five business days. Finally, if an end-user is using the swap to “hedge or mitigate commercial risks” as defined in the applicable regulations (*e.g.*, using an interest rate swap to hedge interest rate risk on a variable rate bond), it can elect to utilize an exception from any applicable mandatory clearing requirement.

Documentation and Uniform Industry Protocols

All swap counterparties, including municipal issuers, are required to incorporate various terms into their master agreements governing their swaps to comply with CFTC regulations. The International Swaps and Derivatives Association, Inc. (ISDA), which publishes the standard master swap agreement, has created resources to reduce the administrative burden of producing the required documentation. In 2012 and 2013, ISDA published Dodd-Frank protocols, each of which provides an ISDA Dodd-Frank Supplement (“ISDA DF Supplement”) with substantive amendments for the purpose of facilitating uniformity of documentation and easing compliance with relevant rules. For each protocol, an “ISDA DF Protocol Questionnaire” is used by participants to exchange required information and establish the parts of the relevant ISDA DF Supplement that will apply to their documentation (*e.g.*, informing a swap dealer as to whether the end-user is a special entity).

The ISDA 2012 DF Protocol amends any existing master agreements and allows end-users to make representations that enable a swap dealer to trade with them. Using this protocol is not required by law, but swap dealers commonly request its use when negotiating with special entities because it provides representations to establish the existence of a QIR or fiduciary, and additional swap dealer protections in the form of permissible end-user safe harbor representations. For example, there is an optional Schedule 4 to the ISDA DF Supplement that waives the swap dealer’s duty to recommend only swaps and swap trading strategies that are in the best interests of the special entity (*e.g.*, a municipal entity), thus relieving the swap dealer of its regulatory duty. A separate protocol published by ISDA (the ISDA March 2013 DF Protocol) addresses certain requirements of the CFTC swap documentation rules relating to clearing,

⁸ The end-user requirements referenced in this paragraph refer to CFTC rules. *See generally* 17 CFR 45.1 *et seq.*, 17 CFR 50.1 *et seq.*

⁹ *See* <https://www.gleif.org/en/>.

timely confirmation of trades, portfolio reconciliation and swap-trading relationship documentation.¹⁰ In lieu of using the ISDA Dodd-Frank protocols, any end-user, including a municipal issuer, may wish to negotiate bilateral amendments to its master agreements with terms that it believes are more appropriate or favorable to it, so long as the resulting terms comply with all applicable regulations.

Conclusion

Municipal market participants indicated that they anticipate an increase in the use of municipal derivatives as an alternative to issuing tax-exempt advance refunding bonds. Industry trade associations have developed educational resources that highlight risks that might be associated with such transactions and issues for consideration when structuring advance refunding alternatives.¹¹ Market participants that engage in these or other types of swap transactions in connection with the issuance of municipal securities also should be aware of the associated regulatory obligations established by the Dodd-Frank Act, which afford them important protections.

About the MSRB

The MSRB protects investors, state and local governments and other municipal entities, and the public interest by promoting a fair and efficient municipal securities market. The MSRB fulfills this mission by regulating the municipal securities firms, banks and municipal advisors that engage in municipal securities and advisory activities. To further protect market participants, the MSRB provides market transparency through its Electronic Municipal Market Access (EMMA[®]) website, the official repository for information on all municipal bonds. The MSRB also serves as an objective resource on the municipal market, conducts extensive education and outreach to market stakeholders, and provides market leadership on key issues. The MSRB is a Congressionally-chartered, self-regulatory organization governed by a 21-member board of directors that has a majority of public members, in addition to representatives of regulated entities. The MSRB is subject to oversight by the SEC.

¹⁰ See 17 CFR 23.500 *et seq.* All ISDA documents and additional information on them are available on the ISDA website *available at* <https://www.isda.org/>.

¹¹ See, e.g., <http://www.gfoa.org/potential-impacts-tax-reform-outstanding-and-future-municipal-debt-issuance>; <https://www.nabl.org/DesktopModules/Bring2mind/DMX/Download.aspx?portalid=0&EntryId=1156>.