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Comments to Proposed Rule:
Business Conduct Standards for Swap Dealers and
Major Swap Participants with Counterparties (RIN 3038-AD25)
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Calhoun, Baker Inc. serves as the Program Administrator for the Delaware Valley Regional Finance Authority ("DelVal"). Bucks, Chester, Delaware, and Montgomery Counties created DelVal in 1985 to provide loans to local governments in Pennsylvania (the "Loan Program"). The Loan Program currently provides 221 loans, approximately $900 million principal amount, to 127 local governments throughout Pennsylvania. DelVal utilizes interest rate swaps to hedge its exposure to future changes in long-term interest rates and to provide both variable rate and fixed rate loans to participants in the Loan Program. As of December 31, 2010, DelVal had outstanding more than 250 interest rate swap transactions, with a notional amount, including offsetting transactions, of more than $1.5 billion, with a net market value of approximately $115 million, under five Master Agreements.

The proposed Rule addresses the headline abuses in the derivatives market by imposing very strict standards of conduct on Swap Dealers and Major Swap Participants. From the perspective of the municipal interest rate swap market in Pennsylvania, the proposed Rule does not directly address the causes of the abuses that have occurred in the municipal market. A simpler approach would be to prohibit the practices that led to the abuses.

The Experience in Pennsylvania

Most of the abuses of interest rate swaps in Pennsylvania have occurred to solve budgetary problems or to evade referenda requirements. Some local governments facing a budget deficit entered into forward swap transactions, typically related to debt to be issued more than a year later, under which they received up-front payments in return for paying above-market fixed rates in the future. These transactions were substantively working capital loans.

Many school districts in Pennsylvania authorized bond issues to be sold in the future, often years later, in order to circumvent the effect of legislation, subsequently enacted, that reduced the amount of debt that could be issued by school districts without approval by referenda. Many districts authorized variable rate bond issues and entered into forward swap agreements to lock fixed rates that were often substantially higher than the prevailing rates on the effective dates.

The standard business practice for the execution of swaps in Pennsylvania is that the Swap Dealer pays the fees of the financial and legal advisors to the local government. This

practice has led to the formation of cabals of Swap Dealers, financial advisors, and law firms that roamed the Commonwealth pitching swap solutions to budget duress and referenda avoidance.

Virtually all of the swaps entailed basis risk to maximize the up-front payment to the local government or to reduce the fixed rate payable in the future by the local government. The variable rate payment to the municipality was indexed to LIBOR. In the wake of the market collapse in 2008, the volatility of tax-exempt variable rate debt and the expense of the attendant liquidity facilities made the cost of the basis risk dear.

The Pennsylvania *Local Government Unit Debt Act* (the *"Debt Act"*) prohibits leveraging of interest rate swaps. The leveraged debacles that occurred in other states were not an issue in Pennsylvania. Instead, the poster children for abuse entered into offsetting transactions, often with new up-front payments, with even greater basis risk.

The *Debt Act* requires the preparation of an interest rate management plan with analyses of market risk, basis risk, credit risk, termination risk, estimated and worst case scenarios, disclosure of any fees paid to the local government's legal and financial advisors by the swap counterparty, and a plan to monitor the risks of the transaction. The abuses occurred nevertheless.

Most of the swaps were terminated before or shortly after their effective dates. The termination payments were typically funded from proceeds of bond issues.

The first lesson of the Pennsylvanian experience is that a representative of a Swap Dealer or Major Swap Participant recommending a financial product or negotiating the terms of a transaction is not a Municipal Advisor and is certainly not a fiduciary to any Special Entity. No one can be, and no one will be in truth, a fiduciary to both sides of a business transaction.

The second lesson is that the Swap Dealer should have no rights of approval of the Municipal Advisor that represents the Special Entity. The right of approval could be too easily abused. The swap cabals would flourish.

The third lesson is that the business practice of the Swap Dealer paying the fees of the financial advisor and law firm representing the Special Entity undermines the independence of their advice. It creates a symbiosis that transcends any particular transaction and leads to the formation of swap cabals.

The final, and most important, lesson is that the up-front payments to state and local governments are the crack cocaine of officials addicted to the avoidance of fiscal responsibility. The up-front payments allow the governments to "print money" until the effective date. Then, if the government can sell bonds, it can fund the termination payment and push the pain of funding the deficit to the next administration and the next generation.

Conclusion

The Rule should focus on actually preventing abuses. Language in the Rule that dignifies the pretense that the Swap Dealer or Major Swap Participant is a fiduciary and that grant them

the right to approve a fiduciary that represents a Special Entity should be eliminated. The Rule should bright line the conduct that fosters abuse. The Rule should prohibit:

i) Any transactions with up-front payments to a Special Entity that is a state or local government,
ii) The Swap Dealer or Major Swap Participant from funding the fees of the legal and financial advisors representing any Special Entity,
iii) LIBOR-based payments to a Special Entity that is a state or local government unless the payments on the related obligations are also based on a LIBOR index,
iv) Leveraging of transactions by a Special Entity that is a state or local government, and
v) Forward commitments to a Special Entity that is a state or local government more than one year to the effective date.

Enforcement of these prohibitions would be unambiguous and would have prevented all of the headline disasters in the municipal swap market.

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