Full Margin Posting + 100% Capital Charge for a Security-Based Swap with a Flip Clause or Walkaway Provision

Re: File No. S7-08-12

"Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker Dealers"

Submission to the US Securities and Exchange Commission
By William J. Harrington
Senior Fellow, Croatan Institute
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November 19, 2018

About the Submitter:

Bill Harrington is a senior fellow at Croatan Institute. His work centers on boosting the sustainability of the world financial system with the dual aims of rationalizing economic decision-making and avoiding bailouts. He focuses on the capitalization and regulation of derivative contracts, structured finance, and a singularly harmful nexus of the preceding — namely, a flip clause swap.

Bill's Croatan Institute Working Paper "Can Green Bonds Flourish in a Complex-Finance Brownfield?" argues that some financial products labelled "green" or "ESG" embed features such as a flip clause swap that undermine financial sustainability. As a corrective, the working paper proposes financial sustainability scores to measure the impact of a financial product in any sector (green or otherwise) on the marginal: improvement or distortion of price signals; reduction or buttressing of chronic economic imbalances; boosting or draining of public resources; and reduction or increase in the odds of self-induced catastrophe.

Bill has evaluated products in the international financial markets since 1987, most recently as a research journalist at Debtwire ABS and before that as a senior vice president and derivatives analyst at Moody's Investors Service (Moody's). At Moody's, Bill was the company's go-to person in North America both for flip clause swaps and for derivative product companies. The latter are derivative providers that operate via a walkway swap with a global bank sponsor. Prior to Moody's, Bill structured derivative contracts that referenced currencies and global interest rates at Merrill Lynch and analyzed the trading patterns of these indices as an economist at The WEFA Group.

Since 2011, Bill has conducted a private citizen advocacy to rectify the under-capitalization and deficient regulation of the types of complex finance such as flip clause swaps that started and fueled the financial crisis. He has submitted technical comments to US and European regulators, to US and UK legislative committees, and to rating agencies such as Fitch Ratings, Moody's, and S&P Global. Bill also provided insights regarding rating practices at Moody's to the attorneys general of 21 US states and the District of Columbia who, along with the US Justice Department, obtained a USD 864MM settlement with Moody's Corporation, Moody's Investors Service, and Moody's Analytics on January 2017.

Bill has self-financed this advocacy and conducts it entirely in the public domain. He regularly speaks to the press, and his work has been profiled in the New York Times, *the* Financial Times, *the Guardian, Bloomberg, Business Insider, ProPublica,* Wall Street Journal, *the* Washington Post, *and on the BBC, American Public Media's* Marketplace, and CGTN ("After the Fall," an upcoming, three-part assessment of the financial crisis that will air globally.) *Bill places all work on government and other websites and actively engages regulators, market practitioners, journalists, and other parties in on-the-record dialog.*

Additionally, Bill serves on the Experts Board of Wikirating.org.

Bill has two degrees from the University of Pennsylvania: an M.B.A. with a concentration in finance from the Wharton School; and a B.A. in Economics from the College of Arts and Sciences.

Bill can be reached at [redacted] *and* [redacted].

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William J. Harrington Submission Re: File Number S7-08-12 "Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker Dealers"

William J. Harrington
[redacted]

November 19, 2018

VIA ELECTRONIC MAIL

Mr. Eduardo A. Aleman
Assistant Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20002-4224

Re: File Number S7-08-12
(17 CFR Part 240 / Release Np. 34—84409; File No. S7-08-12 / RIN 3235—AL12
Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker Dealers)

Dear Assistant Secretary Aleman:

I submit the followng "comments that take into account regulatory and market developments," as well as legal developments, regarding a crisis-causing, uncleared swap with a flip clause, walkaway, or similar provision.[1] The insights and analysis herein provide "further information [that] would be particularly helpful to the Commission in the following areas: capital, margin, segregation, substituted compliance, compliance dates, as well as the economic implications," for security-based swaps with flip clauses and other types of walkway provisions.[2]

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[1] For the definition of a flip clause swap, see William J. Harrington, "Can Green Bonds Flourish in a Complex-Finance Brownfield?", *Croatan Institute Working Paper*, July 2018, 13. "The five components of a flip clause swap — (1) uncleared; (2) non-margined; (3) rating agency conditions; (4) replacement provisions; and (5) a flip clause — singly and collectively enable both an ABS dealmaker and a swap counterparty to undercapitalize the respective exposures. Making a flip clause swap balance-guaranteed or long-dated increases the extent of an ABS deal's under-capitalization. Making the same type of swap a cross-currency one increases the respective under-capitalization by quantums. A dealmaker would better protect an ABS deal — and the broader financial system — by foregoing a flip clause swap altogether and increasing deal resources instead." Also, pages 16-17 for a description of the operation of a flip clause using the rating agency and remittance reports for two ABS deals — Green STORM 2018 and SLM Student Loan Trust 2004-10, respectively.

[2] US Securities and Exchange Commission press release, "SEC Reopens Comment Period for Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants," October 11, 2018.

This submission closely updates my 2017 submission to the CFTC and the prudential regulators on the same topic with respect to uncleared swaps with a flip clause, walkaway, or similar provision.[3] Each of the Commission question is quoted and answered in the order of appearance in the re-proposal.

The three appendices substantiate, respectively:
-- the widespread knowledge within the asset-backed security (ABS) sector of the deficiencies of flip clause swaps since 1999 (Appendix 1);
-- ongoing ABS rating inflation by NRSROs, which mandates that ABS be subject to 100% collateral haircuts in margin and capital calculations (Appendix 2); and
-- my 2017 submission to the CFTC and the prudential regulators on the same topic, per preceding paragraph (Appendix 3.)

Finally, this submission contains a comprehensive Source for all materials cited.

Sincerely yours,

William J. Harrington
Senior Fellow, Croatan Institute
Experts Board, Wikirating.org – Key Expert, Structured Finance Topics

[3] Please see Appendix 3 of this submission or the CFTC file Submission to the US Commodity Futures Trading Commission "Re: RIN 3038-AD54 'Capital Requirements for Swap Dealers and Major Swap Participants'" (May 4, 2017).

Flip Clause Swaps: Trap Doors into a Systemic Black Hole

An uncleared swap with a flip clause or other type of walkway swap is deficient in design and construction and exposes both a swap provider and investors to outsize losses.[4]

Unfortunately, the collateralized loan obligation (CLO) sector is gearing up to enter into security-based swaps with flip clauses.[5]

The Commission must adjust the rule proposal with respect to a Security-Based Swap Dealer (SBSD) or Major Security-Based Swap Participant (MSBSP) that is exposed to a flip clause, walkaway or similar provision in an uncleared security-based swap “to ensure the safety and soundness” of such an entity, investors, and the entire financial system.

I propose the following adjustment. An SBSD or MSBSP that is exposed to a flip clause, walkaway or similar provision in an uncleared security-based swap must hold capital equal to the following for each such swap in all capital calculations.

> The maximum of: [0, 100% of the market value of the security-based swap on the books of the SBSD or MSBSP].
>
> **N.B.** Using the market value of the uncleared security-based swap with a flip clause, walkaway or similar provision on the books of the respective SBSD or MSBSP is critical to ensuring its “safety and soundness.” Otherwise, the second term may converge to USD 0.00 for even a deeply in-the-money swap as an SBSD or MSBSP approaches bankruptcy, insolvency, non-performing status or similar credit-impairment.

In holding the additional capital that this adjustment specifies, an SBSD or MSBSP that is party to an uncleared swap or uncleared security-based swap with a flip clause, walkaway or similar provision will fully offset the 100% loss of mark-to-market asset that the SBSD or MSBSP agreed, in a flagrantly willfully negligent manner, to accept in the event of its bankruptcy, insolvency, non-performing status or similar credit-impairment.

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[4] CFTC intake call with Bill Harrington and Rick Michalek of 12 May 2015. “Commenters believe ABS issuers’ current practice for dealing with counterparty credit risk is inadequate by construction and presents a systemic risk.” The CFTC notice of this intake call and accompanying presentation by the commenters is available at: https://www.cftc.gov/node/157371.

[5] William J. Harrington, "Can Green Bonds Flourish in a Complex-Finance Brownfield?", *Croatan Institute Working Paper*, July 2018, page 25-26, e.g., footnotes 105 & 106.

Footnote 105: “In recent instances, S&P posted pre-sale reports of 11 new US CLOs between March 27, 2018 and April 25, 2018. Seven of the eleven CLOs had waterfall flip clauses (RR 4; Bain Capital Credit CLO 2018-1; Antares CLO 2018-1; Greywolf CLO VI; Ivy Hill Middle Market Credit Fund XIV; Goldentree Loan Management US CLO 3; and Northwoods Capital XI-B). The remaining four CLOs did not have waterfall flip clauses (Chenango Park CLO; Woodmont 2018-4 Trust; Benefit Street Partners CLO V-B; and Neuberger Berman Loan Advisers CLO 28).”

Footnote 106: “For instance, a 2018 deal ZAIS CLO 8 Ltd contains two flip clauses in the priorities of payments but no capital, operational, or legal capabilities to post margin daily. See Christopher R. Davis and Jerry Jurcisin, "Presale: ZAIS CLO 8 Ltd," (New York: S&P Global Ratings, February 13, 2018), 14. In Table 14 “Interest Waterfall Payment Priority,” Nos. 3 and 19 comprise the first flip clause. In table 15 “Principal Waterfall Payment Priority,” Nos. 1A and 14N comprise the second flip clause.”

Big Picture Problem: SBSDs and MSBSPs Exposed to a Flip Clause in an Uncleared Security-Based Swap are *100% Undercapitalized*

Flip clause swaps and swaps with walkaway provisions belong in the dustbin of failed products along with other synthetic concoctions such as aerosol sprays, asbestos tiles, and trans fats.[6]

As a refresher, flip clause swaps:
-- were integral components of pre-crisis ABS such as CDOs, RMBS, synthetic, and TRUPS deals that ignited and fueled the financial crisis;
-- were integral components of other pre-crisis ABS such as auto ABS, CLOs, and student loan ABS that would have failed but for bailouts, other direct taxpayer support, and indirect taxpayer support;
-- are integral components of most new Australian, European, and Japanese ABS such as auto ABS, CLOs, RMBS and student loan ABS;
-- integral components of what would have been characterized as security-based swaps, i.e., the 250 swaps that saddled the estate of Lehman Brothers with losses of 100% of all mark-to-market assets and which remain the source of litigation to the present date; and
-- were, along with other derivative contracts with similar walkaway provisions, a large part of the Lehman Brothers portfolio. Other of my analysis indicates that this flip clause and walkaway exposure reduced Lehman equity by at least USD 8 billion in 2008, to USD 20 billion from the USD 28-30 billion commonly cited.

A flip clause case that the estate of Lehman Brothers continues to litigate — *Lehman Brothers Special Financing Inc. v. Branch Banking and Trust Co. et. al.* — demonstrates the 100% losses that an SBSD or MSBSP, respectively, exposes itself to under a security-based swap that has a flip clause, walkaway, or similar provision."[7]

A walkaway, flip clause or similar provision in an uncleared swap enables one party to cease making payments owed the second party following certain instances of its credit-impairment. Typically, these instances include bankruptcy, insolvency, non-performing status or the second party having incurred an event of default under the uncleared swap, another contract or a financial instrument.

"Walkaway clauses, including those that permit a party to suspend or condition payment, are not enforceable against the FDIC when acting as receiver or conservator of an insured depository institution or as receiver of a financial company under Title II of the Dodd Frank Act, or against the FHFA when acting as a receiver or conservator of Fannie Mae, Freddie Mac, or a Federal Home Loan Bank."[8]

This is for good reason. The circumstance that allow one counterparty to activate a walkaway clause — the severe credit-impairment of the second party — enable *all* its counterparties with a walkaway to activate it at the same time. The 100% correlation of walkaway activation would strip an insured depository institution, financial company or government-sponsored entity of swap assets *after* it had already become severely credit-impaired. Clearly, this would defeat the purpose of receivership or

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[6] Please see all my submissions to the Commission, the CFTC, and the prudential regulators in the "Sources" section of this submission, which follows the Appendices. Key words are "DPC," "BSFP," "AIG," "replacement," "RAC," "guarantee," & "Moody's Hedge Framework," "counterparty risk assessment," "counterparty instrument rating," "balance-guaranteed," and "Navient." Please also see Appendix 3 of this submission.

[7] William J. Harrington, "Can Green Bonds Flourish in a Complex-Finance Brownfield?", *Croatan Institute Working Paper*, July 2018. See Section 5. "Happy 10th Anniversary! Securitization world still picking at picked-over Lehman derivatives." An excerpt: "[T]he US legal proceeding pitted the estate of Lehman Brothers against 200-plus investors, eight global too-big-to-fail institutions, and counsel at 22 law firms.[7] The case, in which Lehman lost 100% of in-the-money swap assets that had been valued at USD 1 billion, represented a fraction of the more than USD 6 billion in swap assets that Lehman lost when other flip clauses were also activated *against it*." See also Cleary Gottlieb, "District Court Rules that Provisions in Lehman CDOs Setting Priority Payments Are Protected by Safe Harbor," Alert Memorandum, April 24, 2018.

[8] See Prudential Regulators, 'Margin and Capital Requirements for Covered Swap Entities,' footnote 124. This document is available at: https://www.occ.treas.gov/news-issuances/news-releases/2015/nr-occ-2015-142aaa.pdf.

conservatorship — i.e., to preserve the assets of the credit-impaired entity and thereby limit losses to US taxpayers.

Flip clauses — "provisions in structured finance documents that reverse or 'flip' the priority of payment obligations owed to swap counterparties on the one hand and noteholders on the other, following a specified event of default" [9] — operate very similarly to walkaway clauses.

"A flip clause is a fallback against failed replacement that subordinates the obligation of an ABS issuer to pay a termination amount to an insolvent counterparty when an asset pool has appreciated — i.e., to walk away from the securitization swap without making any termination payment at all."[10]

A securitization or structured product issuer that activates a flip clause reduces or even eliminates all payments that were owed a SBSD, MSBSP, or other swap provider just a moment prior to the activation.[11] As is the case with a walkaway clause, an SBSD, MSBSP, or other swap provider will incur this loss when insolvent or otherwise non-performing — i.e., at the time that the impaired swap provider already poses a grave risk to financial stability.

The uncleared swap with a flip clause has been the go-to swap of the securitized and structured product sectors for 20 years *precisely* because it adds to the risks of both parties and allows each to undercapitalize the respective risks of the swap, not despite this capacity.

"Without a flip clause, an ABS issuer cannot justify holding zero reserves against ABS losses that may arise from counterparty insolvency. (With a flip clause, a counterparty cannot justify valuing a securitization swap that is an asset at full mark-to-market, given that receipt of the asset is largely a function of the counterparty's own credit profile rather than that of the ABS issuer.)"[12]

The track record of uncleared, undercapitalized swaps with flip clauses during the financial crisis speaks volumes — much went wrong with the both the swaps and the borrowing that the swaps had facilitated.

The recklessness of an SBSD or MSBSP that provides an uncleared swap or uncleared security-based swap with a flip clause, walkaway or similar provisions should be very well known to the SES, based on my submissions and discussion with staff from 2011 onwards.

Moreover, these deficiencies are a widely-known open secret within the legal, rating, securitization, and structured finance communities, to name just a few.[13]

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[9] See William J. Harrington, 'Re: Rule Comment Number 466-1,' Comment to the SEC (3 June 2013). PDF-numbered p. 22. This submission is available at https://www.sec.gov/comments/4-661/4661-28.pdf. See also William J. Harrington, Letter to the SEC and ESMA of 11 September 2013. Pages 12-13. This letter is available at: http://www.wikirating.org/data/other/20130917_Harrington_J_William_ABS_Losses_Attributable_to_Securitization_Swaps.pdf.

[10] See William J. Harrington, 'Re: Rule Comment Number 466-1,' Comment to the SEC (3 June 2013). PDF-numbered p. 3. This submission is available at https://www.sec.gov/comments/4-661/4661-28.pdf.

[11] Ibid.

[12] Ibid.

[13] See Karen O'Flynn and Flora Innes, 'The Courts flip-flopping (again) on the validity of 'flip clauses,' Clayton Utz (1 September 2016) regarding the rule in *Lehman Brothers Special Financing Inc. vs. Bank of America National Association et al*. This note is available at: https://www.claytonutz.com/knowledge/2016/september/the-courts-flip-flopping-again-on-the-validity-of-flip-clauses. "However, LBSF will no doubt appeal Judge Chapman's decision and, in doing so, prolong the wait for a final resolution for *all* [italics added] who are affected." Defendant banks include: Bank of America, National Association; Goldman Sachs & Co.; Goldman Sachs International; Merrill Lynch, Pierce, Fenner & Smith Incorporated; Merrill Lynch International; and US Bank. See also Dave Simpson, "Bankruptcy Court's Block Of $1B Lehman Clawback Upheld,' *Law360*, March 14, 2018. **"The noteholders are represented by** [bold added] Ballard Spahr LLP, Chaffetz Lindsey LLP, Chapman and Cutler LLP, Cleary Gottlieb Steen & Hamilton LLP, Cravath Swaine & Moore LLP, Gray Plant Mooty Mooty & Bennett PA, Hogan Lovells, Hunton & Williams LLP, Jackson Walker LLP, K&L Gates LLP, Kleinberg Kaplan Wolff & Cohen PC, Locke Lord LLP, McCarter & English LLP, McGuire Woods LLP, Morgan Lewis & Bockius LLP, Munger Tolles & Olson LLP, Nixon Peabody LLP, Olshan Frome Wolosky LLP, Reed Smith LLP, Seward & Kissel LLP, Sidley Austin LLP and Wuersch & Gering LLP." **Separately, *Law360* lists the following 30 entities as current or former parties to the suit [bold added]**: Security Benefit;

These communities rely on the SEC and the CFTC to perpetuate the open secret of this recklessness by ignoring it in rule making and by issuing no-action letters such as the CFTC Letter No. 15-21 of 31 March 2015[14] and the SEC Letter No-Action Letter of 23 November 2010 addressed to Ford Motor Credit Company LLC.[15]

For its part, the SEC allows nationally recognized statistical rating organizations (NRSROs) to perpetuate a rating-based, risk arbitrage that incentivizes issuers of securitization and structured product issuers to offset the potential depreciation of securitized assets via-a-via rated debt by entering into uncleared and unmargined swaps with flip clauses rather than by purchasing options or securitizing additional assets.[16]

In the absence of this rating-based, risk arbitrage, an issuer of securitization or structured product debt *should* be indifferent between the three approaches. The flip clause is key to this rating-based, risk arbitrage and its preservation by the Commission is both an embarrassment and an extremely unsound risk management practice.

When a securitization or structured product issuer activates a flip clause in terminating an uncleared security-based swap, an SBSD or MSBSP is due payment of as little as USD 0.00 for the extinguishment of what had been an asset just an instant earlier.

This will be the case regardless of the extent to which the uncleared swap had been an in-the-money asset to an SBSD or MSBSP. An asset of USD 1,000.00 or USD 1,000,000.00 or even USD 1,000,000,000.00 will be terminated with the SSBD or MSBSP receiving as little as USD 0.00.

Moreover, 100% of the securitization and structured product issuers with a flip clause in an uncleared security-based swap with an SSBD or MSBSP that is bankrupt, insolvent, non-performing, or similarly credit-impaired are likely to activate the respective flip clauses simultaneously.

In other words, an SBSD or MSBSP with a portfolio of uncleared swaps or uncleared security-based swaps with a flip clause is exposed to receiving USD 0.00 per USD 1.00 owed under 100% of those swaps that are in-the-money.

For instance, if 44 separate securitization issuers each simultaneously actives a flip clause with the same bankrupt SD, the total payout to that SBSD remains USD 0.00 even though the sum of written-off swap assets increased 44-fold.

The bankruptcy of Lehman Brothers provided a real-world example of a bankrupt swap provider that received USD 0.00 per USD 1.00 owed under 100% of in-the-money, uncleared swaps that contained flip

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Citigroup; Shenandoah Life Insurance; MoneyGram; Morgan Stanley; State Street Global Advisors; Susquehanna Bancshares; MBIA; BONY Mellon; Marsh & Mclennan; Diversey Holdings; Bank of America; Modern Woodmen of America; U.S. Bancorp; UniCredit; AIG; Valeo; Natixis; New York Racing Association; Wells Fargo; BB&T; SCOR; Goldman Sachs; Euroclear; Sentinel Management; Deutsche Bank; Reinsurance Group of America; Principal Financial; JPMorgan Chase; and Credit Suisse.

[14] The CFTC Letter No. 15-21 of 31 March 2015 is available at: http://www.cftc.gov/idc/groups/public/@lrlettergeneral/documents/letter/15-21.pdf.

[15] The SEC Letter No-Action Letter of 23 November 2010 addressed to Ford Motor Credit Company LLC is available at: https://www.sec.gov/divisions/corpfin/cf-noaction/2010/ford072210-1120.htm. See also William J. Harrington, "Can Green Bonds Flourish in a Complex-Finance Brownfield?", *Croatan Institute Working Paper*, July 2015, page 11. “My research at *Debtwire ABS* in 2015 found that the SEC acted preemptively to prevent Dodd-Frank Section 939G from taking effect. The preemption sequence — an incoming letter from two Ford Motor Company entities that requested suspension of the provision, followed by the SEC no-action letter that effectuated the suspension — appeared to be market generated but in fact was orchestrated by the SEC.”

[16] See Appendix 2 to this submission. Also, see William J, Harrington, ‘Re: File Number S7-18-11, Request for Re-proposal Relating to Nationally Recognized Statistical Rating Organizations,’ (29 May 2014) p. 14. This submission is available at: https://www.sec.gov/comments/s7-18-11/s71811-84.pdf. See also William J. Harrington, Electronic Letter to S&P Global Analysts and the US Securities and Exchange Commission Offices of Credit Ratings, the Investor Advocate, and the Whistleblower Re: S&P Violations of SEC rules in Rating US CLOs with Waterfall Flip Clauses, US SLABS with Flip Clause Swaps and Navient, email, (May 10, 2018). Wikirating.org posted this email on May 22, 2018.

clauses with 44 securitization issuers. United States Bankruptcy Judge Shelley C. Chapman detailed these "payments" of USD 0.00 in a ruling on *Lehman Brothers Special Financing Inc. vs. Bank of America National Association et al of 28 June 2016.*[17]

"Upon providing notice of an Event of Default under the Swaps and the Indentures, the Trustees liquidated the assets, including the Collateral securing the Issuers' obligations under the Swaps and Indentures, and deposited the proceeds into accounts held by each Trustee for that purpose. The Trustees subsequently distributed the proceeds pursuant to the applicable Waterfall (the "Distributions"). In each instance, the Trustees applied Noteholder Priority because the Early Terminations were the result of an Event of Default and LBSF was the Defaulting Party. *The amount of the proceeds of the liquidation of the Collateral was insufficient to make any payment to LBSF [italics added] under the Waterfall after proceeds were paid pursuant to Noteholder Priority.*"

Unfortunately, Judge Chapman went on to confuse cause and effect by characterizing the broader financial crisis as "a time we truly hope was a 'singular' event."

In fact, Lehman Brothers was not an unlucky bystander to the crisis nor was the company blindsided by the 100% losses that it incurred under 100% of uncleared swaps with flip clauses that were in-the-money assets. These swaps performed exactly as Lehman Brothers *itself* and other global counterparties had both structured and advertised.

The shoddy practices of the financial sector writ large — accountants, counsel, investors, issuers, investors, Lehman Brothers, Lehman Brothers trading partners, other swap providers, rating agencies, regulators and underwriters — made the financial crisis inevitable.[18]

In other words, there was nothing "singular" about the financial crisis. Nor can "hope" alone prevent a recurrence. Robust capital, liquidity and financial reporting requirements are needed.

For instance, defendant banks in *Lehman Brothers Special Financing Inc. vs. Bank of America National Association et al* included: Bank of America, National Association; Goldman Sachs & Co.; Goldman Sachs International; Merrill Lynch, Pierce, Fenner & Smith Incorporated; Merrill Lynch International; and US Bank.

Each institution has first-hand knowledge of the 100% losses that an SBSD or MSBSP can incur under 100% of the uncleared security-based swaps with a flip clause, walkaway or similar provision that are in-the-money.

Yet, many of these same institutions also *provide* this very same type of swap and similarly assume the very same risk of 100% loss of 100% of swap assets without making special provisions or holding offsetting capital. SBSDs and MSBSPs will do the same unless the Commission adopts the proposals contained herein.

Following is a list of reckless providers of uncleared swaps with RAC provisions and flip clauses to student loan asset-backed transactions that Navient Corporation originated or sponsors.

Among these reckless swap providers are SDs such as: Bank of America NA; The Bank of New York; Citibank N.A.; Barclays Bank PLC; BNP Paribas SA; Deutsche Bank AG; JP Morgan Chase Bank National Association; Morgan Stanley Capital Services LLC; Royal Bank of Canada; The Royal Bank of Scotland, plc; and Wells Fargo Bank NA.

[17] "Memorandum Decision on Omnibus Motion of the Noteholder Defendants to Dismiss the Fourth Amended Complaint signed on 6/28/2016" by Judge Shelley C. Chapman is available at: http://www.nysb.uscourts.gov/sites/default/files/opinions/202553_1360_opinion.pdf.

[18] See Appendix A to this submission.

Capital (Questions 1-5)

1. ***"[A] provision that would establish a financial ratio-derived minimum net capital requirement for a nonbank SBSD equal to eight percent (8%) of the firm's risk margin amount."***

"The 2012 Proposals included a provision that would establish a financial ratio-derived minimum net capital requirement for a nonbank SBSD equal to eight percent (8%) of the firm's risk margin amount. The risk margin amount would be the sum of:

• The greater of the total margin required to be delivered by the nonbank SBSD with respect to security-based swap transactions cleared for securitybased swap customers at a clearing agency or the amount of the deductions (haircuts) that would apply to the cleared security-based swap positions of the security-based swap customers pursuant to the proposed capital requirements; and

• The total margin amount calculated by the nonbank SBSD with respect to non-cleared security-based swaps pursuant to the proposed margin rule. The total of these two amounts would be multiplied by eight percent (8%) to determine the dollar amount of this ratio requirement (and the nonbank SBSD's minimum net capital requirement would be the greater of a fixed-dollar amount and a ratio amount). The proposal for a ratio amount relating to security-based swaps was designed to establish a minimum net capital requirement that increases in tandem with an increase in the risks associated with a nonbank SBSD's security-based swap activities."

a. "The Commission requests comment and supporting data on the potential minimum net capital amounts that would be required of nonbank SBSDs as a result of the requirement, as proposed. How would those potential minimum net capital amounts compare with the amounts of capital currently maintained by entities that may register as nonbank SBSDs?"

b. "One commenter suggested that the Commission modify its proposed definition of the risk margin amount to reflect the lower risk associated with central clearing. In light of the comment and the goals of this provision, the Commission requests comment on whether the input to the risk margin amount for cleared securitybased swaps should be modified… The purpose of this potential modification would be to simplify the calculation, align it with the clearing agency margin requirements, and more closely align it with the CFTC's existing rules and proposals."

<u>WJH Response to Question 1</u>

1.a. A nonbank SBSD that is exposed to an uncleared swap with a flip clause, walkway or similar provision must add the following amount for each such swap to all calculations of capital and initial margin:

The maximum of: [0, 100% of the market value of the security-based swap on the books of the SBSD or MSBSP].

N.B. Using the market value of the uncleared security-based swap with a flip clause, walkaway or similar provision on the books of the respective SBSD or MSBSP is critical to ensuring its "safety and soundness." Otherwise, the second term may converge to USD 0.00 for even a deeply in-the-money swap as an SBSD or MSBSP approaches bankruptcy, insolvency, non-performing status or similar credit-impairment.

In holding the additional capital and initial margin that this adjustment specifies, an SBSD or MSBSP that is party to an uncleared swap or uncleared security-based swap with a flip clause, walkaway or similar provision will fully offset the 100% loss of mark-to-market asset that the SBSD or MSBSP agreed, in a flagrantly willfully negligent manner, to accept in the event of its bankruptcy, insolvency, non-performing status or similar credit-impairment.

1.b. The Commission must adopt ironclad rules for swap margin, eligible collateral, and capital requirements that will aid nonbank SBSDs and MSBSPs in ferreting out systemic problems with respect to security-based swaps. Iron-clad rules for security-based swaps will mimic the swap margin rules of the prudential regulators in all respects — two-way posting of variation margin on a daily basis, initial margin, treatment of affiliates (as distinct from the CFTC rules), haircuts for eligible collateral, and the lack of exemptions for any type of financial end user, for a start.[19]

2. ***Capital Charge for Cleared Security-Based Swap***

"The 2012 Proposals included a capital charge that would apply if a nonbank SBSD collects an amount of margin from a counterparty to a cleared security-based swap that is less than the deduction that would apply to the security-based swap if it was a proprietary position of the firm."

<u>WJH Response to Question 2</u>
No opinion

3. ***"As an alternative to taking the 100% charge, the Commission proposed that firms using internal models to calculate net capital could take a credit risk charge if the uncollected margin involved a transaction with a commercial end user [and possibly other types of user]."***

"The 2012 Proposals included a provision that a nonbank SBSD would be required to take a 100 percent (100%) capital charge when it does not collect variation or initial margin for noncleared security-based swaps because of an exception from collecting margin. The proposed capital charge was intended to require a nonbank SBSD to set aside net capital to address the risks that would otherwise be mitigated through the collection of variation and initial margin. The set aside net capital would serve as an alternative to obtaining margin. As an alternative to taking the 100 percent (100%) charge, the Commission proposed that firms using internal models to calculate net capital could take a credit risk charge if the uncollected margin involved a transaction with a commercial end user."

a. "Commenters requested that nonbank SBSDs be permitted to apply the credit risk charge to other types of counterparties. In light of the comments and the goals of this provision, the Commission requests comment on whether the use of the credit risk charge should be expanded to other types of counterparties and transactions. Should the rule permit a firm to apply the credit risk charge for uncollected initial margin for securitybased swaps and swap transactions with any type of counterparty and for uncollected variation margin for transactions with a commercial end user only? The purpose of limiting the application of the credit risk charge with respect to uncollected variation margin to transactions with commercial end users would be to reduce the types of unsecured receivables that qualify as allowable assets for net capital purposes and, thereby, promote the liquidity of the nonbank SBSD."

b. "The Commission requests comment on whether the rule should establish a threshold for uncollected margin above which the use of the credit risk charge would not be permitted. Should there be a threshold when the aggregate amount of uncollected margin across all counterparties exceeds a level of the nonbank SBSD's tentative net capital? Should the threshold apply to the aggregate amount of uncollected initial and variation margin or just to the aggregate amount of uncollected variation margin? The latter approach would focus the threshold on unsecured receivables that result from not collecting variation margin and, thereby, promote the liquidity of the nonbank SBSD. Should there be a

[19] US Prudential Regulators (FRB, FDIC, OCC, FHFA, and FCA). "Margin and Capital Requirements for Covered Swaps Entities," October 25, 2015.

threshold with respect to uncollected variation margin for security-based swap and swap transactions with commercial end users and should that threshold be ten percent (10%) or some other percent of the nonbank SBSD's tentative net capital? This threshold would be designed to limit the nonbank SBSD's aggregate exposure arising from not collecting variation margin from commercial end users and would be scalable to the nonbank SBSD's financial condition."

c. "The potential modifications to the rule text in the 2012 Proposals discussed above in 3.a and 3.b would include: (1) Changing the proposed rule to permit a nonbank SBSD to apply the credit risk charge for uncollected initial margin for security-based swaps and swaps from any type of counterparty and for uncollected variation margin from a commercial end user; and (2) establishing a risk-based threshold with respect to uncollected variation margin from commercial end users. Would rule language as described below effect this potential modification to the rule text in the 2012 Proposals? If not, please explain why and suggest alternative rule language. If the Commission were to use the language described below, would it strike an appropriate balance in terms of achieving the objectives of the proposed rule and addressing commenters' requests to apply the credit risk charge more broadly? If not, please explain why and suggest alternative rule language that could more effectively and efficiently strike the balance and achieve the objective.

"The potential modifications to paragraph (a)(7) of Rule 15c3–1 would provide: In accordance with Appendix E to this section (§ 240.15c3–1e), the Commission may approve, in whole or in part, an application or an amendment to an application by a broker or dealer to calculate net capital using the market risk standards of appendix E to compute a deduction for market risk on some or all of its positions, instead of the provisions of paragraphs (c)(2)(vi) and (c)(2)(vii) of this section, and § 240.15c3–1b, and using the credit risk standards of Appendix E to compute a deduction for credit risk for certain security-based swap and swap transactions, as specified in this paragraph, instead of the provisions of paragraphs (c)(2)(iv), (c)(2)(xv)(B)(1), and (c)(2)(xv)(B)(2) of this section, subject to any conditions or limitations on the broker or dealer the Commission may require as necessary or appropriate in the public interest or for the protection of investors. A broker or dealer may use the credit risk standards of Appendix E to compute a deduction for credit risk for security-based swap transactions with commercial end users as that term is defined in § 240.18a– 3(b)(2), and swap transactions in which a counterparty qualifies for an exception from margin requirements pursuant to Section 4s(e)(4) of the Commodity Exchange Act (7 U.S.C. 6s(e)(4)) instead of the provisions of paragraph (c)(2)(iv) of this section, provided that the deductions, in the aggregate, do not exceed ten percent (10%) of the tentative net capital of the broker or dealer. A broker or dealer also may use the credit risk standards of Appendix E to compute a deduction for credit risk for security-based swap transactions that are subject to an initial margin exception set forth in § 240.18a– 3(c)(1)(iii) instead of the provisions of paragraph (c)(2)(xv)(B)(1) of this section, and for swap transactions instead of the provisions of paragraph (c)(2)(xv)(B)(2) of this section.

"Similarly, the potential modifications to paragraph (a)(2) of Rule 18a–1 would provide: In accordance with paragraph (d) of this section, the Commission may approve, in whole or in part, an application or an amendment to an application by a security-based swap dealer to calculate net capital using the market risk standards of paragraph (d) to compute a deduction for market risk on some or all of its positions, instead of the provisions of paragraphs (c)(1)(iv), (vi), and (vii) of this section, and § 240.18a–1b, and using the credit risk standards of paragraph (d) to compute a deduction for certain security-based swap and swap transactions, as specified in this paragraph, instead of the provisions of paragraphs (c)(1)(iii), (c)(1)(ix)(B)(1), and (c)(1)(ix)(B)(2) of this section, subject to any conditions or limitations on the security-based swap dealer the Commission may require as necessary or appropriate in the public interest or for the protection of investors. A security-based swap dealer may use the credit risk standards of paragraph (d) to compute a deduction for credit risk for security-based swap transactions with commercial end users as that term is defined in § 240.18a–3(b)(2), and swap transactions in which a counterparty qualifies for an exception from margin requirements pursuant to Section 4s(e)(4) of the Commodity Exchange Act (7 U.S.C. 6s(e)(4)) instead of the provisions of paragraph (c)(1)(iii) of this section, provided that the deductions, in the aggregate, do not exceed ten percent (10%) of the tentative net capital of security-based swap dealer. A security-based swap dealer also may use the credit risk standards of paragraph (d) to compute a deduction for credit risk for securitybased swap transactions that are subject to an initial margin exception set forth in § 240.18a–3(c)(1)(iii) instead of the provisions of paragraph (c)(1)(ix)(B)(1) of this section, and for swap transactions instead of the provisions of paragraph (c)(1)(ix)(B)(2) of this section."

WJH Response to Question 3

3.a. A nonbank SBSD that is exposed to an uncleared, with a flip clause, walkway or similar provision must add the following amount for each such swap to all calculations of capital and initial margin:

The maximum of: [0, 100% of the market value of the security-based swap on the books of the SBSD or MSBSP].

N.B. Using the market value of the uncleared security-based swap with a flip clause, walkaway or similar provision on the books of the respective SBSD or MSBSP is critical to ensuring its "safety and soundness." Otherwise, the second term may converge to USD 0.00 for even a deeply in-the-money swap as an SBSD or MSBSP approaches bankruptcy, insolvency, non-performing status or similar credit-impairment.

In holding the additional capital and initial margin that this adjustment specifies, an SBSD or MSBSP that is party to an uncleared swap or uncleared security-based swap with a flip clause, walkaway or similar provision will fully offset the 100% loss of mark-to-market asset that the SBSD or MSBSP agreed, in a flagrantly willfully negligent manner, to accept in the event of its bankruptcy, insolvency, non-performing status or similar credit-impairment.

3.b. The Commission must adopt ironclad rules for swap margin, eligible collateral, and capital requirements that will aid nonbank SBSDs and MSBSPs in ferreting out systemic problems with respect to security-based swaps. Iron-clad rules for security-based swaps will mimic the swap margin rules of the prudential regulators in all respects — two-way posting of variation margin on a daily basis, initial margin, treatment of affiliates (as distinct from the CFTC rules), haircuts for eligible collateral, and the lack of exemptions for any type of financial end user, for a start.[20]

4. ***Segregation of Initial Margin***

"**The 2012 Proposals** included a capital charge for nonbank SBSDs when a counterparty requires initial margin to be segregated pursuant to Section 3E(f) of the Act, which among other things, provides that the collateral must be carried by an independent third-party custodian. Collateral held in this manner would not be in the possession or control of the nonbank SBSD, nor would it would be capable of being liquidated promptly by the nonbank SBSD without the intervention of a third party."

WJH Response to Question 4

No opinion

5. ***Net Capital Calculation for a Nonbank SBSD That has Delivered Initial Margin***

[20] US Prudential Regulators (FRB, FDIC, OCC, FHFA, and FCA). "Margin and Capital Requirements for Covered Swaps Entities," October 25, 2015.

"**The 2012 Proposals** noted that a nonbank SBSD would need to deduct from net worth the value of initial margin delivered to a counterparty when computing net capital. A comment letter encouraged the Commission to provide a means for nonbank SBSDs to post initial margin to SBSDs and other types of counterparties without incurring the capital charge."

WJH Response to Question 5

5.a. A nonbank SBSD that is exposed to an uncleared swap with a flip clause, walkway or similar provision must add the following amount for each such swap to all calculations of capital and initial margin:

The maximum of: [0, 100% of the market value of the security-based swap on the books of the SBSD or MSBSP].

N.B. Using the market value of the uncleared security-based swap with a flip clause, walkaway or similar provision on the books of the respective SBSD or MSBSP is critical to ensuring its "safety and soundness." Otherwise, the second term may converge to USD 0.00 for even a deeply in-the-money swap as an SBSD or MSBSP approaches bankruptcy, insolvency, non-performing status or similar credit-impairment.

In holding the additional capital and initial margin that this adjustment specifies, an SBSD or MSBSP that is party to an uncleared swap or uncleared security-based swap with a flip clause, walkaway or similar provision will fully offset the 100% loss of mark-to-market asset that the SBSD or MSBSP agreed, in a flagrantly willfully negligent manner, to accept in the event of its bankruptcy, insolvency, non-performing status or similar credit-impairment.

5.b. The Commission must adopt ironclad rules for swap margin, eligible collateral, and capital requirements that will aid nonbank SBSDs and MSBSPs in ferreting out systemic problems with respect to security-based swaps. Iron-clad rules for security-based swaps will mimic the swap margin rules of the prudential regulators in all respects — two-way posting of variation margin on a daily basis, initial margin, treatment of affiliates (as distinct from the CFTC rules), haircuts for eligible collateral, and the lack of exemptions for any type of financial end user, for a start.[21]

[21] US Prudential Regulators (FRB, FDIC, OCC, FHFA, and FCA). "Margin and Capital Requirements for Covered Swaps Entities," October 25, 2015.

Margin (Questions 6-9)

6. ***Allowing SBSDs "to apply to use models other than proprietary capital models to compute initial margin, including applying to use a standard industry model"***

"The 2012 Proposals included a provision that would require a nonbank SBSD to calculate a daily initial margin amount for each counterparty. The nonbank SBSD could use the standardized or model-based deductions prescribed in the proposed capital rule for nonbank SBSDs to calculate the initial margin amount, except that initial margin for equity security-based swaps would need to be determined exclusively using the standardized deductions.

"Some commenters argued that the Commission should approve a uniform initial margin model because it would reduce counterparty disputes and increase efficiency. Since the publication of the 2012 Proposals, the prudential regulators and the CFTC adopted final margin rules that permit the use of a model to calculate initial margin subject to the approval of the CFTC or a firm's prudential regulator. The Commission understands that the firms subject to these final rules have widely adopted the use of an industrydeveloped uniform model to compute initial margin. In light of the comments and the goals of this provision, the Commission requests comment on whether the margin rule should permit nonbank SBSDs to apply to use models other than proprietary capital models to compute initial margin, including applying to use a standard industry model. The purpose would be to provide flexibility to nonbank SBSDs to apply to the Commission for authorization to use a proprietary or other model to compute initial margin, and, with respect to an industry standard model, to increase transparency and decrease margin disputes among counterparties.

II

"The potential modifications to paragraph (d)(2)(i) of Rule 18a–3 would provide: For security-based swaps other than equity security-based swaps, a security-based swap dealer may apply to the Commission for authorization to use a model to compute the margin amount required by paragraph (c)(1)(i)(B) of this section and to compute the deductions required by paragraph § 240.15c3–1(c)(2)(xv) or § 240.18a–1(c)(1)(ix), as applicable, subject to the application process in § 240.15c3–1e or § 240.18a– 1(d), as applicable. The model must use a ninety-nine percent (99%), one-tailed confidence level with price changes equivalent to a ten business-day movement in rates and prices, and must use risk factors sufficient to cover all the material price risks inherent in the positions for which the margin amount or deductions are being calculated, including foreign exchange or interest rate risk, credit risk, equity risk, and commodity risk, as appropriate. Empirical correlations may be recognized by the model within each broad risk category, but not across broad risk categories."

WJH Response to Question 6

6.a. A nonbank SBSD that is exposed to an uncleared swap with a flip clause, walkway or similar provision must add the following amount for each such swap to all calculations of capital and initial margin:

The maximum of: [0, 100% of the market value of the security-based swap on the books of the SBSD or MSBSP].

N.B. Using the market value of the uncleared security-based swap with a flip clause, walkaway or similar provision on the books of the respective SBSD or MSBSP is critical to ensuring its "safety and soundness." Otherwise, the second term may converge to USD 0.00 for even a deeply in-the-money swap as an SBSD or MSBSP approaches bankruptcy, insolvency, non-performing status or similar credit-impairment.

In holding the additional capital and initial margin that this adjustment specifies, an SBSD or MSBSP that is party to an uncleared swap or uncleared security-based swap with a flip clause, walkaway or similar provision will fully offset the 100% loss of mark-to-market asset that the SBSD or MSBSP agreed, in a flagrantly willfully negligent manner, to accept in the event of its bankruptcy, insolvency, non-performing status or similar credit-impairment.

6.b. The Commission must adopt ironclad rules for swap margin, eligible collateral, and capital requirements that will aid nonbank SBSDs and MSBSPs in ferreting out systemic problems with respect to security-based swaps. Iron-clad rules for security-based swaps will mimic the swap margin rules of the prudential regulators in all respects — two-way posting of variation margin on a daily basis, initial margin, treatment of affiliates (as distinct from the CFTC rules), haircuts for eligible collateral, and the lack of exemptions for any type of financial end user, for a start.[22]

7. *Threshold for Posting Initial Margin*

"The 2012 Proposals included a requirement that a nonbank SBSD would need to collect initial and variation margin from each counterparty unless an exception applies. The proposed rule contained four exceptions under which variation and/or initial margin need not be collected: (1) When the counterparty is a commercial end user; (2) when the counterparty is another SBSD; (3) when the counterparty requires segregation pursuant to Section 3E(f) of the Act; and (4) when the counterparty's account holds only legacy transactions.

"Some commenters encouraged the Commission to adopt a threshold below which initial margin need not be collected and noted that the prudential regulators and the CFTC established a $50 million threshold (consistent with the recommendation of an international standard setting body). In light of the comments and the goals of this provision, the Commission requests comment on whether it would be appropriate to establish a risk-based threshold.

<u>WJH Response to Question 7</u>

7.a. The Commission must adopt rules that obligate a nonbank SBSD or MSBSP to exchange daily, two-way variation margin with all financial end users, including structured finance issuers, asset-backed security issuers, structured product issuers, re-packaged securities and other special purpose vehicles, CLO combination securities, the securitization entities of "captive finance companies," and any counterparty to a security-based swap with a flip clause, walkway, or similar provision, including Moreover, the threshold amount for posting variation margin should be zero and the minimum increments of exchange should be de minimus, e.g., US 10,000.[23]

7.b. A nonbank SBSD that is exposed to an uncleared swap with a flip clause, walkway or similar provision must add the following amount for each such swap to all calculations of capital and initial margin:

The maximum of: [0, 100% of the market value of the security-based swap on the books of the SBSD or MSBSP].

N.B. Using the market value of the uncleared security-based swap with a flip clause, walkaway or similar provision on the books of the respective SBSD or MSBSP is critical to ensuring its "safety and soundness." Otherwise, the second term may converge to USD 0.00 for even a deeply in-the-money swap as an SBSD or MSBSP approaches bankruptcy, insolvency, non-performing

[22] US Prudential Regulators (FRB, FDIC, OCC, FHFA, and FCA). "Margin and Capital Requirements for Covered Swaps Entities," October 25, 2015.

[23] Bill Harrington, "Existing ABS swaps also caught in swap margin net — ANALYSIS," *Debtwire ABS*, 12 August 2016. In particular, see subsection "Rorschach test—maybe the margin rules are a great solution?"

status or similar credit-impairment.

In holding the additional capital and initial margin that this adjustment specifies, an SBSD or MSBSP that is party to an uncleared swap or uncleared security-based swap with a flip clause, walkaway or similar provision will fully offset the 100% loss of mark-to-market asset that the SBSD or MSBSP agreed, in a flagrantly willfully negligent manner, to accept in the event of its bankruptcy, insolvency, non-performing status or similar credit-impairment.

7.c. The Commission must adopt ironclad rules for swap margin, eligible collateral, and capital requirements that will aid nonbank SBSDs and MSBSPs in ferreting out systemic problems with respect to security-based swaps. Iron-clad rules for security-based swaps will mimic the swap margin rules of the prudential regulators in all respects — two-way posting of variation margin on a daily basis, initial margin, treatment of affiliates (as distinct from the CFTC rules), haircuts for eligible collateral, and the lack of exemptions for any type of financial end user, for a start.[24]

8. Exempt and nonbank SBSD from posting initial margin to another SBSD?

"**[T]he 2012 Proposals** included an exception from collecting margin when the counterparty is another SBSD. In particular, the Commission proposed two alternatives with respect to SBSD counterparties. Under the first alternative, a nonbank SBSD would not need to collect initial margin if the counterparty is another SBSD ("Alternative A"). This approach is consistent with the broker-dealer margin rules, which generally do not require a broker-dealer to collect margin from another broker-dealer. Under the proposed second alternative, a nonbank SBSD would be required to collect initial margin from another SBSD and the initial margin would need to be segregated pursuant to Section 3E(f) of the Act ("Alternative B")."

WJH Response to Question 8

8.a. A nonbank SBSD that is exposed to an uncleared swap with a flip clause, walkway or similar provision must add the following amount for each such swap to all calculations of capital and initial margin:

The maximum of: [0, 100% of the market value of the security-based swap on the books of the SBSD or MSBSP].

N.B. Using the market value of the uncleared security-based swap with a flip clause, walkaway or similar provision on the books of the respective SBSD or MSBSP is critical to ensuring its "safety and soundness." Otherwise, the second term may converge to USD 0.00 for even a deeply in-the-money swap as an SBSD or MSBSP approaches bankruptcy, insolvency, non-performing status or similar credit-impairment.

In holding the additional capital and initial margin that this adjustment specifies, an SBSD or MSBSP that is party to an uncleared swap or uncleared security-based swap with a flip clause, walkaway or similar provision will fully offset the 100% loss of mark-to-market asset that the SBSD or MSBSP agreed, in a flagrantly willfully negligent manner, to accept in the event of its bankruptcy, insolvency, non-performing status or similar credit-impairment.

8.b. The Commission must adopt ironclad rules for swap margin, eligible collateral, and capital

[24] US Prudential Regulators (FRB, FDIC, OCC, FHFA, and FCA). "Margin and Capital Requirements for Covered Swaps Entities," October 25, 2015.

requirements that will aid nonbank SBSDs and MSBSPs in ferreting out systemic problems with respect to security-based swaps. Iron-clad rules for security-based swaps will mimic the swap margin rules of the prudential regulators in all respects — two-way posting of variation margin on a daily basis, initial margin, treatment of affiliates (as distinct from the CFTC rules), haircuts for eligible collateral, and the lack of exemptions for any type of financial end user, for a start.[25]

9. Portfolio Margining

"In response to the 2012 Proposals, commenters argued that the requirements adopted pursuant to Title VII of the Dodd-Frank Act should permit the portfolio margining of security-based swaps, swaps, and related positions. Portfolio margining of security-based swaps, swaps, and related positions can offer benefits to investors and the markets, including aligning margin requirements more closely with the overall risks of a customer's portfolio. Further, portfolio margining may help to improve cash flows and liquidity, and reduce volatility.

"a. The Commission requests comment on whether swaps should be permitted to be held in a security-based swap account at an entity that is registered as a broker-dealer, nonbank SBSD, and swap dealer to provide a means to portfolio margin security-based swaps with swaps and related cash market and listed options positions. The Commission also requests comment on whether security-based swaps should be permitted to be held in a swap account at an entity that is registered as an FCM, swap dealer, and nonbank SBSD to provide a means to portfolio margin security-based swaps with swaps and related futures positions.

"b. The Commission requests comment on whether swaps should be permitted to be held in a security-based swap account at an entity that is registered as a nonbank SBSD and swap dealer (but not as a broker-dealer or FCM) to provide a means to portfolio margin security-based swaps and swaps in a security-based swap account. The Commission also requests comment on whether security-based swaps should be permitted to be held in a swap account at an entity that is registered as a swap dealer and SBSD (but not as an FCM or broker-dealer) to provide a means to portfolio margin security-based swaps and swaps in a swap account."

<u>WJH Response to Question 9</u>

9.a. Portfolio margining cannot apply to any swap or security-based swap with a flip clause, walkaway, or similar provision. Each such swap must be treated on a stan-alone basis.

9.b. The Commission must adopt rules that obligate a nonbank SBSD or MSBSP to exchange daily, two-way variation margin with all financial end users, including structured finance issuers, asset-backed security issuers, structured product issuers, re-packaged securities and other special purpose vehicles, CLO combination securities, the securitization entities of "captive finance companies," and any counterparty to a security-based swap with a flip clause, walkway, or similar provision, including Moreover, the threshold amount for posting variation margin should be zero and the minimum increments of exchange should be de minimus, e.g., US 10,000.[26]

9.c. A nonbank SBSD that is exposed to an uncleared swap with a flip clause, walkway or similar provision must add the following amount for each such swap to all calculations of capital and initial margin:

The maximum of: [0, 100% of the market value of the security-based swap on the books of the

[25] US Prudential Regulators (FRB, FDIC, OCC, FHFA, and FCA). "Margin and Capital Requirements for Covered Swaps Entities," October 25, 2015.
[26] Bill Harrington, "Existing ABS swaps also caught in swap margin net — ANALYSIS," *Debtwire ABS*, 12 August 2016. In particular, see subsection "Rorschach test—maybe the margin rules are a great solution?"

SBSD or MSBSP].

N.B. Using the market value of the uncleared security-based swap with a flip clause, walkaway or similar provision on the books of the respective SBSD or MSBSP is critical to ensuring its "safety and soundness." Otherwise, the second term may converge to USD 0.00 for even a deeply in-the-money swap as an SBSD or MSBSP approaches bankruptcy, insolvency, non-performing status or similar credit-impairment.

In holding the additional capital and initial margin that this adjustment specifies, an SBSD or MSBSP that is party to an uncleared swap or uncleared security-based swap with a flip clause, walkaway or similar provision will fully offset the 100% loss of mark-to-market asset that the SBSD or MSBSP agreed, in a flagrantly willfully negligent manner, to accept in the event of its bankruptcy, insolvency, non-performing status or similar credit-impairment.

9.d. The Commission must adopt ironclad rules for swap margin, eligible collateral, and capital requirements that will aid nonbank SBSDs and MSBSPs in ferreting out systemic problems with respect to security-based swaps. Iron-clad rules for security-based swaps will mimic the swap margin rules of the prudential regulators in all respects — two-way posting of variation margin on a daily basis, initial margin, treatment of affiliates (as distinct from the CFTC rules), haircuts for eligible collateral, and the lack of exemptions for any type of financial end user, for a start.[27]

[27] US Prudential Regulators (FRB, FDIC, OCC, FHFA, and FCA). "Margin and Capital Requirements for Covered Swaps Entities," October 25, 2015.

Segregation (Questions 10-13)

10. ***Initial Margin of Non-Cleared Security-Based Swaps***

"**Section 3E(f) of the Act** provides that a counterparty to a non-cleared security-based swap with an SBSD can require that initial margin be segregated at a third-party custodian or waive segregation. The 2012 Proposals included a third alternative under which the initial margin for the noncleared security-based swap could be held by the SBSD and subject to requirements modeled on the brokerdealer customer protection rule but tailored to security-based swaps ("omnibus segregation requirements"). The omnibus segregation requirements would be mandatory for initial margin held by the SBSD for cleared security-based swaps."

<u>WJH Response to Question 10</u>
No opinion

11. ***Credit for Margin Posted at a Clearing Agency***

"**The Commission received a comment** that the broker-dealer customer protection rule (Rule 15c3–3) should be amended to take into account margin that is posted at a clearing agency by broker-dealers not registered as SBSDs."

<u>WJH Response to Question 11</u>
No opinion

12. ***Control of "Excess Securities Collateral"***

"**The Commission requests comment** on how initial margin posted by an SBSD to a bank SBSD to hedge a transaction with a security-based swap customer should be treated for purposes of the possession or control and customer reserve requirements in the proposed SBSD segregation rule. For purposes of the possession or control and customer reserve account requirements, should the initial margin be treated similarly to how initial margin an SBSD posts to a nonbank SBSD is treated if the purpose is to enter into a transaction that hedges a transaction with a security-based swap customer? The purpose would be to accommodate an SBSD that elects to enter into a hedging transaction with a bank SBSD and must post initial margin that is segregated at a third-party custodian."

<u>WJH Response to Question 12</u>
No opinion

13. ***Raise Threshold for SBSD Customer Reserve Accounts at a Single Bank***

"**The Commission requests comment** on whether, for consistency with brokerdealers, the threshold applicable to SBSD customer reserve accounts held at a bank should be increased to fifteen percent (15%) of the bank's equity capital and whether any cash deposited with an affiliated bank should be excluded. The purpose would be to more closely align the proposed segregation requirements for securitybased swaps with the existing customer reserve requirements in Rule 15c3–3, as amended in 2013. Should the fifteen percent (15%) threshold not apply if the SBSD is a bank and maintains the security-based swap customer reserve account itself rather than at an affiliated or non-affiliated bank? The purpose of this exception would be to accommodate a bank SBSD that holds the customer reserve account directly."

WJH Response to Question 13

13.a. The threshold applicable to SBSD customer reserve accounts held at a bank should be measured by the bank's equity capital less the maximum of: [0, 100% of the market value of the security-based swap on the books of the SBSD] for each security-based swap that exposes the SBSD to a flip clause, walkaway, or similar provision.

Substituted Compliance (Question 14)

14. *Comparability of Non-US Regimes to US Re: Capital and Margin Requirements*

"**The 2013 Proposals** would make substituted compliance with respect to capital and margin requirements available to foreign nonbank SBSDs that are not also registered as brokerdealers. Upon a Commission substituted compliance determination, this type of SBSD would be able to satisfy relevant capital and margin requirements by complying with corresponding requirements under a foreign regulatory system. The Commission requests comment on whether the potential modifications to the rule text in the 2012 Proposals discussed in this release would have an impact on substituted compliance determinations. If so, please explain how.

"A number of commenters requested that the Commission consider consistency with the prudential regulators, international standards, and foreign regulators when making substituted compliance determinations with respect to the proposed nonbank SBSD capital requirements.

"**a.** Commenters generally requested additional guidance regarding the criteria the Commission would consider when making substituted compliance determinations. In light of the comments and the goals of this provision, the Commission requests comment on the factors it should consider in making a substituted compliance determination with respect to the proposed nonbank SBSD capital requirements of Section 15F(e) of the Act and proposed Rule 18a–1. In making a substituted compliance determination, should the Commission consider whether the capital requirements of the foreign financial regulatory system are designed to help ensure the safety and soundness of registrants in a manner that is comparable to the proposed capital requirements for nonbank SBSDs? In addition, the proposed nonbank SBSD capital rule prescribes a net liquid assets test that requires the firm to have an amount of highly liquid assets that exceeds the amount of the firm's unsubordinated liabilities. In terms of the conditions that might be included in an order making an affirmative substituted compliance determination, should the Commission consider a condition that requires foreign nonbank SBSDs relying on the order to maintain liquid assets in excess of their unsubordinated liabilities? Are there reasonable alternatives to a net liquid assets test that could be the basis for a condition that is designed to ensure the foreign nonbank SBSD maintains sufficient liquidity to meet its obligations to security-based swap customers and other creditors? If so, describe them and explain how they would achieve this objective. Would these alternatives be appropriate for a domestic nonbank SBSD that is not registered as a broker-dealer? If so, explain why. Should the Commission consider a condition that the foreign nonbank SBSD not have a disproportionate number of U.S. customers? If not, explain why.

"**b.** The Commission requests comment on the composition of the balance sheets of entities in foreign jurisdictions that may register as nonbank SBSDs. Are the assets and liabilities of these foreign entities similar to the assets and liabilities of U.S. broker-dealers that are subject to the net liquid assets test? If not, explain the differences.

"**c.** The approach described in 14.a would modify Rule 3a71–6 (proposed as Exchange Act Rule 3a71–5 at 78 FR 30967, 31207–08) to describe factors that the Commission would consider in making a substituted compliance determination with respect to the proposed nonbank SBSD capital requirements. Would rule language as described below effect this potential modification to the rule text in the 2012 Proposals? If not, please explain why and suggest alternative rule language. If the Commission were to use the language described below, would it strike an appropriate balance in terms of achieving the objectives of the proposed rule and addressing the commenters' concerns described above? If not, please explain why and suggest alternative rule language that could more effectively and efficiently strike the balance and achieve the objective.

"**The potential modifications** to paragraph (d)(4) of Rule 3a71–6 would provide that substituted compliance is available with respect to: The capital requirements of Section 15F(e) of the Act (15 U.S.C. 78o–10(e)) and § 240.18a–1; provided, however, that prior to making such substituted compliance determination with respect to security-based swap dealers, the Commission intends to consider (in addition to any conditions imposed) whether the capital requirements of the foreign financial regulatory system are designed to help ensure the safety and soundness of registrants in a manner that is comparable to the applicable provisions arising under the Act and its rules and regulations."

WJH Response to Question 14

14.a All Commission rules must exempt flip clause swaps and swaps with walkaway provisions from a determination of substituted compliance with respect to every domicile.

Furthermore, the Commission must insist that a foreign, nonbank SBSD that is exposed to an uncleared swap with a flip clause, walkway or similar provision must add the following amount for each such swap to all calculations of capital and initial margin:

The maximum of: [0, 100% of the market value of the security-based swap on the books of the foreign, nonbank SBSD].

N.B. Using the market value of the uncleared security-based swap with a flip clause, walkaway or similar provision on the books of the respective foreign, nonbank SBSD is critical to ensuring its "safety and soundness." Otherwise, the second term may converge to USD 0.00 for even a deeply in-the-money swap as a foreign, nonbank SBSD approaches bankruptcy, insolvency, non-performing status or similar credit-impairment.

In holding the additional capital and initial margin that this adjustment specifies, a foreign, nonbank SBSD that is party to an uncleared swap or uncleared security-based swap with a flip clause, walkaway or similar provision will fully offset the 100% loss of mark-to-market asset that the foreign, nonbank SBSD agreed, in a flagrantly willfully negligent manner, to accept in the event of its bankruptcy, insolvency, non-performing status or similar credit-impairment.

14.b. Similarly, all Commission rules must apply a 100% haircut to a structured product, asset-backed security, re-packaged note, combination security, and any other complex instrument that a foreign, nonbank SBSD has posted as swap margin or holds as capital. In this aspect, the Commission must conform with the respective swap margin rules of the prudential regulators and the CFTC, respectively.

The Commission has first hand knowledge of the systemic undercapitalization of structured products, asset-backed securities, re-packaged notes, combination securities, and all other complex instruments.[28] Very often, a rating from one or more accredited credit rating agencies masks the under-capitalization, by mutual agreement of the issuer and the credit rating agencies. With respect to NRSROs, the Commission actively incentivizes the respective credit ratings to assign inflated, often fanciful ratings to structured products, asset-backed securities, re-packaged notes, combination securities, and all other complex instruments.[29]

14.c. The Commission should ***not*** "consider consistency with the prudential regulators, international standards, and foreign regulators when making substituted compliance determinations with respect to the proposed foreign, nonbank SBSD capital requirements."

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[28] William J. Harrington, Electronic Letter to S&P Global Analysts and the US Securities and Exchange Commission Offices of Credit Ratings, the Investor Advocate, and the Whistleblower Re: S&P Violations of SEC rules in Rating US CLOs with Waterfall Flip Clauses, US SLABS with Flip Clause Swaps and Navient, email, (May 10, 2018). Wikirating.org posted this email on May 22, 2018.

[29] Ibid., pages 3-4 for a description of six basic errors in the S&P methodology for flip clause swaps that the S&P analyst parroted rather than corrected. Pages 5-7 correct other basic failings in the S&P methodology and rating practice for flip clause swaps.

For a start, foundations of bankruptcy law regarding the enforceability of flip clause swaps and walkaway provisions, as well as societal acceptance of bailouts for derivatives providers such as a foreign, nonbank SBSD, vary widely across domiciles. As example, the European Union and the UK both largely exempt flip clause swaps from a key swap margin obligation via the very high thresholds for two-way posting of variation margin that are applicable to structured finance issuers, special purpose vehicles, and similar entities. Further undermining the "safety and soundness" of their own respective financial systems, the European Union and the UK also allow any entity to count certain types of structured finance, asset-backed securities, and re-packaged notes — including instruments that themselves embed flip clause swaps — towards the respective swap margin requirements.

Clearly, "the assets and liabilities of these foreign entities" are not "similar to the assets and liabilities of U.S. broker-dealers that are subject to the net liquid assets test." The liabilities of a foreign entity that has provided a flip clause swap or swap with walk-away provisions are understated. Similarly, the assets of a foreign entity that holds structured finance, asset-backed securities, re-packaged notes, and other complex finance are overstated.

Equally concerning, the developers of international standards are often entirely unaware that flip clause swaps exist, let alone know about the swaps fatal, internal deficiencies.[30]

Finally, two prudential regulators — the FDIC and FHFA — cannot generally have a walkaway provision enforced against them.[31] Moreover, the respective swap margin rules of the prudential regulators and the CFTC both obligate the provider of a flip clause swap to exchange daily variation margin with the respective structured finance issuer, special purpose vehicle, or other type of financial end user counterparty. Two-way, daily margin posting defuses the deficiencies of a flip clause swap. For these reasons, the prudential regulators may have been less concerned about the capital treatment of a flip clause swap than the Commission and the CFTC must be.[32]

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[30] As an example, research staff at the IMF recommended that uncleared swaps with flip clauses be priced *conveniently* as one means of promoting "growth-supportive, sustainable securitization markets" in 2013. See Miguel Segoviano, Bradley Jones, Peter Lindner, and Johannes Blankenheim, 'Securitization: Lessons Learned and the Road Ahead,' *IMF Working Paper WP/13/255* (November 2013) pp. 38-39 (PDF-numbered pages 40-41). "In some cases, CRAs [credit rating agencies] seem to have taken an excessively risk-averse approach in their ratings of securitizations. CRAs have come under intense scrutiny… Unfortunately, these pressures…appear to have pushed CRAs to modify requirements for counterparties…in a very stringent manner, making securitizations more difficult and costly than justified by the risk characteristics of the structures…[A]ter the crisis, CRAs imposed tougher requirements on original swap counterparties. For instance, derivatives counterparties rated by S&P cannot be rated more than four notches below the rating of the supported security if no collateral is posted (S&P, 2012). This will make securitization origination more difficult and costly by up to 25 bps per annum according to estimates by market participants." I apprised Dr. Segoviano and his co-authors of the risk characteristics of an uncleared swap with a flip clause in a teleconference on 16 January 2014. They had not been aware of these risk characteristics such as a flip clause when preparing the working paper. It is available at: https://www.imf.org/external/pubs/ft/wp/2013/wp13255.pdf. See also Appendix 3 of this submission.

[31] US Prudential Regulators (FRB, FDIC, OCC, FHFA, and FCA). "Margin and Capital Requirements for Covered Swaps Entities," October 25, 2015, Footnote 124. "Walkaway clauses, including those that permit a party to suspend or condition payment, are not enforceable against the FDIC when acting as receiver or conservator of an insured depository institution or as receiver of a financial company under Title II of the Dodd-Frank Act, or against the FHFA when acting as a receiver or conservator of Fannie Mae, Freddie Mac, or a Federal Home Loan Bank." See also Appendix 3 if this submission.

[32] The CFTC, unlike the prudential regulators, exempted *existing* flip clause swaps from the swap margin rules in certain instances. See US Commodity Futures Trading Commission, *CFTC Letter No. 17-52 Re: No-Action Position: Variation Margin Requirements Applicable to Swaps with Special Purpose Vehicles*, Washington, DC, October 27, 2017.

In sum, the Commission's proposed language is deficient and inadequate. I urge the Commission to rectify the deficiency with the above proposals.

14.d. The Commission must adopt ironclad rules for swap margin, eligible collateral, and capital requirements that will aid foreign, nonbank SBSDs in ferreting out systemic problems with respect to security-based swaps. Iron-clad rules for security-based swaps will mimic the swap margin rules of the prudential regulators in all respects — two-way posting of variation margin on a daily basis, initial margin, treatment of affiliates (as distinct from the CFTC rules), haircuts for eligible collateral, and the lack of exemptions for any type of financial end user, for a start.[33]

However, the CFTC premised the exemption on 31 misrepresentations that the Structured Finance Industry Group and other market participants made in requesting the no-action position. See William J. Harrington, *Electronic Letter to CFTC Secretary Christopher Kirkpatrick Re: CFTC Letter No. 17-52* (February 2, 2018), 16-17. Wikirating.org posted this letter on February 3, 2018.

[33] US Prudential Regulators (FRB, FDIC, OCC, FHFA, and FCA). "Margin and Capital Requirements for Covered Swaps Entities," October 25, 2015.

Compliance Date (Question 15)

15. *Shorten or Extend Compliance Date?*

"In the Commission's release establishing the registration process for SBSDs and MSBSPs, the Commission provided that the compliance date for the SBSD and MSBSP registration requirements will be the later of: Six months after the date of publication in the Federal Register of final rules establishing capital, margin, and segregation requirements for SBSDs and MSBSPs; the compliance date of final rules establishing recordkeeping and reporting requirements for SBSDs and MSBSPs; the compliance date of final rules establishing business conduct requirements under Sections 15F(h) and 15F(k) of the Exchange Act; or the compliance date for final rules establishing a process for a registered SBSD or MSBSP to make an application to the Commission to allow an associated person who is subject to a statutory disqualification to effect or be involved in effecting security-based swaps on the SBSD or MSBSP's behalf (the "Registration Compliance Date"). Would this provide enough time for registrants to take the necessary steps to come into compliance with applicable requirements? If not, explain why. Would a longer period, such as 18 months after the date of publication of the last of four releases noted above in the Federal Register, be more appropriate? If so, explain why. Would a shorter period be more appropriate? If so, explain why. Should the Commission consider the timing of the phased implementation of initial margin requirements provided for by other regulators in making any changes to the compliance period? If so, explain why."

<u>WJH Response to Question 15</u>
Shorten the compliance date to one month after publication in the Federal Register.

As private sector practitioners who pride themselves on being as efficient as that description suggests, SBSD and MSBSP staff can comply with all Commission rules within one month after publication in the Federal Register. To incentivize them, SBSD and MSBSP management need only tie bonuses to achievement of the goal.

As a public policy matter, the derivatives sector is dangerously inefficient. The failure to prepare for the end of LIBOR is just one example, albeit a major one. To reverse the endemic inefficiency of the derivatives sector, the Commission must stop coddling SBSDs and MSBSPs.

Additional Request for Comment—Economic Implications (Question 16)

16. ***Cost-Benefit Trade-Off***

"The Proposals contain economic analyses seeking to identify and consider the benefits and costs—including the effects on efficiency, competition and capital formation—that would result from the proposed capital, margin, and segregation requirements. To assist in the quantification of the economic effects of the proposed requirements, the Commission requests comment and supporting data on the current risk management practices that support the trading activity in securitybased swaps. Specifically, what are the main sources of funding available to entities that would be registering as nonbank SBSDs to support their trading activity? How much of the capital available to an entity that would be registering as a nonbank SBSD consists of liquid capital? What are typical risk management procedures for dealing with losses stemming from the market risk of security-based swap positions? What are typical risk management procedures for dealing with losses stemming from the credit risk of uncollateralized security-based swap positions? In the event that losses from trading activities overcome the available liquid capital, how are excess losses dealt with? What are the operational risks and concerns associated with maintaining adequate levels of capital?"

"**The Commission also** requests comment and data on how the baseline of the economic analyses has changed since the publication of the Proposals. For example, in 2015, the U.S. prudential regulators and the CFTC adopted final rules on minimum margin requirements for non-cleared swaps that began to be implemented in September 2016. A June 2017 survey on dealer financing terms noted that some of the survey respondents indicated that their clients' transaction volume or their own transaction volume in non-cleared swaps decreased somewhat over the period of September 2016 to June 2017. However, the respondents reported no changes in the prices that they quote to their clients in noncleared swaps over this period. Onefifth of the survey respondents also reported that they would be less likely to exchange daily variation margin with mutual funds, exchange-traded funds, pension plans, endowments, and separately managed accounts established with investment advisers due primarily to lack of operational readiness (e.g., the need to establish or update the necessary credit support annexes to cover daily exchange of variation margin) over this period. Twofifths of the survey respondents also reported that the volume of mark and collateral disputes on variation margin has increased somewhat over this period. Furthermore, the survey noted that there is variation among respondents with respect to the number of days it takes to resolve a mark and collateral dispute on variation margin, with one-third reporting less than two days, while three-fifths reporting more than two days but less than a week, on average. This type of data could provide insight regarding how entities that may register as nonbank SBSDs may respond to the Commission's final margin requirements.

"Commenters are asked to describe changes, if applicable, in: (1) The trading volumes in the relevant securitybased swap and swap markets; (2) the regulatory structure of these markets; and (3) the number and types of entities that participate in these markets. Commenters also are asked to describe how those changes in the baseline would impact the potential benefits and costs—including the effects on efficiency, competition and capital formation—of the Proposals as well as the potential benefits and costs— including the effects on efficiency, competition and capital formation—that would result from the potential alternatives described in the questions above taking the changes in the baseline into account (if applicable).

"Finally, the Commission requests comment on whether there are economic considerations apart from those discussed in the Proposals that should be considered in the economic analysis of the capital, margin, and segregation requirements as well as the alternatives described in the questions above.

<u>WJH Response to Question 16</u>

16.a. Most certainly, "there are economic considerations apart from those discussed in the Proposals that should be considered in the economic analysis of the capital, margin, and segregation requirements as well as the alternatives described in the questions above." The Commission must develop capital and margin rules that obligate a nonbank SBSD to fully insulate itself and the financial systems from the designed-to-fail complex finance that almost destroyed the US financial system in 2008.[34]

There are *no* risk management practices with respect to a prime example of designed to fail complex finance — namely, uncollateralized flip clause swaps or swaps with walkaway provisions. Nor can there be any risk management practices, other than doing away with flip clause swaps and swaps with walkaway provisions altogether.

A flip clause swap or walkaway swap presents systemic threat by undermining both parties irrespective of whether the swap is in-the-money or out-of-the-money.[35] A flip clause swap or walkaway swap is uniquely harmful to the financial system by exposing a nonbank SBSD to both its own credit risk and that of a counterparty. My 20-years of having analyzed flip clause swaps and walkway swaps from the opposing vantages of both a financial end user on one hand and a swap provider on the other hand has produced an inescapable conclusion:

Flip clause swaps and swaps with walkaway provisions belong in the dustbin of failed products along with other synthetic concoctions such as aerosol sprays, asbestos tiles, and trans fats.[36]

As a refresher, flip clause swaps:
-- were integral components of pre-crisis ABS such as CDOs, RMBS, synthetic, and TRUPS deals that ignited and fueled the financial crisis;
-- were integral components of other pre-crisis ABS such as auto ABS, CLOs, and student loan ABS that would have failed but for bailouts, other direct taxpayer support, and indirect taxpayer support;
-- are integral components of most new Australian, European, and Japanese ABS such as auto ABS, CLOs, RMBS and student loan ABS;
-- integral components of what would have been characterized as security-based swaps, i.e., the 250 swaps that saddled the estate of Lehman Brothers with losses of 100% of all mark-to-market assets and which remain the source of litigation to the present date; and
-- were, along with other derivative contracts with similar walkaway provisions, a large part of the Lehman Brothers portfolio. Other of my analysis indicates that this flip clause and walkaway exposure reduced Lehman equity by at least USD 8 billion in 2008, to USD 20 billion from the USD 28-30 billion commonly cited.

Accordingly, the Commission should more properly ask: *"What are the operational risks and concerns associated with NOT maintaining adequate levels of capital?"*

In answer, the Commission rules should meet three criteria.

1. *The Commission must calibrate cost/benefit analysis so that the findings are defensible to a*

[34] See also Appendix 3 of this submission or the CFTC file [Submission to the US Commodity Futures Trading Commission "Re: RIN 3038-AD54 'Capital Requirements for Swap Dealers and Major Swap Participants'"]() (May 4, 2017).
[35] William J. Harrington, ["Can Green Bonds Flourish in a Complex-Finance Brownfield?"](), *Croatan Institute Working Paper*, July 2018.
[36] Please see all my submissions to the Commission, the CFTC, and the prudential regulators in the "Sources" section of this submission, which follows the Appendices. Key words are "DPC," "BSFP," "AIG," "replacement," "RAC," "guarantee," & "Moody's Hedge Framework," "counterparty risk assessment," "counterparty instrument rating," "balance-guaranteed," and "Navient." Please also see Appendix 3 of this submission.

lay person.

The rule that the Commission ultimately adopts *must* ensure that both parties to an uncleared security-based swap pay the true rather than the convenient, i.e., artificially cheap, price of being party to the swap.[37]

Accordingly, the Commission must be very skeptical in assigning benefits to the undercapitalization of an uncleared security-based swap and be very aggressive in estimating the commensurate costs.

The phrase "garbage in, garbage out…refers "to the fact that computers, since they operate by logical processes, will unquestioningly process flawed, even nonsensical, input data ('garbage in') and produce undesired, often nonsensical, output ('garbage out')," according to the entry on Wikipedia.org.

"The principle also applies more generally to all analysis and logic, in that arguments are unsound if their premises are flawed."

Accordingly, the cost/benefit analysis should reject a very flawed, unsound premise — namely that the financial crisis was akin to an act of god that "no one could have foreseen" — and, furthermore, satisfy a second condition.

2. *The Commission rule, if in place in 2003, would have moderated or even prevented the financial crisis.*

For instance, had the Commission rule been in place in 2003, *would* it have incentivized:
- AIG *not* to lend money to CDOs under uncleared swaps with RAC provisions and flip clauses?; and
- Lehman Brothers to *not* to provide the uncleared swaps with flip clauses that lost 100% of value when counterparties activated flip clauses?

Thirdly, the cost/benefit analysis must incorporate an *achievable* benchmark so that this condition *can* be satisfied.

3. *The Commission rule would have survived this cost/benefit analysis in 2003.*

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[37] In direct opposition to research staff at the IMF, who recommended that uncleared swaps with flip clauses be priced *conveniently* as one means of promoting "growth-supportive, sustainable securitization markets" in 2013. See Miguel Segoviano, Bradley Jones, Peter Lindner, and Johannes Blankenheim, 'Securitization: Lessons Learned and the Road Ahead,' *IMF Working Paper WP/13/255* (November 2013) pp. 38-39 (PDF-numbered pages 40-41). "In some cases, CRAs [credit rating agencies] seem to have taken an excessively risk-averse approach in their ratings of securitizations. CRAs have come under intense scrutiny… Unfortunately, these pressures…appear to have pushed CRAs to modify requirements for counterparties…in a very stringent manner, making securitizations more difficult and costly than justified by the risk characteristics of the structures…[A]ter the crisis, CRAs imposed tougher requirements on original swap counterparties. For instance, derivatives counterparties rated by S&P cannot be rated more than four notches below the rating of the supported security if no collateral is posted (S&P, 2012). This will make securitization origination more difficult and costly by up to 25 bps per annum according to estimates by market participants." I apprised Dr. Segoviano and his co-authors of the risk characteristics of an uncleared swap with a flip clause in a teleconference on 16 January 2014. They had not been aware of these risk characteristics such as a flip clause when preparing the working paper. It is available at: https://www.imf.org/external/pubs/ft/wp/2013/wp13255.pdf.

Otherwise, the cost/benefit analysis understates the costs and overstates the benefits to the US economy from nonbank SBSDs and other swaps providers continuing to undercapitalize uncleared swaps with flip clauses.

After all, subjecting AIG and Lehman Brothers to higher capital, liquidity and financial reporting requirements for uncleared swaps might have seemed unreasonably costly to AIG, Lehman Brothers, the financial system and the US economy in 2006.

In retrospect, these "costly" requirements would have been the deal of the century.

This submission suggests several conditions that a properly calibrated cost/benefit analysis will satisfy.

For example, the only defensible finding with respect to an uncleared security-based swap with a flip clause or walkaway provision is that none of these swaps are needed because the costs to the US financial system and economy always outweigh the benefits.

As an analogy, the only sensible finding with respect to construction in earthquake zones using specifications for non-earthquake zones and materials that fail basic quality controls is that "*all* of this deficient construction is risky and outright criminal when knowingly designed or built below standard. Architects, engineers and builders are responsible for loss of life and property in such an instance."[38]

As a first step in calibrating the cost/benefit analysis, the Commission must *adjust* the baseline assumption of the cost/benefit analysis of uncleared swaps and uncleared security-based swaps by 180 degrees as follows:

"Uncleared security-based swaps that are artificially cheap increase the costs and reduce the benefits to the economy, rather than vice-versa."

In doing so, the Commission will *purge* the cost/benefit analysis of the marketing mantras that the financial industry represents as being empirically-driven findings.

For instance, uncleared security-based swaps do *not* hedge the risk exposures of end users. These swaps, simply by their nature as contracts, *add* to the risk exposures of an end user. More contractual obligations mean more that can go wrong.

The intrinsic characteristic of an uncleared security-based swap — namely, that it is a one-off, highly-negotiated, bilateral contract — enables either party or both to laden the contract with convenient provisions that are potentially loss-inducing.

The result is a highly-idiosyncratic contract with risk characteristics that differ markedly — and thus evolve differently — from other, ostensibly similar contracts.[39]

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[38] Per an architect friend who added: "I do like the building analogy because it demonstrates that only those who are involved in setting up these [complicated finance] constructs really understand the danger to the unsuspecting public."
[39] Indeed, the highly idiosyncratic nature of an uncleared swap underlies the following observations that the Commission cites in this Question No. 16. "A June 2017 survey on dealer financing terms noted that some of the survey respondents indicated that their clients' transaction volume or their own transaction volume in non-cleared swaps decreased somewhat over the period of September 2016 to June 2017… Onefifth of the survey respondents also reported that they would be less likely to exchange daily variation margin with mutual funds, exchange-traded funds, pension plans, endowments, and separately managed accounts established with investment advisers due

Moreover, most uncleared security-based swaps also add to the idiosyncratic exposures that US taxpayers underwrite.

More unfortunately still for US taxpayers, their involuntary backstop incentivizes parties to routinely undercapitalize uncleared security-based swaps, i.e., to evade accountability in designing and effectuating the swaps. As a result, each uncleared security-based swap is likely to contain many loss-inducing provisions and be insufficiently capitalized.[40]

The taxpayer backstop for most uncleared security-based swaps argues *against* imbuing the cost/benefit analysis with the veneer of hard-science rigor.

"How precise can a cost/benefit analysis be given that most swap dealers benefited either directly or indirectly from the financial crisis bailouts?

The data limitations that the idiosyncratic risk characteristics of an uncleared security-based swap impose on cost/benefit analysis are not inconsistent with the sectors' early stage of development.[41] After all, these contract types are less than 30 years old. As with other comparatively new products, uncleared swaps and uncleared security-based swaps deliver less than proponents claim.

Collectively, artificially cheap, uncleared security-based swaps continue to wreak havoc on the US economy by distorting price signals and thereby directing capital to sub-optimal uses. This distorted pricing represents a failure of market accountability and capitalism.

In fact, artificially cheap derivative contracts may well have engendered the endemically slow growth that has accompanied the emergence and growing use of these swaps in the last 30 years.[42] On its own, the potential that artificially cheap, uncleared security-based swaps will

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primarily to lack of operational readiness (e.g., the need to establish or update the necessary credit support annexes to cover daily exchange of variation margin) over this period. Twofifths of the survey respondents also reported that the volume of mark and collateral disputes on variation margin has increased somewhat over this period. Furthermore, the survey noted that there is variation among respondents with respect to the number of days it takes to resolve a mark and collateral dispute on variation margin, with one-third reporting less than two days, while three-fifths reporting more than two days but less than a week, on average. This type of data could provide insight regarding how entities that may register as nonbank SBSDs may respond to the Commission's final margin requirements."

[40] US Securities and Exchange Commission, Public Statement by Commissioner Robert J. Jackson, Jr., "Statement on Re-Opening Comment Period for Capital/Margin/Segregation for Security-Based Swap Dealers," October 11, 2018.

[41] Several industry groups for the larger derivatives sector made a self-inculpatory admission that underscored the immaturity of the market for uncleared swaps in early 2017. *As of February 2017, less than 6% of financial end users could comply with the looming implementation date for the swap margin rules of 1 March 2017, even though the CFTC and prudential regulators had set this date 14 and 16 months earlier, respectively*. In response, the CFTC issued the CFTC Letter No. 17-11 of 13 February 2017, which extended the implementation date to 1 September 2017. This letter is available at: http://www.cftc.gov/idc/groups/public/@lrlettergeneral/documents/letter/17-11.pdf.

[42] Stephen Mihm, Associate Professor of History at University of Georgia, posits that an inverse relationship exists between the size of the financial sector and its utility to the broader economy. "[T]here is growing literature within economics that examines the possibility that inequality, household debt and financial crises may be related… As in our own age, *the growing dominance of finance in the 1920s* [italics added] went hand in hand with another trend: rising inequality…it's hard to read these as anything but a misallocation of economic resources. *In each instance, the metastatic growth of finance* [italics added] along with staggering amounts of debt, yielded towers of leverage that came crashing down. And then, as now, this had real effects on the larger economy." Stephen Mihm, 'When Europe Sneezed. A new history of the Depression looks beyond Wall Street to the global roots of the crisis.' [Review of the

continue to be a drag on useful investment and economic growth indicates that these swaps are a cost to the economy and not a benefit.

Certainly, the proliferation of artificially cheap, uncleared swaps drove the US and global financial system into near collapse and obligated US taxpayers to provide massive bailouts and implicit support to the financial sector. The potential for artificially cheap, uncleared swaps to do the same again is clearly a cost.

Nonbank SBSDs Exposed to a Flip Clause or Walkaway Provision in an Uncleared Security-Based Swap are *Woefully* Undercapitalized

A walkaway, flip clause or similar provision in an uncleared security-based swap enables one party to cease making payments owed the second party following certain instances of its credit-impairment. Typically, these instances include bankruptcy, insolvency, non-performing status or the second party having incurred an event of default under the uncleared swap, another contract or a financial instrument.

“Walkaway clauses, including those that permit a party to suspend or condition payment, are not enforceable against the FDIC when acting as receiver or conservator of an insured depository institution or as receiver of a financial company under Title II of the Dodd Frank Act, or against the FHFA when acting as a receiver or conservator of Fannie Mae, Freddie Mac, or a Federal Home Loan Bank.”[43]

This is for good reason. The circumstance that allow one counterparty to activate a walkaway clause — the severe credit-impairment of the second party — enables *all* its counterparties with a walkaway to activate it at the same time. The 100% correlation of walkaway activation would strip an entity of swap assets *after* it had already become severely credit-impaired. Clearly, this would defeat the purpose of receivership or conservatorship — i.e., to preserve the assets of the credit-impaired entity and thereby limit losses to US taxpayers.

Flip clauses — “provisions in structured finance documents that reverse or ‘flip’ the priority of payment obligations owed to swap counterparties on the one hand and noteholders on the other, following a specified event of default” [44] — operate very similarly to walkaway clauses.

“A flip clause is a fallback against failed replacement that subordinates the obligation of an ABS issuer to pay a termination amount to an insolvent counterparty when an asset pool has appreciated — i.e., to walk away from the securitization swap without making any termination payment at all.”[45]

A securitization or structured product issuer that activates a flip clause reduces or even eliminates

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book *A Rabble of Dead Money. The Great Crash and the Global Depression: 1929-1939*, by Charles R. Morris.] *The New York Times Book Review* (23 April 2017).

[43] See Prudential Regulators, ‘Margin and Capital Requirements for Covered Swap Entities,’ footnote 124. This document is available at: https://www.occ.treas.gov/news-issuances/news-releases/2015/nr-occ-2015-142aaa.pdf.

[44] See William J. Harrington, ‘Re: Rule Comment Number 466-1,’ Comment to the SEC (3 June 2013). PDF-numbered p. 22. This submission is available at https://www.sec.gov/comments/4-661/4661-28.pdf. See also William J. Harrington, Letter to the SEC and ESMA of 11 September 2013. Pages 12-13. This letter is available at: http://www.wikirating.org/data/other/20130917_Harrington_J_William_ABS_Losses_Attributable_to_Securitization_Swaps.pdf.

[45] See William J. Harrington, ‘Re: Rule Comment Number 466-1,’ Comment to the SEC (3 June 2013). PDF-numbered p. 3. This submission is available at https://www.sec.gov/comments/4-661/4661-28.pdf.

all payments that were owed a nonbank SBSD or other swap provider just a moment prior to the activation.[46] As is the case with a walkaway clause, a nonbank SBSD or other swap provider will incur this loss when insolvent or otherwise non-performing — i.e., at the time that the impaired swap provider already poses a grave risk to financial stability.

The uncleared swap with a flip clause has been the go-to swap of the securitized and structured product sectors for 20 years *precisely* because it adds to the risks of both parties and allows each to undercapitalize the respective risks of the swap, not despite this capacity.

"Without a flip clause, an ABS issuer cannot justify holding zero reserves against ABS losses that may arise from counterparty insolvency. (With a flip clause, a counterparty cannot justify valuing a securitization swap that is an asset at full mark-to-market, given that receipt of the asset is largely a function of the counterparty's own credit profile rather than that of the ABS issuer.)"[47]

The track record of uncleared, undercapitalized swaps with flip clauses during the financial crisis speaks volumes — much went wrong with the both the swaps and the borrowing that the swaps had facilitated.

The recklessness of a nonbank SBD or other provider of a security-based swap should be very well known to the Commission based on my many submissions and discussions with its staff from 2011 to the present date.

Moreover, these deficiencies are a widely-known open secret within the legal, rating, securitization, and structured finance communities, to name just a few.[48]

These communities rely on the SEC and the CFTC to perpetuate the open secret of this recklessness by ignoring it in rule making and by issuing no-action letters such as the CFTC Letter No. 15-21 of 31 March 2015[49] and the SEC Letter No-Action Letter of 23 November 2010 addressed to Ford Motor Credit Company LLC.[50]

For its part, the SEC allows nationally recognized statistical rating organizations (NRSROs) to perpetuate a rating-based, risk arbitrage that incentivizes issuers of securitization and structured product issuers to offset the potential depreciation of securitized assets via-a-via rated debt by entering into uncleared and unmargined security-based swaps with flip clauses rather than by

[46] See Karen O'Flynn and Flora Innes, 'The Courts flip-flopping (again) on the validity of 'flip clauses,' Clayton Utz (1 September 2016) regarding the rule in *Lehman Brothers Special Financing Inc. vs. Bank of America National Association et al*. This note is available at: https://www.claytonutz.com/knowledge/2016/september/the-courts-flip-flopping-again-on-the-validity-of-flip-clauses.

[47] Ibid.

[48] William J. Harrington, "Can Green Bonds Flourish in a Complex-Finance Brownfield?", *Croatan Institute Working Paper*, July 2015. See Section 5 "Happy 10th Anniversary! Securization world still picking at picked-over Lehman derivatives."

[49] The CFTC Letter No. 15-21 of 31 March 2015 is available at: http://www.cftc.gov/idc/groups/public/@lrlettergeneral/documents/letter/15-21.pdf.

[50] The SEC Letter No-Action Letter of 23 November 2010 addressed to Ford Motor Credit Company LLC is available at: https://www.sec.gov/divisions/corpfin/cf-noaction/2010/ford072210-1120.htm. See also William J. Harrington, "Can Green Bonds Flourish in a Complex-Finance Brownfield?", *Croatan Institute Working Paper*, July 2015, page 11. "My research at *Debtwire ABS* in 2015 found that the SEC acted preemptively to prevent Dodd-Frank Section 939G from taking effect. The preemption sequence — an incoming letter from two Ford Motor Company entities that requested suspension of the provision, followed by the SEC no-action letter that effectuated the suspension — appeared to be market generated but in fact was orchestrated by the SEC."

purchasing options or securitizing additional assets.[51]

In the absence of this rating-based, risk arbitrage, an issuer of securitization or structured product debt *should* be indifferent between the three approaches. The flip clause is key to this rating-based, risk arbitrage and its preservation by the Commission — the principal US regulator of derivative contracts — is both an embarrassment and an extremely unsound risk management practice.

When a securitization or structured product issuer activates a flip clause in terminating an uncleared swap or uncleared security-based swap, a nonbank SBSD is due payment of as little as USD 0.00 for the extinguishment of what had been an asset just an instant earlier.

This will be the case regardless of the extent to which the uncleared security-based swap had been an in-the-money asset to a nonbank SBSD. An asset of USD 1,000.00 or USD 1,000,000.00 or even USD 1,000,000,000.00 will be terminated with the SD or MSP receiving as little as USD 0.00.

Moreover, 100% of the securitization and structured product issuers with a flip clause in an uncleared security-based swap with a nonbank SBSD that is bankrupt, insolvent, non-performing, or similarly credit-impaired are likely to activate the respective flip clauses simultaneously.

In other words, a nonbank SBSD with a portfolio of uncleared swaps or uncleared security-based swaps with a flip clause is exposed to receiving USD 0.00 per USD 1.00 owed under 100% of those swaps that are in-the-money.

For instance, if 44 separate securitization issuers each simultaneously actives a flip clause with the same bankrupt nonbank SBSD, the total payout to that nonbank SBSD remains USD 0.00 even though the sum of written-off swap assets increased 44-fold.

The bankruptcy of Lehman Brothers provided a real-world example of a bankrupt swap provider that received USD 0.00 per USD 1.00 owed under 100% of in-the-money, uncleared swaps that contained flip clauses with 44 securitization issuers. United States Bankruptcy Judge Shelley C. Chapman detailed these "payments" of USD 0.00 in a ruling on *Lehman Brothers Special Financing Inc. vs. Bank of America National Association et al of 28 June 2016.*[52]

"Upon providing notice of an Event of Default under the Swaps and the Indentures, the Trustees liquidated the assets, including the Collateral securing the Issuers' obligations under the Swaps and Indentures, and deposited the proceeds into accounts held by each Trustee for that purpose. The Trustees subsequently distributed the proceeds pursuant to the applicable Waterfall (the "Distributions"). In each instance, the Trustees applied Noteholder Priority because the Early Terminations were the result of an Event of Default and LBSF was the Defaulting Party. *The amount of the proceeds of the liquidation of the Collateral was insufficient to make any payment to LBSF [italics added] under the Waterfall after proceeds were paid pursuant to Noteholder Priority.*"

[51] See William J, Harrington, 'Re: File Number S7-18-11, Request for Re-proposal Relating to Nationally Recognized Statistical Rating Organizations,' (29 May 2014) p. 14. This submission is available at: https://www.sec.gov/comments/s7-18-11/s71811-84.pdf.

[52] "Memorandum Decision on Omnibus Motion of the Noteholder Defendants to Dismiss the Fourth Amended Complaint signed on 6/28/2016" by Judge Shelley C. Chapman is available at: http://www.nysb.uscourts.gov/sites/default/files/opinions/202553_1360_opinion.pdf.

Unfortunately, Judge Chapman went on to confuse cause and effect by characterizing the broader financial crisis as “a time we truly hope was a ‘singular’ event.”

In fact, Lehman Brothers was not an unlucky bystander to the crisis nor was the company blindsided by the 100% losses that it incurred under 100% of uncleared swaps with flip clauses that were in-the-money assets. These swaps performed exactly as Lehman Brothers *itself* and other global counterparties had both structured and advertised.

The shoddy practices of the financial sector writ large — accountants, counsel, investors, issuers, investors, Lehman Brothers, Lehman Brothers trading partners, other swap providers, rating agencies, regulators and underwriters — made the financial crisis inevitable.

In other words, there was nothing “singular” about the financial crisis. Nor can “hope” alone prevent a recurrence. Robust capital, liquidity and financial reporting requirements are needed.

For instance, defendant banks in *Lehman Brothers Special Financing Inc. vs. Bank of America National Association et al* included: Bank of America, National Association; Goldman Sachs & Co.; Goldman Sachs International; Merrill Lynch, Pierce, Fenner & Smith Incorporated; Merrill Lynch International; and US Bank.

Each institution has first-hand knowledge of the 100% losses that an SD or MSP can incur under 100% of the uncleared swaps or uncleared security-based swaps with a flip clause, walkaway or similar provision that are in-the-money.

Yet, many of these same institutions, as well as many other swap providers, also *provide* this very same type of swap and similarly assume the very same risk of 100% loss of 100% of swap assets without making special provisions or holding offsetting capital.

Similarly, many issuers of collateralized loan obligations (CLOs) are gearing up to enter into uncleared security-based swaps with flip clauses.[53] None of these CLOs have the operational, capital, or legal capacity to enter into swaps with two-way daily exchange of variation margin.[54]

16.b. The data in Question 16 that is shaded in green, further above, answer the Commission’s questions that are also shaded in green.

Taking the date in sequence: “[I]n 2015, the U.S. prudential regulators and the CFTC adopted final rules on minimum margin requirements for non-cleared swaps that began to be implemented in September 2016. A June 2017 survey on dealer financing terms noted that some of the survey

[53] William J. Harrington, "Can Green Bonds Flourish in a Complex-Finance Brownfield?", *Croatan Institute Working Paper*, July 2015. In particular, see page 26, footnote 105. “In recent instances, S&P posted pre-sale reports of 11 new US CLOs between March 27, 2018 and April 25, 2018. Seven of the eleven CLOs had waterfall flip clauses (RR 4; Bain Capital Credit CLO 2018-1; Antares CLO 2018-1; Greywolf CLO VI; Ivy Hill Middle Market Credit Fund XIV; Goldentree Loan Management US CLO 3; and Northwoods Capital XI-B). The remaining four CLOs did not have waterfall flip clauses (Chenango Park CLO; Woodmont 2018-4 Trust; Benefit Street Partners CLO V-B; and Neuberger Berman Loan Advisers CLO 28).”
[54] Ibid., page 26 footnote 106. “For instance, a 2018 deal ZAIS CLO 8 Ltd contains two flip clauses in the priorities of payments but no capital, operational, or legal capabilities to post margin daily. See Christopher R. Davis and Jerry Jurcisin, "Presale: ZAIS CLO 8 Ltd," (New York: S&P Global Ratings, February 13, 2018), 14. In Table 14 “Interest Waterfall Payment Priority,” Nos. 3 and 19 comprise the first flip clause. In table 15 “Principal Waterfall Payment Priority,” Nos. 1A and 14N comprise the second flip clause.”

respondents indicated that their clients' transaction volume or their own transaction volume in non-cleared swaps decreased somewhat over the period of September 2016 to June 2017. However, the respondents reported no changes in the prices that they quote to their clients in noncleared swaps over this period."

Clearly, the respective swap margin rules of the prudential regulators and CFTC imposed better practices on the US swap markets. As in any sector, some business is not worth transacting, such as uncleared swaps with flip clause or other walkaway swaps. Nonbank SBSDs, counterparties and the entire financial system benefits when best practices for margin posting discourage any type of swap dealer and counterparty from entering into superfluous, potentially harmful trades. Moreover, the observation that prices did not rise demonstrates that the swap margin rules help swap providers incorporate the truce cost of business in to swap prices.

"Onefifth of the survey respondents also reported that they would be less likely to exchange daily variation margin with mutual funds, exchange-traded funds, pension plans, endowments, and separately managed accounts established with investment advisers due primarily to lack of operational readiness (e.g., the need to establish or update the necessary credit support annexes to cover daily exchange of variation margin) over this period."

Great! Swap providers such as nonbanks SBSDs, as well as the entire financial system, benefit when the former ration their respective businesses to only those entities with robust operational readiness and shut out entities that cannot execute best practices for margin posting despite having had many years to prepare. After all, the free market is supposed to penalize laggards such as "mutual funds, exchange-traded funds, pension plans, endowments, and separately managed accounts established with investment advisers" that still "need to establish or update the necessary credit support annexes to cover daily exchange of variation margin." The prudential regulators and CFTC proposed the respective swap margin rules many years prior to the 2015 approvals!

"Twofifths of the survey respondents also reported that the volume of mark and collateral disputes on variation margin has increased somewhat over this period. Furthermore, the survey noted that there is variation among respondents with respect to the number of days it takes to resolve a mark and collateral dispute on variation margin, with one-third reporting less than two days, while three-fifths reporting more than two days but less than a week, on average."

Great! Best practices for the swap markets obligates participants to verify marks and collateral for variation margin today to avoid much more costly disputes tomorrow. In fact, the disputes themselves, including the length of time for resolutions, indicate that swap valuations are much more of an art that is rife with conflict of interest than the objective discipline of industry lobbyists' representations.

"This type of data could provide insight regarding how entities that may register as nonbank SBSDs may respond to the Commission's final margin requirements."

Indeed! The problems that swap dealers have encountered in adhering to the respective swap margin rules of the prudential regulators and the CFTC mandate that the Commission quickly adopt iron-clad rules for swap margin, eligible collateral, and capital requirements that will aid nonbank SBSDs in ferreting out systemic problems with respect to security-based swaps. Iron-clad rules for security-based swaps will mimic the swap margin rules of the prudential regulators in all respects — two-way posting of variation margin on a daily basis, initial margin, treatment of affiliates (as distinct from the CFTC rules), haircuts for eligible collateral, and the lack of exemptions for any type of financial end user, for a start.

Additionally, ironclad rules for swap margin, eligible collateral, and capital requirements that will aid nonbank SBSDs in ferreting out systemic problems with respect to security-based swaps. Iron-clad rules for security-based swaps will mimic the swap margin rules of the prudential regulators in all respects — two-way posting of variation margin on a daily basis, initial margin, treatment of affiliates (as distinct from the CFTC rules), haircuts for eligible collateral, and the lack of exemptions for any type of financial end user, for a start.[55]

[55] US Prudential Regulators (FRB, FDIC, OCC, FHFA, and FCA). "Margin and Capital Requirements for Covered Swaps Entities," October 25, 2015.

Appendix 1: WJH Email to Former Moody's Flip Clause Swap Colleague with Copy to 28 Credit Rating, Legal, Journalism, Judicial, and Regulatory Practitioners, October 17, 2018 (pp. 39-41)

From: Bill Harrington [redacted]>
To: Marlow Gereluk <[redacted]>
Cc: '[redacted]" <[redacted]>; [redacted]" <[redacted]>; [redacted]" <[redacted]>; '[redacted]" <[redacted]>; '[redacted]" [redacted]>; '[redacted]" [redacted]; [redacted]" [redacted]>; '[redacted]" <[redacted]>; [redacted]" <[redacted]>; [redacted]" [redacted]>; '[redacted]" [redacted]>; [redacted]" [redacted]>; MCLE Inbox [redacted]g>; [redacted]" [redacted]>; Rostin Behnam <[redacted]>; '[redacted]" <[redacted]>; "ombudsman@sec.gov" <ombudsman@sec.gov>; [redacted]" [redacted]>; Edward Manchester <[redacted]>; Mark Risi <[redacted]>; Kevin Duignan [redacted]>; '[redacted]" [redacted]>; '[redacted]" [redacted]>; Chester Spatt [redacted]>; [redacted]" <[redacted]>; '[redacted]" [redacted]>; Cezary Podkul [redacted]>; '[redacted]
Sent: Wednesday, October 17, 2018 5:48 PM
Subject: Update on Lehman Flip Clause Swaps

Hi Marlow,

I am writing to update you on the flip clause swaps that you and I assessed and memorialized at Moody's Investors Service from 2004 to 2006. Twenty-eight credit rating, legal, journalism, judicial, and regulatory practitioners with a common interest in flip clause swaps are copied here.

This email attaches the Moody's global cross-sector methodology for flip clause swaps "Framework for De-Linking Hedge Counterparty Risks from Global Structured Finance Cashflow Transactions" of October 18, 2010. You and I are both justifiably proud of the methodology, which we researched, shepherded through an often dubious and sometimes hostile Moody's committee, and wrote over a two-year period. The methodology obtained globally from 25 May 2006 until 11 November 2013.

Our then colleague Edward Manchester, who is one of the 28 copied here, wrote the implementation Appendix and continues as Moody's lead analyst for flip clause swaps globally. The attached methodology version of October 18, 2010, which lists Edward as first author, was one of many minor revisions to our work. Please see page 2 for the acknowledgement: "Marlow Gereluk and Bill Harrington contributed to the publication."

Please see Table 2B "Termination -- Amended Market Quotation and Payment Priorities" for an early, if not the first, rating-agency endorsement of the flip clause, i.e., the final entry "Priority of Termination Payments to Counterparty," on page 16. Frankly, I was thrilled that you proposed the rubric therein, i.e., "A: General Rule; B: Exception to General Rule; and C: Exception to Exception." I had assessed the flip clause from the competing vantages of CDO issuer and swap provider since joining Moody's in 1999. The work revealed that the Moody's new issue practice was almost entirely dependent on assuming that a flip clause swap introduced zero expected losses to a highly-rated deal. Accordingly, in our shared view, Moody's was obligated to publish a rigorous methodology to ensure that market participants made Moody's flip clause assumptions a practical reality with each new deal.

You may remember that we published two preceding comment requests, the first of which was dated March 30, 2005. Doing so enabled you and me to hold the feet of Moody's management to the fire of analytical integrity. We each had persistent concerns that Moody's management would try to dilute the methodology for flip clause swaps, for instance by removing the transparent rubric that you proposed and we both recommended.

I knew that your Moody's work was largely governed by UK law but did not appreciate that it had commonly been expected to uphold the enforceability of the flip clause. US law turned out to be a very different situation. After Judge Peck handed his famous decision that struck down the enforceability of a flip clause on January 25, 2010, one US Moody's legal analyst stated to me (as paraphrased) "Everyone knew that the flip clause would never hold up." A second US Moody's legal analyst stated, while listening to outside counsel brief us on the Judge Peck decision (as paraphrased): "Judge Peck is right." A third US Moody's legal analyst confided (as paraphrased) "No deal counsel submitted a single clean opinion on waterfall enforceability with respect to the flip clause."

In other words, many if not most US lawyers expected the flip clause to fail under US law. This was a dirty, open secret that I as a non-lawyer did not know prior to January 25, 2010.

The refusal of Moody's management to address the emerging shortcomings of flip clause swaps was one of many factors that prompted my resignation in July 2010. The same refusal more than eight years later validates the benefit that my advocacy to improve the under-capitalization and inflated credit ratings of derivative contracts, securitizations, structured finance, and the innumerable combinations of the foregoing confers on US and other societies.

My bio on the website of the Croatan Institute, where I am a senior fellow, provides link to much of my advocacy. http://www.croataninstitute.org/william-j-harrington. Please also see my Croatan Institute working paper "Can Green Bonds Flourish in a Complex-Finance Brownfield?" for a comprehensive review of flip clause swaps. The following is a link to the landing page for the working paper on the Croatan Institute website. http://www.croatanins titute.org/publications/ publication/can-green-bonds- flourish-in-a-complex-finance- brownfield

The paper proposes a scoring system to supplant deficient credit and green analysis. Asset-backed securities (ABS) with flip clause swaps and the respective swap counterparties are the test cases. More particularly, ABS deals such as Navient student loan ABS, US CLO deals, Dutch RMBS deals and the respective swap providers, as well as Lehman as provider of crisis-era flip clause swaps that failed spectacularly, are scored. All do poorly, i.e., the scores diverge sharply from the respective credit ratings. For a summary, please see "Table: Summary of Representative Financial Sustainability Scores for Products Described in this Working Paper," in Appendix 1, pages 32-38.

As a refresher, flip clause swaps:
-- were integral components of pre-crisis ABS such as CDOs, RMBS, synthetic, and TRUPS deals that ignited and fueled the financial crisis;
-- were integral components of other pre-crisis ABS such as auto ABS, CLOs, and student loan ABS that would have failed but for bailouts, other direct taxpayer support, and indirect taxpayer support;
-- are integral components of most new Australian, European, and Japanese ABS such as auto ABS, CLOs, RMBS and student loan ABS;
-- were, along with other derivative contracts with similar walkaway provisions, a large part of the Lehman Brothers portfolio. Other of my analysis indicates that this flip clause and walkaway exposure reduced Lehman equity by at least USD 8 billion in 2008, to USD 20 billion from the USD 28-30 billion commonly cited.

Please see my working paper, Section 5 "Happy 10th Anniversary! Securitization world still picking at picked-over Lehman derivative contracts." The section is subtitled "If a flip clause fails, and everyone hears it, will anyone make a sound?"

In short, the legal sector has done a poor job of understanding its own handiwork. Legal practitioners, academicians, and jurists seemingly don't grasp the lose-lose, zero sum nature of the flip clause swaps that they created. Instead, legal practitioners focus on the never ending and much easier task of tracking the domiciles that do and do not uphold the enforceability of flip clauses. In other words, flip clause swaps are long overdue for commonsense evaluations.

Going forward, I hope to submit an amicus brief in the ongoing Lehman appeal of flip clause decisions (US Court of Appeals for the Second Circuit, Case number 18-1079.) I have posted a draft amicus brief on my LinkedIn profile. WJH Draft Amicus Brief — Lehman Appeal to US Second Circuit, Case No. 18-1079, Enforceability of 250 Flip Clauses.

Best regards,

Bill Harrington

[redacted]

Appendix 2: "FFELP ABS downgrades drag on 18 months after Fed alert; just a 'technicality'? — ANALYSIS" *Debtwire ABS*, July 26, 2016 (pages, pp. 42-43)

26 July 2016 | 17:20 EDT

This week has already been eventful in the FFELP ABS sector. Fitch published an updated methodology for rating FFELP ABS today. Moody's assigned a provisional rating of AAA to a USD 1.008bn tranche of a new Navient FFELP ABS today and released a detailed spreadsheet for modeling FFELP ABS yesterday.

Unfortunately, neither Fitch nor Moody's has resolved even a subset of the substantial backlog of FFELP tranches that each agency has on review for possible downgrade. This delay may be attributable in part to Navient having hit a lull in obtaining extensions to the legal final maturity dates of tranches on review for possible downgrade. Navient has obtained extensions for USD 6.8bn in FFELP ABS through 13 June but none since, according to the company website.

Nelnet, which is also trying to obtain extensions, has not posted the announcement of any successes on the company website.

S&P belatedly joined the FFELP action earlier this month. The rating agency placed a lone tranche of a FFELP ABS on negative watch on 8 July and released its "inaugural semiannual FFELP tracker" on 12 July, according to the respective announcements.

All of this because a team in the Federal Reserve Bank of New York posed this same question to individual rating agencies in early 2015 — were rating models projecting some FFELP tranches to extend past the respective legal final maturity dates? The New York Fed team wanted to corroborate the surprise findings that its own in-house modeling had shown, according to a source familiar with the matter.

The answers started to trickle in "several months later," according to the source, when Moody's and Fitch began placing tranches on review for possible downgrade. Subsequently, the two agencies added more and more tranches to the respective watchlists and removed only a few.

The reluctance of the rating agencies to finally downgrade is reflected in descriptions of the failure of a FFELP tranche to be repaid in full by legal final maturity. The new Fitch methodology terms such a failure to be a "technical event of default" and sets up two sets of cash flows to model a transaction. The first set stresses "the transaction from a credit perspective" and is given more emphasis than the second, which assesses "the probability of missing the legal final maturity date, even if ultimate principal is paid thereafter."

Moody's analysts make a similar distinction — "We are not talking about a credit issue here; we're talking about a technicality" — as previously reported (see article, 30 June).

However, the source familiar with the New York Fed disagreed. Failure to pay in full by the legal final maturity is a "real default, not a technical one." This fundamental disagreement reflects an underlying driver for the New York Fed team to model FFELP tranches in-house in the first place. The team was looking at vendor prices as an alternative to structured finance ratings, noticed there were few vendor prices for FFELP ABS and started its own modeling.

In other words, the NY Fed was not looking for extension risk in FFELP ABS per se but rather in the course of its own due diligence caught the rating agencies asleep at the wheel, again. Disappointing, but not a complete surprise. Many of the rating teams that surveil FFELP ABS are the "same teams" that had surveilled RMBS ratings, observed the source.

The Fitch announcement that accompanied the methodology update is vague on the scale of looming downgrades and the schedule for rating resolutions. In fact, Fitch may add to its workload before completing the rating review. "Over the coming months," the agency "will review all FFELP SLABS transactions, including those not on Rating Watch Negative" and consider "remaining time to maturity, payment trends, and sponsor support" along with model results in finalizing rating decisions.

The work seems intended to fulfill an intention of Fitch to limit downgrades, as previously reported (see article, 17 June). Most prominently, the methodology affords surveillance teams the ability to extend "rating tolerance" to "outstanding transactions where the maturity stresses indicate an implied rating from Fitch's cash flow model that differs from the current rating."

Spokespersons from Fitch, Moody's and S&P each declined to comment.

by Bill Harrington

Bill Harrington has been conducting research on the obligations and risks of derivative contracts in the structured finance sector for 15 years, most recently at Debtwire ABS and previously at Moody's Investors Service. He has filed evaluations of rating processes and derivative methodologies with US and European regulators and with credit rating agencies. Bill has also worked as a derivative structurer at Merrill Lynch and a currency analyst at Wharton Econometrics. Bill has an MBA from The Wharton School.

Appendix 3: WJH Submission to CFTC Re: RIN 3038-AD54 "Capital Requirements for Swap Dealers and Major Swap Participants," May 4, 2017 (pages, pp. 44-210)

William J. Harrington
[redacted]

May 4, 2017

VIA ELECTRONIC MAIL

Mr. Christopher Kirkpatrick
Secretary of the Commission
Commodities Futures Trading Commission
Three Lafayette Centre
1155 21st Street NW
Washington, DC 20581

Re: RIN 3038-AD54
"Capital Requirements for Swap Dealers and Major Swap Participants"

Dear Mr. Kirkpatrick,

Herein is my response to the questions posed in the proposal cited above (CFTC Proposal) and suggested improvements to it.

I am a private US citizen engaged in a fulltime effort to alert regulators, market participants, the media and credit rating agencies to the respective undercapitalization of both parties to an uncleared swap with a flip clause. My LinkedIn profile[56] contains my bona fides.

My credentials include 18 years of specifying and evaluating the appropriate capitalization of the two parties to an uncleared swap with a flip clause — most commonly, a swap dealer or other provider on one hand and an issuer of securitized or structured debt on the other.

I have co-authored rating methodologies and a peer-reviewed law journal article and authored regulatory submissions, journalistic articles and presentations regarding uncleared swaps with flip clauses.

Many of these documents and presentations can be accessed from my LinkedIn profile. I also cite my work and provide links to it in this response.

[56] LinkedIn profile of "Bill Harrington" available at: https://www.linkedin.com/in/williamjharrington.

The 18-year takeaway? *An uncleared swap with a flip clause is deficient in design and construction and exposes both a swap provider and investors to outsize losses.*[57]

In other words, both a securitization or structured product issuer on one hand and a swap dealer of major swap participant on the other hand that enter an uncleared swap with a flip clause do so recklessly.[58]

As a corrective, a swap dealer or major swap participant — the subjects of the CFTC Proposal — must hold substantially more capital.

A Suggested Improvement to the CFTC Proposal

The Federal Register published the CFTC Proposal (Volume 81, Number 242, pages 91252-91334) on 16 December 2016. The acronyms used therein have the same respective meanings in this response.

"Section 731 of the Dodd-Frank Act amended the CEA by adding section 4s(e), which requires the Commission to adopt rules establishing capital requirements for SDs and MSPs to help ensure the safety and soundness of the SDs and MSPs."

I urge the Commission to adjust the CFTC Proposal with respect to an SD or MSP that is exposed to a flip clause, walkaway or similar provision in an uncleared swap or an uncleared security-based swap "to ensure the safety and soundness" of such an entity.

I propose this adjustment. An SD or MSP that is exposed to a flip clause, walkaway or similar provision in an uncleared swap or uncleared security-based swap must hold capital equal to the following for each such swap.

> The maximum of: [0, 100% of the "uncleared swap margin" as defined in footnote 25 of the CFTC Proposal + 100% of the market value of the swap or security-based swap on the books of the SD or MSP].
>
> **N.B.** Using the market value of the swap or security-based swap on the books of the respective SD or MSP is critical to ensuring its "safety and soundness." Otherwise, the second term may converge to USD 0.00 for even a deeply in-the-money swap as an SD or MSP approaches bankruptcy, insolvency, non-performing status or similar credit-impairment.

In holding the additional capital that this adjustment specifies, an SD or MSP that is party to an uncleared swap or uncleared security-based swap with a flip clause, walkaway or similar provision will fully offset the 100% loss of mark-to-market asset that the SD or MSP agreed to

[57] CFTC intake call with Bill Harrington and Rick Michalek of 12 May 2015. "Commenters believe ABS issuers' current practice for dealing with counterparty credit risk is inadequate by construction and presents a systemic risk." The CFTC notice of this intake call and accompanying presentation by the commenters is available at: https://www.cftc.gov/node/157371.

[58] "A swap contract with a flip clause is an NRSRO [rating agency] construct that underpins AAA ratings in most ABS sectors worldwide and has no analog among mainstream derivative contracts. Since the ABS industry's inception, issuers have jerry-rigged flip clauses into swap contracts as a means of keeping issuance costs artificially low." William J, Harrington, 'Re: File Number S7-18-11, Request for Re-proposal Relating to Nationally Recognized Statistical Rating Organizations,' (29 May 2014) p. 3. This submission is available at: https://www.sec.gov/comments/s7-18-11/s71811-84.pdf.

accept in the event of its bankruptcy, insolvency, non-performing status or similar credit-impairment.

This adjustment is scaled up linearly from the CFTC Proposal — i.e., the capital requirement for an SD or MSP that is party to an uncleared swap or uncleared security-based swap *without* a flip clause, walkaway or similar provision. For these swaps, the CFTC Proposal specifies a much lower minimum capital requirement that corresponds to the much lower scale of loss posed to the SD or MSP.

Specifically, the CFTC Proposal specifies a "minimum capital requirement based upon *eight percent* [italics added] of the margin required on the SD's cleared and uncleared swaps and security-based swaps and the margin required on the SD's futures and foreign futures" *without* a flip clause, walkaway or similar provision. Furthermore, the CFTC Proposal also includes in the computation of the minimum capital requirement those "swaps and security-based swaps that are exempt or excluded from the uncleared margin requirements (e.g., legacy swaps and security-based swaps, and swaps with commercial end users)."

In sum, the CFTC Proposal specifies that an SD or MSP capitalize an uncleared swap or security-based swap *without* a flip clause, walkaway or similar provisions in the same amount irrespective of whether the swap is or is not subject to the swap margin requirement.

Similarly, the suggested adjustment for an uncleared swap or security-based swap *with* a flip clause, walkaway or similar provision reflects the correspondingly much larger exposure of an SD or MSP to 100% loss of mark-to-market asset. This adjustment will apply equally to all uncleared swaps or uncleared security-based swaps with a flip clause, walkaway or similar provision, irrespective of whether the swap is or is not subject to the swap margin requirement.

I look forward to the CFTC posting this response and the staff of the Division of Swap Dealer and Intermediary Oversight discussing the response with me. This discussion will serve many purposes including allowing me to correct the serious misrepresentations regarding uncleared swaps with flip clauses that the Structured Finance Industry Group (SFIG) has made to the CFTC from 2014 to the present date.[59]

Six Aims of the CFTC Proposal that Warrant the Suggested Improvement

Following are six excerpts from the CFTC Proposal, each of which is followed by a rationale for the adjustment for an SD or MSP that is party to an uncleared swap or security-based swap with a flip clause, walkway or similar provision.

1. "The Commission is also proposing in this release to require SDs to meet defined liquidity and funding requirements and is proposing certain limitations on the withdrawal

[59] SFIG staff and members discussed uncleared swaps with flip clauses with CFTC staff in two meetings, one of which also included staff of the prudential regulators, and multiple conversations in February 2017 alone, according to SFIG announcements. An SFIG email blast of 16 February described a series of conversations *and* a meeting. "Over the past week, SFIG staff and members have continued discussions with *senior* [italics added] staff at the CFTC Division of Swap Dealer & Intermediary Oversight regarding SFIG members' requests for relief under the swaps margin rule." Separately, "The latest no-action position issued by the CFTC on February 13, 2017 followed an SFIG meeting at which we discussed members' request for temporary relief for legacy securitization transactions from variation margin requirements." An SFIG email blast of 23 February described "a meeting that SFIG held with the CFTC and prudential regulators yesterday, February 22nd, to discuss our recent request for temporary relief for legacy securitization transactions from the compliance date for variation margin requirements."

of capital from SDs as part of the SD capital requirements."

A flip clause, walkaway or similar provision can undermine the "liquidity and funding requirements" of an SD or MSP that is credit impaired by jeopardizing the full value of the respective swap asset.

2. "The Commission believes that its approach is consistent with its statutory mandate – helping to ensure the safety and soundness of the SDs subject to its jurisdiction."

   An SD that is party to an uncleared swap or uncleared security-based swap with a flip clause, walkaway or similar provision is extremely reckless and undermines its own "safety and soundness."

3. "In developing its proposed margin requirement for uncleared swap transactions, the Commission recognized that different categories of counterparties present different levels of risk."

   *The category of counterparties that can activate a flip clause, walkaway or similar provision in an uncleared swap with an SD presents the **highest** level of risk to an SD — namely the self-referencing risk to its own credit profile.*

4. "The Commission states its belief that financial firms generally present a higher level of risk than non-financial firms."

   Securitization and structured product issuers present a "higher level of risk" than other financial end users because the overwhelming majority of such issuers that are party to an uncleared swap have a flip clause in the swap. Uncleared swaps with flip clauses underpinned the issuance of undercapitalized securitizations that were central to the financial crisis such as CDOs and RMBS.

5. "Capital, however, serves as an overall financial resource for the SD and is intended to cover potential risks that are not adequately covered by other risk management programs (i.e., 'residual risk') including margin on uncleared swaps."

   Substantial infusions of capital is needed for each SD that is party to an uncleared swap with a flip clause, walkaway or similar provision, based on my experience in rating and assessing these swaps since 1999. The instantaneous losses of 100% of asset value on 100% of swaps that are exposed to a flip clause, walkaway or similar provision "are not adequately covered by other risk management programs." This is not "residual risk" but rather inherent risk that an SD and a securitization or structure product issuer intentionally embedded into the swaps from the outset.

6. "Capital is intended to help ensure the safety and soundness of the SD by providing financial resources to allow an SD to absorb unanticipated losses and declines in asset values from all aspects of its business operations, including swap dealing activities, while also continuing to meet its financial obligations. The Commission is proposing to require

> than an SD reserve against all uncollateralized swaps exposures as such exposures pose residual risk not covered by other assets of the SD."
>
> *An SD that is exposed to a flip clause, walkaway or similar provision in an uncleared swap is exposed to instantaneous "declines in asset value" of 100% under all such swaps that are in-the-money. This is among the riskiest of "swap dealing activities" that can prevent an SD from "continuing to meet its financial obligations," both with respect to swaps that are and are not collateralized.*

Calibrating the Cost/Benefit Analysis so that Findings are Defensible

The rule that the Commission ultimately adopts *must* ensure that both parties to an uncleared swap or uncleared security-based swap pay the true rather than the convenient, i.e., artificially cheap, price of being party to the swap.[60]

Accordingly, the Commission must be very skeptical in assigning benefits to the undercapitalization of uncleared swaps and uncleared security-based swaps and be very aggressive in estimating the commensurate costs.

This response suggests several conditions that a properly calibrated cost/benefit analysis will satisfy.[61]

For a start, the cost/benefit analysis must satisfy the following condition.

> "*The cost/benefit analysis produces a defensible finding.*"

For example, the only defensible finding with respect to uncleared swaps with flip clauses and uncleared security-based swaps with flip clauses is that none of these swaps are needed because the costs to the US financial system and economy outweigh the benefits.

As an analogy, the only sensible finding with respect to construction in earthquake zones using specifications for non-earthquake zones and materials that fail basic quality controls is that "*all* of this deficient construction is risky and outright criminal when knowingly designed or built below standard. Architects, engineers and builders are responsible for loss of life and property in such an instance."[62]

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[60] In contrast, research staff at the IMF recommended that uncleared swaps with flip clauses be priced *conveniently* as one means of promoting "growth-supportive, sustainable securitization markets" in 2013. See Miguel Segoviano, Bradley Jones, Peter Lindner, and Johannes Blankenheim, 'Securitization: Lessons Learned and the Road Ahead,' *IMF Working Paper WP/13/255* (November 2013) pp. 38-39 (PDF-numbered pages 40-41). "In some cases, CRAs [credit rating agencies] seem to have taken an excessively risk-averse approach in their ratings of securitizations. CRAs have come under intense scrutiny… Unfortunately, these pressures…appear to have pushed CRAs to modify requirements for counterparties…in a very stringent manner, making securitizations more difficult and costly than justified by the risk characteristics of the structures…[A]ter the crisis, CRAs imposed tougher requirements on original swap counterparties. For instance, derivatives counterparties rated by S&P cannot be rated more than four notches below the rating of the supported security if no collateral is posted (S&P, 2012). This will make securitization origination more difficult and costly by up to 25 bps per annum according to estimates by market participants." I apprised Dr. Segoviano and his co-authors of the risk characteristics of an uncleared swap with a flip clause in a teleconference on 16 January 2014. They had not been aware of these risk characteristics such as a flip clause when preparing the working paper. It is available at: https://www.imf.org/external/pubs/ft/wp/2013/wp13255.pdf.

[61] See the section entitled "Other Public Interest Considerations" pp. 94-97.

[62] Per an architect friend who added: "I do like the building analogy because it demonstrates that only those who are involved in setting up these [complicated finance] constructs really understand the danger to the unsuspecting public."

As a first step in calibrating the cost/benefit analysis, the Commission must *adjust* the baseline assumption of the cost/benefit analysis of uncleared swaps and uncleared security-based swaps by 180 degrees as follows:

> *"Uncleared swaps and uncleared security-based swaps that are artificially cheap increase the costs and reduce the benefits to the economy, rather than vice-versa."*

In doing so, the Commission will *purge* the cost/benefit analysis of the marketing mantras that the financial industry represents as being empirically-driven findings.

For instance, uncleared swaps and uncleared security-based swaps do *not* hedge the risk exposures of end users. These swaps, simply by their nature as contracts, *add* to the risk exposures of an end user. More contractual obligations mean more that can go wrong.

The intrinsic characteristic of an uncleared swap or an uncleared security-based swap — namely, that it is a one-off, highly-negotiated, bilateral contract — enables either party or both to laden the contract with convenient provisions that are potentially loss-inducing.

The result is a highly-idiosyncratic contract with risk characteristics that differ markedly — and thus evolve differently — from other, ostensibly similar contracts.

Moreover, most uncleared swaps, uncleared security-based swaps and uncleared options also add to the idiosyncratic exposures that US taxpayers underwrite, given that a significant amount of these derivatives are booked in the government-insured subsidiaries of one of a few bank holding companies.[63]

More unfortunately still for US taxpayers, their involuntary backstop incentivizes parties to routinely undercapitalize uncleared swaps and uncleared security-based swaps, i.e., to evade accountability in designing and effectuating the swaps. As a result, each uncleared swap and uncleared security-based swap is likely to contain many loss-inducing provisions and be insufficiently capitalized.

The taxpayer backstop for most uncleared swaps, security-based swaps and options argues *against* imbuing the cost/benefit analysis with the veneer of hard-science rigor.

> *"How precise can a cost/benefit analysis be given that at least one party to most uncleared swaps and uncleared options is in an FDIC-insured subsidiary?"*

The data limitations that the idiosyncratic risk characteristics of an uncleared swap or uncleared security-based swap impose on cost/benefit analysis are not inconsistent with the sectors' early stage of development.[64] After all, these contract types are less than 30 years old. As with other comparatively new products, uncleared swaps and uncleared security-based swaps deliver less than proponents claim.

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[63] Tyler Durden, 'Presenting the USD 303 Trillion in Derivatives that US Taxpayers are Now on the Hook For' *Zerohedge.com* (13 December 2014).

[64] Several industry groups made a self-inculpatory admission that underscored the immaturity of the market for uncleared swaps in early 2017. *As of February 2017, less than 6% of financial end users could comply with the looming implementation date for the swap margin rules of 1 March 2017, even though the CFTC and prudential regulators had set this date 14 and 16 months earlier, respectively*. In response, the CFTC issued the CFTC Letter No. 17-11 of 13 February 2017, which extended the implementation date to 1 September 2017. This letter is available at: http://www.cftc.gov/idc/groups/public/@lrlettergeneral/documents/letter/17-11.pdf.

Collectively, artificially cheap, uncleared swaps continue to wreak havoc on the US economy by distorting price signals and thereby directing capital to sub-optimal uses. This distorted pricing represents a failure of market accountability and capitalism.

In fact, artificially cheap, uncleared swaps may well have engendered the endemically slow growth that has accompanied the emergence and growing use of these swaps in the last 30 years.[65] On its own, the potential that artificially cheap, uncleared swaps will continue to be a drag on useful investment and economic growth indicates that these swaps are a cost to the economy and not a benefit.

Certainly, the proliferation of artificially cheap, uncleared swaps drove the US and global financial system into near collapse and obligated US taxpayers to provide massive bailouts and implicit support to the financial sector. The potential for artificially cheap, uncleared swaps to do the same again is clearly a cost.

SDs Exposed to a Flip Clause in an Uncleared Swap are *Woefully* Undercapitalized

A walkaway, flip clause or similar provision in an uncleared swap enables one party to cease making payments owed the second party following certain instances of its credit-impairment. Typically, these instances include bankruptcy, insolvency, non-performing status or the second party having incurred an event of default under the uncleared swap, another contract or a financial instrument.

"Walkaway clauses, including those that permit a party to suspend or condition payment, are not enforceable against the FDIC when acting as receiver or conservator of an insured depository institution or as receiver of a financial company under Title II of the Dodd Frank Act, or against the FHFA when acting as a receiver or conservator of Fannie Mae, Freddie Mac, or a Federal Home Loan Bank."[66]

This is for good reason. The circumstance that allow one counterparty to activate a walkaway clause — the severe credit-impairment of the second party — enable *all* its counterparties with a walkaway to activate it at the same time. The 100% correlation of walkaway activation would strip an insured depository institution, financial company or government-sponsored entity of swap assets *after* it had already become severely credit-impaired. Clearly, this would defeat the purpose of receivership or conservatorship — i.e., to preserve the assets of the credit-impaired entity and thereby limit losses to US taxpayers.

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[65] Stephen Mihm, Associate Professor of History at University of Georgia, posits that an inverse relationship exists between the size of the financial sector and its utility to the broader economy. "[T]here is growing literature within economics that examines the possibility that inequality, household debt and financial crises may be related… As in our own age, *the growing dominance of finance in the 1920s* [italics added] went hand in hand with another trend: rising inequality…it's hard to read these as anything but a misallocation of economic resources. *In each instance, the metastatic growth of finance* [italics added] along with staggering amounts of debt, yielded towers of leverage that came crashing down. And then, as now, this had real effects on the larger economy." Stephen Mihm, 'When Europe Sneezed. A new history of the Depression looks beyond Wall Street to the global roots of the crisis.' [Review of the book *A Rabble of Dead Money. The Great Crash and the Global Depression: 1929-1939*, by Charles R. Morris.] *The New York Times Book Review* (23 April 2017).

[66] See Prudential Regulators, 'Margin and Capital Requirements for Covered Swap Entities,' footnote 124. This document is available at: https://www.occ.treas.gov/news-issuances/news-releases/2015/nr-occ-2015-142aaa.pdf.

Flip clauses — "provisions in structured finance documents that reverse or 'flip' the priority of payment obligations owed to swap counterparties on the one hand and noteholders on the other, following a specified event of default" [67] — operate very similarly to walkaway clauses.

"A flip clause is a fallback against failed replacement that subordinates the obligation of an ABS issuer to pay a termination amount to an insolvent counterparty when an asset pool has appreciated — i.e., to walk away from the securitization swap without making any termination payment at all."[68]

A securitization or structured product issuer that activates a flip clause reduces or even eliminates all payments that were owed a SD, MSP, CSE or other swap provider just a moment prior to the activation.[69] As is the case with a walkaway clause, an SD, MSP, CSE or other swap provider will incur this loss when insolvent or otherwise non-performing — i.e., at the time that the impaired swap provider already poses a grave risk to financial stability.

The uncleared swap with a flip clause has been the go-to swap of the securitized and structured product sectors for 20 years *precisely* because it adds to the risks of both parties and allows each to undercapitalize the respective risks of the swap, not despite this capacity.

"Without a flip clause, an ABS issuer cannot justify holding zero reserves against ABS losses that may arise from counterparty insolvency. (With a flip clause, a counterparty cannot justify valuing a securitization swap that is an asset at full mark-to-market, given that receipt of the asset is largely a function of the counterparty's own credit profile rather than that of the ABS issuer.)"[70]

The track record of uncleared, undercapitalized swaps with flip clauses during the financial crisis speaks volumes — much went wrong with the both the swaps and the borrowing that the swaps had facilitated.

The recklessness of an SD or MSP that provides an uncleared swap or uncleared security-based swap with a flip clause, walkaway or similar provisions should be very well known to the CFTC Division of Swap Dealer and Intermediary Oversight, based on my submissions to it and discussion with its staff in 2015, 2016 and 2017.

Moreover, these deficiencies are a widely-known open secret within the legal, rating, securitization, and structured finance communities, to name just a few.[71]

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[67] See William J. Harrington, 'Re: Rule Comment Number 466-1,' Comment to the SEC (3 June 2013). PDF-numbered p. 22. This submission is available at https://www.sec.gov/comments/4-661/4661-28.pdf. See also William J. Harrington, Letter to the SEC and ESMA of 11 September 2013. Pages 12-13. This letter is available at: http://www.wikirating.org/data/other/20130917_Harrington_J_William_ABS_Losses_Attributable_to_Securitization_Swaps.pdf.

[68] See William J. Harrington, 'Re: Rule Comment Number 466-1,' Comment to the SEC (3 June 2013). PDF-numbered p. 3. This submission is available at https://www.sec.gov/comments/4-661/4661-28.pdf.

[69] See Karen O'Flynn and Flora Innes, 'The Courts flip-flopping (again) on the validity of 'flip clauses,' Clayton Utz (1 September 2016) regarding the rule in *Lehman Brothers Special Financing Inc. vs. Bank of America National Association et al*. This note is available at: https://www.claytonutz.com/knowledge/2016/september/the-courts-flip-flopping-again-on-the-validity-of-flip-clauses.

[70] Ibid.

[71] Ibid. "However, LBSF will no doubt appeal Judge Chapman's decision and, in doing so, prolong the wait for a final resolution for *all* [italics added] who are affected." Defendant banks include: Bank of America, National Association; Goldman Sachs & Co.; Goldman Sachs International; Merrill Lynch, Pierce, Fenner & Smith Incorporated; Merrill Lynch International; and US Bank.

These communities rely on the SEC and the CFTC to perpetuate the open secret of this recklessness by ignoring it in rule making and by issuing no-action letters such as the CFTC Letter No. 15-21 of 31 March 2015[72] and the SEC Letter No-Action Letter of 23 November 2010 addressed to Ford Motor Credit Company LLC.[73]

For its part, the SEC allows nationally recognized statistical rating organizations (NRSROs) to perpetuate a rating-based, risk arbitrage that incentivizes issuers of securitization and structured product issuers to offset the potential depreciation of securitized assets via-a-via rated debt by entering into uncleared and unmargined swaps with flip clauses rather than by purchasing options or securitizing additional assets.[74]

In the absence of this rating-based, risk arbitrage, an issuer of securitization or structured product debt *should* be indifferent between the three approaches. The flip clause is key to this rating-based, risk arbitrage and its preservation by the Commission — the principal US regulator of derivative contracts — is both an embarrassment and an extremely unsound risk management practice.

When a securitization or structured product issuer activates a flip clause in terminating an uncleared swap or uncleared security-based swap, an SD or MSP is due payment of as little as USD 0.00 for the extinguishment of what had been an asset just an instant earlier.

This will be the case regardless of the extent to which the uncleared swap had been an in-the-money asset to an SD or MSP. An asset of USD 1,000.00 or USD 1,000,000.00 or even USD 1,000,000,000.00 will be terminated with the SD or MSP receiving as little as USD 0.00.

Moreover, 100% of the securitization and structured product issuers with a flip clause in an uncleared swap or uncleared security-based swap with an SD or MSP that is bankrupt, insolvent, non-performing, or similarly credit-impaired are likely to activate the respective flip clauses simultaneously.

In other words, an SD or MSP with a portfolio of uncleared swaps or uncleared security-based swaps with a flip clause is exposed to receiving USD 0.00 per USD 1.00 owed under 100% of those swaps that are in-the-money.

For instance, if 44 separate securitization issuers each simultaneously actives a flip clause with the same bankrupt SD, the total payout to that SD remains USD 0.00 even though the sum of written-off swap assets increased 44-fold.

The bankruptcy of Lehman Brothers provided a real-world example of a bankrupt swap provider that received USD 0.00 per USD 1.00 owed under 100% of in-the-money, uncleared swaps that contained flip clauses with 44 securitization issuers. United States Bankruptcy Judge Shelley C.

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[72] The CFTC Letter No. 15-21 of 31 March 2015 is available at: http://www.cftc.gov/idc/groups/public/@lrlettergeneral/documents/letter/15-21.pdf.

[73] The SEC Letter No-Action Letter of 23 November 2010 addressed to Ford Motor Credit Company LLC is available at: https://www.sec.gov/divisions/corpfin/cf-noaction/2010/ford072210-1120.htm.

[74] See William J, Harrington, 'Re: File Number S7-18-11, Request for Re-proposal Relating to Nationally Recognized Statistical Rating Organizations,' (29 May 2014) p. 14. This submission is available at: https://www.sec.gov/comments/s7-18-11/s71811-84.pdf.

Chapman detailed these "payments" of USD 0.00 in a ruling on *Lehman Brothers Special Financing Inc. vs. Bank of America National Association et al of 28 June 2016.*[75]

"Upon providing notice of an Event of Default under the Swaps and the Indentures, the Trustees liquidated the assets, including the Collateral securing the Issuers' obligations under the Swaps and Indentures, and deposited the proceeds into accounts held by each Trustee for that purpose. The Trustees subsequently distributed the proceeds pursuant to the applicable Waterfall (the "Distributions"). In each instance, the Trustees applied Noteholder Priority because the Early Terminations were the result of an Event of Default and LBSF was the Defaulting Party. *The amount of the proceeds of the liquidation of the Collateral was insufficient to make any payment to LBSF [italics added] under the Waterfall after proceeds were paid pursuant to Noteholder Priority*."

Unfortunately, Judge Chapman went on to confuse cause and effect by characterizing the broader financial crisis as "a time we truly hope was a 'singular' event."

In fact, Lehman Brothers was not an unlucky bystander to the crisis nor was the company blindsided by the 100% losses that it incurred under 100% of uncleared swaps with flip clauses that were in-the-money assets. These swaps performed exactly as Lehman Brothers *itself* and other global counterparties had both structured and advertised.

The shoddy practices of the financial sector writ large — accountants, counsel, investors, issuers, investors, Lehman Brothers, Lehman Brothers trading partners, other swap providers, rating agencies, regulators and underwriters — made the financial crisis inevitable.

In other words, there was nothing "singular" about the financial crisis. Nor can "hope" alone prevent a recurrence. Robust capital, liquidity and financial reporting requirements are needed.

For instance, defendant banks in *Lehman Brothers Special Financing Inc. vs. Bank of America National Association et al* included: Bank of America, National Association; Goldman Sachs & Co.; Goldman Sachs International; Merrill Lynch, Pierce, Fenner & Smith Incorporated; Merrill Lynch International; and US Bank.

Each institution has first-hand knowledge of the 100% losses that an SD or MSP can incur under 100% of the uncleared swaps or uncleared security-based swaps with a flip clause, walkaway or similar provision that are in-the-money.

Yet, many of these same institutions, as well as many SDs, also *provide* this very same type of swap and similarly assume the very same risk of 100% loss of 100% of swap assets without making special provisions or holding offsetting capital.

Following is a list of reckless providers of uncleared swaps with RAC provisions and flip clauses to student loan asset-backed transactions that Navient Corporation originated or sponsors.

Among these reckless swap providers are SDs such as: Bank of America NA; The Bank of New York; Citibank N.A.; Barclays Bank PLC; BNP Paribas SA; Deutsche Bank AG; JP Morgan Chase Bank National Association; Morgan Stanley Capital Services LLC; Royal Bank of Canada; The Royal Bank of Scotland, plc; and Wells Fargo Bank NA.

[75] "Memorandum Decision on Omnibus Motion of the Noteholder Defendants to Dismiss the Fourth Amended Complaint signed on 6/28/2016" by Judge Shelley C. Chapman is available at: http://www.nysb.uscourts.gov/sites/default/files/opinions/202553_1360_opinion.pdf.

Navient and Navient-Sponsored Private Student Loan Securitizations with Uncleared, Balance-Guaranteed[76] Swaps that Reference the Prime Rate and LIBOR and Contain Flip Clauses and RAC Provisions and Respective Swap Providers (Shading denotes an SD)

Sources: Navient Website; Rating Agency Announcements and Reports; and CFTC.gov.

1. SLM Private Credit Student Loan Trust 2002-A – Merrill Lynch Derivative Products AG
2. SLM Private Credit Student Loan Trust 2003-B – 2 Counterparties: 1. Merrill Lynch Derivative Products AG; & 2. Citibank, N.A.
3. SLM Private Credit Student Loan Trust 2003-C – 2 Counterparties: 1. Merrill Lynch Derivative Products AG; & 2. JPMorgan Chase Bank North America
4. SLM Private Credit Student Loan Trust 2003-A – 2 Counterparties: 1. Merrill Lynch Derivative Products AG; & 2. Citibank, N.A.
5. SLM Private Credit Student Loan Trust 2004-A – JPMorgan Chase Bank NA
6. SLM Private Credit Student Loan Trust 2004-B – JPMorgan Chase Bank NA
7. SLM Private Credit Student Loan Trust 2005-A – Morgan Stanley Capital Services
8. SLM Private Credit Student Loan Trust 2005-B – Royal Bank of Scotland
9. SLM Private Credit Student Loan Trust 2006-A – Deutsche Bank New York
10. SLM Private Credit Student Loan Trust 2006-B – Deutsche Bank New York
11. SLM Private Credit Student Loan Trust 2006-C – Bank of America NA
12. SLM Private Credit Student Loan Trust 2007-A – Credit Suisse First Boston International
13. SLM Private Education Student Loan Trust 2010-B – Royal Bank of Scotland
14. SLM Private Education Student Loan Trust 2010-C – Royal Bank of Scotland
15. SLM Private Education Student Loan Trust 2011-C – Royal Bank of Canada, Toronto
16. SLM Private Education Student Loan Trust 2012-A – GSMMDP
17. SLM Private Education Student Loan Trust 2012-B – Bank of New York
18. SLM Private Education Student Loan Trust 2012-C – Bank of New York
19. SLM Private Education Student Loan Trust 2012-D – Royal Bank of Canada, Toronto
20. SLM Private Education Student Loan Trust 2012-E – Bank of New York
21. SLM Private Education Student Loan Trust 2013-A – Bank of New York
22. SLM Private Education Student Loan Trust 2013-B – Bank of New York
23. SLM Private Education Student Loan Trust 2013-C – Bank of New York
24. SLM Private Education Student Loan Trust 2014-A – Bank of New York
25. Navient Private Education Student Loan Trust 2014-CT – JPMorgan Chase Bank NA
26. Navient Private Education Loan Trust 2014-A – Royal Bank of Canada
27. Navient Private Education Student Loan Trust 2014-CT – JPMorgan Chase NA
28. Navient Private Education Loan Trust 2015-A – Royal Bank of Canada
29. Navient Private Education Loan Trust 2015-B – Wells Fargo Bank
30. Navient Private Education Loan Trust 2015-C – JPMorgan Chase Bank NA
31. Navient Private Education Loan Trust 2016-A – JPMorgan Chase Bank NA

Navient and Navient-Sponsored Student Loan Securitizations with Uncleared, Balance-Guaranteed[77] Swaps that Reference Currencies and Contain Flip Clauses and RAC

[76] "Residential mortgage ABS and student loan ABS have pronounced exposure to counterparty risk, given their reliance on a highly idiosyncratic type of swap: a balance-guarantee swap with a flip clause. 'Balance guarantee' indicates that the swap offsets two mismatches in payment characteristics between securitized assets and ABS — a standard mismatch such as that between basis rates, interest rates, or currencies and a second, highly idiosyncratic mismatch between prepayment rates." See William J, Harrington, 'Re: File Number S7-18-11, Request for Re-proposal Relating to Nationally Recognized Statistical Rating Organizations,' (29 May 2014) p. 14. This submission is available at: https://www.sec.gov/comments/s7-18-11/s71811-84.pdf.

[77] In 2006, a major swap provider concluded that "balance-guaranteed" uncleared swaps in the RMBS sector could not be replaced. See William J. Harrington, 'Re: Rule Comment Number 466-1,' Comment to the SEC (3 June 2013) PDF-numbered pp. 25-29. "Under the RAC, BSFP presented RMBS issuers with a derivative contract that made failure by BSP to post collateral at the Second Trigger an Additional Termination Event rather than an Event of Default. *The*

Provisions and Respective Swap Providers (Shading denotes an SD)
Sources: Navient Website; Rating Agency Announcements and Reports; and CFTC.gov.

1. SLM Student Loan Trust 2003-2 – CDC IXIS Capital Markets (Euro 187mm / USD 203mm)
2. SLM Student Loan Trust 2003-5 – CDC IXIS Capital Markets (Euro 270mm / USD 309mm)
3. SLM Student Loan Trust 2003-7 – CDC IXIS Capital Markets (Euro 490mm / USD 550mm)
4. SLM Student Loan Trust 2003-10 – CDC IXIS Capital Markets (GBP 1.25bn / USD 1.7bn)
5. SLM Student Loan Trust 2003-12 – Citibank (GBP 400mm / USD 670mm)
6. SLM Student Loan Trust 2004-2 – CDC IXIS Capital Markets (Euro 796mm / USD 1bn)
7. SLM Student Loan Trust 2004-5 – Swiss Re Financial Products (Euro 760mm / USD 930mm)
8. SLM Student Loan Trust 2004-10 – AIG Financial Products Corp. (Euro 408mm / USD 501mm)
9. SLM Student Loan Trust 2005-9 – Deutsche Bank NY (Euro 500mm / USD 597mm)
10. SLM Student Loan Trust 2006-4 – 2 Counterparties: 1. Credit Suisse First Boston International (Euro 436mm / USD 530mm); and 2. Banque Nationale De Paris (Euro 436mm / USD 530mm)
11. SLM Student Loan Trust 2006-6 – Barclays Capital Markets (Euro 372mm / USD 473mm)
12. SLM Student Loan Trust 2006-10 – Barclays Capital Markets (Euro 302mm / USD 386mm)
13. SLM Student Loan Trust 2007-4 – Barclays Capital (Euro 305mm / USD 406mm)
14. SLC Student Loan Trust 2008-01 – Credit Suisse First Boston International (euro 134mm / USD 208mm)

Flip Side of the Flip Clause: Undercapitalized ABS are also Systemically Dangerous

The presence of a common, rating-based provision in the uncleared swap or uncleared security-based swap *increases* the likelihood that an SD or MSP will still have the swap on its books when it encounters financial distress and thus remain exposed to the activation of a flip clause.

This is even though remedial provisions in these swaps *ostensibly* direct the SD or MSP to take pre-emptive action such as novating or transferring the swap to another swap provider ("replacement") to limit exposure to a flip clause. However, SDs and MSPs have avoided replacing themselves[78] simply by obtaining a letter or other communication from a rating agency that the "rating agency condition" (RAC) is satisfied without such replacement having occurred.[79]

Uncleared swaps with RAC provisions and flip clauses contributed to the undercapitalization of whole sectors of securitization debt and structured product debt. This undercapitalized debt started the financial crisis, exacerbated it, failed in some cases and benefited from significant government support in other cases.

Many of these undercapitalized sectors — cashflow CDOs; cashflow TRuPS CDOs; cashflow CDO-squared; cashflow RMBS; repackaged securitizations of all sectors; structured credit

BSFP rationale in petitioning for RAC was that balance-guarantee hedges with RMBS issuers could not be replaced [italics added] and BSFP lacked resources to post collateral for the duration of each balance-guaranteed swap." See also PDF-numbered page 40, footnote 53. This submission is available at https://www.sec.gov/comments/4-664661-28.pdf.

[78] Lukas Becker and Catherine Contiguglia, 'Moody's Bank Swap Ratings May Halt ABS Downgrades' *Risk.net* (17 June 2015). "Several dealers involved in ABS deals have fallen below the second trigger following a series of bank ratings downgrades since 2012. However, finding other counterparties to step into the trades has been extremely tricky due to the dearth of highly rated and the *complexity of pricing* [italics added] involved."

[79] Norbert Gaillard and William J. Harrington, 'Efficient, commonsense actions to foster accurate credit ratings,' Capital Markets Law Journal (2016) 11 (1): 38-59. Footnotes 41, 42 and 44 describe RACs generally and with respect to the failure of swap providers of uncleared swaps with RAC provisions and flip clauses to replace these swaps.

default swaps; structured notes of all securitization sectors; synthetic CDOs; and synthetic RMBS — are the poster children of the financial crisis.

However, the remaining securitization sectors — e.g., those backed by auto loans, credit cards, equipment leases, levered loans and student loans — were also undercapitalized owing to the presence of uncleared swaps with RAC provisions and flip clauses.

These sectors benefited indirectly from the explicit bailouts and other support that the US government provided to global counterparties after Lehman Brothers failed. Without this government support, the undercapitalization of these remaining securitization sectors might have caused them to follow the poster children sectors into complete and ignominious collapse.

Response Organization

This response addresses each question in the CFTC Proposal in the order of appearance therein. See pages 23-121.

This response also contains five appendices. See pages 122-171.

Staff of the CFTC Division of Swap Dealer and Intermediary Oversight laid out their conditions for accepting and posting a proposal response such as this one in an email to me of 9 March 2016. I have strictly observed the CFTC conditions in writing this response.

Appendix C to this response, pages 136-142 contains the CFTC email of 9 Mach 2016 and others between the CFTC staff and me. The section below that describes Appendix C also details the email of 9 March 2016.

Appendix A, pages 122-133, contains an email correspondence that a spokesperson from Fitch Ratings, Inc. (Fitch) and I conducted from 17 November 2016 to 11 January 2017. We each copied Fitch derivative analysts, the CFTC Office of Inspector General and CFTC, SEC and SFIG staff in this correspondence.

In the email of 11 January 2017, I posed 13 questions that highlighted the lack of either empirical or legal bases for key rating constructs such as *replacement* that are cited repeatedly in Fitch derivative methodologies for securitization issuers. The Fitch spokesperson and staff had not replied to any of the 13 questions at the time of this writing.

Fitch and five other NRSROs have long specified replacement and other rating constructs such as RAC provisions and flip clauses as the key underpinnings of their respective methodologies for the derivative contracts that securitization and structured product issuers use.

The six NRSROs are: DBRS, Inc. (DBRS); Fitch; Kroll Bond Rating Agency, Inc. (KBRA); Moody's Investors Service (Moody's); Morningstar Credit Ratings, LLC (Morningstar); and S&P Global Ratings (S&P). The respective derivative methodology of four of these NRSROs — DBRS, Fitch, Moody's and S&P — also contains the template of an uncleared swap that effectuates the shared rating constructs.

An uncleared swap based on the entirety or even a portion of the Fitch template will *fully* insulate securitization debt against losses that might otherwise arise from the bankruptcy or insolvency of a derivative provider such as an SD, according to Fitch methodologies, rating announcements and sector commentary.[80] Accordingly, Fitch assigns a rating of as high as AAA to securitization debt where a securitization issuer has implemented at least *some* of the template elements in an uncleared swap contract.[81]

In the same email of 11 January 2017, I recounted my having publicly questioned SEC Commissioner Piwowar on margin posting for uncleared swaps with flip clauses and on the enforceability of flip clauses at two conference in 2015 — "Capital Unbound: the Cato Summit on Financial Regulation" in New York City on 2 June 2015 and "The Economics of Credit Rating Agencies, Credit Ratings and Information Intermediaries" at Carnegie Mellon Tepper School of Business in Pittsburgh from 3-5 December 2015.

Acting Chair Giancarlo spoke at the Cato Summit and was present when I posed my question to Commissioner Piwowar. I contacted the staff of both commissioners repeatedly to follow up but received no response from either staff.

Lastly, my email of 11 January 2017 contained the following information: "My comment letter to the prudential regulators of 31 January 2016 contains both my letter of 15 May 2015 and email of 7 April 2015. Please see Appendix A (pp. 6-22) and Appendix B (pp. 23-24), respectively. https://www.fdic.gov/regulations/laws/federal/2015/2015-covered_swap_entities_3064%E2%80%93AE21-c02.pdf."

The FDIC scrubbed the above-mentioned letter to the prudential regulators of 31 January 2016 from FDIC.gov sometime after 11 January 2017. This purging is a violation of law and may jeopardize the effectiveness of the interim final rule that my letter addressed.

Accordingly, I include my letter to the prudential regulators of 31 January 2016 as Appendix E to this response. Please see further below.

In the email of 21 December 2016, I posed six questions regarding the inaccurate statements on uncleared swaps with RAC provisions and flip clauses that Fitch published in the announcement "Pending U.S. swap rules could impact structured finance transactions" of 17 November 2016.

In particular:

> "*Had Fitch misinformed the public, the CFTC and the SEC in making these inaccurate statements regarding uncleared swaps with RAC provisions and flip clause?"*

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[80] The derivative methodologies of Fitch, Moody's, and S&P explicitly state that key provisions may be absent from uncleared swaps with RAC provisions and flip clauses between ABS issuers and SDs. See William J. Harrington, 'Re: Rule Comment Number 4-661,' Comment to the SEC (3 June 2013). The PDF-numbered pages 110-115 describe Moody's commentary on the partial incorporation of its swap template into uncleared swaps with flip clauses between ABS issuers and SDs. This document is available at: https://www.sec.gov/comments/4-661/4661-28.pdf.

[81] Other NRSROs also assign AAA ratings to debt when an issuer has effectuated *only a portion* of the respective swap template. For instance, DBRS has assigned a AAA rating to the Class A Notes **of Navient Private Education Loan Trust 2015-C** since the transaction closed on 10 December 2015 *despite* the omission of a key provision of the DBRS template in the uncleared, balance-guaranteed swap with RAC provisions and a flip clause. "A DBRS downgrade of the Swap Counterparty would not obligate the Swap Counterparty to provide certain remedial actions per the transaction's swap documents," according to the DBRS pre-sale report dated 30 November 2015. Typically, replacement is one of these remedial actions that a NRSRO swap template specifies.

Appendix B, pages 134-135, contains an email correspondence that I conducted with 21 addressees including 19 Moody's derivatives analysts and managers from 12 May 2011 to 16 May 2011. Many of the addressees were colleagues during my 11-year tenure at Moody's from June 1999 to July 2010.

I initiated the correspondence on 12 May 2011 to apprise the Moody's analysts and managers of the deficient replacement assumptions that were a key aspect of Moody's methodology for uncleared, unmargined swaps with RAC provisions and flip clauses.

As background, I had resigned as a Moody's senior vice president in 2010 after concluding that the company would prevent me from conducting a rigorous and interdisciplinary evaluation of the capitalization of counterparties to derivative contracts such as uncleared swaps with RAC provisions and flip clauses.[82]

A few months before my resignation, a Moody's senior manager asked me to join the credit policy group. This group oversees the development of methodologies for derivative contracts and other instruments that committees both rate and use as inputs to other ratings.

My review of *all* the methodologies for derivative contracts that Moody's has published since my resignation has validated my decision to resign.

> *Moody's derivative methodologies are fanciful concoctions that serve a single purpose — enable Moody's to assign ratings of as high as AAA to undercapitalized debt and issuers.*[83]

My review of *all* the methodologies for *all* types of derivative contracts of *all* NRSROs has prompted me to expand this assessment.

No NRSRO allows analysts or rating committee to use best-faith methods to evaluate the capitalization of debt or issuers in any sector — corporate, financial, municipal, securitization, sovereign, structured or supranational — that is backed by or is party to a derivative contract.[84]

Sixteen of the Moody's addresses in the email exchange of May 2011 continue their respective work as a Moody's derivatives analyst or manager. In these capacities, all continue to assign inflated ratings to undercapitalized securitization debt and uncleared swaps by ignoring the deficient assumptions such as replacement in Moody's methodologies for uncleared, unmargined swaps with RAC provisions and flip clauses.

Appendix C, pages 136-142, contains an email correspondence that I conducted with staff of the CFTC Division of Swap Dealer and Intermediary Oversight from 4 March 2016 to 17 October 2016. I also included the CFTC Office of Inspector General in this correspondence from 31 March 2106 onward.

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[82] William J. Harrington, 'Re: File Number S7-18-11— Comment on SEC Proposed Rules for Nationally Recognized Statistical Rating Organizations,' Comment to the SEC (8 August 2011) available at: https://www.sec.gov/comments/s7-18-11/s71811-33.pdf.

[83] Bill Harrington, 'Moody's DOJ Settlement Won't Stop Fake Rating Analysis & Derivatives Denial,' (17 January 2017). This article is available at: https://www.linkedin.com/pulse/moodys-doj-settlement-wont-stop-fake-rating-analysis-bill-harrington.

[84] Ibid. See section entitled "The 800-page gorilla — rating methodologies are protected speech."

The staff of the CFTC Division of Swap Dealer and Intermediary Oversight were assessing the Interim Final Rule of the Margin Requirements for Uncleared Swap Dealers and Major Swap Participants (CFTC Interim Final Rule). Many of these CFTC staff will also evaluate responses to the CFTC Proposal, including this response.

In the email of 4 March 2016, I asked these CFTC staff to schedule an intake call with me.

I wanted to discuss my response to the CFTC Interim Final Rule, which I had submitted one day late on 6 February 2016. Appendix D (pages 143-146) contains the entirety of this response including two appendices.

I had submitted a nearly identical response to the nearly identical interim final rule of the prudential regulators *ahead* of the respective common deadline of 31 January 2016, i.e. a week earlier than the CFTC deadline.

I discussed my response to the prudential regulators of 31 January 2016 in a teleconference with FDIC staff on 31 March 2016.

My response of 31 January 2016 was *formerly* available on the FDIC website.[85] As I mentioned above in the description of Appendix A to this response, the FDIC removed my letter of 31 January 2016 from FDIC.gov sometime after 17 January 2017.

Accordingly, I include my letter to the prudential regulators of 31 January 2016 as Appendix E to this response. Please see further below for a description of Appendix E.

My response to the prudential regulators of 31 January 2016 *remained* available on the website of the FCA at the time of this writing.[86]

Immediately below is a screenshot of the FCA entry for my letter as it appeared on the website of the FCA at the time of this writing.

I will continue to track the presence of my response to the prudential regulators of 31 January 2016 on the FCA website.

https://www.federalreserve.gov/SECRS/2016/February/20160217/R-1415/R-1415_013116_130180_508327057758_1.pdf.

The email correspondence with CFTC staff of 4 March 2016 to 17 October 2016 shows that they declined to schedule an intake call with me. The CFTC staff also declined to accept my response

[85] My letter of 31 January 2016 was once available at: https://www.fdic.gov/regulations/laws/federal/2015/2015-covered_swap_entities_3064%E2%80%93ae21-c02.pdf.

[86] William J. Harrington, 'Re: Margin and Capital Requirements for Covered Swap Entities; Interim Final Rule to Exempt Commercial End Users and Small Banks (Federal Register Vol. 80, No. 229, Pages 74916-74924)' & 'Re: Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants; Interim Final Rule (Federal Register Vol 81, No. 3, Pages 636-638),' Comment to: Department of Treasury, Office of the Comptroller of the Currency; Federal Reserve System; Federal Deposit Insurance Corporation; Farm Credit Administration; Federal Housing Finance Agency; and Commodities Futures Trading Commission (31 January 2016). This comment is available at: https://ww3.fca.gov/projectws/regdev/Lists/Public%20Comments/DispForm.aspx?ID=6039.

to the CFTC Interim Final Rule of 6 February 2016, owing to its having been submitted a day late.

However, the CFTC staff *did* specify the strict terms that they observed in deciding whether to accept or reject a response in their email of 9 March 2016. I have taken these terms to heart in preparing this response — hence its length.[87]

"It is our standard procedure to address every comment in the preamble (except the odd, obvious prank letters), regardless of usefulness, as long as it was submitted following the procedures and timelines set out in the Federal Register releases. Last year we relaxed our process but that may have been a mistake. The comment period for the IFR closed before your letter was submitted so it will not be part of the record nor posted in our public site."

However, this and other of the CFTC emails also highlighted, perhaps inadvertently, that the CFTC staff themselves were unaware of CFTC policy regarding the applicability of the swap margin rules to certain hedging swaps of certain securitization vehicles of "captive finance companies."

The CFTC uncertainty on this point prompted me to conduct more research in 2016. This work corroborated the thrust of my response to the CFTC Interim Final Rule of 6 February 2016.

My research also corrected a mistaken assumption that securitization participants had widely shared.

My own email of 9 March 2016 lists the CFTC Letter No. 15-27 of 5 May 2015,[88] which some securitization participants including counsel, rating agencies and SFIG have incorrectly cited as exempting the hedging swaps of some securitization issuers from the swap margin requirements. A Moody's publication on the swap margin rule and securitization issuers[89] repeated this erroneous information just last month on 22 May 2017!

However, my research at *Debtwire ABS* in 2016 demonstrated that the CFTC had made no such determination. In short, the CFTC had not exempted *any* securitization issuers from the swap margin rule in 2015, in 2016 or at the time of this writing in 2017.

Debtwire ABS posted my first article on this topic — "Auto ABS still part of the margin-posting pack; road diverges ahead?" — on 4 April 2016.

This article is not on the *Debtwire ABS* public site. Following is the relevant excerpt.

"Earlier CFTC relief for ABS vehicles of captive finance companies not transferrable to margin posting

"As part of the swap margin rules adopted in 2015, the prudential regulators and the CFTC each established an interim final rule and comment period with respect to the exemption for

[87] In the matter of preparing a comprehensive response, I follow the example of Commissioner Giancarlo. He has produced white papers of 100-pages or more.
[88] The letter and press announcement are available at: http://www.cftc.gov/PressRoom/PressReleases/pr7169-15.
[89] Edward Manchester and Heidi J. Schmid, 'Proposed Changes to Moody's Rating Criteria Reflect New Swap Margin Rules,' Moody's Investors Service (22 March 2017). Footnote 7: "Certain structured finance issuers may qualify for the 'captive finance company' exemption — see CFTC Letter No. 15-27."

captive finance companies. Neither of the interim final rules linked the captive finance companies to respective ABS vehicles.

"Neither did either of the interim final rules make reference to the CFTC Letter No. 15-27 of 4 May 2015…

"Finally, neither the prudential regulators nor the CFTC revised the respective interim final rules subsequent to the respective comment periods. As a result, the interim final rules in their original form — i.e., without reference to the CFTC Letter No. 15-27 — took effect Friday along with the other components of the swap margin rules.

"'CFTC Letter 15-27 does not provide relief from the uncleared margin requirement. The uncleared margin requirements had not been finalized when CFTC Letter 15-27 was published,' said a source familiar with the matter.

"If the captive finance companies wish to clarify whether or not their ABS vehicles will be exempted from the swap margin rule, 'they can make a request' along those lines to the applicable regulator, stated the source."

I wrote three more *Debtwire ABS* articles that showed that the CFTC had not changed course as of August 2016. The third of these articles — "Existing ABS swaps also caught in the swap margin net" — of 12 August 2016 is posted on the public *Debtwire ABS* site.[90]

Following is the relevant excerpt.

"As an aside, the question of whether the securitization entities of 'captive finance companies' benefit from the TRIPRA exemption for new swaps, and thus amended ones, remains open. The CFTC still had not responded to the following question — Does the hedging swap of an SPV of a 'captive finance company' benefit from the TRIPRA exemption from margin requirements? Debtwire ABS first asked this question more than a week ago, as previously reported (see article, 4 August)."

My cited article — "Swap margin for SPVs of captive finance companies, over to you, CFTC" — of 4 August 2016 is not on the public *Debtwire ABS* site.

Following is the relevant excerpt.

"However, the prudential regulators, as well as the CFTC, have not provided an answer as to whether the TRIPRA exemption applies to hedging swaps used by the SPVs of captive finance companies. The prudential regulators advised checking with the CFTC on this score, as 'there's an aspect of a legal definition that they are best suited to answer,' wrote [a] Federal Reserve spokesperson…in an email response to an inquiry by Debtwire ABS.

"The CFTC had not responded…at the time of this writing."

Appendix D, pages 143-166, contains my response to the CFTC Interim Final Rule dated 6 February 2016.

[90] This article is available at: http://www.debtwire.com/info/existing-abs-swaps-also-caught-swap-margin-net-%E2%80%94-analysis.

The CFTC declined to accept, post or discuss this response owing to my having submitted it a day late. See Appendix C, immediately above.

The CFTC Interim Final Rule addressed Title III of the Terrorist Risk Insurance Program Reauthorization Act (TRIPRA).

In preparing my response of 6 February 2016, I reviewed the TRIPRA Bill Summary & Status, 114th Congress (2015-2016), H.R.26, CRS Summary and the CFTC Margin Requirement for Uncleared Swap Dealers and Major Swap Participants.

My concern was and remains that the CFTC might extend the TRIPRA exemption from the swap margin requirements to the uncleared hedging swaps of those securitization issuers that can be classified as a captive finance company.

My response to the CFTC Interim Final Rule of 6 February 2016 advocated the following three actions.

1. The CFTC should clarify that an uncleared swap "with either a flip clause or a RAC provision does not qualify for an exemption from…the Margin Requirements for Uncleared Swaps for Swap Dealers."

2. A captive finance company using the TRIPRA exemption for an uncleared hedging swap must attest that it does "not have: (1) a flip clause; (2) any other clause that can be reasonably classified as a walk-away provision; or (3) a RAC provision."

3. An SD or MSP must "post both initial margin and variation margin to its guarantor or hedging affiliate against a swap that contains a (1) a flip clause; or (2) any other clause that can be reasonably classified as a walk-away provision."

My response to the CFTC Interim Final Rule of 6 February 2016 had two appendices, both of which are included in Appendix D to this response.

The two appendices contained my correspondence with US and EU regulators from 7 April 2015 to 15 May 2015. I enumerated the many misrepresentations regarding uncleared swaps with RAC provisions and flip clauses that SFIG had made to the CFTC in successfully inducing it to issue the CFTC Letter No. 15-21 of 31 March 2015.

The CFTC Letter No. 15-21 of 31 March 2015 is the letter that Fitch cited in its announcement of 17 November 2016. See Appendix A and the section above that details it.

The first appendix contains my letter to staff of the CFTC including the signatories to the CFTC Letter No. 15-21 of 31 March 2015, of the SEC Office of Credit Ratings and of the ESMA dated 15 May 2015. This letter details 14 misrepresentations that SFIG had made to the CFTC regarding uncleared swaps with RAC provisions and flip clauses.[91]

[91] "Appendix A — WJH Letter 'Re: CFTC Letter No. 15-21 of March 31, 2015, Division of Swap Dealer and Intermediary Oversight 'No-Action Position: Certain Commission Regulations Applicable to Swaps with Legacy Special Purpose Vehicles" Dated 15 May 2015."

A former Moody's colleague and I discussed my letter of 15 May 2015 with the signatories to the CFTC Letter No. 15-21 of 31 March 2015 in a teleconference on 28 May 2015. These signatories may also be evaluating responses to the CFTC proposal including this response.

The second appendix contains my email to staff of the CFTC, of the SEC Office of Credit Ratings, of other US regulators and of the ESMA of 7 April 2015.

This email outlined the SFIG misrepresentations in broad terms and noted that the misrepresentations gave law enforcement authorities grounds to bring actions against the rating agencies.[92]

I discussed these misrepresentations as pertained to Moody's with staff of the attorneys general of 14 states and the District of Columbia in an in-person meeting in New York City on 18 May 2016. These states and the District of Columbia were among the 21 that joined the US Justice Department in settling with Moody's on 17 January 2017.[93]

Appendix E, pages 167-171, contains my letter response to the prudential regulators' interim final rule dated 31 January 2016. See also Appendix C, above.

My letter to the prudential regulators of 31 January 2016 is nearly identical to my letter to the CFTC of 6 February 2016 which is contained in Appendix D to this response and described in the immediately preceding section.

My letter to the prudential regulators of 31 January 2016 advocated the same three actions that I advocated in my letter to the CFTC of 6 February 2016.

My letter to the prudential regulators of 31 January 2016 also included the two appendices are summarized immediately above with respect to my letter to the CFTC of 6 February 2016. For reasons of parsimony, I have omitted these two appendices from this Appendix E.

[92] "Appendix B — April 7, 2015 e-mail to Mr. Thomas Smith, Acting Director, Division of Swap Dealer and Intermediary Oversight: 'CFTC Letter No. 15-21 & Inaccurate Representations of Delinking Criteria.'"

[93] Notice of the settlement is available at: https://www.justice.gov/opa/pr/justice-department-and-state-partners-secure-nearly-864-million-settlement-moody-s-arising.

Responses to Request for Comment, p. 91260

"The Commission requests comment on all aspects of the proposed bank-based capital approach."

Each aspect of the proposed bank-based capital approach ignores the 100% exposure to itself that an SD bears under a flip clause, walkaway or similar provision in an uncleared swap or an uncleared security-based swap. These provisions enable a counterparty to an uncleared swap that is in-the-money to an SD or an uncleared security-based swap that is in-the-money to an SD to write off all payments that would otherwise be due the SD simply because it is bankrupt, insolvent, non-performing or similarly impaired.

As example, one aspect of the proposed bank-based capital approach – the use of credit risk models – typically evaluates only the swap receivables that might not be paid to an SD because a counterparty rather than the SD itself is bankrupt, insolvent, non-performing or similarly impaired. These credit risk models entirely neglect the 100% loss that a credit-impaired SD will incur under an uncleared swap that is in-the-money or an uncleared security-based swap that is in-the-money if the counterparty activates a flip clause, walkaway or similar provision.

The bankruptcy of Lehman Brothers provided a real-world example of a bankrupt swap provider that received USD 0.00 per USD 1.00 owed under 100% of in-the-money, uncleared swaps that contained flip clauses with 44 securitization issuers. United States Bankruptcy Judge Shelley C. Chapman detailed these "payments" of USD 0.00 in a ruling on *Lehman Brothers Special Financing Inc. vs. Bank of America National Association et al of 28 June 2016.*

"Upon providing notice of an Event of Default under the Swaps and the Indentures, the Trustees liquidated the assets, including the Collateral securing the Issuers' obligations under the Swaps and Indentures, and deposited the proceeds into accounts held by each Trustee for that purpose. The Trustees subsequently distributed the proceeds pursuant to the applicable Waterfall (the "Distributions"). In each instance, the Trustees applied Noteholder Priority because the Early Terminations were the result of an Event of Default and LBSF was the Defaulting Party. *The amount of the proceeds of the liquidation of the Collateral was insufficient to make any payment to LBSF [italics added] under the Waterfall after proceeds were paid pursuant to Noteholder Priority*."

To "ensure the safety and soundness of an SD" that is exposed to a flip clause, walkaway or similar provision in an uncleared swap or an uncleared security-based swap, the CFTC must adjust each aspect of the proposed bank-based capital approach to reflect the 100% exposure to itself that an SD bears.

The adjustments must require an SD that is exposed to a flip clause, walkaway or similar provision in an uncleared swap or an uncleared security-based swap to hold capital equal to the following for each such swap and security-based swap.

> The maximum of: [0, 100% of the "uncleared swap margin" as defined in footnote 25 of the CFTC proposal + 100% of the market value of the swap or security-based swap on the books of the SD].
>
> **N.B.** Using the market value of the swap or security-based swap on the books of the SD will ensure its "safety and soundness." Otherwise, the last term may converge to USD 0.00 for

even a deeply in-the-money swap as an SD approaches bankruptcy, insolvency, non-performing status or similar credit-impairment.

"In addition, the Commission requests comment, including empirical data in support of comments, in response to the following questions:"

1. No, the "proposed USD 20mm fixed amount of tier 1 capital" is *not* appropriate when an SD is exposed to a flip clause, walkaway or similar provision in an uncleared swap or an uncleared security-based swap.

   In this case, an SD should hold additional capital equal to the maximum of: [0, 100% of the "uncleared swap margin" as defined in footnote 25 of the CFTC proposal + 100% of the market value of the swap or security-based swap on the books of the SD].

2. No, the "proposed minimum capital requirement based on an SD's common equity tier 1 capital" is *not* appropriate when an SD is exposed to a flip clause, walkaway or similar provision in an uncleared swap or an uncleared security-based swap.

   In this case, an SD should hold additional capital equal to the maximum of: [0, 100% of the "uncleared swap margin" as defined in footnote 25 of the CFTC proposal + 100% of the market value of the swap or security-based swap on the books of the SD].

3. No, the "proposed minimum capital requirement based upon eight percent of the SD's risk weighted assets" is *not* appropriate when an SD is exposed to a flip clause, walkaway or similar provision in an uncleared swap or an uncleared security-based swap.

   In this case, an SD should hold additional capital equal to the maximum of: [0, 100% of the "uncleared swap margin" as defined in footnote 25 of the CFTC proposal + 100% of the market value of the swap or security-based swap on the books of the SD].

4. No, the "proposed minimum capital requirement based upon eight percent of the margin required on the SD's cleared and uncleared swaps and security-based swaps, and the margin required on the SD's futures and foreign futures" is *not* appropriate when an SD is exposed to a flip clause, walkaway or similar provision in an uncleared swap or an uncleared security-based swap.

   In this case, an SD should hold additional capital equal to the maximum of: [0, 100% of the "uncleared swap margin" as defined in footnote 25 of the CFTC proposal + 100% of the market value of the swap or security-based swap on the books of the SD].

   Yes, "ensuring the safety and soundness of an SD" *does* obligate the CFTC to include "in the computation margin for swaps and security-based swaps that are exempt or excluded from the uncleared margin requirements (e.g., legacy swaps and security-based swaps, and swaps with commercial end users)." These "uncollateralized exposures" *do* "result in risk to the SD without capital to address that risk."

5. No, the Commission should *not* "exclude cleared swaps from the capital calculation requirements."

   To "ensure the safety and soundness of an SD," the Commission should include cleared swaps that do not have flip clauses, walkaways or similar provisions in a manner that mirrors "the proposed minimum capital requirement based upon eight percent of the margin required on the SD's cleared and uncleared swaps and security-based swaps, and the margin required on the SD's futures and foreign futures."

   Similarly, for a cleared swap *with* a flip clause, walkway or similar provision, an SD should hold additional capital *equivalent* to the maximum of: [0, 100% of the "uncleared swap margin" as defined in footnote 25 of the CFTC proposal + 100% of the market value of the swap or security-based swap on the books of the SD].

6. No, the CFTC should *not* "limit its capital calculation to uncleared swaps only." The CFTC has a mandate to "ensure the safety and soundness of an SD." To fulfil this mandate, the CFTC must ensure that an SD holds capital commensurate to its exposures under all and not merely a portion of derivative contracts.

   The SEC has a very poor track record with respect to ensuring the "safety and soundness" of any entity or class of financial instruments. In fact, some SEC commissioners and officials have disavowed this responsibility altogether and instead have outlined a much more limited obligation of merely ensuring that capital market participants make adequate disclosures.

   Moreover, my experience at Moody's from 1999 to 2010 and as a private citizen advocate from 2010 to the present date indicates that few if any SEC officials or staff are concerned with the operations and risk exposures of derivative contracts such as cleared swaps, uncleared swaps, futures and foreign futures.

   Why would the CFTC, which is the main US regulator for derivative contracts, adopt this shallow and arguably negligent level of engagement?

   Furthermore, the SEC may entirely abandon remaining Dodd-Frank rulemaking such as that with respect to security-based swaps, according to recent statements by Acting Chair Piwowar.

   SEC rulemaking or lack thereof should not serve as a baseline for CFTC rulemaking.

7. No opinion.

Responses to Request for Comment, pp. 91262-3

"The Commission requests comment on all aspects of the proposed net liquid assets capital approach."

Each aspect of the proposed net liquid assets capital approach ignores the 100% exposure to itself that an SD bears under a flip clause, walkaway or similar provision in an uncleared swap or an uncleared security-based swap. These provisions enable a counterparty to an uncleared swap that is in-the-money to an SD or an uncleared security-based swap that is in-the-money to an SD to write off all payments that would otherwise be due the SD simply because it is bankrupt, insolvent, non-performing or similarly impaired.

As example, a ubiquitous aspect of the net liquid assets capital approach — the use of credit risk models in the computation of the minimum capital requirement — typically evaluates only the swap receivables that might not be paid to an SD because a counterparty rather than the SD itself is bankrupt, insolvent, non-performing or similarly impaired. These credit risk models entirely neglect the 100% loss that a credit-impaired SD will incur under an uncleared swap that is in-the-money or an uncleared security-based swap that is in-the-money if the counterparty activates a flip clause, walkaway or similar provision.

For the same reason, core calculations in the net liquid assets capital approach — the calculations of tentative net capital and net capital — overstates both amounts.

These overstatements invalidate the remaining steps in the net liquid assets capital approach – the "Computation of Minimum Capital Requirement," and "Swap Dealers Computation of Tentative Net Capital and Net Capital Without Approval to Use Internal Capital Models."

Footnote 50 of the CFTC proposal provides a definition of tentative net capital and net capital. "SEC rules generally define 'tentative net capital' as the registrant's assets less liabilities (excluding certain qualifying subordinated debt), and 'net capital' as tentative net capital less certain capital deductions such as market risk and credit risk deductions."

The CFTC proposal reveals a deficiency in how tentative net capital — and thus also net capital — is overstated when an SD is exposed to a flip clause, walkaway or similar provision in an uncleared swap or uncleared security-based swap.

"SDs would also be required to compute standardized credit risk charges pursuant to proposed Rule 18a-1. Rule 18a-1 generally provides that a SBSD's unsecured receivables are subject to a 100 percent credit risk charge (i.e., the SBSD would have to deduct 100 percent of any unsecured receivable balance from tentative net capital in computing its net capital)."

Technically, the "receivable balance" that a SBSD is owed under an uncleared security-based swap with a flip clause, walkaway or similar provision *is* secured and hence would not be deducted "from tentative net capital in computing net capital."

SFIG has made this same, very disingenuous point in its so far unsuccessful lobbying for the CFTC and the prudential regulators to exempt securitization and structured finance issuers — 100% of whom place flip clauses, walkaways and similar provisions in uncleared swaps and uncleared security-based swap — from the daily exchange of variation margin with SDs, MSPs and covered swap entities.

However, the security that an SD enjoys in an in-the-money uncleared swap or in-the-money uncleared security-based swap is *illusory* when a counterparty activates a flip clause, walkaway or similar provision. In these cases, the security does not apply to the full in-the-money amount but only to the newly-reduced receivable which can be as little as USD 0.00.

In other words, the activation of a flip clause, walkaway or similar provision reduces an uncleared swap or uncleared security-based swap that is in-the-money to an SD to a *subordinated asset*. Furthermore, the degree of subordination is so pronounced that the newly-subordinated asset is effectively worth USD 0.00, notwithstanding the extent to which the asset was previously in-the-money.

The bankruptcy of Lehman Brothers provided a real-world example of a bankrupt swap provider that received USD 0.00 per USD 1.00 owed under 100% of in-the-money, uncleared swaps that contained flip clauses with 44 securitization issuers. United States Bankruptcy Judge Shelley C. Chapman detailed these "payments" of USD 0.00 in a ruling on *Lehman Brothers Special Financing Inc. vs. Bank of America National Association et al of 28 June 2016.*

"Upon providing notice of an Event of Default under the Swaps and the Indentures, the Trustees liquidated the assets, including the Collateral securing the Issuers' obligations under the Swaps and Indentures, and deposited the proceeds into accounts held by each Trustee for that purpose. The Trustees subsequently distributed the proceeds pursuant to the applicable Waterfall (the "Distributions"). In each instance, the Trustees applied Noteholder Priority because the Early Terminations were the result of an Event of Default and LBSF was the Defaulting Party. *The amount of the proceeds of the liquidation of the Collateral was insufficient to make any payment to LBSF [italics added] under the Waterfall after proceeds were paid pursuant to Noteholder Priority."*

To "ensure the safety and soundness of an SD" that is exposed to a flip clause, walkaway or similar provision in an uncleared swap or an uncleared security-based swap, the CFTC must adjust each aspect of the proposed net liquid assets capital approach to reflect the 100% exposure to itself that an SD bears.

The adjustments must require an SD that is exposed to a flip clause, walkaway or similar provision in an uncleared swap or an uncleared security-based swap to hold capital equal to the following for each such swap and security-based swap.

> The maximum of: [0, 100% of the "uncleared swap margin" as defined in footnote 25 of the CFTC proposal + 100% of the market value of the swap or security-based swap on the books of the SD].
>
> **N.B.** Using the market value of the swap or security-based swap on the books of the SD will ensure its "safety and soundness." Otherwise, the last term may converge to USD 0.00 for even a deeply in-the-money swap as an SD approaches bankruptcy, insolvency, non-performing status or similar credit-impairment.

This adjustment may not be present in the "credit risk model requirements adopted by the Federal Reserve Board" because it published those requirements on 11 October 2013 — i.e., 32 months before the ruling by Judge Chapman in *Lehman Brothers Special Financing Inc. vs. Bank of America National Association et al of 28 June 2016.*

This ruling by Judge Chapman to uphold the validity of a flip clause directly conflicted with both a 2010 ruling and a separate 2011 ruling by her predecessor in two other Lehman Brothers cases. Both earlier rulings placed the validity of a flip clause in doubt and may have informed *the Federal Reserve Board adoption of credit risk model requirements in the case of an SD that* is exposed to a flip clause, walkaway or similar provision in an uncleared swap.

The 2010 ruling in Lehman Bros. Special Fin. Inc. v. BNY Corp. Trustee Servs. Ltd., 422 B.R. 407, 420 (Bankr. S.D.N.Y. 2010) (JMP) ("BNY") *invalidated a flip clause. The 2011 ruling in* Lehman Bros. Special Fin. Inc. v. Ballyrock ABS CDO 2007-1 Ltd. (In re Lehman Bros. Holdings Inc.), 452 B.R. 31 (Bankr. S.D.N.Y. 2011) (JMP) *did not restore the validity* of a flip clause.

Additionally, the proposed adjustment may not be present in the "credit risk model requirements adopted by the Federal Reserve Board" because the adjustment would be redundant. "Walkaway clauses, including those that permit a party to suspend or condition payment, are not enforceable against the FDIC when acting as receiver or conservator of an insured depository institution or as receiver of a financial company under Title II of the Dodd Frank Act, or against the FHFA when acting as a receiver or conservator of Fannie Mae, Freddie Mac, or a Federal Home Loan Bank."[94] A flip clause operates very similarly to a walkaway provision and may be categorized as one.

Lastly, the proposed adjustment may not be present in the "credit risk model requirements adopted by the Federal Reserve Board" because the Margin and Capital Requirements for Covered Swap Entities" that the prudential regulators jointly adopted in October 2015 *do not exempt securitization and structured product issuers* from the category of financial end users with which a covered swap entity must exchange variation margin on a daily basis. To the extent that the prudential regulators enforce this rule, a covered swap entity that is party to an uncleared swap or uncleared security-based swap with a flip clause will hold variation margin equal to the market value of the swap when it is an asset on the books of the covered swap entity.

In light of the 28 June 2016 ruling by Judge Chapman, I will submit this comment to the Federal Reserve Board and the four other prudential regulators so that they may update their respective credit risk model requirements *in the case of an SD that* is exposed to a flip clause, walkaway or similar provision in an uncleared swap or an uncleared security-based swap.

Staff of the CFTC Division of Swap Dealer and Intermediary Oversight should follow my lead and make a similar suggestion when they next meet with the prudential regulators to discuss uncleared swaps and uncleared security-based swaps with flip clauses, walkways and similar provisions.

A recent such meeting occurred on 22 February, according to an SFIG email blast of 23 February. The blast described "a meeting that SFIG held with the CFTC and prudential

[94] See Prudential Regulators, 'Margin and Capital Requirements for Covered Swap Entities,' footnote 124. This document is available at: https://www.occ.treas.gov/news-issuances/news-releases/2015/nr-occ-2015-142aaa.pdf.

regulators yesterday, February 22nd, to discuss our recent request for temporary relief for legacy securitization transactions from the compliance date for variation margin requirements."

Meanwhile, the CFTC must *deviate* from the credit risk model requirements adopted by the Federal Reserve Board to the extent that these requirements have been invalidated by legal developments.

Preserving the "safety and soundness of an SD" depends on it capitalizing against future risks rather than grandfathering obsolete practices in the name of regulatory consistency.

"In addition, the Commission requests comment, including empirical data in support of comments, in response to the following questions:"

1. No, the "proposed USD 20mm fixed-dollar amount of net capital" is *not* appropriate when an SD is exposed to a flip clause, walkaway or similar provision in an uncleared swap or an uncleared security-based swap.

   In this case, an SD should hold additional capital equal to the maximum of: [0, 100% of the "uncleared swap margin" as defined in footnote 25 of the CFTC proposal + 100% of the market value of the swap or security-based swap on the books of the SD].

2. No, the "proposed minimum USD 100mm fixed dollar amount of tentative net capital" is *not* appropriate when an SD is exposed to a flip clause, walkaway or similar provision in an uncleared swap or an uncleared security-based swap.

   In this case, an SD should hold additional capital equal to the maximum of: [0, 100% of the "uncleared swap margin" as defined in footnote 25 of the CFTC proposal + 100% of the market value of the swap or security-based swap on the books of the SD].

3. No, the "proposed minimum capital requirement based upon eight percent of the margin required on the SD's cleared and uncleared swaps and security-based swaps, and the margin required on the SD's futures and foreign futures" is *not* appropriate when an SD is exposed to a flip clause, walkaway or similar provision in an uncleared swap or an uncleared security-based swap.

   In this case, an SD should hold additional capital equal to the maximum of: [0, 100% of the "uncleared swap margin" as defined in footnote 25 of the CFTC proposal + 100% of the market value of the swap or security-based swap on the books of the SD].

   Yes, "ensuring the safety and soundness of an SD" *does* obligate the CFTC to include "in the computation margin for swaps and security-based swaps that are exempt or excluded from the uncleared margin requirements (e.g., legacy swaps and security-based swaps, and swaps with commercial end users)." These "uncollateralized exposures" *do* "result in risk to the SD in the absence of "capital to address that risk."

4. No, the "proposed requirement for an SD to compute its capital in accordance with the SEC proposed capital rules for stand-alone SBSDs (i.e., SEC proposed Rule 18a-1)" is *not* appropriate when an SD is exposed to a flip clause, walkaway or similar provision in

an uncleared swap or an uncleared security-based swap.

In this case, an SD should hold additional capital equal to the maximum of: [0, 100% of the “uncleared swap margin” as defined in footnote 25 of the CFTC proposal + 100% of the market value of the swap or security-based swap on the books of the SD].

5. No, the “proposal to allow SDs to recognize as current assets margin funds deposited with third-party custodians as margin for uncleared swaps or security-based swaps” is *not* “in accordance with the Commission’s margin rules.”

   An SD facing a capital shortfall cannot use the margin funds deposited with a third-party custodian for uncleared swaps or security based swaps without compromising its ability to return these funds to the respective counterparties on the following day. Accordingly, these margin funds do not serve the basic purpose of capital, i.e., “to preserve the safety and soundness of an SD” as well as the financial system as a whole.

6. Yes, any SD that is exposed to a flip clause, walkaway or similar provision in an uncleared swap or an uncleared security-based swap should hold additional capital equal to the maximum of: [0, 100% of the “uncleared swap margin” as defined in footnote 25 of the CFTC proposal + 100% of the market value of the swap or security-based swap on the books of the SD].

7. No opinion.

Responses to Request for Comment, p. 91264

"The Commission requests comment on all aspects of the proposed tangible net worth capital approach for SDs that are predominantly engaged in non-financial activities."

Each aspect of the proposed tangible net worth capital approach ignores the 100% exposure to itself that an SD bears under a flip clause, walkaway or similar provision in an uncleared swap or an uncleared security-based swap. These provisions enable a counterparty to an uncleared swap that is in-the-money to an SD or an uncleared security-based swap that is in-the-money to an SD to write off all payments that would otherwise be due the SD simply because it is bankrupt, insolvent, non-performing or similarly impaired.

As example, a ubiquitous aspect of the net worth capital approach — the use of credit risk models in the computation of the minimum capital requirement — typically evaluates only the swap receivables that might not be paid to an SD because a counterparty rather than the SD itself is bankrupt, insolvent, non-performing or similarly impaired. These credit risk models entirely neglect the 100% loss that a credit-impaired SD will incur under an uncleared swap that is in-the-money or an uncleared security-based swap that is in-the-money if the counterparty activates a flip clause, walkaway or similar provision.

The same deficiency exists with respect to the proposed definition for determining "net worth." The CFTC proposal states that "all long and short positions in swaps, security-based swaps and related positions must be marked to their market value to ensure that the tangible net worth reflects the current market value of the SD's swaps and security-based swaps, including any accrued losses on such positions."

Unfortunately, the market value of an in-the-money uncleared swap or in-the-money security-based swap with a flip clause, walkaway or similar provisions does not reflect the reduction in value to USD 0.00 that results when an SD is bankrupt, insolvent, non-performing or similarly impaired.

The bankruptcy of Lehman Brothers provided a real-world example of a bankrupt swap provider that received USD 0.00 per USD 1.00 owed under 100% of in-the-money, uncleared swaps that contained flip clauses with 44 securitization issuers. United States Bankruptcy Judge Shelley C. Chapman detailed these "payments" of USD 0.00 in a ruling on *Lehman Brothers Special Financing Inc. vs. Bank of America National Association et al of 28 June 2016.*

"Upon providing notice of an Event of Default under the Swaps and the Indentures, the Trustees liquidated the assets, including the Collateral securing the Issuers' obligations under the Swaps and Indentures, and deposited the proceeds into accounts held by each Trustee for that purpose. The Trustees subsequently distributed the proceeds pursuant to the applicable Waterfall (the "Distributions"). In each instance, the Trustees applied Noteholder Priority because the Early Terminations were the result of an Event of Default and LBSF was the Defaulting Party. *The amount of the proceeds of the liquidation of the Collateral was insufficient to make any payment to LBSF [italics added] under the Waterfall after proceeds were paid pursuant to Noteholder Priority*."

To "ensure the safety and soundness of an SD" that is exposed to a flip clause, walkaway or similar provision in an uncleared swap or an uncleared security-based swap, the CFTC must adjust each aspect of the proposed tangible net worth capital approach to reflect the 100% exposure to itself that an SD bears.

The adjustments must require an SD that is exposed to a flip clause, walkaway or similar provision in an uncleared swap or an uncleared security-based swap to hold capital equal to the following for each such swap and security-based swap.

> The maximum of: [0, 100% of the "uncleared swap margin" as defined in footnote 25 of the CFTC proposal + 100% of the market value of the swap or security-based swap on the books of the SD].
>
> **N.B.** Using the market value of the swap or security-based swap on the books of the SD will ensure its "safety and soundness." Otherwise, the last term may converge to USD 0.00 for even a deeply in-the-money swap as an SD approaches bankruptcy, insolvency, non-performing status or similar credit-impairment.

"In addition, the Commission requests comment, including empirical data in support of comments, in response to the following questions:"

1. No, the "proposed minimum net capital requirement of USD 20mm plus the amount of the SD's market risk and credit risk charges for its dealing swaps" is *not* "appropriate for SDs that are eligible and elect the tangible net worth capital approach" when an SD is exposed to a flip clause, walkaway or similar provision in an uncleared swap or an uncleared security-based swap.

   In this case, an SD should hold additional capital equal to the maximum of: [0, 100% of the "uncleared swap margin" as defined in footnote 25 of the CFTC proposal + 100% of the market value of the swap or security-based swap on the books of the SD].

2. Yes, the "market risk and credit risk associated with the SD's security-based swap positions" *should* be "added to the market risk and credit risk associated with the SD's swap positions in setting the minimum capital requirements under proposed Regulation 23.101(a)(2)(A)."

   However, when an SD is exposed to a flip clause, walkaway or similar provision in an uncleared swap or an uncleared security-based swap, the SD should hold additional capital equal to the maximum of: [0, 100% of the "uncleared swap margin" as defined in footnote 25 of the CFTC proposal + 100% of the market value of the swap or security-based swap on the books of the SD].

3. Subject to a caveat, the "proposed minimum capital requirement based upon eight percent of the margin required on the SD's cleared and uncleared swaps and security-based swaps, and the margin required on the SD's futures and foreign futures" *is* appropriate.

   The caveat is as follows. When an SD is exposed to a flip clause, walkaway or similar provision in an uncleared swap or an uncleared security-based swap, the SD should hold additional capital equal to the maximum of: [0, 100% of the "uncleared swap margin" as defined in footnote 25 of the CFTC proposal + 100% of the market value of the swap or security-based swap on the books of the SD].

4. No opinion.

5. No opinion.

6. Unclear.

   Receivables from uncleared swaps, security-based swaps, futures and foreign futures *should* be included in the term “financial activities.” However, The CFTC proposal is not clear as to whether this is the case.

   While the CFTC proposal *does* list six activities that are included “in the extensive range of financial activities and services,” the six activities do not include entering into uncleared swaps, security-based swaps, futures and foreign futures.

Responses to Request for Comment, p. 91265

"The Commission requests comment on the proposed capital requirements for MSPs."

Each aspect of the proposed capital requirements for MSPs ignores the 100% exposure to itself that an MSP bears under a flip clause, walkaway or similar provision in an uncleared swap or an uncleared security-based swap. These provisions enable a counterparty to an uncleared swap that is in-the-money to an MSP or an uncleared security-based swap that is in-the-money to an MSP to write off all payments that would otherwise be due the MSP simply because it is bankrupt, insolvent, non-performing or similarly impaired.

As example, a key aspect of the proposed capital requirements for MSPs — the reliance on market value — typically entirely ignores the 100% loss that a credit-impaired MSP will incur under an uncleared swap that is in-the-money or an uncleared security-based swap that is in-the-money if the counterparty activates a flip clause, walkaway or similar provision.

The same deficiency exists with respect to the term "tangible net worth." Unfortunately, the "generally accepted accounting principles in the United States" as applied to an uncleared swap or uncleared security-based swap with a flip clause, walkaway or similar provision that is in-the-money to an MSP do not reflect the reduction in value to USD 0.00 that results when an MSP is bankrupt, insolvent, non-performing or similarly impaired.

Likewise, the use of "market risk and credit charges." These charges typically evaluate only the swap receivables that might not be paid to an MSP because a counterparty rather than the MSP itself is bankrupt, insolvent, non-performing or similarly impaired. These charges entirely neglect the 100% loss that a credit-impaired MSP will incur under an uncleared swap that is in-the-money or an uncleared security-based swap that is in-the-money if the counterparty activates a flip clause, walkaway or similar provision.

The bankruptcy of Lehman Brothers provided a real-world example of a bankrupt swap provider that received USD 0.00 per USD 1.00 owed under 100% of in-the-money, uncleared swaps that contained flip clauses with 44 securitization issuers. United States Bankruptcy Judge Shelley C. Chapman detailed these "payments" of USD 0.00 in a ruling on *Lehman Brothers Special Financing Inc. vs. Bank of America National Association et al of 28 June 2016.*

"Upon providing notice of an Event of Default under the Swaps and the Indentures, the Trustees liquidated the assets, including the Collateral securing the Issuers' obligations under the Swaps and Indentures, and deposited the proceeds into accounts held by each Trustee for that purpose. The Trustees subsequently distributed the proceeds pursuant to the applicable Waterfall (the "Distributions"). In each instance, the Trustees applied Noteholder Priority because the Early Terminations were the result of an Event of Default and LBSF was the Defaulting Party. *The amount of the proceeds of the liquidation of the Collateral was insufficient to make any payment to LBSF [italics added] under the Waterfall after proceeds were paid pursuant to Noteholder Priority.*"

To "ensure the safety and soundness of an MSP" that is exposed to a flip clause, walkaway or similar provision in an uncleared swap or an uncleared security-based swap, the CFTC must adjust each aspect of the proposed capital requirements for MSPs to reflect the 100% exposure to itself that an MSP bears.

The adjustments must require an MSP that is exposed to a flip clause, walkaway or similar provision in an uncleared swap or an uncleared security-based swap to hold capital equal to the following for each such swap and security-based swap.

> The maximum of: [0, 100% of the "uncleared swap margin" as defined in footnote 25 of the CFTC proposal + 100% of the market value of the swap or security-based swap on the books of the SD].
>
> **N.B.** Using the market value of the swap or security-based swap on the books of the MSP will ensure its "safety and soundness." Otherwise, the last term may converge to USD 0.00 for even a deeply in-the-money swap as an MSP approaches bankruptcy, insolvency, non-performing status or similar credit-impairment.

"In addition, the Commission requests comment, including empirical data in support of comments, in response to the following questions:"

1. No, the "tangible net worth test" is *not* an "appropriate standard" when an MSP is exposed to a flip clause, walkaway or similar provision in an uncleared swap or an uncleared security-based swap.

   Likewise, neither the "net liquid assets approach" nor the "bank-based capital approach" is a "more appropriate method for establishing capital requirements" when an MSP is exposed to a flip clause, walkaway or similar provision in an uncleared swap or an uncleared security-based swap.

   Under each of these tests and approaches, an MSP should hold additional capital equal to the maximum of: [0, 100% of the "uncleared swap margin" as defined in footnote 25 of the CFTC proposal + 100% of the market value of the swap or security-based swap on the books of the SD].

2. The "proposed minimum capital requirement for MSPs" *should* include a "fixed-dollar amount of tangible net worth" *plus* an additional amount when an MSP is exposed to a flip clause, walkaway or similar provision in an uncleared swap or an uncleared security-based swap.

   In this case, an MSP should hold additional capital equal to the maximum of: [0, 100% of the "uncleared swap margin" as defined in footnote 25 of the CFTC proposal + 100% of the market value of the swap or security-based swap on the books of the SD].

3. Yes, the "proposed Regulation 23.101(b)" *should* "require an MSP to maintain positive tangible net worth in an amount in excess of the market risk and credit risk charges on the MSP's swaps and security-based swap positions," subject to a caveat. The "credit risk charges" should be adjusted when an MSP is exposed to a flip clause, walkaway or similar provision in an uncleared swap or an uncleared security-based swap.

   In this case, an MSP should hold additional capital equal to the maximum of: [0, 100% of the "uncleared swap margin" as defined in footnote 25 of the CFTC proposal + 100% of the market value of the swap or security-based swap on the books of the SD].

Responses to Request for Comment, p. 91269

"The Commission requests comments on all aspects of the proposed amendments to the FCM capital requirements."

FCMs do not typically enter into uncleared swaps and uncleared security-based swaps with flip clauses, walkaways or similar provisions.

However, an FCM that is also an SD may in its capacity as an SD enter into uncleared swaps and uncleared security-based swaps with flip clauses, walkways or similar provisions.

Some key aspects of the proposed amendments to the FCM capital requirements ignore the 100% exposure to itself that an FCM that is dually registered as an SD bears under a flip clause, walkaway or similar provision in an uncleared swap or an uncleared security-based swap. These provisions enable a counterparty to an uncleared swap that is in-the-money to an FCM that is dually registered as an SD or an uncleared security-based swap that is in-the-money to an FCM that is dually registered as an SD to write off all payments that would otherwise be due the FCM that is dually registered as an FCM simply because it is bankrupt, insolvent, non-performing or similarly impaired.

As example, the "standardized market risk and credit risk capital charges" typically evaluate only the swap receivables that might not be paid to an FCM that is dually registered as an SD because a counterparty rather than the FCM that is dually registered as an SD itself is bankrupt, insolvent, non-performing or similarly impaired. These charges entirely neglect the 100% loss that a credit-impaired FCM that is dually registered as an SD will incur under an uncleared swap that is in-the-money or an uncleared security-based swap that is in-the-money if the counterparty activates a flip clause, walkaway or similar provision.

The bankruptcy of Lehman Brothers provided a real-world example of a bankrupt swap provider that received USD 0.00 per USD 1.00 owed under 100% of in-the-money, uncleared swaps that contained flip clauses with 44 securitization issuers. United States Bankruptcy Judge Shelley C. Chapman detailed these "payments" of USD 0.00 in a ruling on *Lehman Brothers Special Financing Inc. vs. Bank of America National Association et al of 28 June 2016.*

"Upon providing notice of an Event of Default under the Swaps and the Indentures, the Trustees liquidated the assets, including the Collateral securing the Issuers' obligations under the Swaps and Indentures, and deposited the proceeds into accounts held by each Trustee for that purpose. The Trustees subsequently distributed the proceeds pursuant to the applicable Waterfall (the "Distributions"). In each instance, the Trustees applied Noteholder Priority because the Early Terminations were the result of an Event of Default and LBSF was the Defaulting Party. *The amount of the proceeds of the liquidation of the Collateral was insufficient to make any payment to LBSF [italics added] under the Waterfall after proceeds were paid pursuant to Noteholder Priority*."

To "ensure the safety and soundness of an" FCM that is also an SD and is exposed to a flip clause, walkaway or similar provision in an uncleared swap or an uncleared security-based swap, the CFTC must adjust each aspect of the proposed amendments to the FCM capital requirements to reflect the 100% exposure to itself that an FCM that is dually registered as an SD bears.

The adjustments must require an FCM that is dually registered as an SD that is exposed to a flip clause, walkaway or similar provision in an uncleared swap or an uncleared security-based swap to hold capital equal to the following for each such swap and security-based swap.

The maximum of: [0, 100% of the "uncleared swap margin" as defined in footnote 25 of the CFTC proposal + 100% of the market value of the swap or security-based swap on the books of the SD].

N.B. Using the market value of the swap or security-based swap on the books of the FCM that is dually registered as an SD will ensure its "safety and soundness." Otherwise, the last term may converge to USD 0.00 for even a deeply in-the-money swap as an FCM that is dually registered as an SD approaches bankruptcy, insolvency, non-performing status or similar credit-impairment.

"In addition, the Commission requests comment, including empirical data in support of comments, in response to the following questions:"

1. No, the "proposed minimum adjusted net capital requirement of USD 20mm" is *not* "appropriate for an SD that is dually registered as an FCM" when the entity is exposed to a flip clause, walkaway or similar provision in an uncleared swap or an uncleared security-based swap.

   In this case, an SD that is dually registered as an FCM should hold additional capital equal to the maximum of: [0, 100% of the "uncleared swap margin" as defined in footnote 25 of the CFTC proposal + 100% of the market value of the swap or security-based swap on the books of the SD].

2. No, "the proposed minimum net capital requirement of USD 100mm" is *not* "appropriate for an FCM that is dually registered as an SD, and has been approved to use internal models to compute market risk and credit risk" when the entity is exposed to a flip clause, walkaway or similar provision in an uncleared swap or an uncleared security-based swap.

   In this case, an SD that is dually registered as an FCM should hold additional capital equal to the maximum of: [0, 100% of the "uncleared swap margin" as defined in footnote 25 of the CFTC proposal + 100% of the market value of the swap or security-based swap on the books of the SD].

3. No, "the proposal's minimum capital requirement based on 8 percent of margin," which "includes swaps exempt or excluded from the CFTC's margin requirements, such as inter-affiliate swaps," *should not* be narrowed.

   However, when an SD that is dually registered as an FCM is exposed to a flip clause, walkaway or similar provision in an uncleared swap or an uncleared security-based swap, this entity should hold additional capital equal to the maximum of: [0, 100% of the "uncleared swap margin" as defined in footnote 25 of the CFTC proposal + 100% of the market value of the swap or security-based swap on the books of the SD].

4. No opinion.

Responses to Request for Comment, pp. 91272-3

"The Commission requests comment on all aspects of the proposed model approval process and the computation of the credit risk charges."

Each aspect of the proposed model approval process and the computation of the credit risk charges ignores the 100% exposure to itself that an SD bears under a flip clause, walkaway or similar provision in an uncleared swap or an uncleared security-based swap. These provisions enable the counterparty to an uncleared swap or an uncleared security-based swap to write off all payments that would otherwise be due an SD simply because it is bankrupt, insolvent, non-performing or similarly impaired.

As example, a key aspect of the proposed capital requirements for SDs — the reliance on credit risk charges — typically entirely ignore the 100% loss that a credit-impaired SD will incur under an uncleared swap that is in-the-money or an uncleared security-based swap that is in-the-money if the counterparty activates a flip clause, walkaway or similar provision.

Moreover, the correlation of activation of all flip clauses, walkaways or similar provisions will be 100%, i.e. 100% of counterparties to uncleared swaps and uncleared security-based swaps with these clauses and provisions that are in-the-money to an SD will simultaneously activate them against the SD when it is bankrupt, insolvent, non-performing or similarly impaired.

The same deficiency exists with respect to the terms "counterparty exposure charge," "counterparty concentration charge" and "portfolio concentration charge." When applied to an uncleared swap or security-based swap with a flip clause, walkaway or similar provisions, neither the counterparty exposure charge, nor the counterparty concentration charge nor the portfolio concentration charge reflects the reduction in value of all such uncleared swaps and uncleared security-based swaps that are in-the-money to USD 0.00 when a counterparty activates a flip clause, walkaway or similar provision.

The CFTC proposal addresses "specific risks" but also notes that the "Commission understands that not all debt, equity or securitization positions (for example, certain interest rate swaps) have specific risk." In fact, each interest rate, basis, credit default and currency uncleared swap and uncleared security-based swap with a flip clause, walkaway or similar provisions presents enormous risk to an SD. The main counterparties under these uncleared swaps and uncleared security-based swaps are *securitization* and *structured finance* issuers.

The bankruptcy of Lehman Brothers provided a real-world example of a bankrupt swap provider that received USD 0.00 per USD 1.00 owed under 100% of in-the-money, uncleared swaps that contained flip clauses with 44 securitization issuers. United States Bankruptcy Judge Shelley C. Chapman detailed this 100% correlation of individual "payments" of USD 0.00 in a ruling on *Lehman Brothers Special Financing Inc. vs. Bank of America National Association et al of 28 June 2016.*

"Upon providing notice of an Event of Default under the Swaps and the Indentures, the Trustees liquidated the assets, including the Collateral securing the Issuers' obligations under the Swaps and Indentures, and deposited the proceeds into accounts held by each Trustee for that purpose. The Trustees subsequently distributed the proceeds pursuant to the applicable Waterfall (the "Distributions"). In each instance, the Trustees applied Noteholder Priority because the Early Terminations were the result of an Event of Default and LBSF was the Defaulting Party. *The amount of the proceeds of the liquidation of the Collateral was insufficient to make any payment* *to LBSF [italics added] under the Waterfall after proceeds were paid pursuant to Noteholder Priority*."

To "ensure the safety and soundness of an SD" that is exposed to a flip clause, walkaway or similar provision in an uncleared swap or an uncleared security-based swap, the CFTC must adjust each aspect of the proposed model approval process and the computation of the credit risk charges to reflect the 100% exposure to itself that an SD bears.

The adjustments must require that an SD that is exposed to a flip clause, walkaway or similar provision in an uncleared swap or an uncleared security-based swap to hold capital equal to the following for each such swap and security-based swap.

> The maximum of: [0, 100% of the "uncleared swap margin" as defined in footnote 25 of the CFTC proposal + 100% of the market value of the swap or security-based swap on the books of the SD].
>
> **N.B.** Using the market value of the swap or security-based swap on the books of the SD will ensure its "safety and soundness." Otherwise, the last term may converge to USD 0.00 for even a deeply in-the-money swap as an SD approaches bankruptcy, insolvency, non-performing status or similar credit-impairment.

This adjustment may not be present in the "credit risk model requirements adopted by the Federal Reserve Board" because it published those requirements on 11 October 2013 — i.e., 32 months before the ruling by Judge Chapman in *Lehman Brothers Special Financing Inc. vs. Bank of America National Association et al of 28 June 2016.*

This ruling by Judge Chapman to uphold the validity of a flip clause directly conflicted with both a 2010 ruling and a separate 2011 ruling by her predecessor in two other Lehman Brothers cases. Both earlier rulings placed the validity of a flip clause in doubt and may have informed *the Federal Reserve Board adoption of credit risk model requirements in the case of an SD that* is exposed to a flip clause, walkaway or similar provision in an uncleared swap.

The 2010 ruling in Lehman Bros. Special Fin. Inc. v. BNY Corp. Trustee Servs. Ltd., 422 B.R. 407, 420 (Bankr. S.D.N.Y. 2010) (JMP) ("BNY") *invalidated a flip clause. The 2011 ruling in* Lehman Bros. Special Fin. Inc. v. Ballyrock ABS CDO 2007-1 Ltd. (In re Lehman Bros. Holdings Inc.), 452 B.R. 31 (Bankr. S.D.N.Y. 2011) (JMP) *did not restore the validity* of a flip clause.

Additionally, the proposed adjustment may not be present in the "credit risk model requirements adopted by the Federal Reserve Board" because the adjustment would be redundant. "Walkaway clauses, including those that permit a party to suspend or condition payment, are not enforceable against the FDIC when acting as receiver or conservator of an insured depository institution or as receiver of a financial company under Title II of the Dodd Frank Act, or against the FHFA when acting as a receiver or conservator of Fannie Mae, Freddie Mac, or a Federal Home Loan Bank."[95] A flip clause operates very similarly to a walkaway provision and may be categorized as one.

[95] See Prudential Regulators, 'Margin and Capital Requirements for Covered Swap Entities,' footnote 124. This document is available at: https://www.occ.treas.gov/news-issuances/news-releases/2015/nr-occ-2015-142aaa.pdf.

Lastly, the proposed adjustment may not be present in the "credit risk model requirements adopted by the Federal Reserve Board" because the Margin and Capital Requirements for Covered Swap Entities" that the prudential regulators jointly adopted in October 2015 *do not exempt securitization and structured product issuers* from the category of financial end users with which a covered swap entity must exchange variation margin on a daily basis. To the extent that the prudential regulators enforce this rule, a covered swap entity that is party to an uncleared swap or uncleared security-based swap with a flip clause will hold variation margin equal to the market value of the swap when it is an asset on the books of the covered swap entity.

In light of the 28 June 2016 ruling by Judge Chapman, I will submit this comment to the Federal Reserve Board and the four other prudential regulators so that they may update their respective credit risk model requirements *in the case of an SD that* is exposed to a flip clause, walkaway or similar provision in an uncleared swap or an uncleared security-based swap.

Staff of the CFTC Division of Swap Dealer and Intermediary Oversight should follow my lead and make a similar suggestion when they next meet with the prudential regulators to discuss uncleared swaps and uncleared security-based swaps with flip clauses, walkways and similar provisions.

The CFTC and prudential regulators had such a meeting on 22 February, according to an SFIG email blast of 23 February. The blast described "a meeting that SFIG held with the CFTC and prudential regulators yesterday, February 22nd, to discuss our recent request for temporary relief for legacy securitization transactions from the compliance date for variation margin requirements."

Meanwhile, the CFTC must *deviate* from the credit risk model requirements adopted by the Federal Reserve Board to the extent that legal developments have invalidated these requirements. Preserving the "safety and soundness of an SD" obligates it to capitalize against future risks rather than grandfather obsolete practices in the name of regulatory consistency.

The CFTC proposal observes that "NFA currently is the only RFA."

I apprised the NFA and CFTC staff from the Division of Swap Dealer and Intermediary Oversight of the self-referencing risks that an SD incurred under an uncleared and unmargined swap with RAC provisions in a letter dated 15 May 2015.

Accordingly, I will also submit this response to the NFA.

My letter of 15 May 2015 details 14 misrepresentations regarding unlceared and unmargined swaps with RAC provisions and flip clauses that SFIG made to the NFA and CFTC in successfully lobbying it to issue the CFTC Letter No. 15-21 of 31 March 2015.

My letter of 15 May 2015 may be found in Appendix A, pp. 6-22 of my response to the CFTC of 6 February 2016.[96] In turn, the entirety of that document comprises Appendix D to this response.

[96] William J. Harrington, 'Re: Margin and Capital Requirements for Covered Swap Entities; Interim Final Rule to Exempt Commercial End Users and Small Banks (Federal Register Vol. 80, No. 229, Pages 74916-74924)' & 'Re: Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants; Interim Final Rule (Federal Register Vol 81, No. 3, Pages 636-638),' Comment to: Department of Treasury, Office of the Comptroller of the Currency; Federal Reserve System; Federal Deposit Insurance Corporation; Farm Credit Administration; Federal

A former Moody's colleague and I discussed the SFIG misrepresentations that my letter of 15 May 2015 enumerates with the chief counsel of the CFTC Division of Swap Dealer and Intermediary Oversight and the signatory to the CFTC Letter No. 15-21 in a teleconference on 28 May 2015.

My review of subsequent SFIG lobbying regarding uncleared and unmargined swaps with RAC provisions and flip clauses shows that SFIG continues to misrepresent the risks of these swaps to the CFTC, other regulators and the public at large.

For instance, SFIG misled the CFTC and the prudential regulators in a letter request for "Temporary Relief from the 1 March 2017 Variation Margin Compliance Date" dated 6 February 2017.[97]

SFIG based its rationale for the request on two, intertwined misrepresentations:

1. "Difficulty in replacing a swap counterparty;" and
2. "Credit rating agencies need additional time to assess impact of margin rules."

In fact, the US swap margin rules are the *last* rather than the first nail in the common *replacement* assumption that all NRSROs use to assign AAA ratings to securitization and structured product debt when an issuer is party to an uncleared, unmargined swap with RAC provisions and a flip clause.[98]

The problems with replacement pre-date the US swap margin rules by at least eight years.[99] NRSROs should have already removed the replacement assumption from their respective methodologies and downgraded ALL securitization and structured product debt where an issuer is party to an uncleared and unmargined swap with RAC provisions and a flip clause.

Housing Finance Agency; and Commodities Futures Trading Commission (31 January 2016). This comment is available at: https://ww3.fca.gov/projectws/regdev/Lists/Public%20Comments/DispForm.aspx?ID=6039.

[97] Richard Johns, 'Re: Request for Temporary Relief from March 1, 2017 Variation Margin Compliance Date,' Letter to: Federal Reserve System; Commodities Futures Trading Commission; Farm Credit Administration; Federal Housing Finance Agency; Federal Deposit Insurance Corporation; and Department of Treasury, Office of the Comptroller of the Currency (6 February 2017). This letter is available at: http://www.sfindustry.org/images/uploads/pdfs/Request_for_Temp_Relief_from_Variation_Margin_Compliance_Date_FINAL_for_website.pdf.

[98] Lukas Becker and Catherine Contiguglia, 'Moody's Bank Swap Ratings May Halt ABS Downgrades' *Risk.net* (17 June 2015). "Several dealers involved in ABS deals have fallen below the second trigger following a series of bank ratings downgrades since 2012. However, finding other counterparties to step into the trades has been extremely tricky due to the dearth of highly rated and the *complexity of pricing* [italics added] involved."

[99] William J. Harrington, 'Re: File Number S7-18-11— Comment on SEC Proposed Rules for Nationally Recognized Statistical Rating Organizations,' Comment to the SEC (8 August 2011). "Item 4b. 2009-2010. AIG was the downgraded hedge provider...AIG was counterparty to interest rate swaps with 50+ CDOs and other ABS transactions that had become deep-in the money, mark-to-market assets of AIG. In addition to providing an interest rate hedge to the transactions, AIG had also lent money to some of them at issuance. The CDOs that had borrowed in this fashion were repaying the loans through higher-than-market fixed rates that had resulted in particularly large mark-to-market assets for AIG. The respective swap contracts allowed the CDOs (both those that had borrowed from AIG and those that had not) to terminate the swaps without making any payment *as AIG had not complied with the replacement provisions following its 2008 downgrades* [italics added]. If the CDOs had exercised these rights, they would have removed a large liability from the top of their waterfalls, to the benefit of their rated notes. By corollary, AIG would have recorded a 100% loss on each of the deeply-in-the-money swap assets." Pp. 63 (PDF-page 65). See also pp. 64-73 (PDF-pages 66-75). This comment is available at: https://www.sec.gov/comments/s7-18-11/s71811-33.pdf.

Updating methodologies and downgrading debt are basic NRSRO responsibilities and *not* calamitous events as SFIG represented in its letter of 6 February 2017.

Unfortunately, NRSROs have been shirking these basic responsibilities for eight years with the help of SFIG and if its lobbying succeeds, the CFTC as well.

For instance, senior Moody's staff such as Chief Credit Officer for Structured Finance Nicolas Weill and Senior Vice President Edward Manchester have had first-hand knowledge since 2010 that the replacement assumption represents wishful thinking rather than commercial reality. Even so, the replacement assumption remains a AAA lynchpin of the Moody's methodology for uncleared swaps with RAC provisions and flip clauses seven years later and counting.[100]

Nicolas, Edward and I had worked closely on Moody's global methodology for uncleared swaps with RAC provisions and flip clauses (Moody's Hedge Framework)[101] from 2006 until my resignation from Moody's in 2010.

From 2006 to the present date, Edward has led Moody's global efforts in formulating adjustments to the methodology for uncleared swaps with RAC provisions and flip clauses[102] and in approving contract templates that providers of these swaps propose. and Nicolas oversees this and all methodologies that pertain to the debt and uncleared derivatives of securitization and structured product issuers.

I apprised Edward and other Moody's colleagues in a 2010 teleconference that one of the major swap counterparties for issuers of US cashflow RMBS — Bear Stearns Financial Products Inc. (BSFP) — had concluded in 2006 that the replacement assumption was not valid for uncleared, balance-guaranteed swaps with RAC provisions and flip clauses. This balance-guaranteed type of uncleared swap with RAC provisions and flip clauses was the standard swap in the RMBS sector.[103]

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[100] Pressure from issuers and SFIG incentivize Moody's and other NRSRO to avoid downgrading methodologies and ratings for securitization and structured product issuers that are party to uncleared swaps with RAC provisions and flip clauses. I was an SFIG member in 2013 and participated in Derivatives Taskforce, which was devoted almost entirely to these uncleared swaps. On one, very well-attended teleconference, a senior executive of Ford Motor Credit Company asked, to paraphrase: "Can't the rating agencies be *ameliorated* in some way?" I remember having thought: "*Placated* is a better verb and the eternal answer is: 'Of course, the rating agencies can be placated with respect to uncleared swaps with RAC provisions and flip clauses and anything else that issuers want.'"

[101] Edward Manchester, William Harrington and Nicholas Lindstrom, 'Framework for De-Linking Hedge Counterparty Risks from Global Structured Finance Cashflow Transactions,' (25 May 2006).

[102] For a recent example, see Edward Manchester and Heidi J. Schmid, 'Proposed Changes to Moody's Rating Criteria Reflect New Swap Margin Rules,' Moody's Investors Service (22 March 2017). Moody's alone of the NRSROs has proposed a methodology update to reflect the margin requirements for uncleared swaps. However, this proposal does not address the replacement assumption. By implication, the Moody's proposal *retains* the replacement assumption.

[103] See William J. Harrington, 'Re: Rule Comment Number 466-1,' Comment to the SEC (3 June 2013). PDF-numbered pp. 25-29. This submission is available at https://www.sec.gov/comments/4-661/4661-28.pdf. "Under the RAC, BSFP presented RMBS issuers with a derivative contract that made failure by BSP to post collateral at the Second Trigger an Additional Termination Event rather than an Event of Default. *The BSFP rationale in petitioning for RAC was that balance-guarantee hedges with RMBS issuers could not be replaced* [italics added] and BSFP lacked resources to post collateral for the duration of each balance-guaranteed swap." See also PDF-numbered page 40, footnote 53.

Edward's responded along the lines of "Well, I wish I had known that in 2006." This point *was* valid in 2010 but is a little stale seven years later in 2017.

Nicolas Weill was aware of the BSFP RACs, although not necessarily the BSFP conclusion that the replacement assumption was invalid for balance-guaranteed uncleared swaps with RAC provisions and flip clauses, by December 2007.[104]

Nicolas was also deeply involved with another real-world repudiation of the replacement assumption — the ongoing failure of AIG to replace deep, in-the-money, uncleared swaps with RAC provisions and flip clauses with 50+ issuers of cashflow CDOs and other structured debt.[105],[106]

"SFIG believes that relief is urgently required to protect legacy securitization transactions."

Why the urgency? Under the swap margin rule, securitization and structured product issuers with existing uncleared and unmargined swaps with RAC provisions and flip clauses "would be unable to enter into replacement swaps on equivalent economic terms, resulting in *potential credit ratings downgrades* [italics added] on rated securities issued by the SPVs."

For a corrective to the SFIG misrepresentations, please see Appendix A to this response, which contains an email correspondence that a spokesperson from Fitch and I conducted from 21 December 2016 to 11 January 2017. Fitch derivative analysts, CFTC staff, the CFTC Office of Inspector General, SEC staff and SFIG staff were copied in this correspondence.

In the email of 11 January 2017, I posed 13 questions that highlighted the lack of either empirical or legal bases for replacement and other key rating constructs that the Fitch methodologies for uncleared, unmargined swaps with RAC provisions and flip clauses cite.

I also observed that swap providers have not effected timely replacement in nearly enough instances since 2008 to justify replacement as a core feature of the Fitch methodology. This failure to effect replacement leaves an SD and or other swap provider fully exposed to the self-referencing risk of 100% loss of swap asset when a securitization or structure product issuer activates a flip clause.

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[104] Nicolas Weill raised questions with me regarding the third successive BSFP RAC that my team issued in December 2007. For a coda for the entire BSFP portfolio (i.e., not just the uncleared, balance-guaranteed swaps with RMBS issuers), see footnotes 40 and 41 and the PDF-numbered pps. 38-40 and 49-52 of the document cited in the preceding footnote.

[105] Op. cit. (Harrington, 3 June 2103), PDF-numbered page 59. "Moody's mgmt. can't 'replace' structured finance committees voting independently of AIG/BoA pressure. In 2010, management continued to treat committee independence with respect to MLDP, Bank of America and AIG as a hindrance. Per my June 2010 entry 'Exasperated Management: It's High Time to Let AIG Have Its Way' in 'WJH Comment to SEC on Proposed Rules for NRSROs (p73-74).' '*Nicolas Weill of Credit Policy interrupted an AIG/MLDP committee by asking why the transfer wasn't simpler, given MLDP's Aaa rating? (The rating of MLDP was Aa3.)* [italics added]" For more details on the failed AIG replacement efforts in 2008-2010, see the PDF-numbered pages 57-58.

[106] William J. Harrington, Letter to the SEC and ESMA of 11 September 2013. Pages 12-13. This letter is available at: http://www.wikirating.org/data/other/20130917_Harrington_J_William_ABS_Losses_Attributable_to_Securitization_Swaps.pdf.

The Fitch spokesperson and staff had not replied to any of the 13 questions at the time of my having submitted this response.

I sent separate emails with the same 13 questions that highlighted the lack of either empirical or legal bases for replacement and other rating constructs to the respective rating teams at the five other NRSROs – DBRS, Kroll, Moody's, Morningstar and S&P – in mid-January 2017.

Only S&P had replied to my email at the time of this writing.

An S&P derivative analyst emailed the following on 25 March 2017. "We received your emails dated February 12, 2017 and January 19, 2017 regarding the recent swap margin rules. As you may know, our credit rating criteria represents our methodology to assess credit risk and takes into account various factors, including business, economic, legal, structural, and other factors we view as relevant to credit analysis. We apply our credit rating criteria to produce ratings that are consistent with our rating definitions. We have forwarded your email to our criteria comment box for review."

However, S&P has not updated its methodology or downgraded the ratings of securitization or structured product debt where an issuer is party to an unlceared, unmargined swap with RAC provisions and flip clauses at the time of this writing.

Instead, the S&P methodology continues to state that a securitization or structured product issuer *cannot* comply with requirements to post margin to an SD under an uncleared swap with RAC provisions and flip clauses.

I pointed this out to S&P in March 2016, i.e., more than a year ago in my then capacity as a research journalist at *Debtwire ABS.* I emailed detailed questions to S&P and five other NRSRO rating teams in March 2016. Each respective set of questions focused on how that NRSRO was evaluating the impact of the swap margin rules on new and existing uncleared swaps with flip clauses and RAC provisions.

My questions to each of the six teams was based on my review of the respective methodology for uncleared swaps with RAC provisions and flip clauses. In sum, the six methodologies totaled 800 pages.

For example, I posed this question and eleven others to an S&P spokesperson on 24 March 2016. "'General: Global Derivative Agreement Criteria,' is based in part on the following assumption that is laid out in Methodology, Criteria, paragraph #9. '*The issuer does not have the financial resources to both maintain the ratings on its obligations and post collateral to a counterparty* [italics added].' Will this and the other criteria be entirely obsolete under the swap margin rules?"

I also attached an article that I wrote for *Debtwire ABS*[107] to each of the six emails of March 2016. My thought was that if I as a research journalist could analyze the impact of the parallel

[107] Bill Harrington, 'US margin rule for swaps obliges securitization issuers to overhaul structures, add resources, and rethink capital structures' *Debtwire ABS* (4 November 2015). This article is available at: http://www.debtwire.com/info/2015/11/04/analysis-us-margin-rule-swaps-obliges-securitization-issuers-overhaul-structures-add-resources-rethink-capital-structures/.

swap rules of the prudential regulators and the CFTC on *new* uncleared swap contracts with RAC provisions and flip clauses, then so too could the NRSROs.

I followed up by submitting additional questions throughout 2016 to the respective rating team at each of the six NRSROs regarding progress in updating the methodology for *new* uncleared swaps with RAC provisions and flip clauses to reflect the swap margin rule. My thought was that each NRSRO was ignoring its responsibility to propose a methodology update, given that the prudential regulators adopted their joint rule in October 2015 and the CFTC followed suit in December 2015.

Furthermore, my research at *Debtwire ABS* in the summer of 2016 indicated yet another deficiency — i.e., namely, that the swap margin rules also invalidated the NRSRO methodologies with respect to *existing* uncleared, unmargined swaps with RAC provisions.

Accordingly, I forwarded a second article that I wrote for *Debtwire ABS*[108] to the rating teams at each of the six NRSROs in August 2016. My thought was that since I had reached this conclusion simply by reviewing the parallel rules closely, then each of the NRSROs should have done so as well. After all, the impact was very serious – *ALL securitization debt where an issuer was party to an existing uncleared, unmargined swap with a RAC provision and a flip clause should be downgraded.*

Contrary to the SFIG assertion that NRSROs need more time to "assess the impact of margin rules" on securitization and structured debt that is backed in party by uncleared and unmargined swaps contracts with RAC provisions and flip clauses, the NRSROs have had *plenty* of time to do so.

In fact, the NRSROs, SFIG, the CFTC and the prudential regulators all know the impact – SFIG expressed it in the letter of 6 February 2017. "[I]t is highly unlikely that legacy deals can replace legacy SPV swaps on substantially similar economic terms to those that are already in place, resulting in the possible *credit ratings downgrade* [italics added] of a legacy transaction."

The NRSRO and SFIG staff expressed this same view at an SFIG conference in Las Vegas from 26 February 2017 to 1 March. Mr. Mark Adelson posted notes from many of the sessions,[109] including those devoted to regulatory issues such as the swap margin rules and to credit rating agency issues.

"The following summaries reflect the remarks of the panelists who participated in selected sessions at the conference. For the most part, the summaries are drawn from notes taken during the sessions. The summaries have not been reviewed or approved by the panelists. While we have tried to capture panelists' remarks accurately, we apologize in advance for any inaccuracies and omissions."

Panelists on the "CRA Roundtable: Key Updates from the Major Rating Agency Leaders" discussed "margin posting requirements for swaps" among other topics on Monday afternoon, 27 February 2017, according to Mr. Adelson.

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108 Bill Harrington, 'Existing ABS swaps also caught in swap margin net,' *Debtwire ABS* (12 August 2016). This article is available at: http://www.debtwire.com/info/existing-abs-swaps-also-caught-swap-margin-net-%E2%80%94-analysis.

109 Mark Adelson, 'SFIG Vegas 2017 Conference Notes,' (11 March 2017). These notes are available at: http://www.markadelson.com/pubs/SFIG-Vegas-2017-Conference-Notes.pdf.

"One [rating agency] panelist explains that CFTC rules would require securitization structures to post margin with respect to embedded swaps. Many old deals have no ability to post margin. This raises the issue of whether the rating agencies would *downgrade* [italics added] the deals."

"Another panelist says that margin posting requirements will drive the use of swaps out of securitization deals. He asserts that legacy deals with outstanding swaps would likely have to be *downgraded* [italics added]. The good news is that embedded swaps are less prevalent in U.S. deals than they are in European deals."

Earlier that same Monday, 27 February 2017, a panelist at the session on SFIG advocacy had gone further, stating that "the requirements for posting margin on swaps included in securitizations does not benefit any parties, and it creates *downgrade* [italics added] risk for deals that include swaps," according to Mr. Adelson.

However, issuers and investors did not vocalize the NRSRO and SFIG concerns. "The Annual Investor vs. Issuer Family Feud Game and Fireside Chat" conducted in the morning of Tuesday, 28 February 2017 surveyed issuers on the post-crisis regulations to *repeal* and surveyed investors on the post-crisis regulations to *retain*.

Neither the issuers nor the investors placed the swap margin rules in the top seven regulations of the respective categories. Nor did Mr. Adelson report that investors complained about downgrades to securitized and structured product debt where an issuer was party to an uncleared swap with RAC provisions and a flip clause.

NRSROS have known that the replacement and other methodology foundations have not worked since at least 2011, based on my advocacy as a private citizen.

I filed a submission with the SEC regarding its proposed rules for NRSROs on 8 August 2011.[110] Pages 24-35 of this submission contain a detailed critique of the replacement and other methodology assumptions for uncleared, unmargined swaps with RAC provisions and flip clauses. Even so, the six NRSROs continue to use many of these assumptions preserve many of these assumptions in the respective methodologies.

I described my 2011 outreach to the NRSROs and regulators in the SEC submission, referring to myself as "the contributor. The Moody's methodology for uncleared, unmargined swaps with RAC provisions and flip clauses was known as the "Hedge Framework."

"The contributor has brought his insights regarding the implications of the Hedge Framework for bank capital to former colleagues in Moody's Credit Policy, Derivatives and Banking Groups, Moody's Analytics and to Michael Kanef in RMBS/Compliance. (Mr. Kanef's RMBS/Compliance Department showed a great avidity for the topic while the contributor worked on it in a series of proposed AIG transactions. Please see "J.36. Post-2008: Cozy Up to Regulators. Clear the Way for AIG. Blame, Blame, Blame the Analysts." Moody's

[110] William J. Harrington, 'Re: File Number S7-18-11— Comment on SEC Proposed Rules for Nationally Recognized Statistical Rating Organizations,' Comment to the SEC (8 August 2011) available at: https://www.sec.gov/comments/s7-18-11/s71811-33.pdf.

acknowledged receipt of the contributor's materials, but had offered no response at the time of this writing."

"The contributor looked through the websites of other rating agencies to locate emails of as many individuals as possible who are versed in their methodologies that are analogous to the Hedge Framework. As a result, he was able to bring the same insights to many individuals at S&P and Fitch. Fitch performed the courtesy of replying to the contributor and helped refine his thinking further. S&P had not responded at the time of this writing."

The failure of the NRSROs to update the respective methodologies for uncleared swaps with RAC provisions and flip clauses is especially puzzling because board approval is required for each methodology.

Accordingly, I will send this response to each of the six NRSROs that evaluate uncleared swaps with RAC provisions and flip clauses and in each instance, copy the SEC Office of Credit Ratings.

Appendix B to this response — "WJH Correspondence with Derivatives Analysts and Managers at Moody's Investors Services Regarding Deficient 'Replacement' Assumptions for Uncleared, Unmargined Swaps with RAC Provisions and Flip Clauses" — contains an email exchange between several of my Moody's colleagues and me regarding replacement in 2011. See pages 134-135.

"Thanks, Bill. We'll take a look at this," Mr. Andy Kimball, the (now retired) Executive Vice President, Structured Finance emailed on 14 May 2011.

"We understand that you have contacted several Moody's employees to provide your comments on this topic. You are welcome to direct any further comments directly to me, and I will make sure that they are shared with the relevant rating and credit policy personnel," Moody's Chief Credit Officer Richard Cantor emailed on 16 May 2011.

However, Moody's has responded to the flawed methodology assumptions of replacement and flip clauses by introducing *new* types of ratings that mask these methodology flaws rather than by downgrading debt and swap providers that are exposed to these flawed assumptions.

This is directly relevant to the CFTC and the prudential regulators because SDs and other swap providers use these new types of ratings to mask the self-referencing risk of 100% loss of swap asset that an SD bears when exposed to a flip clause.

For instance, Moody's Counterparty Instrument Rating evaluates an uncleared, unmargined swap with a flip clause from the vantage of an SD or other swap provider subject to a big caveat – the rating ignores the 100% loss of swap value that can occur when a flip clause is activated. This is because Moody's defined a Counterparty Risk Assessment to carve-out termination payments.[111]

[111] Norbert Gaillard and William J. Harrington, 'Efficient, commonsense actions to foster accurate credit ratings,' Capital Markets Law Journal (2016) 11 (1): 38-59, Footnote 23. "A Counterparty Instrument Rating (CI Rating) assesses the obligations of an SF issuer to make scheduled payments under a swap contract but carves out termination payments. This rating is applicable only to the specified derivative provider and is extinguished upon transfer of the

Moody's Counterparty Risk Assessment ostensibly covers most of the worlds' derivative contracts as well as other contractual obligations of global banks, many of which are SDs registered with the CFTC.[112] However, Moody's does not perform even the basic step of measuring the contracts of a global bank in assigning a Counterparty Risk Assessment. Instead, a rating team is instructed to focus "purely on subordination (which provides a cushion against default) and take no account of the volume of the instrument class (which affect loss given default.)[113]

The breadth of the Counterparty Risk Assessment notwithstanding, Moody's primarily uses it for the narrow purpose of avoiding downgrades of securitized and structured product debt where an issuer is party to an uncleared and unmargined swap with RAC provisions and a flip clause.[114] To justify this outcome, Moody's bases a Counterparty Risk Assessment in part on an assumption that regulators such as the CFTC and the prudential regulators will preserve the operations of the derivative and other contractual obligations of an impaired bank.

See also my *Debtwire ABS* article "Moody's best Germany will support Deutsche Bank Derivatives above all else" of 12 October 2016.[115]

Moody's settled suits related to the financial crisis with the US Justice Department, 21 states and the District of Columbia on 13 January 2017.[116] As part of the settlement, Moody's "agrees to develop and maintain a function responsible for overseeing that the work of the groups responsible for the development, review and approval of methodologies is carried out on a timely basis" for at least five years.[117]

Accordingly, I will send this response to the US Department of Justice, to the U.S. Attorney's Office for the District of New Jersey, to the state attorneys general that signed the agreement with Moody's and to the District of Columbia signatory to the agreement.

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contract to a second provider. Moody's, 'Moody's Approach to Counterparty Instrument Ratings' (16 June 2015). S&P, 'Request for Comment: Counterparty Instrument Ratings and Methodology' (30 September 2015)."

112 Ibid., Footnote 22. "Moody's has introduced a Counterparty Risk Assessment (CR Assessment) that lumps together payment obligations under derivative contracts and many other contracts such as covered bonds, secured transactions, letters of credit, third-party guarantees, and servicing and trustee obligations. According to Moody's, the CR Assessment is "not a rating, but an assessment of the ability of an issuer to avoid defaulting on its operating obligations taking into account the issuer's intrinsic standalone strength as well as our assessment of the likelihood of affiliate and government support."

113 Moody's, 'Bank Methodology' (2016). P. 68.

114 Deutsche Bank AG, a beneficiary of the counterparty risk assessment, routinely touts its breadth of application. See Deutsche Bank quarterly presentation to fixed-income investors, '4Q16 Fixed Income Investor Conference Call,' (13 February 2017). P. 17. "The counterparty rating is relevant to more than 95% of DB's clients." This presentation is available at: https://www.db.com/ir/en/download/Deutsche_Bank_FI_Call_4Q2106_results.pdf.

115 Bill Harrington, 'Moody's bets Germany will support Deutsche Bank derivatives above all else — ANALYSIS' Debtwire ABS (12 October 2016). This article is available at: http://www.debtwire.com/info/moody%E2%80%99s-bets-germany-will-support-deutsche-bank-derivatives-above-all-else-%E2%80%94-analysis.

116 US Department of Justice, 'Justice Department and State Partners Secure Nearly USD 864 million Settlement with Moody's Arising from Conduct in the Lead up to the Financial Crisis' (13 January 2017). This announcement is available at: https://www.justice.gov/opa/pr/justice-department-and-state-partners-secure-nearly-864-million-settlement-moody-s-arising.

117 Ibid., 'Annex 2, 'Moody's Compliance Commitments', available at: https://www.justice.gov/opa/press-release/file/926561/download.

Separately, the CFTC should not rely on evaluations by foreign regulators with respect to uncleared swaps and uncleared security-based swaps with flip clauses, walkways and similar provisions. The foreign regulators may have conducted their respective reviews and approvals of capital models for an SD or equivalent entity *using a baseline assumption of government support including bailouts for SDs, MSPs, covered swap entities and analogous entities.*

In some foreign domiciles, regulators assume that government support including bailouts may be available to all financial entities.

Also, some foreign domiciles have cited the need to jumpstart the securitization markets as rationales for not requiring an SD or equivalent entity to capitalize the self-referencing credit risk of a flip clause, walkaway or similar provisions in an uncleared swap or uncleared security-based swap. This greenlight for non-US securitization issuers to bring undercapitalized deals to market has proved self-defeating. EU and other non-US securitization sectors have not rebounded since the financial crisis.[118]

In contrast, the CFTC mission is "to ensure the safety and soundness of an SD," even one that is exposed to a flip clause, walkaway or similar provision in an uncleared swap or an uncleared security-based swap, *on a standalone basis without government support or bailouts.*

"In addition, The Commission requests comment, including empirical data in support of comments, in response to the following questions:"

1. No, the "proposed models" do *not* "appropriately account for the market and credit risks of swaps and security-based swaps" that contain flip clauses, walkaways or similar provisions.

   In these cases, an SD should hold additional capital equal to the maximum of: [0, 100% of the "uncleared swap margin" as defined in footnote 25 of the CFTC proposal + 100% of the market value of the swap or security-based swap on the books of the SD].

2. No, the "proposed model review process" is *not* "appropriate" for an uncleared swap or uncleared security-based swap with a flip clause, walkaway or similar provision.

   In these cases, the "model review process" should ensure that the models are specified so that an SD will hold additional capital equal to the maximum of: [0, 100% of the "uncleared swap margin" as defined in footnote 25 of the CFTC proposal + 100% of the market value of the swap or security-based swap on the books of the SD].

3. No, the Commission and NFA should *not* consider "a prudential regulator's or foreign regulator's review and approval of capital models that are used in the corporate family" for an SD that is exposed to a flip clause, walkaway or similar provision in an uncleared swap or an uncleared security-based swap.

   The *prudential regulators*' respective reviews and approvals of capital models that are used in the corporate family for an SD or covered swap entity that is exposed to a flip

[118] 'Europe's Securitisation Market Remains Stunted' *The Economist* (23 February 2017), available at: http://www.economist.com/news/finance-and-economics/21717426-efforts-pep-it-up-are-looking-increasingly-lacklustre-europes-securitisation.

clause, walkaway or similar provision in an uncleared swap or an uncleared security-based swap *may be obsolete* given the ruling by United States Bankruptcy Judge Shelley C. Chapman in *Lehman Brothers Special Financing Inc. vs. Bank of America National Association et al on 28 June 2016.*

Moreover, the *prudential regulators*' respective reviews and approvals of capital models that are used in the corporate family for an SD or covered swap entity may not have addressed exposure to a flip clause, walkaway or similar provision in an uncleared swap or an uncleared security-based swap for two reasons.

A. "Walkaway clauses, including those that permit a party to suspend or condition payment, are not enforceable against the FDIC when acting as receiver or conservator of an insured depository institution or as receiver of a financial company under Title II of the Dodd Frank Act, or against the FHFA when acting as a receiver or conservator of Fannie Mae, Freddie Mac, or a Federal Home Loan Bank."[119] A flip clause operates very similarly to a walkaway provision and may be categorized as one.

B. The Margin and Capital Requirements for Covered Swap Entities" that the prudential regulators jointly adopted in October 2015 *do not exempt securitization and structured product issuers* from the category of financial end users with which a covered swap entity must exchange variation margin on a daily basis. As a result, a covered swap entity that is party to an uncleared swap or uncleared security-based swap with a flip clause will hold variation margin equal to the market value of the swap when it is an asset on the books of the covered swap entity.

Foreign regulators may have conducted their respective reviews and approvals of capital models for an SD or other entity that is exposed to a flip clause, walkaway or similar provision in an uncleared swap or an uncleared security-based swap *using a baseline assumption of government support for SDs, MSPs, covered swap entities and analogous entities. In some foreign domiciles, regulators assume that government support including bailouts may be available to all financial entities.*

However, US policy is predicated on the assumption that SDs will not be bailed out. Accordingly, the CFTC and NFA missions are "to ensure the safety and soundness of an SD" — even one that is exposed to a flip clause, walkaway or similar provision in an uncleared swap or an uncleared security-based swap — *on a standalone basis without government support or bailouts.*

Separately, some foreign domiciles have cited the need to jumpstart the securitization markets as rationales for not requiring an SD or equivalent entity to capitalize the self-referencing credit risk that an SD bears when exposed to a flip clause, walkaway or similar provisions in an uncleared swap or uncleared security-based swap.

However, foreign securitization markets such as those in the EU and UK are shrinking. This demonstrates that the undercapitalization of securitization issuers and swap counterparties impedes rather than fosters the development of robust, sustainable

[119] See Prudential Regulators, 'Margin and Capital Requirements for Covered Swap Entities,' footnote 124. This document is available at: https://www.occ.treas.gov/news-issuances/news-releases/2015/nr-occ-2015-142aaa.pdf.

securitization markets.

Accordingly, the CFTC and NFA must ensure that an SD holds additional capital equal to the maximum of: [0, 100% of the "uncleared swap margin" as defined in footnote 25 of the CFTC proposal + 100% of the market value of the swap or security-based swap on the books of the SD].

4. No, the Commission should *not* provide for either automatic or temporary approval of "capital models already approved by a prudential or foreign regulator" with respect to an SD that is exposed to a flip clause, walkaway or similar provision in an uncleared swap or an uncleared security-based swap.

   The *prudential regulators*' respective reviews and approvals of capital models that are used in the corporate family for an SD or covered swap entity that is exposed to a flip clause, walkaway or similar provision in an uncleared swap or an uncleared security-based swap *may be obsolete* given the ruling by United States Bankruptcy Judge Shelley C. Chapman in *Lehman Brothers Special Financing Inc. vs. Bank of America National Association et al on 28 June 2016.*

   Moreover, the *prudential regulators*' respective reviews and approvals of capital models that are used in the corporate family for an SD or covered swap entity may not have addressed exposure to a flip clause, walkaway or similar provision in an uncleared swap or an uncleared security-based swap for two reasons.
   A. "Walkaway clauses, including those that permit a party to suspend or condition payment, are not enforceable against the FDIC when acting as receiver or conservator of an insured depository institution or as receiver of a financial company under Title II of the Dodd Frank Act, or against the FHFA when acting as a receiver or conservator of Fannie Mae, Freddie Mac, or a Federal Home Loan Bank."[120] A flip clause operates very similarly to a walkaway provision and may be categorized as one.
   B. The Margin and Capital Requirements for Covered Swap Entities" that the prudential regulators jointly adopted in October 2015 *do not exempt securitization and structured product issuers* from the category of financial end users with which a covered swap entity must exchange variation margin on a daily basis. As a result, a covered swap entity that is party to an uncleared swap or uncleared security-based swap with a flip clause will hold variation margin equal to the market value of the swap when it is an asset on the books of the covered swap entity.

   Foreign regulators may have conducted their respective reviews and approvals of capital models for an SD or other entity that is exposed to a flip clause, walkaway or similar provision in an uncleared swap or an uncleared security-based swap *using a baseline assumption of government support for SDs, MSPs, covered swap entities and analogous entities. In some foreign domiciles, regulators assume that government support including bailouts may be available to all financial entities.*

[120] See Prudential Regulators, 'Margin and Capital Requirements for Covered Swap Entities,' footnote 124. This document is available at: https://www.occ.treas.gov/news-issuances/news-releases/2015/nr-occ-2015-142aaa.pdf.

However, US policy is predicated on the assumption that SDs will not be bailed out. Accordingly, the CFTC and NFA missions are "to ensure the safety and soundness of an SD" – even one that is exposed to a flip clause, walkaway or similar provision in an uncleared swap or an uncleared security-based swap – *on a standalone basis without government support or bailouts.*

Separately, some foreign domiciles have cited the need to jumpstart the securitization markets as rationales for not requiring an SD or equivalent entity to capitalize the self-referencing credit risk that an SD bears when exposed to a flip clause, walkaway or similar provisions in an uncleared swap or uncleared security-based swap.

However, foreign securitization markets such as those in the EU and UK are shrinking. This demonstrates that the undercapitalization of securitization issuers and swap counterparties impedes rather than fosters the development of robust, sustainable securitization markets.

Accordingly, the CFTC and NFA must ensure that an SD hold additional capital equal to the maximum of: [0, 100% of the "uncleared swap margin" as defined in footnote 25 of the CFTC proposal + 100% of the market value of the swap or security-based swap on the books of the SD].

5. The Commission should set an effective date of 1 May 2017 for the subset of capital rules that apply to an SD that *is* exposed to a flip clause, walkaway or similar provision in an uncleared swap or an uncleared security-based swap.

   In this case, an SD must hold additional capital equal to the maximum of: [0, 100% of the "uncleared swap margin" as defined in footnote 25 of the CFTC proposal + 100% of the market value of the swap or security-based swap on the books of the SD].

   An effective date of 1 May 2017 will "ensure the safety and soundness of an SD" ahead of EU elections that may produce extreme market volatility.

6. No, there are "no other approaches available to facilitate the timely review of applications from SDs to use internal models" when an SD is exposed to a flip clause, walkaway or similar provision in an uncleared swap or an uncleared security-based swap.

   In these cases, an SD must hold additional capital equal to the maximum of: [0, 100% of the "uncleared swap margin" as defined in footnote 25 of the CFTC proposal + 100% of the market value of the swap or security-based swap on the books of the SD].

7. No "implementation time is needed for the Commission's proposed model review and approval process" with respect to an SD that is exposed to a flip clause, walkaway or similar provision in an uncleared swap or an uncleared security-based swap.

   In this case, an SD must hold additional capital equal to the maximum of: [0, 100% of the "uncleared swap margin" as defined in footnote 25 of the CFTC proposal + 100% of the market value of the swap or security-based swap on the books of the SD].

8. No, the "proposed methods of computing the credit risk charge" is *not* "appropriate for nonbanks SDs" that are exposed to flip clauses, walkaways or similar provisions in uncleared swaps or uncleared security-based swaps.

   Credit risk charges typically evaluate only the swap receivables that might not be paid to an SD because a counterparty rather than the SD itself is bankrupt, insolvent, non-performing or similarly impaired. These charges entirely neglect the 100% loss that a credit-impaired SD will incur under an uncleared swap that is in-the-money or an uncleared security-based swap that is in-the-money if the counterparty activates a flip clause, walkaway or similar provision.

   Accordingly, such an SD must hold additional capital equal to the maximum of: [0, 100% of the "uncleared swap margin" as defined in footnote 25 of the CFTC proposal + 100% of the market value of the swap or security-based swap on the books of the SD].

9. No, the "method of computing the counterparty exposure charge" is *not* "appropriate for nonbank SDs" that are exposed to flip clauses, walkaways or similar provisions in uncleared swaps or uncleared security-based swaps.

   Counterparty exposure charges typically evaluate only the swap receivables that might not be paid to an SD because a counterparty rather than the SD itself is bankrupt, insolvent, non-performing or similarly impaired. These charges entirely neglect the 100% loss that a credit-impaired SD will incur under an uncleared swap that is in-the-money or an uncleared security-based swap that is in-the-money if the counterparty activates a flip clause, walkaway or similar provision.

   Accordingly, such an SD must hold additional capital equal to the maximum of: [0, 100% of the "uncleared swap margin" as defined in footnote 25 of the CFTC proposal + 100% of the market value of the swap or security-based swap on the books of the SD].

10. No opinion.

11. The "conditions for taking netting agreements into account when calculating the credit equivalent amount" *should* be "appropriate for nonbank SD's."

    This is because the definition of a "qualifying master netting agreement" *should* prevent a nonbank SD from being exposed to flip clauses, walkaways or similar provisions in uncleared swaps or uncleared security-based swaps that are governed by a qualifying master netting agreement in the first place.

    "Qualifying master netting agreement means a written, legally enforceable agreement provided that:
    …

(3) The agreement does not contain a walkaway clause (that is, a provision that permits a non-defaulting counterparty to make a lower payment than it otherwise would make under the agreement, or no payment at all, to a defaulter or the estate of a defaulter, even if the defaulter or the estate of the defaulter is a net creditor under the agreement);"

A flip clause operates very similarly to a walkaway provision and may be categorized as one.

However, a nonbank SD that is exposed to a flip clause, walkaway or similar provision in an uncleared swap or uncleared security-based that is governed by a qualified master netting agreement swap must hold additional capital equal to the maximum of: [0, 100% of the "uncleared swap margin" as defined in footnote 25 of the CFTC proposal + 100% of the market value of the swap or security-based swap on the books of the SD].

12. No opinion.

13. No, the "method of computing the counterparty concentration charge" is *not* "appropriate for nonbank SDs" that are exposed to flip clauses, walkaways or similar provisions in uncleared swaps or uncleared security-based swaps.

    The counterparty concentration charge entirely neglects the 100% loss of swap assets that a credit-impaired SD will incur when all counterparties that can activate a flip clause, walkaway or similar provision in an uncleared swap or uncleared security-based swap simultaneously do so.

    The correlation of activation of all flip clauses, walkaways or similar provisions = 100%, i.e. 100% of counterparties to uncleared swaps and uncleared security-based swaps with these clauses and provisions that are in-the-money to an SD will simultaneously activate them against the SD when it is bankrupt, insolvent, non-performing or similarly impaired.

    Accordingly, such an SD must hold additional capital equal to the maximum of: [0, 100% of the "uncleared swap margin" as defined in footnote 25 of the CFTC proposal + 100% of the market value of the swap or security-based swap on the books of the SD].

14. No, the "method of computing the portfolio concentration charge" is *not* "appropriate for nonbank SDs" that are exposed to flip clauses, walkaways or similar provisions in uncleared swaps or uncleared security-based swaps.

    The portfolio concentration charge entirely neglects the 100% loss of swap assets that a credit-impaired SD will incur when all counterparties that can activate a flip clause, walkaway or similar provision in an uncleared swap or uncleared security-based swap simultaneously do so.

    The correlation of activation of all flip clauses, walkaways or similar provisions = 100%, i.e. 100% of counterparties to uncleared swaps and uncleared security-based swaps with these clauses and provisions that are in-the-money to an SD will simultaneously activate them against the SD when it is bankrupt, insolvent, non-performing or similarly impaired.

Accordingly, such an SD must hold additional capital equal to the maximum of: [0, 100% of the "uncleared swap margin" as defined in footnote 25 of the CFTC proposal + 100% of the market value of the swap or security-based swap on the books of the SD].

Responses to Request for Comment, pp. 91274-5

"The Commission requests comment on all aspects of the proposed capital rule and liquidity requirements, including empirical data in support of comments."

Unfortunately, the "Commission's proposed liquidity requirements" *don't* adequately "address the potential risk that an SD may not be able to efficiently meet both expected and unexpected current and future cashflow and collateral needs as a result of adverse events impacting the SD's daily operations or financial condition."

Each aspect of the proposed capital rule and liquidity requirements ignores the 100% exposure to itself that an SD bears under a flip clause, walkaway or similar provision in an uncleared swap or an uncleared security-based swap. These provisions enable the counterparty to an uncleared swap or an uncleared security-based swap to write off all payments that would otherwise be due an SD simply because it is bankrupt, insolvent, non-performing or similarly impaired.

As example, a key aspect of the proposed liquidity requirements for SDs — the liquidity stress test — typically entirely ignores the 100% loss that a credit-impaired SD will incur under an uncleared swap that is in-the-money or an uncleared security-based swap that is in-the-money if the counterparty activates a flip clause, walkaway or similar provision.

Similarly, the provision that "inflows that can be included to offset outflows are limited to 75% of the outflows" to mirror "losses from derivatives positions" is inadequate. This stress to inflows only partially reflects the 100% loss that a credit-impaired SD will incur under an uncleared swap that is in-the-money or an uncleared security-based swap that is in-the-money if the counterparty activates a flip clause, walkaway or similar provision.

Moreover, the correlation of activation of all flip clauses, walkaways or similar provisions will be 100%, i.e. 100% of counterparties to uncleared swaps and uncleared security-based swaps with these clauses and provisions that are in-the-money to an SD will simultaneously activate them against the SD when it is bankrupt, insolvent, non-performing or similarly impaired.

This omission is entirely inconsistent with the bedrock assumptions in a liquidity stress test that is governed either by common sense or simply the first term in footnote 103 of the Commission proposal. "The assumptions would include (1) a decline in creditworthiness of the SD severe enough to trigger contractual related commitment provisions of counterparty agreements."

Such a "decline in creditworthiness" of an SD would prompt 100% of its counterparties to uncleared swaps and uncleared security-based swaps with flip clauses, walkways or other provisions that are in-the-money to the SD to gear up simultaneously to activate these clauses and provisions.

As a result, the SD in question could suddenly find itself having to write off 100% of the payments that it had been scheduled to receive under these uncleared swaps and uncleared security-based swaps in the subsequent 30 days.

In other words, the proposed liquidity requirements would *not* "ensure that SD is maintaining sufficient liquidity and is not overly reliant on inflows." In fact, the presence of flip clauses, walkaways or similar provisions in the uncleared swaps and uncleared security-based swaps of an SD can both contribute to and exacerbate "adverse events impacting the SD's daily operations or financial condition."

The contingency funding plan that an SD will be required to produce must address the 100% losses that an SD will incur under uncleared swaps and uncleared security-based swaps that are in-the-money when counterparties activate flip clauses, walkaways and similar provisions.

The bankruptcy of Lehman Brothers provided a real-world example of a bankrupt swap provider that received USD 0.00 per USD 1.00 owed under 100% of in-the-money, uncleared swaps that contained flip clauses with 44 securitization issuers. In this real-world example, the correlation of counterparties that activated flip clauses against the swap provider was 100%.

United States Bankruptcy Judge Shelley C. Chapman detailed this 100% correlation of individual "payments" of USD 0.00 in a ruling on *Lehman Brothers Special Financing Inc. vs. Bank of America National Association et al of 28 June 2016.*

"Upon providing notice of an Event of Default under the Swaps and the Indentures, the Trustees liquidated the assets, including the Collateral securing the Issuers' obligations under the Swaps and Indentures, and deposited the proceeds into accounts held by each Trustee for that purpose. The Trustees subsequently distributed the proceeds pursuant to the applicable Waterfall (the "Distributions"). In each instance, the Trustees applied Noteholder Priority because the Early Terminations were the result of an Event of Default and LBSF was the Defaulting Party. *The amount of the proceeds of the liquidation of the Collateral was insufficient to make any payment to LBSF [italics added] under the Waterfall after proceeds were paid pursuant to Noteholder Priority*."

To "ensure the safety and soundness of an SD" that is exposed to a flip clause, walkaway or similar provision in an uncleared swap or an uncleared security-based swap, the CFTC must adjust each aspect of the capital rule and liquidity requirements to reflect the 100% exposure to itself that an SD bears.

The adjustments must require that an SD that is exposed to a flip clause, walkaway or similar provision in an uncleared swap or an uncleared security-based swap to hold capital equal to the following for each such swap and security-based swap.

> The maximum of: [0, 100% of the "uncleared swap margin" as defined in footnote 25 of the CFTC proposal + 100% of the market value of the swap or security-based swap on the books of the SD].
>
> **N.B.** Using the market value of the swap or security-based swap on the books of the SD will ensure its "safety and soundness." Otherwise, the last term may converge to USD 0.00 for even a deeply in-the-money swap as an SD approaches bankruptcy, insolvency, non-performing status or similar credit-impairment.

This adjustment may not be present in the "existing liquidity requirements adopted by the Federal Reserve Board for bank holding companies" because it published those requirements on 1 January 2015[121], i.e., 18 months prior to the ruling by Judge Chapman in *Lehman Brothers Special Financing Inc. vs. Bank of America National Association et al of 28 June 2016.*

This ruling by Judge Chapman to uphold the validity of a flip clause directly conflicted with both a 2010 ruling and a separate 2011 ruling by her predecessor in two other Lehman Brothers

[121] Federal Reserve Board, "12 CFR 249 – Liquidity Risk Measurement Standards (Regulation WW)' (1 January 2015). This document is available at: https://www.gpo.gov/fdsys/granule/CFR-2015-title12-vol4/CFR-2015-title12-vol4-part249/content-detail.html.

cases. Both earlier rulings placed the validity of a flip clause in doubt and may have informed *the Federal Reserve Board adoption of liquidity requirements in the case of an SD that* is exposed to a flip clause, walkaway or similar provision in an uncleared swap.

The 2010 ruling in Lehman Bros. Special Fin. Inc. v. BNY Corp. Trustee Servs. Ltd., 422 B.R. 407, 420 (Bankr. S.D.N.Y. 2010) (JMP) ("BNY") *invalidated a flip clause. The 2011 ruling in* Lehman Bros. Special Fin. Inc. v. Ballyrock ABS CDO 2007-1 Ltd. (In re Lehman Bros. Holdings Inc.), 452 B.R. 31 (Bankr. S.D.N.Y. 2011) (JMP) *did not restore the validity* of a flip clause.

Additionally, the proposed adjustment may not be present in the "liquidity requirements adopted by the Federal Reserve Board" because the adjustment would be redundant. "Walkaway clauses, including those that permit a party to suspend or condition payment, are not enforceable against the FDIC when acting as receiver or conservator of an insured depository institution or as receiver of a financial company under Title II of the Dodd Frank Act, or against the FHFA when acting as a receiver or conservator of Fannie Mae, Freddie Mac, or a Federal Home Loan Bank."[122] A flip clause operates very similarly to a walkaway provision and may be categorized as one.

Lastly, the proposed adjustment may not be present in the "liquidity requirements adopted by the Federal Reserve Board" because the Margin and Capital Requirements for Covered Swap Entities" that the prudential regulators jointly adopted in October 2015 *do not exempt securitization and structured product issuers* from the category of financial end users with which a covered swap entity must exchange variation margin on a daily basis. As a result, a covered swap entity that is party to an uncleared swap or uncleared security-based swap with a flip clause will hold variation margin equal to the market value of the swap when it is an asset on the books of the covered swap entity.

In light of the 28 June 2016 ruling by Judge Chapman, I will submit this comment to the Federal Reserve Board and the four other prudential regulators so that they may update their respective liquidity requirements *in the case of an SD that* is exposed to a flip clause, walkaway or similar provision in an uncleared swap or an uncleared security-based swap.

Staff of the CFTC Division of Swap Dealer and Intermediary Oversight should follow my lead and make a similar suggestion when they next meet with the prudential regulators to discuss uncleared swaps and uncleared security-based swaps with flip clauses, walkways and similar provisions.

A recent such meeting occurred on 22 February, according to an SFIG email blast of 23 February. The blast described "a meeting that SFIG held with the CFTC and prudential regulators yesterday, February 22nd, to discuss our recent request for temporary relief for legacy securitization transactions from the compliance date for variation margin requirements."

Meanwhile, the CFTC must *deviate* from the liquidity requirements adopted by the Federal Reserve Board to the extent that these requirements have been invalidated by legal developments.

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[122] See Prudential Regulators, 'Margin and Capital Requirements for Covered Swap Entities,' footnote 124. This document is available at: https://www.occ.treas.gov/news-issuances/news-releases/2015/nr-occ-2015-142aaa.pdf.

Separately, the Commission *should not* modify “the proposal to provide that an SD organized and domiciled outside of the US may include in its HQLAs assets held in its home country jurisdiction.” Doing so will not “ensure the safety and soundness” of the SD’s US operations, particularly if the SD is a large one that is integral to its home economy such as Deutsche Bank AG.

“In addition, the Commission requests comment in response to the following questions:”

1. No, the Commission should *not* “phase-in the implementation of any final capital rule” with respect to an SD rules that *is* exposed to a flip clause, walkaway or similar provision in an uncleared swap or an uncleared security-based swap.

   In this instance, there is *no* reason for the capital requirements to be implemented first and the liquidity requirements to be implemented second.

   Rather, an SD must immediately begin holding additional capital equal to the maximum of: [0, 100% of the “uncleared swap margin” as defined in footnote 25 of the CFTC proposal + 100% of the market value of the swap or security-based swap on the books of the SD].

2. Yes, the Commission *should* “consider alternative approaches to the proposed liquidity requirements” when an SD *is* exposed to a flip clause, walkaway or similar provision in an uncleared swap or an uncleared security-based swap.

   In this case, an SD must immediately begin holding additional capital equal to the maximum of: [0, 100% of the “uncleared swap margin” as defined in footnote 25 of the CFTC proposal + 100% of the market value of the swap or security-based swap on the books of the SD].

Responses to Request for Comment, p. 91280

"The Commission requests comment on all aspects of the proposed financial reporting, recordkeeping and notification requirements."

Unfortunately, the "proposed financial reporting, recordkeeping and notification requirements" *don't* adequately address the 100% exposure to itself that an SD or MSP bears under a flip clause, walkaway or similar provision in an uncleared swap or an uncleared security-based swap. These provisions enable the counterparty to an uncleared swap or an uncleared security-based swap to write off all payments that would otherwise be due an SD simply because it is bankrupt, insolvent, non-performing or similarly impaired.

Redressing this omission with respect to all SDs and MSPs — i.e., those that are "subject to the capital rules of a prudential regulator" and those that are not — will help "ensure the safety and soundness of each SD and MSP" by allowing market participants to independently evaluate its financial condition.

Redressing this omission will also promote efficient and self-sustaining derivative markets by increasing transparency and also by augmenting the incomplete assessment, oversight and investigations by the CFTC when it is limited by budget constraints.

"Proposed Regulation 23.105(d)(1) would require and SD or MSP to file a monthly unaudited financial report within 17 business days of the close of business every month, and Proposed Regulation 23.105(e)(1) would require and SD or MSP to file an annual audited financial report within 60 days of the close of the SD's or MSP's fiscal year-end date."

The unaudited and audited reports must include, among other information: "(6) any further materials that are necessary to make the required statements not misleading." Non-disclosure of the presence of a flip clause, walkaway or similar provision in an uncleared swap or uncleared security-based swap makes the required statements of an SD or MSP very misleading. Accordingly, an SD or MSP must require such a disclosure with respect to both Proposed Regulation 23.105(d)(1) and Proposed Regulation 23.105(e)(1).

The Commission may also require that an SD or MSP disclose each uncleared swap and uncleared security-based swap with a flip clause, walkaway or other provision in Proposed Regulation 23.105(h).

This "additional financial and operational information" will certainly be "necessary at times when an SD or MSP is experiencing a financial or operational crisis" and will be critically "necessary for the Commission to assess whether the SD or MSP will be able to meet its obligations to counterparties and other creditors." The correlation of activation of all flip clauses, walkaways or similar provisions will be 100%, i.e. 100% of counterparties to uncleared swaps and uncleared security-based swaps with these clauses and provisions that are in-the-money to an SD will simultaneously activate them against the SD when it is bankrupt, insolvent, non-performing or similarly impaired.

The Commission must amend Proposed Regulation 23.105(c). The bolded words in the amended section of the summary of Proposed Regulation 23.105(c) in the CFTC proposal below provide a template.

"…, if any such withdrawal or payment, and any other similar transactions that are scheduled to occur within the succeeding six months, result in the SD holding less than 120 percent of the minimum regulatory capital that the SD is required to hold, **such calculation of minimum regulatory capital to exclude all future receipts under an uncleared swap or uncleared security-based swap that contains a flip clause, walkaway or similar provision**…"

The Commission must include the presence of a flip clause, walkaway or similar provision in an uncleared swap or uncleared security-based swap among the "additional information" that "would be necessary in order to accept financial reports prepared in accordance with local accounting standards."

"In addition, the Commission requests comment, including empirical data in support of comments, in response to the following questions:"

1. No, "IFRS issued by the IASB" is *not* "an appropriate accounting standard that would allow the Commission and RFA to properly assess the financial condition of SDs and MSPs" that are organized and domiciled outside the US and exposed to a flip clause, walkaway or similar provision in an uncleared swap or an uncleared security-based swap.

   In these cases, an SD or MSP must hold additional capital equal to the maximum of: [0, 100% of the "uncleared swap margin" as defined in footnote 25 of the CFTC proposal + 100% of the market value of the swap or security-based swap on the books of the SD or MSP].

2. No, the Commission should *not* "accept financial statements prepared in accordance with local accounting standards from SDs or MSPs located in foreign jurisdictions" when such and SD or MSP is exposed to a flip clause, walkaway or similar provision in an uncleared swap or an uncleared security-based swap.

   In these cases, the financial statements should be augmented with information including but not limited to the market value of the swap or security-based swap with a flip clause, walkaway or similar provision on the books of the SD or MSP. The financial statements should also be augmented by the scheduled cashflows for the subsequent five years for each such uncleared swap or uncleared security-based swap with a flip clause, walkaway or similar provision.

3. No opinion.

4. No opinion.

5. Yes, the Commission *should* "require SDs that are subject to the capital rules of a prudential regulator to file notices with the Commission regarding changes to their capital status." Moreover, these SDs should also present their capital status in a second way that reflects the 100% loss of swap asset that can incur when a counterparty activates a flip clause, walkaway or similar provision in an uncleared swap or uncleared security-based swap.

   Doing so will "ensure the safety and soundness of an SD" and its counterparties.

There is no legal restriction that prevents an SD or MSP that is subject to the capital rules of a prudential regulator from presenting its capital status in a way that reflects the 100% loss of swap asset that can incur when a counterparty activates a flip clause, walkaway or similar provision in an uncleared swap or uncleared security-based swap.

No, these rules do *not* "adequately address SDs and MSPs that are foreign domiciled entities subject to prudential regulation by foreign banking authorities." These SDs and MSPs should present their financial information and capital status in a second way that reflects the 100% loss of swap asset that can incur when a counterparty activates a flip clause, walkaway or similar provision in an uncleared swap or uncleared security-based swap.

Doing so will "ensure the safety and soundness of an SD or MSP" and its US-based counterparties.

6. No, the "reporting elements to Appendix A" are *not* "adequately defined to capture the relevant information."

Schedule 1, #6. "Private label mortgage-backed securities" should be expanded to two categories.

Category #6a. will be "Private label mortgage-backed securities **where an issuer is NOT party to an uncleared swap or uncleared security-based swap with one or more RAC provisions or with one or more flip clauses, walkways or similar provisions.**"

Category #6b. will be "Private label mortgage-backed securities **where an issuer *IS* party to an uncleared swap or uncleared security-based swap with one or more RAC provisions or with one or more flip clauses, walkways or similar provisions.**"

The presence of an uncleared swap or uncleared security-based swap with one or more RAC provisions or with one or more flip clauses, walkways or similar provisions in a private-label mortgage-backed security exposes it to additional losses compared to an otherwise similar private label mortgage-backed security with no RAC provisions and with no flip clauses, walkways or similar provisions.

Schedule 1, #7. "Other asset-backed securities" should be expanded to two categories.

Category #7a. will be "Other asset-backed securities **where an issuer is NOT party to an uncleared swap or uncleared security-based swap with one or more RAC provisions or with one or more flip clauses, walkways or similar provisions.**"

Category #7b. will be "Other asset-backed securities **where an issuer *IS* party to an uncleared swap or uncleared security-based swap with one or more RAC provisions**

or with one or more flip clauses, walkways or similar provisions."

The presence of an uncleared swap or uncleared security-based swap with one or more RAC provisions or with one or more flip clauses, walkways or similar provisions in an asset-backed security exposes it to additional losses compared to an otherwise similar asset-backed security with no RAC provisions and with no flip clauses, walkways or similar provisions.

Each of the eight types of security-based swap in Schedule 1, Section 12 "Security-based swaps" should be broken into two categories.

The first category will be "…security-based swaps **with *NO* RAC provisions and with *NO* flip clauses, walkways or similar provisions.**"

The second category will be "…security-based swaps ***WITH* one or more RAC provisions or *WITH* one or more flip clauses, walkways or similar provisions.**"

The presence of a RAC provision or a flip clause, walkaway or similar provision exposes the parties to additional losses compared to an otherwise similar security-based swap with no RAC provisions and with no flip clauses, walkways or similar provisions.

Both types of mixed swap in Schedule 1, Section 13 "Mixed swaps" should be broken into two categories.

The first category will be "…mixed swaps **with *NO* RAC provisions and with *NO* flip clauses, walkways or similar provisions.**"

The second category will be "…mixed swaps ***WITH* one or more RAC provisions or *WITH* one or more flip clauses, walkways or similar provisions.**"

The presence of a RAC provision or a flip clause, walkaway or similar provision exposes the parties to additional losses compared to an otherwise similar mixed swap with no RAC provisions and with no flip clauses, walkways or similar provisions.

The seven types of swap in Schedule 1, Section 14 "Swaps" should be broken into two categories.

The first category will be "…swaps **with *NO* RAC provisions and with *NO* flip clauses, walkways or similar provisions.**"

The second category will be "…swaps ***WITH*** **one or more RAC provisions or *WITH* one or more flip clauses, walkways or similar provisions.**"

The presence of a RAC provision or a flip clause, walkaway or similar provision exposes the parties to additional losses compared to an otherwise similar swap with no RAC provisions and with no flip clauses, walkways or similar provisions.

There should be an additional line entry in both Section I and Section II of "Schedule 2 – Credit Concentration Report for Fifteen Largest Exposures in Derivatives," for a sixteenth credit concentration — namely, the self-referencing exposure to 100% loss of swap assets that an SD or MSP poses to itself under uncleared swaps and uncleared security-based swaps with flip clauses, walkways or similar provisions.

The presence of flip clauses, walkaways or similar provision in swaps exposes an SD or MSP to an additional source of credit losses — namely, itself — compared to otherwise similar swaps with no flip clauses, walkways or similar provisions.

7. No, the "reporting elements to Appendix B" are *not* "adequately defined to capture the relevant information."

   Under "Assets," Categories A & B of "2. Securities" should each be expanded to two categories.

   Category #2a(i). will be "Held-to-maturity securities **where an issuer is NOT party to an uncleared swap or uncleared security-based swap with one or more RAC provisions or with one or more flip clauses, walkways or similar provisions.**"

   Category #2a(ii). will be "Held-to-maturity securities **where an issuer *IS* party to an uncleared swap or uncleared security-based swap with one or more RAC provisions or with one or more flip clauses, walkways or similar provisions.**"

   The presence of an uncleared swap or uncleared security-based swap with one or more RAC provisions or with one or more flip clauses, walkways or similar provisions in a held-to-maturity security exposes it to additional losses compared to an otherwise similar held-to-maturity security with no RAC provisions and with no flip clauses, walkways or similar provisions.

   Category #2b(i). will be "Available-for-sale securities **where an issuer is NOT party to an uncleared swap or uncleared security-based swap with one or more RAC provisions or with one or more flip clauses, walkways or similar provisions.**"

   Category #2b(ii). will be "Available-for-sale securities **where an issuer *IS* party to an uncleared swap or uncleared security-based swap with one or more RAC provisions or with one or more flip clauses, walkways or similar provisions.**"

The presence of an uncleared swap or uncleared security-based swap with one or more RAC provisions or with one or more flip clauses, walkways or similar provisions in an available-for-sale security exposes it to additional losses compared to an otherwise similar available-for-sale security with no RAC provisions and with no flip clauses, walkways or similar provisions.

8. Yes, the Commission should make public *all* "other monthly unaudited or annual audited financial information filed by an SD or MSP under Regulation 23.105."

   Doing so will help "ensure the safety and soundness of each SD and MSP" by allowing market participants to independently evaluate its financial condition.

   This will promote efficient and self-sustaining derivative markets by increasing transparency and also by augmenting incomplete assessment, oversight and investigations by the CFTC when it is limited by budget constraints.

9. The Commission should make *all* SD and MSP financial data publicly available.

   Doing so will help "ensure the safety and soundness of each SD and MSP" by allowing market participants to independently evaluate its financial condition.

   This will promote efficient and self-sustaining derivative markets by increasing transparency and also by augmenting incomplete assessment, oversight and investigations by the CFTC when it is limited by budget constraints.

10. No, there should *not* be "different disclosure rules for SDs and MSPs" that are exposed to a flip clause, walkaway or similar provision in an uncleared swap or an uncleared security-based swap.

    In these cases, an SD and MSP should both disclose detailed information on each such uncleared swap and uncleared security-based swap including but not limited to: each flip clause, walkaway or similar provision; the market value of the swap on the books and records of the SD or MSP; and the lifetime projected cashflows of the swap.

11. Yes, "disclosure of certain financial information" *would* "provide SD and MSP counterparties with necessary information concerning some SDs or MSPs without adversely impacting that particular SD's or MSP's ability to maintain a trading book."

    This "certain financial information" includes the exposure of the SD or MSP to a flip clause, walkaway or similar provision in an uncleared swap or an uncleared security-based swap.

    This information will help preserve the solvency of an SD or MSP, and thus its ability to maintain a trading book, by instilling discipline to not recklessly book uncleared swaps or uncleared security-based swaps with flip clauses, walkaways or similar provisions.

This information will also enable a counterparty to an SD or MSP preserve its own "safety and soundness" by assessing the recovery value from an uncleared swap or uncleared security-based swap with an SD or MSP in that event that it becomes insolvent, bankrupt, non-performing or similarly impaired.

12. Yes, absolutely, the "Commission *must* post SD and MSP financial data on the Commission's website." Doing so will help "ensure the safety and soundness of each SD and MSP" by allowing market participants to independently evaluate its financial condition.

    This will promote efficient and self-sustaining derivative markets by increasing transparency and also by augmenting incomplete assessment, oversight and investigations by the CFTC when it is limited by budget constraints.

Responses to Information Collection Comments, pp. 91285-6

"The Commission invites the public and other Federal agencies to comment on any aspect of the proposed information collection requirements discussed above…[T]he Commission will consider public comments on such proposed requirements in:

"– Evaluating whether the proposed collections of information are necessary for the proper performance of the functions of the Commission, including whether the information will have a practical use;"

Unfortunately, the "proposed collection of information" *don't* adequately address the 100% exposure to itself that an SD or MSP bears under a flip clause, walkaway or similar provision in an uncleared swap or an uncleared security-based swap. These provisions enable the counterparty to an uncleared swap or an uncleared security-based swap to write off all payments that would otherwise be due an SD simply because it is bankrupt, insolvent, non-performing or similarly impaired.

Redressing this omission is "necessary for the proper performance of the functions of the Commission."

Otherwise, the Commission may remain captive to the securitization industry in general and susceptible to misrepresentations that the industry group SFIG has made regarding uncleared swaps with RAC provisions and flip clauses.

"– Enhancing the quality, utility, and clarity of the information proposed to be collected; and
– Minimizing the burden of the proposed information collection requirements on respondents…"

The SDs and other providers of uncleared, balance-guaranteed swaps with RAC provisions and flip clauses to securitizations that Navient originated or sponsors can *easily* meet "the proposed information collection requirements." Doing so imposes *no* burden on these global entities.

Navient and Navient-Sponsored Private Student Loan Securitizations with Uncleared, Balance-Guaranteed[123] Swaps that Reference the Prime Rate and LIBOR and Contain Flip Clauses and RAC Provisions and Respective Swap Providers (Shading denotes an SD)
Sources: Navient Website; Rating Agency Announcements and Reports; and CFTC.gov.

1. SLM Private Credit Student Loan Trust 2002-A – Merrill Lynch Derivative Products AG
2. SLM Private Credit Student Loan Trust 2003-B – 2 Counterparties: 1. Merrill Lynch Derivative Products AG; & 2. Citibank, N.A.
3. SLM Private Credit Student Loan Trust 2003-C – 2 Counterparties: 1. Merrill Lynch Derivative Products AG; & 2. JPMorgan Chase Bank North America
4. SLM Private Credit Student Loan Trust 2003-A – 2 Counterparties: 1. Merrill Lynch Derivative Products AG; & 2. Citibank, N.A.
5. SLM Private Credit Student Loan Trust 2004-A – JPMorgan Chase Bank NA
6. SLM Private Credit Student Loan Trust 2004-B – JPMorgan Chase Bank NA

[123] "Residential mortgage ABS and student loan ABS have pronounced exposure to counterparty risk, given their reliance on a highly idiosyncratic type of swap: a balance-guarantee swap with a flip clause. 'Balance guarantee' indicates that the swap offsets two mismatches in payment characteristics between securitized assets and ABS — a standard mismatch such as that between basis rates, interest rates, or currencies and a second, highly idiosyncratic mismatch between prepayment rates." See William J, Harrington, 'Re: File Number S7-18-11, Request for Re-proposal Relating to Nationally Recognized Statistical Rating Organizations,' (29 May 2014) p. 14. This submission is available at: https://www.sec.gov/comments/s7-18-11/s71811-84.pdf.

7. SLM Private Credit Student Loan Trust 2005-A – Morgan Stanley Capital Services
8. SLM Private Credit Student Loan Trust 2005-B – Royal Bank of Scotland
9. SLM Private Credit Student Loan Trust 2006-A – Deutsche Bank New York
10. SLM Private Credit Student Loan Trust 2006-B – Deutsche Bank New York
11. SLM Private Credit Student Loan Trust 2006-C – Bank of America NA
12. SLM Private Credit Student Loan Trust 2007-A – Credit Suisse First Boston International
13. SLM Private Education Student Loan Trust 2010-B – Royal Bank of Scotland
14. SLM Private Education Student Loan Trust 2010-C – Royal Bank of Scotland
15. SLM Private Education Student Loan Trust 2011-C – Royal Bank of Canada, Toronto
16. SLM Private Education Student Loan Trust 2012-A – GSMMDP
17. SLM Private Education Student Loan Trust 2012-B – Bank of New York
18. SLM Private Education Student Loan Trust 2012-C – Bank of New York
19. SLM Private Education Student Loan Trust 2012-D – Royal Bank of Canada, Toronto
20. SLM Private Education Student Loan Trust 2012-E – Bank of New York
21. SLM Private Education Student Loan Trust 2013-A – Bank of New York
22. SLM Private Education Student Loan Trust 2013-B – Bank of New York
23. SLM Private Education Student Loan Trust 2013-C – Bank of New York
24. SLM Private Education Student Loan Trust 2014-A – Bank of New York
25. Navient Private Education Student Loan Trust 2014-CT – JPMorgan Chase Bank NA
26. Navient Private Education Loan Trust 2014-A – Royal Bank of Canada
27. Navient Private Education Student Loan Trust 2014-CT – JPMorgan Chase NA
28. Navient Private Education Loan Trust 2015-A – Royal Bank of Canada
29. Navient Private Education Loan Trust 2015-B – Wells Fargo Bank
30. Navient Private Education Loan Trust 2015-C – JPMorgan Chase Bank NA
31. Navient Private Education Loan Trust 2016-A – JPMorgan Chase Bank NA

Navient and Navient-Sponsored Student Loan Securitizations with Uncleared, Balance-Guaranteed[124] Swaps that Reference Currencies and Contain Flip Clauses and RAC Provisions and Respective Swap Providers (Shading denotes an SD)
Sources: Navient Website; Rating Agency Announcements and Reports; and CFTC.gov.

1. SLM Student Loan Trust 2003-2 – CDC IXIS Capital Markets (Euro 187mm / USD 203mm)
2. SLM Student Loan Trust 2003-5 – CDC IXIS Capital Markets (Euro 270mm / USD 309mm)
3. SLM Student Loan Trust 2003-7 – CDC IXIS Capital Markets (Euro 490mm / USD 550mm)
4. SLM Student Loan Trust 2003-10 – CDC IXIS Capital Markets (GBP 1.25bn / USD 1.7bn)
5. SLM Student Loan Trust 2003-12 – Citibank (GBP 400mm / USD 670mm)
6. SLM Student Loan Trust 2004-2 – CDC IXIS Capital Markets (Euro 796mm / USD 1bn)
7. SLM Student Loan Trust 2004-5 – Swiss Re Financial Products (Euro 760mm / USD 930mm)
8. SLM Student Loan Trust 2004-10 – AIG Financial Products Corp. (Euro 408mm / USD 501mm)
9. SLM Student Loan Trust 2005-9 – Deutsche Bank NY (Euro 500mm / USD 597mm)
10. SLM Student Loan Trust 2006-4 – 2 Counterparties: 1. Credit Suisse First Boston International (Euro 436mm / USD 530mm); and 2. Banque Nationale De Paris (Euro 436mm / USD 530mm)
11. SLM Student Loan Trust 2006-6 – Barclays Capital Markets (Euro 372mm / USD 473mm)
12. SLM Student Loan Trust 2006-10 – Barclays Capital Markets (Euro 302mm / USD 386mm)
13. SLM Student Loan Trust 2007-4 – Barclays Capital (Euro 305mm / USD 406mm)
14. SLC Student Loan Trust 2008-01 – Credit Suisse First Boston International (euro 134mm / USD 208mm)

[124] In 2006, a major swap provider concluded that "balance-guaranteed" uncleared swaps in the RMBS sector could not be replaced. See William J. Harrington, 'Re: Rule Comment Number 466-1,' Comment to the SEC (3 June 2013) PDF-numbered pp. 25-29. "Under the RAC, BSFP presented RMBS issuers with a derivative contract that made failure by BSP to post collateral at the Second Trigger an Additional Termination Event rather than an Event of Default. *The BSFP rationale in petitioning for RAC was that balance-guarantee hedges with RMBS issuers could not be replaced* [italics added] and BSFP lacked resources to post collateral for the duration of each balance-guaranteed swap." See also PDF-numbered page 40, footnote 53. This submission is available at https://www.sec.gov/comments/4-661/4661-28.pdf.

Responses to Request for Comment, pp. 91296-7

1. "Protection of Market Participants and the Public"

   "Do proposed capital, liquidity, and financial reporting requirements properly protect market participants and the public?

   Not yet. The proposed requirements do *not* address the distinct and outsized exposures that accrue to the two respective parties to an uncleared swap or uncleared security-based swap with RAC provisions and a flip clause — i.e., to "the public" as both investors and bailout financiers and to "market participants" as swap providers.

   However, the proposal *will* "protect financial entities from default" if amended with respect to an SD or MSP that is party to an uncleared swap with a flip clause, walkaway or similar provision or an uncleared security-based swap with a flip clause, walkaway or similar provision.

   In these cases, an SD or MSP must hold and report additional capital equal to the maximum of: [0, 100% of the "uncleared swap margin" as defined in footnote 25 of the CFTC proposal + 100% of the market value of the swap or security-based swap on the books of the SD or MSP].

   These adjustments are necessary to "provide SDs with the ability, in times of financial stress, to meet their current and other obligations as they come due." An SD or MSP in financial distress is exposed to simultaneously incurring 100% losses under 100% of the uncleared swaps with a flip clause, walkaway or similar provision that are in-the-money and under 100% of the uncleared security-based swaps with a flip clause, walkaway or similar provision that are in-the-money.

   The proposed adjustment will obligate an SD or MSP that is party to an uncleared swap or uncleared security-based swap with a flip clause, walkaway or similar provision to report its holding of additional capital, which will "strengthen the swaps market by requiring all CSEs to maintain a minimum level of capital and liquidity."

   Uncleared swaps with RAC provisions and flip clauses contributed to the undercapitalization of whole sectors of securitization debt and structured product debt that started the financial crisis, exacerbated it, failed in some cases and benefited from significant government support in other cases.

   Many of these undercapitalized sectors — cashflow CDOs; cashflow TRuPS CDOs; cashflow CDO-squared; cashflow RMBS; repackaged securitizations of all sectors; structured credit default swaps; structured notes of all securitization sectors; synthetic CDOs; and synthetic RMBS — are the poster children of the financial crisis.

   However, the remaining securitization sectors — e.g., those backed by auto loans, credit cards, equipment leases, levered loans and student loans — were also undercapitalized owing to the presence of uncleared swaps with RAC provisions and flip clauses. These sectors benefited indirectly from the explicit bailouts and other support that the US government provided to global counterparties after Lehman Brothers failed. Without this government support, the undercapitalization of these remaining securitization sectors might have caused them to follow the poster children sectors into complete and ignominious collapse.

On the other side of the ledger, uncleared swaps with RAC provisions and flip clauses also contributed to the undercapitalization of major counterparties such as Lehman Brothers and AIG. Pre-crisis requirements for reporting the attributes of in-the-money, uncleared swaps with flip clauses did not obligate swap providers to recognize that these assets would instantaneously transform into deeply-subordinated ones when counterparties activated flip clauses.

The bankruptcy of Lehman Brothers provided a real-world example of a bankrupt swap provider that received USD 0.00 per USD 1.00 owed under 100% of in-the-money, uncleared swaps that contained flip clauses with 44 securitization issuers. In this real-world example, the correlation of counterparties that activated flip clauses against the swap provider was 100%.

United States Bankruptcy Judge Shelley C. Chapman detailed this 100% correlation of individual "payments" of USD 0.00 in a ruling on *Lehman Brothers Special Financing Inc. vs. Bank of America National Association et al of 28 June 2016.*

"Upon providing notice of an Event of Default under the Swaps and the Indentures, the Trustees liquidated the assets, including the Collateral securing the Issuers' obligations under the Swaps and Indentures, and deposited the proceeds into accounts held by each Trustee for that purpose. The Trustees subsequently distributed the proceeds pursuant to the applicable Waterfall (the "Distributions"). In each instance, the Trustees applied Noteholder Priority because the Early Terminations were the result of an Event of Default and LBSF was the Defaulting Party. *The amount of the proceeds of the liquidation of the Collateral was insufficient to make any payment to LBSF [italics added] under the Waterfall after proceeds were paid pursuant to Noteholder Priority.*"

Judge Chapman went on to confuse cause and effect by characterizing the broader financial crisis as "a time we truly hope was a 'singular' event." In fact, Lehman Brothers was not an unlucky bystander to the crisis nor was the company blindsided by the 100% losses that it incurred under 100% of uncleared swaps with flip clauses that were in-the-money assets. These swaps performed exactly as Lehman Brothers *itself* and other global counterparties had both structured and advertised.

The shoddy practices of the financial sector writ large — accountants, counsel, investors, issuers, investors, Lehman Brothers, Lehman Brothers trading partners, other swap providers, rating agencies, regulators, and underwriters — made the financial crisis inevitable.

In other words, there was nothing "singular" about the financial crisis. Nor can "hope" alone prevent a recurrence. Robust capital, liquidity and financial reporting requirements are needed.

Admittedly, robust capital, liquidity and financial reporting requirements may result in few if any SDs providing new uncleared swaps or uncleared security-based swaps with flip clauses, walkaways or similar provisions in the future.

This may be a boon for economic growth and financial stability, given the lose-lose track record of uncleared swaps with flip clauses, walkaways and similar provisions.

Moreover, the timing for such a boon is ideal. Securitization issuers have not entered into many new uncleared swaps with flip clauses recently, but this pattern could change as interest rates rise. However, the protection of market participants and the public depends on fewer rather than more uncleared and unmargined swaps with RAC provisions and flip clauses.

To take one example, issuance of private-label cashflow RMBS *must* remain moribund to the extent that this sector remains undercapitalized owing to reliance on balance-guaranteed, uncleared swaps with flip clauses.

Had robust capital and liquidity requirements been in place prior to the financial crisis, global swap dealers might have provided fewer uncleared swaps with flip clauses to issuers of securitized and structured product debt. In turn, the financial crisis might have been staved off entirely.

Instead, issuers entered into these swaps to effectuate and mask the undercapitalization of securitization and structured product debt and to sell this debt at artificially cheap levels. Swap providers such as Lehman Brothers booked these swaps and explicitly agreed to accept 100% losses under 100% of such swaps that were in-the-money upon becoming bankrupt, insolvent or similarly impaired.

As a result, Lehman Brothers, its bondholders, shareholders, counterparties and the entire financial system paid a terrible price. Without the accompanying bailouts — in which US taxpayers paid an even steeper price — the same would have been true of AIG[125] and

[125] William J. Harrington, 'Re: File Number S7-18-11— Comment on SEC Proposed Rules for Nationally Recognized Statistical Rating Organizations,' Comment to the SEC (8 August 2011). "Item 4b. 2009-2010. AIG was the downgraded hedge provider...AIG was counterparty to interest rate swaps with 50+ CDOs and other ABS transactions that had become deep-in the money, mark-to-market assets of AIG. In addition to providing an interest rate hedge to the transactions, *AIG had also lent money to some of them at issuance* [italics added]. The CDOs that had borrowed in this fashion were repaying the loans through higher-than-market fixed rates that had resulted in particularly large mark-to-market assets for AIG. The respective swap contracts allowed the CDOs (both those that had borrowed from AIG and those that had not) to terminate the swaps without making any payment *as AIG had not complied with the replacement provisions following its 2008 downgrades* [italics added]. If the CDOs had exercised these rights, they would have removed a large liability from the top of their waterfalls, to the benefit of their rated notes. *By corollary, AIG would have recorded a 100% loss on each of the deeply-in-the-money swap assets* [italics added]." Pp. 63 (PDF-page 65). This comment is available at: https://www.sec.gov/comments/s7-18-11/s71811-33.pdf.

many other global swap providers.

Accordingly, the reporting adjustment proposed at the beginning of this section will enable market participants to independently evaluate the financial condition of an SD or MSP that is exposed to flip clauses, walkaways or similar provisions in uncleared swaps or uncleared security-based swaps. This information will enable counterparties to enforce market oversight so that an SD that is exposed to these 100% losses remains viable or at least does not assume even more such exposure.

This will promote efficient and self-sustaining derivative markets that protect market participants and the public by increasing transparency and also by augmenting incomplete assessment, oversight and investigations by the CFTC when it is limited by budget constraints.

In short, An SD or MSP that is party to an uncleared swap or uncleared security-based swap with a flip clause, walkway or similar provision is extremely reckless. Requiring such an SD or MSP to publicly report this recklessness may stop it.

In contrast, if the Commission does not adopt the proposed adjustments to the capital, liquidity and financial reporting requirements, it will be abdicating its responsibility to improve the "safety and soundness" of SDs and "the stability of the US financial system."

Similarly, if the Commission does not adopt the proposed adjustments to the capital, liquidity and financial reporting requirements, it will be harming rather than protecting "market participants and the public."

In this case, cynics will be justified in a belief that little has changed since the financial crisis and that overly complex financial instruments such as the swaps that parties use to undercapitalize respective loss exposures continue to harm rather than protect market participants and the public.

What might drive the Commission to adopt such a destructive path? In my view, a broader lack of confidence in the US economy that is also shared by many other policy makers who see no good solutions to revive US growth and so grasp at bad, discredited ones.

2. "Efficiency, Competitiveness, and Financial Integrity of Swaps Markets"

"Is market integrity adversely affected by the proposed rules? If so, how might the Commission mitigate any harmful impact?

Yes, "market integrity" *is* "adversely affected by the proposed rules" because they do not address the exposure of an SD or MSP to simultaneously incurring 100% losses under 100% of the uncleared swaps with a flip clause, walkaway or similar provision that are in-the-money and under 100% of the uncleared security-based swaps with a flip clause, walkaway or similar provision that are in-the-money.

These uncleared swaps and uncleared security-based swaps are among the most egregious examples of inefficient, non-competitive and deficient swaps that the financial system has foisted on the wider economic system.

Simply put, the numbers in an uncleared swap with a flip clause, walkaway or similar provision *cannot* possibly add up for either party. Instead, each party uses an uncleared swap or uncleared security-based swap with flip clauses, walkaways or similar provisions to both effectuate and mask a significant undercapitalization against the respective loss exposures.

An SD or MSP that is party to an uncleared swap or uncleared security-based swap with a flip clause, walkway or similar provision is extremely reckless. This recklessness distorts the efficiency, competitiveness and integrity of the US swaps market, the US financial system and the US economy.

The deficiencies of an uncleared swap or uncleared security-based swap with a flip clause, walkaway or similar provisions should be very well known to the CFTC Division of Swap Dealer and Intermediary Oversight, based on my submissions to it and discussions with its staff in 2015, 2016 and 2017.

Moreover, these deficiencies are an extremely well-known and open secret within the legal, rating, securitization, and structured finance communities, to name just a few. These communities rely on the SEC and the CFTC to perpetuate this open secret by ignoring it in rule making and by issuing no-action letters such as the CFTC Letter No. 15-21 of 31 March 2015 and the SEC Letter No-Action Letter of 23 November 2010 addressed to Ford Motor Credit Company LLC.

However, the Commission can mitigate this *harmful* impact on efficiency, competitiveness and integrity of the US swaps market, the US financial system and the US economy by adjusting this proposal.

Under this adjusted proposal, an SD or MSP will hold and report additional capital equal to the maximum of: [0, 100% of the “uncleared swap margin” as defined in footnote 25 of the CFTC proposal + 100% of the market value of the swap or security-based swap on the books of the SD or MSP].

These adjustments are necessary to “provide SDs with the ability, in times of financial stress, to meet their current and other obligations as they come due.” An SD or MSP in financial distress is exposed to simultaneously incurring 100% losses under 100% of the uncleared swaps with a flip clause, walkaway or similar provision that are in-the-money and under 100% of the uncleared security-based swaps with a flip clause, walkaway or similar provision that are in-the-money.

The proposed adjustment will obligate an SD or MSP that is party to an uncleared swap or uncleared security-based swap with a flip clause, walkaway or similar provision to report its holding of additional capital, which will "strengthen the swaps market by requiring all CSEs to maintain a minimum level of capital and liquidity."

Uncleared swaps with RAC provisions and flip clauses weakened the efficiency, competitiveness and integrity of the US swaps market, US financial system and US by facilitating the intentional undercapitalization of whole sectors of securitization debt and structured product debt that started the financial crisis, exacerbated it and subsequently failed in some cases and benefited from significant government support in other cases.

Many of these undercapitalized sectors — cashflow CDOs; cashflow TRuPS CDOs; cashflow CDO-squared; cashflow RMBS; repackaged securitizations of all sectors; structured credit default swaps; structured notes of all securitization sectors; synthetic CDOs; and synthetic RMBS — are the poster children of the financial crisis.

However, the remaining securitization sectors — e.g., those backed by auto loans, credit cards, levered loans, equipment leases, and student loans — were also undercapitalized owing to the presence of uncleared swaps with RAC provisions and flip clauses. These sectors benefited indirectly from the explicit bailouts and other support that the US government provided to global counterparties after Lehman Brothers failed. Without this government support, the undercapitalization of these remaining securitization sectors might have caused them to follow the poster children sectors into complete and ignominious collapse.

On the other side of the ledger, uncleared swaps with RAC provisions and flip clauses also weakened the efficiency, competitiveness and integrity of the US swaps market, US financial system and US economy by contributing to the undercapitalization of major counterparties such as Lehman Brothers and AIG. Pre-crisis requirements for capital, liquidity and financial reporting did not address in-the-money, uncleared swaps with flip clauses and did not obligate swap providers to recognize that these very senior assets would instantaneously transform into deeply-subordinated ones when counterparties activated flip clauses.

The bankruptcy of Lehman Brothers provided a real-world example of a bankrupt swap provider that received USD 0.00 per USD 1.00 owed under 100% of in-the-money, uncleared swaps that contained flip clauses with 44 securitization issuers. In this real-world example, the correlation of counterparties that activated flip clauses against the swap provider was 100%.

United States Bankruptcy Judge Shelley C. Chapman detailed this 100% correlation of individual "payments" of USD 0.00 in a ruling on *Lehman Brothers Special Financing Inc. vs. Bank of America National Association et al of 28 June 2016.*

"Upon providing notice of an Event of Default under the Swaps and the Indentures, the Trustees liquidated the assets, including the Collateral securing the Issuers' obligations under the Swaps and Indentures, and deposited the proceeds into accounts held by each Trustee for that purpose. The Trustees subsequently distributed the proceeds pursuant to the applicable Waterfall (the "Distributions"). In each instance, the Trustees applied Noteholder Priority because the Early Terminations were the result of an Event of Default and LBSF was the Defaulting Party. *The amount of the proceeds of the liquidation of the Collateral was insufficient to make any payment to LBSF [italics added] under the Waterfall after proceeds were paid pursuant to Noteholder Priority.*"

Judge Chapman went on to confuse cause and effect by characterizing the broader financial crisis as "a time we truly hope was a 'singular' event." In fact, Lehman Brothers was not an unlucky bystander to the crisis nor was the company blindsided by the 100% losses that it incurred under 100% of uncleared swaps with flip clauses that were in-the-money assets. These swaps performed exactly as Lehman Brothers *itself* and other global counterparties had both structured and advertised.

The shoddy practices of the financial sector writ large — accountants, counsel, investors, issuers, investors, Lehman Brothers, Lehman Brothers trading partners, other swap providers, rating agencies, regulators, and underwriters — made the financial crisis inevitable.

In other words, there was nothing "singular" about the financial crisis. Nor can "hope" alone prevent a recurrence.

For instance, defendant banks in *Lehman Brothers Special Financing Inc. vs. Bank of America National Association et al* included: Bank of America, National Association; Goldman Sachs & Co.; Goldman Sachs International; Merrill Lynch, Pierce, Fenner & Smith Incorporated; Merrill Lynch International; and US Bank.

Each institution has first-hand knowledge of the 100% losses that an SD or MSP can incur under 100% of the uncleared swaps with a flip clause, walkaway or similar provision that are in-the-money and 100% of the uncleared security-based swaps with a flip clause, walkaway or similar provision that are in-the-money.

Yet, many of these same institutions also *provide* this very same type of swap and similarly assume the very same risk of 100% loss of 100% of swap assets without making special provisions or holding offsetting capital.

For instance, Merrill Lynch Derivative Products AG provides uncleared and unmargined balance-guaranteed swaps with RAC provisions and flip clauses to the following four securitization issuers: SLM Private Credit Student Loan Trust 2002-A SLM Private Credit Student Loan Trust 2003-A; SLM Private Credit Student Loan Trust 2003-B; and SLM Private Credit Student Loan Trust 2003-C. Bank of America, National Association provides an uncleared and unmargined balance-guaranteed swap with RAC provisions and flip clauses to SLM Private Credit Student Loan Trust 2006-C. Goldman Sachs Mitsui Marine Derivative Products LP provides an uncleared and unmargined balance-guaranteed swap with RAC provisions and flip clauses to SLM Private Education Student

Loan Trust 2012-A.

Clearly, robust capital, liquidity and financial reporting requirements are needed.

Admittedly, robust capital, liquidity and financial reporting requirements may result in few if any SDs providing new uncleared swaps or uncleared security-based swaps with flip clauses, walkaways or similar provisions in the future.

This may be a boon for economic growth and financial stability, given the lose-lose track record of uncleared swaps with flip clauses, walkaways and similar provisions.

Moreover, the timing for such a boon is ideal. Securitization issuers have not entered into many new uncleared swaps with flip clauses recently but this pattern could change as interest rates rise. However, the efficiency, competitiveness and integrity of the US economy depends on fewer rather than more uncleared and unmargined swaps with RAC provisions and flip clauses.

To take one example, issuance of private-label cashflow RMBS *must* remain moribund to the extent that this sector remains undercapitalized owing to reliance on uncleared swaps with flip clauses.

Had robust capital and liquidity requirements been in place prior to the financial crisis, global swap dealers might have provided fewer uncleared swaps with flip clauses to issuers of securitized and structured product debt and the financial crisis might have been staved off entirely.

Instead, issuers entered into these swaps to mask risks and thereby sell undercapitalized securitization and structured product debt — debt that subsequently collapsed. Swap providers such as Lehman Brothers booked these swaps and explicitly agreed to accept 100% losses under 100% of such swaps that were in-the-money upon becoming bankrupt, insolvent or similarly impaired.

As a result, Lehman Brothers, its bondholders, shareholders, counterparties and the entire financial system paid a terrible price. Without the accompanying bailouts — in which US taxpayers paid an even steeper price — the same would have been true of AIG[126] and

[126] William J. Harrington, 'Re: File Number S7-18-11— Comment on SEC Proposed Rules for Nationally Recognized Statistical Rating Organizations,' Comment to the SEC (8 August 2011). "Item 4b. 2009-2010. AIG was the downgraded hedge provider...AIG was counterparty to interest rate swaps with 50+ CDOs and other ABS transactions that had become deep-in the money, mark-to-market assets of AIG. In addition to providing an interest rate hedge to the transactions, *AIG had also lent money to some of them at issuance* [italics added]. The CDOs that had borrowed in this fashion were repaying the loans through higher-than-market fixed rates that had resulted in particularly large mark-to-market assets for AIG. The respective swap contracts allowed the CDOs (both those that had borrowed from AIG and those that had not) to terminate the swaps without making any payment *as AIG had not complied with the replacement provisions following its 2008 downgrades* [italics added]. If the CDOs had exercised these rights, they would have removed a large liability from the top of their waterfalls, to the benefit of their rated notes. *By corollary, AIG would have recorded a 100% loss on each of the deeply-in-the-money swap assets* [italics added]." Pp. 63 (PDF-page 65). This comment is available at: https://www.sec.gov/comments/s7-18-11/s71811-33.pdf.

many other global swap providers.

Accordingly, the reporting adjustment proposed at the beginning of this section will enable market participants to independently evaluate the financial condition of an SD or MSP that is exposed to flip clauses, walkaways or similar provisions in uncleared swaps or uncleared security-based swaps. This information will enable counterparties to enforce market oversight so that an SD that is exposed to these 100% losses remains viable or at least does not assume even more such exposure.

This will promote efficient, competitive and self-sustaining derivative markets by increasing transparency and also by augmenting incomplete assessment, oversight and investigations by the CFTC when it is limited by budget constraints.

This adjustment may not be present in the prudential regulators' current capital framework such as the "existing liquidity requirements adopted by the Federal Reserve Board for bank holding companies" because it published those requirements on 1 January 2015[127], i.e., 18 months prior to the ruling by Judge Chapman in *Lehman Brothers Special Financing Inc. vs. Bank of America National Association et al of 28 June 2016.*

This ruling by Judge Chapman to uphold the validity of a flip clause directly conflicted with both a 2010 ruling and a separate 2011 ruling by her predecessor in two other Lehman Brothers cases. Both earlier rulings placed the validity of a flip clause in doubt and may have informed *the Federal Reserve Board adoption of liquidity requirements in the case of an SD that* is exposed to a flip clause, walkaway or similar provision in an uncleared swap.

The 2010 ruling in Lehman Bros. Special Fin. Inc. v. BNY Corp. Trustee Servs. Ltd., 422 B.R. 407, 420 (Bankr. S.D.N.Y. 2010) (JMP) ("BNY") *invalidated a flip clause. The 2011 ruling in* Lehman Bros. Special Fin. Inc. v. Ballyrock ABS CDO 2007-1 Ltd. (In re Lehman Bros. Holdings Inc.), 452 B.R. 31 (Bankr. S.D.N.Y. 2011) (JMP) *did not restore the validity* of a flip clause.

Additionally, the proposed adjustment may not be present in the prudential regulators' current capital framework because the adjustment would be redundant. "Walkaway clauses, including those that permit a party to suspend or condition payment, are not enforceable against the FDIC when acting as receiver or conservator of an insured depository institution or as receiver of a financial company under Title II of the Dodd Frank Act, or against the FHFA when acting as a receiver or conservator of Fannie Mae, Freddie Mac, or a Federal Home Loan Bank."[128] A flip clause operates very similarly to a walkaway provision and may be categorized as one.

Lastly, the proposed adjustment may not be present in the prudential regulators' current

[127] Federal Reserve Board, "12 CFR 249 – Liquidity Risk Measurement Standards (Regulation WW)' (1 January 2015). This document is available at: https://www.gpo.gov/fdsys/granule/CFR-2015-title12-vol4/CFR-2015-title12-vol4-part249/content-detail.html.
[128] See Prudential Regulators, 'Margin and Capital Requirements for Covered Swap Entities,' footnote 124. This document is available at: https://www.occ.treas.gov/news-issuances/news-releases/2015/nr-occ-2015-142aaa.pdf.

capital framework such as the "liquidity requirements adopted by the Federal Reserve Board" because the Margin and Capital Requirements for Covered Swap Entities" that the prudential regulators jointly adopted in October 2015 *do not exempt securitization and structured product issuers* from the category of financial end users with which a covered swap entity must exchange variation margin on a daily basis. As a result, a covered swap entity that is party to an uncleared swap or uncleared security-based swap with a flip clause *should* hold variation margin equal to the market value of the swap when it is an asset on the books of the covered swap entity.

In light of the 28 June 2016 ruling by Judge Chapman, I will submit this comment to the Federal Reserve Board and the four other prudential regulators so that they may update their respective liquidity requirements *in the case of an SD that* is exposed to a flip clause, walkaway or similar provision in an uncleared swap or an uncleared security-based swap.

Staff of the CFTC Division of Swap Dealer and Intermediary Oversight should follow my lead and make a similar suggestion when they next meet with the prudential regulators to discuss uncleared swaps and uncleared security-based swaps with flip clauses, walkways and similar provisions.

A recent such meeting occurred on 22 February, according to an SFIG email blast of 23 February. The blast described "a meeting that SFIG held with the CFTC and prudential regulators yesterday, February 22nd, to discuss our recent request for temporary relief for legacy securitization transactions from the compliance date for variation margin requirements."

If the Commission does not adopt these capital, liquidity and financial reporting adjustments, it will be abdicating its responsibility to improve the "safety and soundness" of SDs and the financial system as a whole.

In this case, cynics will be justified in a belief that little has changed since the financial crisis and that overly complex financial instruments such as the swaps that parties use to undercapitalize respective loss exposures continue to undermine the efficiency, competitiveness and integrity of the US financial system.

What might drive the Commission to adopt such a destructive path? In my view, a broader lack of confidence in the US economy that is also shared by many other policy makers who see no good solutions to revive US growth and so grasp at bad, discredited ones.

3. "Price Discovery"

"How might this proposal affect price discovery? Please explain."

The proposal *impedes rather than aids* price discovery with respect to SDs and MSPs that are parties to uncleared swaps or uncleared security-based swaps with flip clauses, walkaways or similar provisions hold additional capital and report these holdings.

These uncleared swaps and uncleared security-based swaps are among the most egregious examples of undercapitalized and mispriced swaps that the financial system has foisted on the wider economic system.

Simply put, the prices for an uncleared swap with a flip clause, walkaway or similar provision *cannot* possibly reflect the true costs to either party. Instead, each party uses an uncleared swap or uncleared security-based swap with flip clauses, walkaways or similar provisions to both effectuate and mask a significant undercapitalization against its respective loss exposure.

An SD or MSP that is party to an uncleared swap or uncleared security-based swap with a flip clause, walkway or similar provision is extremely reckless. This recklessness distorts price signals in all sectors of the economy and saps the competitiveness of the US economy.

The deficiencies of an uncleared swap or uncleared security-based swap with a flip clause, walkaway or similar provisions should be very well known to the CFTC Division of Swap Dealer and Intermediary Oversight, based on my submissions to it and discussion with its staff in 2015, 2016 and 2017.

Moreover, this mispricing is an extremely well-known open secret within the legal, rating, securitization, and structured finance communities, to name just a few. These communities rely on the SEC and the CFTC to perpetuate the open secret of swap mispricing by ignoring it in rule making and by issuing no-action letters such as the CFTC Letter No. 15-21 of 31 March 2015 and the SEC Letter No-Action Letter of 23 November 2010 addressed to Ford Motor Credit Company LLC.

For its part, the SEC allows NRSROs to perpetuate a rating-based, pricing arbitrage that incentivizes issuers of securitization and structured product issuers to offset the potential depreciation of securitized assets via-a-via rated debt by entering into uncleared and unmargined swaps with RAC provisions and flip clauses rather than by purchasing options or securitizing additional assets.

In the absence of this rating-based, pricing arbitrage, an issuer of securitization or structured product debt *should* be indifferent between the three approaches. The flip clause is key to this rating-based, pricing arbitrage and its preservation by the Commission —the principal US regulator of derivative contracts — is an embarrassment.

Accordingly, the Commission must amend the proposal so that an SD or MSP must hold and report additional capital equal to the maximum of: [0, 100% of the “uncleared swap margin” as defined in footnote 25 of the CFTC proposal + 100% of the market value of the swap or security-based swap on the books of the SD or MSP].

These adjustments are necessary to "provide SDs with the ability, in times of financial stress, to meet their current and other obligations as they come due." An SD or MSP in financial distress is exposed to simultaneously incurring 100% losses under 100% of the uncleared swaps with a flip clause, walkaway or similar provision that are in-the-money and under 100% of the uncleared security-based swaps with a flip clause, walkaway or similar provision that are in-the-money.

The proposed adjustment will obligate an SD or MSP that is party to an uncleared swap or uncleared security-based swap with a flip clause, walkaway or similar provision to report its holding of additional capital, which will "strengthen the swaps market by requiring all CSEs to maintain a minimum level of capital and liquidity."

Uncleared swaps with RAC provisions and flip clauses weakened the US economic and financial system by facilitating the intentional mispricing and undercapitalization of whole sectors of securitization debt and structured finance debt that started the financial crisis, exacerbated it and subsequently failed in some cases and benefited from significant government support in other cases.

Many of these mispriced and undercapitalized sectors — cashflow CDOs; cashflow TRuPS CDOs; cashflow CDO-squared; cashflow RMBS; repackaged securitizations of all sectors; structured credit default swaps; structured notes of all securitization sectors; synthetic CDOs; and synthetic RMBS — are the poster children of the financial crisis.

However, the remaining securitization sectors — e.g., those backed by auto loans, credit cards, levered loans, equipment leases, student loans — were also mispriced and undercapitalized owing to the presence of uncleared swaps with RAC provisions and flip clauses. These sectors benefited indirectly from the explicit bailouts and other support that the US government provided to global counterparties after Lehman Brothers failed. Without this government support, the undercapitalization of these remaining securitization sectors might have caused them to follow the poster children sectors into complete and ignominious collapse.

On the other side of the ledger, uncleared swaps with RAC provisions and flip clauses also weakened the US financial system by contributing to the undercapitalization of major counterparties such as Lehman Brothers and AIG. Pre-crisis requirements for capital, liquidity and financial reporting the attributes of in-the-money, uncleared swaps with flip clauses did not obligate swap providers to recognize that these very senior assets would instantaneously transform into deeply-subordinated ones when counterparties activated flip clauses.

As a result, major counterparties such as Lehman Brothers and AIG underpriced — i.e., *mispriced* — 100% of uncleared swaps with flip clauses, walkaways and similar provisions.

The bankruptcy of Lehman Brothers provided a real-world example of a bankrupt swap provider that received USD 0.00 per USD 1.00 owed under 100% of in-the-money, uncleared swaps that contained flip clauses with 44 securitization issuers. In this real-world example, the correlation of counterparties that activated flip clauses against the swap provider was 100%.

United States Bankruptcy Judge Shelley C. Chapman detailed this 100% correlation of individual "payments" of USD 0.00 in a ruling on *Lehman Brothers Special Financing Inc. vs. Bank of America National Association et al of 28 June 2016.*

"Upon providing notice of an Event of Default under the Swaps and the Indentures, the Trustees liquidated the assets, including the Collateral securing the Issuers' obligations under the Swaps and Indentures, and deposited the proceeds into accounts held by each Trustee for that purpose. The Trustees subsequently distributed the proceeds pursuant to the applicable Waterfall (the "Distributions"). In each instance, the Trustees applied Noteholder Priority because the Early Terminations were the result of an Event of Default and LBSF was the Defaulting Party. *The amount of the proceeds of the liquidation of the Collateral was insufficient to make any payment to LBSF [italics added] under the Waterfall after proceeds were paid pursuant to Noteholder Priority.*"

Judge Chapman went on to confuse cause and effect by characterizing the broader financial crisis as "a time we truly hope was a 'singular' event." In fact, Lehman Brothers was not an unlucky bystander to the crisis nor was the company blindsided by the 100% losses that it incurred under 100% of uncleared swaps with flip clauses that were in-the-money assets. These swaps performed exactly as Lehman Brothers *itself* and other global counterparties had both structured and advertised.

The shoddy practices of the financial sector writ large — accountants, counsel, investors, issuers, investors, Lehman Brothers, Lehman Brothers trading partners, other swap providers, rating agencies, regulators, and underwriters — enabled securitization and structured product issuers to underprice issuance costs of their respective debt. This set the financial crisis in motion.

In other words, there was nothing "singular" about the financial crisis. Nor can "hope" alone prevent a recurrence.

For instance, defendant banks in *Lehman Brothers Special Financing Inc. vs. Bank of America National Association et al* included: Bank of America, National Association; Goldman Sachs & Co.; Goldman Sachs International; Merrill Lynch, Pierce, Fenner & Smith Incorporated; Merrill Lynch International; and US Bank.

Each institution has first-hand knowledge of the 100% losses that an SD or MSP can incur under 100% of the uncleared swaps with a flip clause, walkaway or similar provision that are in-the-money and 100% of the uncleared security-based swaps with a flip clause, walkaway or similar provision that are in-the-money.

Yet, many of these same institutions also *provide* this very same type of swap and similarly assume the very same risk of 100% loss of 100% of swap assets without making special provisions or holding offsetting capital.

For instance, Merrill Lynch Derivative Products AG provides uncleared and unmargined swaps with RAC provisions and flip clauses to the following three securitization issuers: SLM Private Credit Student Loan Trust 2003-A; SLM Private Credit Student Loan Trust 2003-B; and SLM Private Credit Student Loan Trust 2003-C. Bank of America, National Association provides an uncleared and unmargined swap with RAC provisions and flip clauses to SLM Private Credit Student Loan Trust 2006-C. Goldman Sachs Mitsui Marine Derivative Products LP provides an uncleared and unmargined swap with RAC provisions and flip clauses to SLM Private Education Student Loan Trust 2012-A.

Clearly, robust mechanisms for price discovery are needed.

Admittedly, robust mechanisms for price discovery may result in few if any SDs providing new uncleared swaps or uncleared security-based swaps with flip clauses, walkaways or similar provisions in the future.

This may be a boon for economic growth and financial stability, given the lose-lose track record of uncleared swaps with flip clauses, walkaways and similar provisions.

Moreover, the timing for such a boon is ideal. Securitization issuers have not entered into many new uncleared swaps with flip clauses recently, but this pattern could change as interest rates rise. However, transparent pricing depends on fewer rather than more uncleared and unmargined swaps with RAC provisions and flip clauses.

To take one example, issuance of private-label cashflow RMBS *must* remain moribund to the extent that this sector remains mispriced and undercapitalized owing to reliance on uncleared swaps with flip clauses.

Had robust capital, liquidity and financial reporting requirements been in place prior to the financial crisis, global swap dealers might have provided fewer uncleared swaps with flip clauses to issuers of securitized and structured product debt and the financial crisis might have been staved off entirely.

Instead, issuers entered into these swaps to mask the true price of and thereby sell undercapitalized, mispriced securitization and structured product debt — debt that subsequently collapsed. Swap providers such as Lehman Brothers mispriced these swaps — after all, no price can compensate for losses of 100% under 100% of such swaps that were in-the-money upon becoming bankrupt, insolvent or similarly impaired.

As a result, Lehman Brothers, its bondholders, shareholders, counterparties and the entire financial system paid a terrible price. Without the accompanying bailouts — in which US taxpayers paid an even steeper price — the same would have been true of AIG[129] and

[129] William J. Harrington, 'Re: File Number S7-18-11— Comment on SEC Proposed Rules for Nationally Recognized Statistical Rating Organizations,' Comment to the SEC (8 August 2011). "Item 4b. 2009-2010. AIG was the downgraded hedge provider...AIG was counterparty to interest rate swaps with 50+ CDOs and other ABS

many other global swap providers.

Accordingly, the capital, liquidity and financial reporting adjustment proposed at the beginning of this section will enable market participants to independently price exposure to an SD or MSP that is exposed to flip clauses, walkaways or similar provisions in uncleared swaps or uncleared security-based swaps. This information will enable counterparties to enforce market oversight so that an SD that is exposed to these 100% losses remains viable or at least does not assume even more such exposure.

This will promote efficient and self-sustaining derivative markets by increasing transparency and also by augmenting incomplete assessment, oversight and investigations by the CFTC when it is limited by budget constraints.

If the Commission does not adopt these reporting adjustments, it will be abdicating its responsibility to improve the "safety and soundness" of SDs and the financial system as a whole.

In this case, cynics will be justified in a belief that little has changed since the financial crisis and that overly complex financial instruments such as the swaps that parties use to undercapitalize respective loss exposures continue to undermine transparent pricing — the foundation of the US economy and financial system.

What might drive the Commission to adopt such a destructive path? In my view, a broader lack of confidence in the US economy that is also shared by many other policy makers who see no good solutions to revive US growth and so grasp at bad, discredited ones.

4. "Sound Management Risk Practices"

"How might this proposal affect sound risk management practices?"

The proposal *will* encourage "sound management practices" when adjusted so that SDs and MSPs that are parties to uncleared swaps or uncleared security-based swaps with flip clauses, walkaways or similar provisions hold additional capital and report these holdings.

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transactions that had become deep-in the money, mark-to-market assets of AIG. In addition to providing an interest rate hedge to the transactions, *AIG had also lent money to some of them at issuance* [italics added]. The CDOs that had borrowed in this fashion were repaying the loans through higher-than-market fixed rates that had resulted in particularly large mark-to-market assets for AIG. The respective swap contracts allowed the CDOs (both those that had borrowed from AIG and those that had not) to terminate the swaps without making any payment *as AIG had not complied with the replacement provisions following its 2008 downgrades* [italics added]. If the CDOs had exercised these rights, they would have removed a large liability from the top of their waterfalls, to the benefit of their rated notes. *By corollary, AIG would have recorded a 100% loss on each of the deeply-in-the-money swap assets* [italics added]." Pp. 63 (PDF-page 65). This comment is available at: https://www.sec.gov/comments/s7-18-11/s71811-33.pdf.

In these cases, an SD must hold and report additional capital equal to the maximum of: [0, 100% of the "uncleared swap margin" as defined in footnote 25 of the CFTC proposal + 100% of the market value of the swap or security-based swap on the books of the SD or MSP].

Entering into an uncleared swap with RAC provisions and a flip clause is among the *least* "sound risk management practices" that SDs and MSPs engage in. An SD or MSP that is party to one of these swaps is extremely *reckless*.

An SD or MSP in financial distress is exposed to simultaneously incurring 100% losses under 100% of the uncleared swaps with a flip clause, walkaway or similar provision that are in-the-money and under 100% of the uncleared security-based swaps with a flip clause, walkaway or similar provision that are in-the-money.

The presence of a RAC provision in the uncleared swap or uncleared security-based swap *increases* the likelihood that an SD or MSP will still have the swap on its books when it encounters financial distress. This is even though remedial provisions in these swaps *ostensibly* direct the SD or MSP to take pre-emptive action such as novating or transferring the swap to another swap provider ("replacement") to prevent such an outcome outcome. However, SDs and MSPs have avoided replacing themselves[130] simply by obtaining a letter or other communication from a rating agency that the "rating agency condition" (RAC) is satisfied without such replacement having occurred.[131]

Following is a list of reckless providers of uncleared swaps with RAC provisions and flip clauses to student loan asset-backed securities that Navient Corporation originated or sponsors.

Among these reckless swap providers are SDs such as: Bank of America NA; The Bank of New York; Citibank N.A.; Barclays Bank PLC; BNP Paribas SA; Deutsche Bank AG; JP Morgan Chase Bank National Association; Morgan Stanley Capital Services LLC; Royal Bank of Canada; The Royal Bank of Scotland, plc; and Wells Fargo Bank NA.

Navient and Navient-Sponsored Private Student Loan Securitizations with Uncleared, Balance-Guaranteed[132] Swaps that Reference the Prime Rate and LIBOR and Contain Flip

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130 Lukas Becker and Catherine Contiguglia, 'Moody's Bank Swap Ratings May Halt ABS Downgrades' *Risk.net* (17 June 2015). "Several dealers involved in ABS deals have fallen below the second trigger following a series of bank ratings downgrades since 2012. However, finding other counterparties to step into the trades has been extremely tricky due to the dearth of highly rated and the *complexity of pricing* [italics added] involved."

131 Norbert Gaillard and William J. Harrington, 'Efficient, commonsense actions to foster accurate credit ratings,' Capital Markets Law Journal (2016) 11 (1): 38-59. Footnotes 41, 42 and 44 describe RACs generally and with respect to the failure of swap providers of uncleared swaps with RAC provisions and flip clauses to replace these swaps.

132 "Residential mortgage ABS and student loan ABS have pronounced exposure to counterparty risk, given their reliance on a highly idiosyncratic type of swap: a balance-guarantee swap with a flip clause. 'Balance guarantee' indicates that the swap offsets two mismatches in payment characteristics between securitized assets and ABS — a standard mismatch such as that between basis rates, interest rates, or currencies and a second, highly idiosyncratic mismatch between prepayment rates." See William J, Harrington, 'Re: File Number S7-18-11, Request for Re-proposal Relating to Nationally Recognized Statistical Rating Organizations,' (29 May 2014) p. 14. This submission is available at: https://www.sec.gov/comments/s7-18-11/s71811-84.pdf.

Clauses and RAC Provisions and Respective Swap Providers (Shading denotes an SD)
Sources: Navient Website; Rating Agency Announcements and Reports; and CFTC.gov.

1. SLM Private Credit Student Loan Trust 2002-A – Merrill Lynch Derivative Products AG
2. SLM Private Credit Student Loan Trust 2003-B – 2 Counterparties: 1. Merrill Lynch Derivative Products AG; & 2. Citibank, N.A.
3. SLM Private Credit Student Loan Trust 2003-C – 2 Counterparties: 1. Merrill Lynch Derivative Products AG; & 2. JPMorgan Chase Bank North America
4. SLM Private Credit Student Loan Trust 2003-A – 2 Counterparties: 1. Merrill Lynch Derivative Products AG; & 2. Citibank, N.A.
5. SLM Private Credit Student Loan Trust 2004-A – JPMorgan Chase Bank NA
6. SLM Private Credit Student Loan Trust 2004-B – JPMorgan Chase Bank NA
7. SLM Private Credit Student Loan Trust 2005-A – Morgan Stanley Capital Services
8. SLM Private Credit Student Loan Trust 2005-B – Royal Bank of Scotland
9. SLM Private Credit Student Loan Trust 2006-A – Deutsche Bank New York
10. SLM Private Credit Student Loan Trust 2006-B – Deutsche Bank New York
11. SLM Private Credit Student Loan Trust 2006-C – Bank of America NA
12. SLM Private Credit Student Loan Trust 2007-A – Credit Suisse First Boston International
13. SLM Private Education Student Loan Trust 2010-B – Royal Bank of Scotland
14. SLM Private Education Student Loan Trust 2010-C – Royal Bank of Scotland
15. SLM Private Education Student Loan Trust 2011-C – Royal Bank of Canada, Toronto
16. SLM Private Education Student Loan Trust 2012-A – GSMMDP
17. SLM Private Education Student Loan Trust 2012-B – Bank of New York
18. SLM Private Education Student Loan Trust 2012-C – Bank of New York
19. SLM Private Education Student Loan Trust 2012-D – Royal Bank of Canada, Toronto
20. SLM Private Education Student Loan Trust 2012-E – Bank of New York
21. SLM Private Education Student Loan Trust 2013-A – Bank of New York
22. SLM Private Education Student Loan Trust 2013-B – Bank of New York
23. SLM Private Education Student Loan Trust 2013-C – Bank of New York
24. SLM Private Education Student Loan Trust 2014-A – Bank of New York
25. Navient Private Education Student Loan Trust 2014-CT – JPMorgan Chase Bank NA
26. Navient Private Education Loan Trust 2014-A – Royal Bank of Canada
27. Navient Private Education Student Loan Trust 2014-CT – JPMorgan Chase NA
28. Navient Private Education Loan Trust 2015-A – Royal Bank of Canada
29. Navient Private Education Loan Trust 2015-B – Wells Fargo Bank
30. Navient Private Education Loan Trust 2015-C – JPMorgan Chase Bank NA
31. Navient Private Education Loan Trust 2016-A – JPMorgan Chase Bank NA

Navient and Navient-Sponsored Student Loan Securitizations with Uncleared, Balance-Guaranteed[133] Swaps that Reference Currencies and Contain Flip Clauses and RAC Provisions and Respective Swap Providers (Shading denotes an SD)
Sources: Navient Website; Rating Agency Announcements and Reports; and CFTC.gov.

1. SLM Student Loan Trust 2003-2 – CDC IXIS Capital Markets (Euro 187mm / USD 203mm)
2. SLM Student Loan Trust 2003-5 – CDC IXIS Capital Markets (Euro 270mm / USD 309mm)
3. SLM Student Loan Trust 2003-7 – CDC IXIS Capital Markets (Euro 490mm / USD 550mm)
4. SLM Student Loan Trust 2003-10 – CDC IXIS Capital Markets (GBP 1.25bn / USD 1.7bn)

[133] In 2006, a major swap provider concluded that "balance-guaranteed" uncleared swaps in the RMBS sector could not be replaced. See William J. Harrington, 'Re: Rule Comment Number 466-1,' Comment to the SEC (3 June 2013) PDF-numbered pp. 25-29. "Under the RAC, BSFP presented RMBS issuers with a derivative contract that made failure by BSP to post collateral at the Second Trigger an Additional Termination Event rather than an Event of Default. *The BSFP rationale in petitioning for RAC was that balance-guarantee hedges with RMBS issuers could not be replaced* [italics added] and BSFP lacked resources to post collateral for the duration of each balance-guaranteed swap." See also PDF-numbered page 40, footnote 53. This submission is available at https://www.sec.gov/comments/4-661/4661-28.pdf.

5. SLM Student Loan Trust 2003-12 – Citibank (GBP 400mm / USD 670mm)
6. SLM Student Loan Trust 2004-2 – CDC IXIS Capital Markets (Euro 796mm / USD 1bn)
7. SLM Student Loan Trust 2004-5 – Swiss Re Financial Products (Euro 760mm / USD 930mm)
8. SLM Student Loan Trust 2004-10 – AIG Financial Products Corp. (Euro 408mm / USD 501mm)
9. SLM Student Loan Trust 2005-9 – Deutsche Bank NY (Euro 500mm / USD 597mm)
10. SLM Student Loan Trust 2006-4 – 2 Counterparties: 1. Credit Suisse First Boston International (Euro 436mm / USD 530mm); and 2. Banque Nationale De Paris (Euro 436mm / USD 530mm)
11. SLM Student Loan Trust 2006-6 – Barclays Capital Markets (Euro 372mm / USD 473mm)
12. SLM Student Loan Trust 2006-10 – Barclays Capital Markets (Euro 302mm / USD 386mm)
13. SLM Student Loan Trust 2007-4 – Barclays Capital (Euro 305mm / USD 406mm)
14. SLC Student Loan Trust 2008-01 – Credit Suisse First Boston International (euro 134mm / USD 208mm)

The recklessness of an SD or MSP that provides an uncleared swap or uncleared security-based swap with RAC provisions and a flip clause, walkaway or similar provisions should be very well known to the CFTC Division of Swap Dealer and Intermediary Oversight, based on my submissions to it and discussion with its staff in 2015, 2016 and 2017.

Moreover, these deficiencies are an extremely well-known open secret within the legal, rating, securitization, and structured finance communities, to name just a few. These communities rely on the SEC and the CFTC to perpetuate the open secret of this recklessness by ignoring it in rule making and by issuing no-action letters such as the CFTC Letter No. 15-21 of 31 March 2015 and the SEC Letter No-Action Letter of 23 November 2010 addressed to Ford Motor Credit Company LLC.

For its part, the SEC allows NRSROs to perpetuate a rating-based, risk arbitrage that incentivizes issuers of securitization and structured product issuers to offset the potential depreciation of securitized assets via-a-via rated debt by entering into uncleared and unmargined swaps with RAC provisions and flip clauses rather than by purchasing options or securitizing additional assets.

In the absence of this rating-based, risk arbitrage, an issuer of securitization or structured product debt *should* be indifferent between the three approaches. The flip clause is key to this rating-based, risk arbitrage and its preservation by the Commission — the principal US regulator of derivative contracts — is both an embarrassment and an extremely unsound risk management practice.

The proposed adjustments to the capital, liquidity and financial reporting requirements are necessary to "provide SDs and MSPs with the ability, in times of financial stress, to meet their current and other obligations as they come due" as well as to foster "sound risk management practices" in SDs and MSPs. An SD or MSP in financial distress is exposed to simultaneously incurring 100% losses under 100% of the uncleared swaps with a flip clause, walkaway or similar provision that are in-the-money and under 100% of the uncleared security-based swaps with a flip clause, walkaway or similar provision that are in-the-money.

The proposed adjustment will obligate an SD or MSP that is party to an uncleared swap or uncleared security-based swap with a flip clause, walkaway or similar provision to report its holding of additional capital, which will "strengthen the swaps market by requiring all CSEs to maintain a minimum level of capital and liquidity."

Uncleared swaps with RAC provisions and flip clauses weakened the US economic and financial system by facilitating the flagrantly *unsound* risk management practices of undercapitalizing whole sectors of securitization debt and structured finance debt that started the financial crisis, exacerbated it and subsequently failed in some cases and benefited from significant government support in other cases.

Many of these mispriced and undercapitalized sectors — cashflow CDOs; cashflow TRuPS CDOs; cashflow CDO-squared; cashflow RMBS; repackaged securitizations of all sectors; structured credit default swaps; structured notes of all securitization sectors; synthetic CDOs; and synthetic RMBS — are the poster children of the financial crisis.

However, the remaining securitization sectors — e.g., those backed by auto loans, credit cards, levered loans, equipment leases, student loans — were also based on the flagrantly unsound risk management practice of undercapitalization owing to the presence of uncleared swaps with RAC provisions and flip clauses. These sectors benefited indirectly from the explicit bailouts and other support that the US government provided to global counterparties after Lehman Brothers failed. Without this government support, the undercapitalization of these remaining securitization sectors might have caused them to follow the poster children sectors into complete and ignominious collapse.

On the other side of the ledger, uncleared swaps with RAC provisions and flip clauses also weakened the US financial system by contributing to the undercapitalization of major counterparties as Lehman Brothers and AIG. Both entities have been rightly pilloried for having flouted "sound risk management practices" prior to the financial crisis.

Pre-crisis requirements for capitalizing and reporting in-the-money, uncleared swaps with flip clauses did not obligate swap providers to recognize that these very senior assets would instantaneously transform into deeply-subordinated ones when counterparties activated flip clauses.

The bankruptcy of Lehman Brothers provided a real-world example of a bankrupt swap provider that received USD 0.00 per USD 1.00 owed under 100% of in-the-money, uncleared swaps that contained flip clauses with 44 securitization issuers. In this real-world example, the correlation of counterparties that activated flip clauses against the swap provider was 100%.

United States Bankruptcy Judge Shelley C. Chapman detailed this 100% correlation of individual "payments" of USD 0.00 in a ruling on *Lehman Brothers Special Financing Inc. vs. Bank of America National Association et al of 28 June 2016.*

"Upon providing notice of an Event of Default under the Swaps and the Indentures, the Trustees liquidated the assets, including the Collateral securing the Issuers' obligations under the Swaps and Indentures, and deposited the proceeds into accounts held by each

Trustee for that purpose. The Trustees subsequently distributed the proceeds pursuant to the applicable Waterfall (the "Distributions"). In each instance, the Trustees applied Noteholder Priority because the Early Terminations were the result of an Event of Default and LBSF was the Defaulting Party. *The amount of the proceeds of the liquidation of the Collateral was insufficient to make any payment to LBSF [italics added] under the Waterfall after proceeds were paid pursuant to Noteholder Priority*."

Judge Chapman went on to confuse cause and effect by characterizing the broader financial crisis as "a time we truly hope was a 'singular' event." In fact, Lehman Brothers was not an unlucky bystander to the crisis nor was the company blindsided by the 100% losses that it incurred under 100% of uncleared swaps with flip clauses that were in-the-money assets.

These swaps performed exactly as Lehman Brothers *itself* and other global counterparties had both structured and advertised. Poor risk management practices produced poor outcomes.

The poor risk management practices of the financial sector writ large — accountants, counsel, investors, issuers, investors, Lehman Brothers, Lehman Brothers trading partners, other swap providers, rating agencies, regulators, and underwriters — enabled swap providers to misprice swap costs and set the financial crisis in motion.

In other words, there was nothing "singular" about the financial crisis. Nor can "hope" alone prevent a recurrence.

For instance, defendant banks in *Lehman Brothers Special Financing Inc. vs. Bank of America National Association et al* included: Bank of America, National Association; Goldman Sachs & Co.; Goldman Sachs International; Merrill Lynch, Pierce, Fenner & Smith Incorporated; Merrill Lynch International; and US Bank.

In other words, these institutions have first-hand knowledge of the 100% losses that an SD or MSP can incur under 100% of the uncleared swaps with a flip clause, walkaway or similar provision that are in-the-money and 100% of the uncleared security-based swaps with a flip clause, walkaway or similar provision that are in-the-money.

Yet, many of these same institutions and affiliates also *provide* this very same type of swap and similarly assume the very same risk of 100% loss of 100% of swap assets without making special provisions or holding offsetting capital.

The swap providers of uncleared swaps with RAC provisions and flip clauses to student loan asset-backed securities that Navient originated and sponsors that are listed further above tell this sad tale.

Clearly, "sound risk management practices" are needed.

Admittedly, "sound risk management practices" may result in few if any SDs providing new uncleared swaps or uncleared security-based swaps with flip clauses, walkaways or similar provisions in the future.

This may be a boon for economic growth and financial stability, given the lose-lose track record of uncleared swaps with flip clauses, walkaways and similar provisions.

Moreover, the timing for such a boon is ideal. Securitization issuers have not entered into many new uncleared swaps with flip clauses recently but this pattern could change as interest rates rise. However, "sound risk management practices" dictate fewer rather than more uncleared and unmargined swaps with RAC provisions and flip clauses.

To take one example, issuance of private-label cashflow RMBS *must* remain moribund to the extent that this sector remains mispriced and undercapitalized owing to reliance on uncleared swaps with flip clauses.

Had sound risk management practices been in place prior to the financial crisis, global swap dealers might have provided fewer uncleared swaps with flip clauses to issuers of securitized and structured product debt and the financial crisis might have been staved off entirely.

Instead, issuers entered into these swaps to mask their true prices and thereby sell undercapitalized, mispriced securitization and structured product debt — debt that subsequently collapsed. Swap providers such as Lehman Brothers engaged in flagrantly *unsound* risk management practices by booking these swaps and explicitly agreeing to accept 100% losses under 100% of such swaps that were in-the-money upon becoming bankrupt, insolvent or similarly impaired.

As a result, Lehman Brothers, its bondholders, shareholders, counterparties and the entire financial system paid a terrible price. Without the accompanying bailouts — in which US taxpayers paid an even steeper price — the same would have been true of AIG[134] and many other global swap providers.

Accordingly, the adjustment proposed at the beginning of this section will enable market participants to independently price exposure to an SD or MSP that is exposed to flip clauses, walkaways or similar provisions in uncleared swaps or uncleared security-based swaps. This information will enable counterparties to enforce market oversight and

[134] William J. Harrington, 'Re: File Number S7-18-11— Comment on SEC Proposed Rules for Nationally Recognized Statistical Rating Organizations,' Comment to the SEC (8 August 2011). "Item 4b. 2009-2010. AIG was the downgraded hedge provider...AIG was counterparty to interest rate swaps with 50+ CDOs and other ABS transactions that had become deep-in the money, mark-to-market assets of AIG. In addition to providing an interest rate hedge to the transactions, *AIG had also lent money to some of them at issuance* [italics added]. The CDOs that had borrowed in this fashion were repaying the loans through higher-than-market fixed rates that had resulted in particularly large mark-to-market assets for AIG. The respective swap contracts allowed the CDOs (both those that had borrowed from AIG and those that had not) to terminate the swaps without making any payment as AIG had not complied with the replacement provisions following its 2008 downgrades. If the CDOs had exercised these rights, they would have removed a large liability from the top of their waterfalls, to the benefit of their rated notes. *By corollary, AIG would have recorded a 100% loss on each of the deeply-in-the-money swap assets* [italics added]." Pp. 63 (PDF-page 65). This comment is available at: https://www.sec.gov/comments/s7-18-11/s71811-33.pdf.

"sound risk management practices" so that an SD that is exposed to these 100% losses remains viable or at least does not assume even more such exposure.

This will promote efficient and self-sustaining derivative markets by increasing transparency and also by augmenting incomplete assessment, oversight and investigations by the CFTC when it is limited by budget constraints.

If the Commission does not adopt these reporting adjustments, it will be abdicating its responsibility to improve the "safety and soundness" of SDs and the financial system as a whole.

In this case, cynics will be justified in a belief that little has changed since the financial crisis and that overly complex financial instruments such as the swaps that parties use to undercapitalize respective loss exposures continue to trump "sound risk management practices."

What might drive the Commission to adopt such a destructive path? In my view, a broader lack of confidence in the US economy that is also shared by many other policy makers who see no good solutions to revive US growth and so grasp at bad, discredited ones.

5. "Other Public Interest Considerations"

"Are there other public interest considerations that the Commission should consider?"

Yes, there *are* "other public interest considerations that the Commission should consider."

The rule that the Commission ultimately adopts must ensure that both parties to an uncleared swap or uncleared security-based swap pay the *true* rather than the convenient, i.e., artificially cheap, price of being party to the swap.[135]

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[135] In contrast, research staff at the IMF recommended that uncleared swaps with flip clauses be priced *conveniently rather than accurately* as one means of promoting "growth-supportive, sustainable securitization markets" in 2013. See Miguel Segoviano, Bradley Jones, Peter Lindner, and Johannes Blankenheim, 'Securitization: Lessons Learned and the Road Ahead,' *IMF Working Paper WP/13/255* (November 2013) pp. 38-39 (PDF-numbered pages 40-41). "In some cases, CRAs [credit rating agencies] seem to have taken an excessively risk-averse approach in their ratings of securitizations. CRAs have come under intense scrutiny… Unfortunately, these pressures…appear to have pushed CRAs to modify requirements for counterparties…in a very stringent manner, making securitizations more difficult and costly than justified by the risk characteristics of the structures…[A]ter the crisis, CRAs imposed tougher requirements on original swap counterparties. For instance, derivatives counterparties rated by S&P cannot be rated more than four notches below the rating of the supported security if no collateral is posted (S&P, 2012). This will make securitization origination more difficult and costly by up to 25 bps per annum according to estimates by market participants." I apprised Dr. Segoviano and his co-authors of the risk characteristics of an uncleared swap with a flip clause in a teleconference on 16 January 2014. They had not been aware of these risk characteristics such as a flip clause when preparing the working paper. It is available at: https://www.imf.org/external/pubs/ft/wp/2013/wp13255.pdf.

Accordingly, the Commission must be very skeptical in assigning benefits to the undercapitalization of uncleared swaps and uncleared security-based swaps and be very aggressive in estimating the commensurate costs.

As a first step, the Commission must *adjust* the baseline assumption of the cost/benefit analysis of uncleared swaps and uncleared security-based swaps by 180 degrees as follows:

> *"Uncleared swaps and uncleared security-based swaps that are artificially cheap increase the costs and reduce the benefits to the economy, rather than vice-versa."*

In doing so, the Commission will *purge* the cost/benefit analysis of the marketing mantras that the financial industry represents as being empirically-driven findings.

For instance, uncleared swaps and uncleared security-based swaps do *not* hedge the risk exposures of end users. These swaps, simply by their nature as contracts, *add* to the risk exposures of an end user. More contractual obligations mean more that can go wrong.

The intrinsic characteristic of an uncleared swap or an uncleared security-based swap — namely, that it is a one-off, highly-negotiated, bilateral contract — enables either party or both to laden the contract with convenient provisions that are potentially loss-inducing.

The result is a highly-idiosyncratic contract with risk characteristics that differ markedly — and thus evolve differently — from other, ostensibly similar contracts.

Moreover, most uncleared swaps, uncleared security-based swaps and uncleared options also add to the idiosyncratic exposures that US taxpayers underwrite, given that a significant amount of these derivatives are booked in the government-insured subsidiary of one of a few bank holding companies.[136]

More unfortunately still for US taxpayers, their involuntary backstop incentivizes parties to routinely undercapitalize uncleared swaps and uncleared security-based swaps, i.e., to evade accountability in designing and effectuating the swaps. As a result, each uncleared swap and uncleared security-based swap is likely to contain many loss-inducing provisions and be insufficiently capitalized.

The taxpayer backstop for most uncleared swaps, security-based swaps and options argues *against* imbuing the cost/benefit analysis with the veneer of hard-science rigor.

> *"How precise can a cost/benefit analysis be given that at least one party to most uncleared swaps and uncleared options is in an FDIC-insured subsidiary?"*

The data limitations that the idiosyncratic risk characteristics of an uncleared swap or uncleared security-based swap impose on cost/benefit analysis are *not* inconsistent with

[136] Tyler Durden, 'Presenting the USD 303 Trillion in Derivatives that US Taxpayers are Now on the Hook For' *Zerohedge.com* (13 December 2014).

the sectors' early stage of development.[137] After all, these contract types are less than 30 years old. As with other comparatively new products, uncleared swaps and uncleared security-based swaps deliver much less than proponents claim.

Collectively, artificially cheap, uncleared swaps continue to wreak havoc on the US economy by distorting price signals and thereby directing capital to sub-optimal uses. This distorted pricing represents a failure of market accountability and capitalism.

In fact, artificially cheap, uncleared swaps may well have engendered the endemically slow growth that has accompanied the emergence and growing use of these swaps in the last 30 years. On its own, the potential that artificially cheap, uncleared swaps will continue to be a drag on useful investment and economic growth indicates that these swaps are a cost to the economy and not a benefit.

Certainly, the proliferation of artificially cheap, uncleared swaps drove the US and global financial system into near collapse and obligated US taxpayers to provide massive bailouts and implicit support to the financial sector. The potential for artificially cheap, uncleared swaps to do the same again is clearly a cost.

Three ways to calibrate cost/benefit analysis using uncleared swaps with flip clauses

Exhibit Number 1 of an artificially cheap, uncleared swap is the uncleared and unmargined swap with RAC provisions and a flip clause.

This type of swap has been the go-to swap of the securitized and structured product sectors for 20 years *because* it adds to the risks of both parties and allows them to undercapitalize, not despite this capacity.

Much went wrong with artificially cheap, undercapitalized, uncleared swaps with RAC provisions and flip clauses as well as with the borrowing that the swaps facilitated. These swaps provide the Commission with a perfect tool for calibrating the cost/benefit analysis of the CFTC Proposal.

For a start, the output of the cost/benefit analysis must satisfy the following condition.

1. "*The cost/benefit analysis produces a defensible finding.*"

For example, the only defensible finding with respect to uncleared swaps and uncleared security-based swaps with RAC provisions and flip clauses is that none of these swaps are needed because the costs to the US financial system and economy outweigh the

[137] Several industry groups made a self-incriminating representation that underscored the immaturity of the market for uncleared swaps in early 2017. *As of February 2017, less than 6% of financial end users could comply with the looming implementation date for the swap margin rules of 1 March 2017, even though the CFTC and prudential regulators had set this date 14 and 16 months earlier, respectively.* In response, the CFTC issued the CFTC Letter No. 17-11 of 13 February 2017, which extended the implementation date to 1 September 2017. This letter is available at: http://www.cftc.gov/idc/groups/public/@lrlettergeneral/documents/letter/17-11.pdf.

benefits.[138]

As an analogy, the only sensible finding with respect to construction in earthquake zones using specifications for non-earthquake zones and materials that fail basic quality controls[139] is that "*all* of this deficient construction is risky and outright criminal when knowingly designed or built below standard.[140]"

The phrase "garbage in, garbage out…refers "to the fact that computers, since they operate by logical processes, will unquestioningly process flawed, even nonsensical, input data ('garbage in') and produce undesired, often nonsensical, output ('garbage out')," according to the entry on Wikipedia.org.

"The principle also applies more generally to all analysis and logic, in that arguments are unsound if their premises are flawed."

Accordingly, the cost/benefit analysis should reject a very flawed, unsound premise — namely that the financial crisis was akin to an act of god that "no one could have foreseen" — and also satisfy a second condition.

2. *"The CFTC Proposal, if in place in 2003, would have moderated or even prevented the financial crisis."*

For instance, had the CFTC Proposal been in place in 2003, *would* it have incentivized:
- AIG *not* to lend money to CDOs under uncleared swaps with RAC provisions and flip clauses?;
- Lehman Brothers *not* to provide the uncleared swaps with flip clauses that lost 100% of value when counterparties activated flip clauses?; and
- global counterparties *not* to provide uncleared swaps with flip clauses to issuers of private-label RMBS?

Lastly, the cost/benefit analysis must incorporate an *achievable* benchmark so that this condition *can* be satisfied.

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138 "A swap contract with a flip clause is an NRSRO construct that underpins AAA ratings in most ABS sectors worldwide and has no analog among mainstream derivative contracts. Since the ABS industry's inception, issuers have jerry-rigged flip clauses into swap contracts as a means of keeping issuance costs artificially low." William J, Harrington, 'Re: File Number S7-18-11, Request for Re-proposal Relating to Nationally Recognized Statistical Rating Organizations,' (29 May 2014) p. 3. This submission is available at: https://www.sec.gov/comments/s7-18-11/s71811-84.pdf.

139 A former Moody's colleague and I conducted a joint teleconference with the six respective teams that were writing the swap margin rules for the CFTC and prudential regulators on 12 May 2015. The CFTC posted the following summary in the call notice. "Commenters argue against an exemption from margin requirements for issuers of asset backed securities. *Commenters believe ABS issuers' current practice for dealing with counterparty credit risk is inadequate by construction and presents a systemic risk* [italics added]. The CFTC notice of this call and accompanying presentation by my colleague and me is available at: https://www.cftc.gov/node/157371.

140 Per an architect friend who added: "[A]rchitects, engineers and builders are responsible for loss of life and property in such an instance…I do like the building analogy because it demonstrates that only those who are involved in setting up these constructs really understand the danger to the unsuspecting public."

3. *"The CFTC Proposal would have survived this cost/benefit analysis in 2003."*

Otherwise, the cost/benefit analysis understates the costs and overstates the benefits to the US economy from SDs, MSPs, CSEs and other swaps providers continuing to undercapitalize uncleared swaps with flip clauses.

After all, subjecting AIG and Lehman Brothers to higher capital, liquidity and financial reporting requirements for uncleared swaps might have seemed unreasonably costly to AIG, Lehman Brothers, the financial system and the US economy in 2006.

In retrospect, these "costly" requirements would have been the deal of the century.

Responses to Request for Comment, p. 91302

"The Commission does not have sufficient financial information about these SDs to estimate precise costs of these proposed requirements and would welcome comments on how the proposed rule would impact the capital structure and the cost of doing business."

Two of my key responsibilities as a Moody's derivatives analyst from 1999 to 2010 were to:

1. assess the capital structures and the collateral adequacy of providers of uncleared swaps and options such as Credit Default Product Companies (CDPCs), Derivative Product Companies (DPCs) and collateralized swap programs; and

2. specify the capitalization and collateral requirements for both parties to an uncleared swap with RAC provisions and flip clauses. The two parties are a swap provider such as an SD and a securitization or structured product issuer.

I provide a timeline of these responsibilities further below in this section.

These two, sometimes intertwined responsibilities informed much of this response such as the adjustment to the CFTC Proposal when an SD is party to an uncleared swap with a flip clause, walkaway or similar provision and the cost/benefit analysis.

Assessing the capital adequacy of providers of uncleared derivative contracts

The first responsibility entailed reviewing daily and weekly reports of the trading portfolio, required capital, capital assets, required collateral, collateral holdings and liquidity profile as well as the exposures to market indices, end users, termination events, flip clauses, trading losses and the correlations of these exposures for each DPC, CDPC and collateralized swap program.

This first responsibility also entailed evaluating the *sufficiency* of the capital and collateral requirements of each CDPC, DPC and collateralized swap program. Where warranted, I specified adjustments to the respective capital or collateral requirement.[141]

In some instances, such as an uncleared option that had become more widely used, the respective adjustments *reduced* the capital and collateral requirements. In other instances, such as the preponderance of flip clauses in a portfolio of uncleared swaps, the respective adjustments *increased* the respective capital and collateral amounts.

Commonsense, experience and close evaluation of a portfolio were equally important tools that complemented algorithmic output in specifying capital and collateral requirements. Most CDPCs, DPCs and collateralized swap programs had at least one asymmetric exposure based on the entity's core franchise.

For instance, CDPCs predominately *sold* credit protection on corporate indices to large financial institutions and issued debt. The Q4 2008 earnings of Morgan Stanley were dominated by the sale of its CDPC — Cournot Financial Products LLC (Cournot). The Cournot portfolio of uncleared credit default swaps had a negative market value of approximate USD 2B but a capital base of only USD 500MM in December 2008.

[141] William J. Harrington, 'Re: Rule Comment Number 466-1,' Comment to the SEC (3 June 2013). Footnote 29. This submission is available at https://www.sec.gov/comments/4-661/4661-28.pdf.

DPCs predominately *received* fixed interest rates from financial and non-financial end users. DPCs continue to provide uncleared swaps and options that reference basis rates, interest rates and currencies to all types of end users including sovereign, supranational, corporate, municipal and securitization counterparties. SDs such as Goldman Sachs Mitsui Marine Derivative Products LP; (GSMMDP); Morgan Stanley Derivative Products (MSDP); and Nomura Derivative Products Inc. (NDPI) are DPCs.[142]

The respective asymmetry of a given SFOC left it more exposed to certain changes in market and credit indices than an algorithm could capture alone. In these cases, my team often specified additional capital and collateral charges to offset a pronounced, embedded asymmetry.

Saying "no" to proposals by CDPCs, DPCs and collateralized swap programs to provide new types of uncleared swaps and options was an equally important capability.

For instance, NDPI, which is both a DPC and an SD, did *not* provide uncleared swaps with flip clauses to securitization or structured product issuers from 2000 to 2010, i.e., the entirety of my Moody's tenure.

This was in large part because I specified a capital adjustment like the one that I am proposing in this response, i.e., that NDPI would hold collateral or capital equal to the full value of the mark-to-market swap asset that was exposed to a flip clause. NDPI concluded that this cost was too high and opted not to provide uncleared swaps with flip clauses.

NDPI is unlikely to have regretted this decision from 2008 onward.

A second DPC that remains an active provider of uncleared swaps and options but is not an SD — Merrill Lynch Derivative Products AG (MLDP) — had ceased providing uncleared swaps with flip clauses for a similar reason by 2004. I specified a capital adjustment like the one that I am proposing in this response, i.e., that MLDP would hold capital equal to the full value of the mark-to-market swap asset that was exposed to a flip clause. MLDP concluded that this cost was too high and ceased providing uncleared swaps with flip clauses.

The Table "Navient and Navient-Sponsored Private Student Loan Securitizations with Uncleared, Balance-Guaranteed[143] Swaps that Reference the Prime Rate and LIBOR and Contain Flip Clauses and RAC Provisions and Respective Swap Providers," further below, tells the tale.

MLDP provided an uncleared, balance-guaranteed swap with a flip clause to SLM Private Credit Student Loan Trust 2002-A in 2002. The following year, MLDP and Cititbank, N.A. split up three similar swaps with three separate trusts — SLM Private Credit Student Loan Trust 2003-A, SLM Private Credit Student Loan Trust 2003-B and SLM Private Credit Student Loan Trust 2003-C.

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[142] Ibid., Footnotes 16, 24 & 52. A key provision that supports the high rating of a DPC relative to its sponsor-affiliate — a trigger event — will prevent a DPC that has incurred one from complying with the US swap margin rules. A DPC that has incurred a trigger event can defer paying amounts owed to the sponsor-affiliate under uncleared swaps for up to two years. The uncleared swaps do not obligate a DPC to post margin against swap payables and in any event, a DPC that has incurred a trigger event will have no resources to do post margin.
[143] Ibid., PDF-numbered pp. 25-29. In 2006, a major swap provider concluded that "balance-guaranteed" uncleared swaps in the RMBS sector could not be replaced. "Under the RAC, BSFP presented RMBS issuers with a derivative contract that made failure by BSP to post collateral at the Second Trigger an Additional Termination Event rather than an Event of Default. *The BSFP rationale in petitioning for RAC was that balance-guarantee hedges with RMBS issuers could not be replaced* [italics added] and BSFP lacked resources to post collateral for the duration of each balance-guaranteed swap." See also PDF-numbered page 40, footnote 53.

In 2004, MLDP was no longer providing new uncleared swaps with flip clauses, a decision that the company's management was unlikely to have regretted by 2008.

However, the discussions regarding the capital treatment of uncleared swaps with flip clauses that I had with MLDP management and marketers in 2003 *were* contentious. I recounted these discussions with MLDP management and marketers in a 2011 submission to the SEC.[144]

I also submitted a comprehensive analysis of the respective undercapitalization of securitization debt on one hand and a DPC on the other hand that the failed rating assumptions regarding replacement, flip clauses and DPC operations created in 2013.[145]

This respective undercapitalization of securitization debt and of the DPC provider of an uncleared swap with a flip clause was a real and potentially systemic concern with respect to Bear Stearns Financial Products Inc. (BSFP), a Bear Stearns DPC.

BSFP was a major provider of a particularly risky type of uncleared swap with a RAC provision and a flip clause — a balance-guaranteed, uncleared swap with a RAC provision and a flip clause — to issuers of US cashflow RMBS.[146] This debt started the financial crisis, fueled it and would not have been issued in the first place had the associated uncleared swaps with flip clauses been adequately capitalized and properly priced.

In 2006, BSFP management concluded that the replacement assumption was not valid with respect to these swaps. This posed an existential threat to BSFP after it incurred a trigger event upon the downgrade of The Bear Stearns Companies Inc. on 14 March 2008.[147]

Fortunately for both BSFP and investors in RMBS with issuers that were BSFP counterparties, BSFP was guaranteed by JPMorgan Chase & Co. on 17 March 2008[148] and merged into JPMorgan Chase Bank NA on 28 May 2009.[149]

The guarantee and merger both applied to the entire BSFP portfolio of uncleared swaps and options. In other words, these extraordinary actions by JPM Chase Bank affiliates were not limited to the BSFP balance-guaranteed, uncleared swaps with RAC provisions and flip clauses and did not validate the replacement assumption as a potential mitigation for the flip clause.

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[144] See William J. Harrington, 'Re: File Number S7-18-11— Comment on SEC Proposed Rules for Nationally Recognized Statistical Rating Organizations,' Comment to the SEC (8 August 2011). "'Court the Bankers. Embrace the Bankers. Love the Bankers. Never, Ever, Harm a Banker'…Giving a hard time to Mr. Witt [an MLDP marketer] consisted of the contributor explaining in an extremely polite manner that a trade being proposed for Merrill Lynch Derivative Products AG was in conflict with Moody's methodology for DPCs." Pp. 55-56 (PDF-numbered pp. 57-58). The trade that Mr. Witt proposed and which was in conflict with Moody's methodology for DPCs was an uncleared swap with a flip clause with a Sallie Mae-sponsored trust. This comment is available at: https://www.sec.gov/comments/s7-18-11/s71811-33.pdf.

[145] See William J. Harrington, 'Re: Rule Comment Number 466-1,' Comment to the SEC (3 June 2013). PDF-numbered pp. 25-29. This submission is available at https://www.sec.gov/comments/4-661/4661-28.pdf.

[146] Ibid. See PDF-numbered pp. 25-29. "Under the RAC, BSFP presented RMBS issuers with a derivative contract that made failure by BSP to post collateral at the Second Trigger an Additional Termination Event rather than an Event of Default. *The BSFP rationale in petitioning for RAC was that balance-guarantee hedges with RMBS issuers could not be replaced* [italics added] and BSFP lacked resources to post collateral for the duration of each balance-guaranteed swap." See also PDF-numbered p. 40, footnote 53.

[147] Ibid. See PDF-numbered page 38.

[148] Ibid. See PDF-numbered page 40.

[149] Ibid. See PDF-numbered page 52.

Without these extraordinary actions, both BSFP and RMBS investors would have incurred much larger losses in the financial crisis.[150]

Timeline of WJH responsibilities as Moody's lead analyst for CDPCs, DPCs and collateralized swap programs 1999-to-2010

I was co-team leader for Structured Finance Operating Companies (SFOCs) from 2006 to 2010. SFOCs included DPCs, CDPCs and collateralized swap programs of major provisionally registered SDs such as JPMorgan Chase Bank National Association.

I was the principal analyst for DPCs at Moody's from 1999 to 2010. DPCs that Moody's continues to rate include provisionally registered SDs such as GSMMDP, Morgan Stanley Derivative Products Inc. (MSDP) and NDPI.[151] I was the lead analyst for NDPI from its formation in 2000 through 2010. I was also the lead analyst for MLDP, another DPC that Moody's continues to rate, during this period.

DPCs that Moody's no longer rates include BSFP, a second Bear Stearns DPC — Bear Stearns Trading Risk Management Inc (BSTRM) — Lehman Brothers Financial Products Inc. (LBFP) and Lehman Brothers Derivative Products Inc. (LBDP).

I was lead analyst for BSTRM from 2005 until 3 April 2009 and for BSFP from 2005 until 26 May 2009, the date that BSFP merged with JPMorgan Chase Bank National Association.

I was the lead analyst for LBFP and LBDP from 2000 to 2009 to 20 January 2009. Moody's withdrew the ratings of both LBFP and LBDP on this date.

I authored the Moody's article "Update on the Lehman Brothers Derivative Product Companies' Bankruptcy (Plan of reorganization by the Lehman bankrupt estate proposes to pay 100% of allowed claims against two Lehman DCPS)" in June 2010.

I co-authored the Moody's methodology for DPCs "Mitigating Voluntary Bankruptcy Risk of U.S.-Domiciled Termination Derivative Products Companies and Assessing the Effectiveness of Continuation Derivative Products" on 16 July 2009.

Timeline of WJH responsibilities as Moody's lead analyst in North America for Hedge Framework 2003-to-2010

I was the go-to person for Moody's analysts in all North American sectors — structured product, financial, corporate and municipal — regarding uncleared swaps and options that referenced basis rates, interest rates and currencies for my entire tenure from 1999 to 2010.

The overwhelming majority of these swaps that securitization and structured product issuers around the world entered into during the entirety of my tenure from 1999 to 2010 were uncleared swaps with flip clauses.

Prior to Moody's, I worked as a trader on derivatives desks for international fixed-income and for currencies at Merrill Lynch. Few at Moody's had similar practical experience of transacting and managing risk in the markets for uncleared derivatives that underlay the structures and ratings of a significant amount of securitization and structured product debt. The lack of

[150] Ibid. See PDF-numbered page 38, footnote 50.
[151] CFTC list of provisionally registered Swap Dealers as of 24 April 2017, available at http://www.cftc.gov/LawRegulation/DoddFrankAct/registerswapdealer.

transactional and risk management experience with respect to uncleared swaps and options remains a deficiency at Moody's and other NRSROs.

I authored "Moody's Approach for Ratings Thresholds of Hedge Counterparties in CDO Transactions" (23 October 2002)

I co-authored "Capping Hedge Termination Payments in Moody's Rated Structured Note Following Default of the Underlying Debt Instrument" (17 September 2004).

From 2003 to 2006, I spearheaded development of a comprehensive set of structural and legal protocols for an issuer of securitized or structured product debt anywhere in the world to incorporate into an uncleared swap with flip clauses that referenced basis rates, interest rates or currencies.

I co-authored "Framework for De-Linking Hedge Counterparty Risks from Global Structured Finance Cashflow Transaction" (Hedge Framework), (25 May 2006). The Hedge Framework specified the flip clause and accompanying conditions and was in worldwide use by Moody's from 25 May 2006 until 13 November 2013.

With the Hedge Framework or the analogous protocol of another NRSRO at least partially implemented in an uncleared swap with a flip clause, an issuer of securitized or structure product debt posted *no* collateral to a swap dealer and held *no* capital against its insolvency.

"NRSROs apply a rating debit of 0.00% to a swap contract with a 'flip clause,' even though a flip clause exposes one of the two parties (i.e., either a derivative provider or an ABS issuer) to 100.00% loss of contract value should the derivative provider become insolvent."[152]

This equation informed the rigorous and in cases punitive capitalization that my Moody's team specified for a DPC that provided an uncleared swap with a flip clause. A rating debit of 0.00% to securitized or structured product debt issued by a party to an uncleared swap with a flip clause meant that the respective DPC provider *must* assume 100% losses from many types of early termination of the swap. These potential losses to the DPC required high capitalization.

"For two decades, Moody's has based the (sf) rating of ABS upon an assessment that no expected losses accrue where an ABS issuer adheres to a Moody's protocol for entering into derivative contracts. Effectively, Moody's treats a counterparty to an ABS issuer as being rated better than Aaa. One eligible counterparty is as reliably excellent as another."

"In fact, Moody's ABS models don't register counterparties on an individual basis at all but simply record scheduled payments under a derivative contract as flowing to and from a generic placeholder. Given that generic placeholders rarely file for bankruptcy or otherwise warrant a downgrade, Moody's models the placeholder as never obligating an ABS issuer to pay an unscheduled amount such as a termination payment or a re-hedging fee."[153]

[152] William J. Harrington 'Re: File Number S7-18-11, Request for Re-proposal Relating to Nationally Recognized Statistical Rating Organizations,' (29 May 2014) p. 3. This submission is available at: https://www.sec.gov/comments/s7-18-11/s71811-84.pdf.

[153] See William J. Harrington, 'Re: Rule Comment Number 466-1,' Comment to the SEC (3 June 2013). PDF-numbered p. 5. This submission is available at https://www.sec.gov/comments/4-661/4661-28.pdf.

Additionally, commonsense dictated that a DPC or other swap provider must have a strong credit profile at the outset of an uncleared swap with a flip clause to validate the assumption that the swap warranted a rating debit of 0.00% to the associated securitized or structured product debt.[154]

Even so, a senior Moody's manager objected to the Hedge Framework (before voting to approve it in 2006) because the Hedge Framework effectively shut out Lehman Brothers from providing most types of uncleared swaps that issuers of cashflow securitizations wanted. The Hedge Framework stipulated that a swap provider that was rated as low as Lehman Brothers was rated in May 2006 must post collateral from the outset under an uncleared swap with a flip clause.[155]

To paraphrase the objection: "This means that I must tell Lehman Brothers that it cannot be a counterparty to most transactions. But, I would like Lehman Brothers to be a counterparty."[156]

This objection was a correct observation. The same was true of DPCs.[157] I didn't regret either outcome in 2006 or any time thereafter.

Few Moody's staff or issuers of securitized or structured product debt would have regretted the exclusion of Lehman Brothers from 2006-8 securitizations with flip clauses on or 15 September 2008.

Even fewer issuers of 2006-8 securitizations would have regretted the absence of Lehman Brothers as counterparty to the respective uncleared swap with flip clauses after 25 January 2010, when Judge Peck ruled in Lehman Bros. Special Fin. Inc. v. BNY Corp. Trustee Servs. Ltd., 422 B.R. 407, 420 (Bankr. S.D.N.Y. 2010) *to invalidate* a flip clause.

Fewer still would have regretted the absence of Lehman Brothers as counterparty to the respective uncleared swap with flip clauses after 25 May 2011, when Judge Peck issued a ruling in Lehman Bros. Special Fin. Inc. v. Ballyrock ABS CDO 2007-1 Ltd. (In re Lehman Bros. Holdings Inc.), 452 B.R. 31 (Bankr. S.D.N.Y. 2011) (JMP) that *did not restore the validity* of a flip clause.

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[154] At the time of this writing, each NRSRO that rates securitized or structured debt has watered down its respective protocols with respect to protections against non-performance of a swap provider such as a high rating at outset but retained the provisions that enable an issuer to post hold no capital against this outcome or post collateral to the swap provider. Norbert Gaillard and William J. Harrington, 'Efficient, commonsense actions to foster accurate credit ratings,' Capital Markets Law Journal (2016) 11 (1): 38-59, pp. 43-44.

[155] Ibid. Today, all NRSRO methodologies allow a counterparty with Lehman Brothers' rating as of May 2006 to provide an uncleared swap with a flip clause without posting collateral from the outset.

[156] The speaker is a continental European who remains based in Europe. Hence the slightly formal, stilted paraphrasing. See also William J. Harrington Letter to the SEC and ESMA of 11 September 2013. Page 5. "Fortuitously for cashflow ABS, Lehman Brothers was counterparty to comparatively few securitization swaps (whereas bailed-out AIG remains counterparty to many)." This letter is available at: http://www.wikirating.org/data/other/20130917_Harrington_J_William_ABS_Losses_Attributable_to_Securitization_Swaps.pdf.

[157] See William J. Harrington, 'Re: Rule Comment Number 466-1,' Comment to the SEC (3 June 2013). PDF-numbered p. 37, footnote 49. "Note omission of DPCs 'as counterparties in structured finance transactions.' This was intentional given that the lead analyst for Moody's Hedge Framework was also Moody's lead analyst for DPCs." This submission is available at https://www.sec.gov/comments/4-661/4661-28.pdf.

"In developing its proposed margin requirement for uncleared swap transactions, the Commission recognized that different categories of counterparties present different levels of risk."

An issuer of securitized or structured product debt that is party to an uncleared swap with RAC provisions and a flip clause — such as the trusts that Navient originated or sponsors that are listed immediately below — pose the *highest* level of risk to an SD or other swap provider.

Navient and Navient-Sponsored Private Student Loan Securitizations with Uncleared, Balance-Guaranteed[158] Swaps that Reference the Prime Rate and LIBOR and Contain Flip Clauses and RAC Provisions and Respective Swap Providers (Shading denotes an SD)
Sources: Navient Website; Rating Agency Announcements and Reports; and CFTC.gov.

1. SLM Private Credit Student Loan Trust 2002-A – Merrill Lynch Derivative Products AG
2. SLM Private Credit Student Loan Trust 2003-B – 2 Counterparties: 1. Merrill Lynch Derivative Products AG; & 2. Citibank, N.A.
3. SLM Private Credit Student Loan Trust 2003-C – 2 Counterparties: 1. Merrill Lynch Derivative Products AG; & 2. JPMorgan Chase Bank North America
4. SLM Private Credit Student Loan Trust 2003-A – 2 Counterparties: 1. Merrill Lynch Derivative Products AG; & 2. Citibank, N.A.
5. SLM Private Credit Student Loan Trust 2004-A – JPMorgan Chase Bank NA
6. SLM Private Credit Student Loan Trust 2004-B – JPMorgan Chase Bank NA
7. SLM Private Credit Student Loan Trust 2005-A – Morgan Stanley Capital Services
8. SLM Private Credit Student Loan Trust 2005-B – Royal Bank of Scotland
9. SLM Private Credit Student Loan Trust 2006-A – Deutsche Bank New York
10. SLM Private Credit Student Loan Trust 2006-B – Deutsche Bank New York
11. SLM Private Credit Student Loan Trust 2006-C – Bank of America NA
12. SLM Private Credit Student Loan Trust 2007-A – Credit Suisse First Boston International
13. SLM Private Education Student Loan Trust 2010-B – Royal Bank of Scotland
14. SLM Private Education Student Loan Trust 2010-C – Royal Bank of Scotland
15. SLM Private Education Student Loan Trust 2011-C – Royal Bank of Canada, Toronto
16. SLM Private Education Student Loan Trust 2012-A – GSMMDP
17. SLM Private Education Student Loan Trust 2012-B – Bank of New York
18. SLM Private Education Student Loan Trust 2012-C – Bank of New York
19. SLM Private Education Student Loan Trust 2012-D – Royal Bank of Canada, Toronto
20. SLM Private Education Student Loan Trust 2012-E – Bank of New York
21. SLM Private Education Student Loan Trust 2013-A – Bank of New York
22. SLM Private Education Student Loan Trust 2013-B – Bank of New York
23. SLM Private Education Student Loan Trust 2013-C – Bank of New York
24. SLM Private Education Student Loan Trust 2014-A – Bank of New York
25. Navient Private Education Student Loan Trust 2014-CT – JPMorgan Chase Bank NA
26. Navient Private Education Loan Trust 2014-A – Royal Bank of Canada
27. Navient Private Education Student Loan Trust 2014-CT – JPMorgan Chase NA
28. Navient Private Education Loan Trust 2015-A – Royal Bank of Canada
29. Navient Private Education Loan Trust 2015-B – Wells Fargo Bank
30. Navient Private Education Loan Trust 2015-C – JPMorgan Chase Bank NA

158 "Residential mortgage ABS and student loan ABS have pronounced exposure to counterparty risk, given their reliance on a highly idiosyncratic type of swap: a balance-guarantee swap with a flip clause. 'Balance guarantee' indicates that the swap offsets two mismatches in payment characteristics between securitized assets and ABS — a standard mismatch such as that between basis rates, interest rates, or currencies and a second, highly idiosyncratic mismatch between prepayment rates." See William J, Harrington, 'Re: File Number S7-18-11, Request for Re-proposal Relating to Nationally Recognized Statistical Rating Organizations,' (29 May 2014) p. 14. This submission is available at: https://www.sec.gov/comments/s7-18-11/s71811-84.pdf.

31. Navient Private Education Loan Trust 2016-A – JPMorgan Chase Bank NA

Navient and Navient-Sponsored Student Loan Securitizations with Uncleared, Balance-Guaranteed[159] Swaps that Reference Currencies and Contain Flip Clauses and RAC Provisions and Respective Swap Providers (Shading denotes an SD)

Sources: Navient Website; Rating Agency Announcements and Reports; and CFTC.gov.

1. SLM Student Loan Trust 2003-2 – CDC IXIS Capital Markets (Euro 187mm / USD 203mm)
2. SLM Student Loan Trust 2003-5 – CDC IXIS Capital Markets (Euro 270mm / USD 309mm)
3. SLM Student Loan Trust 2003-7 – CDC IXIS Capital Markets (Euro 490mm / USD 550mm)
4. SLM Student Loan Trust 2003-10 – CDC IXIS Capital Markets (GBP 1.25bn / USD 1.7bn)
5. SLM Student Loan Trust 2003-12 – Citibank (GBP 400mm / USD 670mm)
6. SLM Student Loan Trust 2004-2 – CDC IXIS Capital Markets (Euro 796mm / USD 1bn)
7. SLM Student Loan Trust 2004-5 – Swiss Re Financial Products (Euro 760mm / USD 930mm)
8. SLM Student Loan Trust 2004-10 – AIG Financial Products Corp. (Euro 408mm / USD 501mm)
9. SLM Student Loan Trust 2005-9 – Deutsche Bank NY (Euro 500mm / USD 597mm)
10. SLM Student Loan Trust 2006-4 – 2 Counterparties: 1. Credit Suisse First Boston International (Euro 436mm / USD 530mm); and 2. Banque Nationale De Paris (Euro 436mm / USD 530mm)
11. SLM Student Loan Trust 2006-6 – Barclays Capital Markets (Euro 372mm / USD 473mm)
12. SLM Student Loan Trust 2006-10 – Barclays Capital Markets (Euro 302mm / USD 386mm)
13. SLM Student Loan Trust 2007-4 – Barclays Capital (Euro 305mm / USD 406mm)
14. SLC Student Loan Trust 2008-01 – Credit Suisse First Boston International (euro 134mm / USD 208mm)

Securitization or structure product issuers that can activate a flip clause, walkaway or similar provision in an uncleared swap or an uncleared security-based swap created a highly-idiosyncratic, 100% exposure to itself for an SD. These provisions enable a securitization or structured product issuer to write off all payments that would otherwise be due an SD simply because it is bankrupt, insolvent, non-performing or similarly impaired.

Moreover, the correlation of activation of all flip clauses, walkaways or similar provisions will be 100%, i.e. 100% of counterparties to uncleared swaps and uncleared security-based swaps with these clauses and provisions that are in-the-money to an SD will simultaneously activate them against the SD when it is bankrupt, insolvent, non-performing or similarly impaired.

The bankruptcy of Lehman Brothers provided a real-world example of a bankrupt swap provider that received USD 0.00 per USD 1.00 owed under 100% of in-the-money, uncleared swaps that contained flip clauses with 44 securitization issuers. In this real-world example, the correlation of counterparties that activated flip clauses against the swap provider was 100%.

United States Bankruptcy Judge Shelley C. Chapman detailed this 100% correlation of individual "payments" of USD 0.00 in a ruling on *Lehman Brothers Special Financing Inc. vs. Bank of America National Association et al of 28 June 2016.*

[159] In 2006, a major swap provider concluded that "balance-guaranteed" uncleared swaps in the RMBS sector could not be replaced. See William J. Harrington, 'Re: Rule Comment Number 466-1,' Comment to the SEC (3 June 2013). PDF-numbered pp. 25-29. "Under the RAC, BSFP presented RMBS issuers with a derivative contract that made failure by BSP to post collateral at the Second Trigger an Additional Termination Event rather than an Event of Default. *The BSFP rationale in petitioning for RAC was that balance-guarantee hedges with RMBS issuers could not be replaced* [italics added] and BSFP lacked resources to post collateral for the duration of each balance-guaranteed swap." See also PDF-numbered page 40, footnote 53. This submission is available at https://www.sec.gov/comments/4-661/4661-28.pdf.

"Upon providing notice of an Event of Default under the Swaps and the Indentures, the Trustees liquidated the assets, including the Collateral securing the Issuers' obligations under the Swaps and Indentures, and deposited the proceeds into accounts held by each Trustee for that purpose. The Trustees subsequently distributed the proceeds pursuant to the applicable Waterfall (the "Distributions"). In each instance, the Trustees applied Noteholder Priority because the Early Terminations were the result of an Event of Default and LBSF was the Defaulting Party. *The amount of the proceeds of the liquidation of the Collateral was insufficient to make any payment to LBSF [italics added] under the Waterfall after proceeds were paid pursuant to Noteholder Priority*."

To differentiate between "categories of counterparties [that] present different levels of risk," the Commission must adjust each aspect of the CFTC Proposal to reflect the 100% exposure to itself that an SD bears when party with a securitization or structured product issuer to an uncleared swap with RAC provisions and a flip clause, walkaway or similar provision.

The adjustments must require that an SD that is exposed to a flip clause, walkaway or similar provision in an uncleared swap or an uncleared security-based swap to hold capital equal to the following for each such swap and security-based swap.

> The maximum of: [0, 100% of the "uncleared swap margin" as defined in footnote 25 of the CFTC proposal + 100% of the market value of the swap or security-based swap on the books of the SD].
>
> **N.B.** Using the market value of the swap or security-based swap on the books of the SD will ensure its "safety and soundness." Otherwise, the last term may converge to USD 0.00 for even a deeply in-the-money swap as an SD approaches bankruptcy, insolvency, non-performing status or similar credit-impairment.

1. Yes, the "minimum capital requirements represent a barrier to entry to firms that may otherwise seek to trades swaps as SDs."

   However, this barrier is commensurate with protecting the safety and soundness of individual SDs and the financial system. The market for uncleared swaps is still very young — less than 30 years old — and neither firms nor end users have established best practice templates for risk management or for accountability.

   The number of SDs that are counterparty to an uncleared swap with RAC provisions and flip clauses with a securitization vehicle that Navient Corporation originated or sponsors is a case in point. These SDs have exercised poor risk management by undercapitalizing these swaps since inception.

   In these cases, an SD must hold additional capital equal to the maximum of: [0, 100% of the "uncleared swap margin" as defined in footnote 25 of the CFTC proposal + 100% of the market value of the swap or security-based swap on the books of the SD].

   Fortunately, these SDs have the resources to fully capitalize these swaps immediately.

   For instance, Table 5 of the CFTC Proposal shows that Goldman Sachs, the parent BHC of the DPC GSMMDP, had a common equity Tier 1 capital ratio of 13.4% as of Q1 2016. GSMMDP is a counterparty to an uncleared, balance-guaranteed, Prime/LIBOR swap with RAC provisions and flip clauses with SLM Private Education Student Loan Trust 2012-A.

In contrast, other SDs that are DPCs such as MSDP and NDPI are counterparties to few if any uncleared swaps with RAC provisions and flip clauses. The capital requirements should operate so that MSDP and NSPI benefit in relative terms viz-a-viz GSMMDP with respect to uncleared swaps with RAC provisions and flip clauses.

To be clear, MSDP and NDPI both have sufficient capital to provide uncleared swaps with RAC provisions and flip clauses. Table 5 of the CFTC Proposal shows that Morgan Stanley, the parent BHC of MSDP, had a common equity Tier 1 ratio of 14.5% as of Q1 2016. Table 6 of the CFTC Proposal shows that Nomura Holdings, Inc., the parent of NDPI, had a common equity tier 1 capital ratio of 15.1%.

Clearly, neither MSDP nor NDPI face an insurmountable barrier in entering the market for these swaps. Even so, these entities and the remaining SDs may well refrain from providing new uncleared swaps with RAC provisions and flip clauses.

This may be a boon for economic growth and financial stability. Uncleared swaps with RAC provisions and flip clauses facilitated the issuance of whole sectors of undercapitalized securitization debt — cashflow CDOs, cashflow TRuPS CDOs, cashflow CDO-squared, cashflow RMBS, repackaged securitizations of all sectors, structured credit default swaps, structured notes of all securitization sectors, synthetic CDOs and synthetic RMBS — that fueled the last financial crisis.

Moreover, the remaining securitization sectors — e.g., those backed by auto loans, credit cards, equipment leases, levered loans and student loans — were also undercapitalized owing to the presence of uncleared swaps with RAC provisions and flip clauses.

These sectors benefited indirectly from the explicit bailouts and other support that the US government provided to global counterparties after Lehman Brothers failed. Without this government support, the undercapitalization of these remaining securitization sectors might have also caused them to collapse.

2. Yes, "firms part of US BHCs that are subject to Basel III and stress testing requirements would be readily able to meet the proposed capital requirement," *including* the proposed amendment for a firm that is exposed to a flip clause, a walkaway or similar provision in an uncleared swap or uncleared security-based swap.

   In these cases, a firm must hold additional capital equal to the maximum of: [0, 100% of the "uncleared swap margin" as defined in footnote 25 of the CFTC proposal + 100% of the market value of the swap or security-based swap on the books of the SD].

3. Yes, "ANC firms would be readily able to meet the proposed capital requirement," *including* the proposed amendment for a firm that is exposed to a flip clause, a walkaway or similar provision in an uncleared swap or uncleared security-based swap.

   In these cases, a firm must hold additional capital equal to the maximum of: [0, 100% of the "uncleared swap margin" as defined in footnote 25 of the CFTC proposal + 100% of the market value of the swap or security-based swap on the books of the SD].

4. Yes, "it would not be too costly for firms or their parents already subject to SEC BD and/or proposed SBSD capital requirements or CFTC's current FM capital requirement to comply with the capital requirement," *including* the proposed amendment for a firm that is exposed to a flip clause, a walkaway or similar provision in an uncleared swap or uncleared security-based swap.

   In these cases, a firm must hold additional capital equal to the maximum of: [0, 100% of the "uncleared swap margin" as defined in footnote 25 of the CFTC proposal + 100% of the market value of the swap or security-based swap on the books of the SD].

5. Yes, the "proposed capital requirements would not be too burdensome for firms that are part of foreign BHCs subject to Basel" even with the proposed amendment for a firm that is exposed to a flip clause, a walkaway or similar provision in an uncleared swap or uncleared security-based swap.

   In these cases, a firm must hold additional capital equal to the maximum of: [0, 100% of the "uncleared swap margin" as defined in footnote 25 of the CFTC proposal + 100% of the market value of the swap or security-based swap on the books of the SD].

6. Yes, it might potentially be "too costly for the smaller SDs and SDs that are not subject to Basel or SEC or CFTC capital requirements to comply" with the proposed amendment for a firm that is exposed to a flip clause, a walkaway or similar provision in an uncleared swap or uncleared security-based swap.

   In these cases, a firm must hold additional capital equal to the maximum of: [0, 100% of the "uncleared swap margin" as defined in footnote 25 of the CFTC proposal + 100% of the market value of the swap or security-based swap on the books of the SD].

   However, these SDs *should* be weeded out from the market for providing an uncleared swap with a flip clause, walkaway or similar provision, both for their own "soundness and safety" and that of the financial system as a whole.

7. A smaller firm should accept a restriction that it will not enter into any uncleared swaps or uncleared security-based swaps with a flip clause, walkaway or similar provision.

   In this way, the smaller firm will not have to adhere to the proposed amendment of holding additional capital equal to the maximum of: [0, 100% of the "uncleared swap margin" as defined in footnote 25 of the CFTC proposal + 100% of the market value of the swap or security-based swap on the books of the SD].

8. An alternative to the proposed amendment is an outright prohibition on an SD, MSP, CSE or other swap provider entering into an uncleared swap or an uncleared security-based swap with a flip clause, walkaway or similar provision.

Responses to Request for Comment, pp. 91302-4

ii. Margin vs Capital

"Accordingly, swaps that are not subject to the margin requirement…would have to be taken into account in determining the capital requirement."

"The Commission is proposing this approach as it believes that it would be appropriate to require an SD to maintain capital for uncollateralized swap exposures to counterparties."

Yes, it is "appropriate to require an SD to maintain capital for uncollateralized swap exposures to counterparties."

For instance, none of the 45 securitization vehicles that Naivent originated or sponsors which are listed above in the previous section entitled "Responses to Request for Comment, p. 91302" posts collateral to the respective SD or non-SD counterparty.

However, each SD or non-SD counterparty is exposed to simultaneously incurring 100% losses under 100% of the in-the-money, uncleared swaps that it provides to a Navient securitization vehicle.

Similarly, an SD or MSP that is counterparty to any other securitization vehicle that does not post collateral under an uncleared swap or uncleared security-based swap with a flip clause, walkaway or similar provision is also exposed to simultaneously incurring 100% losses under 100% of these swaps that are in-the-money.

Such SDs or MSPs may include those that are counterparties to existing uncleared swaps with securitization vehicles and to new uncleared swaps that the CFTC or prudential regulators exempt from the margin requirements.

For this reason, each SD or MSP that is exposed to a flip clause, walkaway or similar provision in an uncleared swap or uncleared security-based swap should hold additional capital equal to the maximum of: [0, 100% of the "uncleared swap margin" as defined in footnote 25 of the CFTC proposal + 100% of the market value of the swap or security-based swap on the books of the SD].

This adjustment has the *effect* of being "consistent with the approach adopted by the prudential regulators in setting capital requirements for SDs subject to their jurisdiction" although the adjustment may not be present in the prudential regulators' current capital framework because two factors make the adjustment redundant.

First, "[w]alkaway clauses, including those that permit a party to suspend or condition payment, are not enforceable against the FDIC when acting as receiver or conservator of an insured depository institution or as receiver of a financial company under Title II of the Dodd Frank Act, or against the FHFA when acting as a receiver or conservator of Fannie Mae, Freddie Mac, or a Federal Home Loan Bank."[160] A flip clause operates very similarly to a walkaway provision and may be categorized as one.

Secondly, the "Margin and Capital Requirements for Covered Swap Entities" that the prudential regulators jointly adopted in October 2015 *do not exempt securitization and structured product issuers* from the category of financial end users with which a covered swap entity must exchange

[160] See Prudential Regulators, 'Margin and Capital Requirements for Covered Swap Entities,' footnote 124. This document is available at: https://www.occ.treas.gov/news-issuances/news-releases/2015/nr-occ-2015-142aaa.pdf.

variation margin on a daily basis. As a result, a covered swap entity that is party to an uncleared swap or uncleared security-based swap with a flip clause *should* be holding variation margin equal to the market value of the swap when it is an asset on the books of the covered swap entity.

"The Commission requests comments on how the proposed capital rule would impact the competitiveness between different SDs based on the legal entity structure of the firm.

An SD that is party with an end user to an uncleared swap or uncleared security-based swap with a flip clause, walkway or similar provision typically excludes the respective flip clause, walkaway or similar provision from an arms-length, uncleared swap or uncleared security-based swap with an affiliate.

Accordingly, there will be little-to-no "double (or more) counting of capital at the parent level for an outward facing swap based on the legal structure of the entity" when an SD that is party to an uncleared swap or uncleared security-based swap with a flip clause, walkaway or similar provision holds additional capital as proposed above.

"iii. Model vs Table"

"Does the proposed capital requirement reflect the increased risk associated with the use of models and trading in a portfolio of swaps?"

No, "the proposed capital requirement" does *not* "reflect the increased risk associated with the use of models and trading in a portfolio of swaps?"

Each aspect of the proposed capita requirement ignores the 100% exposure to itself that an SD or MSP bears under a flip clause, walkaway or similar provision in an uncleared swap or an uncleared security-based swap. These provisions enable the counterparty to an uncleared swap or an uncleared security-based swap to write off all payments that would otherwise be due an SD simply because it is bankrupt, insolvent, non-performing or similarly impaired.

As example, a key aspect of the proposed capital requirements for SDs — the reliance on credit risk charges — typically entirely ignore the 100% loss that a credit-impaired SD will incur under an uncleared swap that is in-the-money or an uncleared security-based swap that is in-the-money if the counterparty activates a flip clause, walkaway or similar provision.

Moreover, the correlation of activation of all flip clauses, walkaways or similar provisions will be 100%, i.e. 100% of counterparties to uncleared swaps and uncleared security-based swaps with these clauses and provisions that are in-the-money to an SD will simultaneously activate them against the SD when it is bankrupt, insolvent, non-performing or similarly impaired.

Accordingly, an SD or MSP that is party to an uncleared swap or an uncleared security-based swap with a flip clause, walkaway or similar provision must hold additional capital equal to the maximum of: [0, 100% of the "uncleared swap margin" as defined in footnote 25 of the CFTC proposal + 100% of the market value of the swap or security-based swap on the books of the SD].

Moreover, the Commission must adjust the "standardized haircut approach" to achieve a similar result.

"The Commission further estimates conservatively that most of these SDs and MSPs would seek to obtain Commission approval to use models for computing their market and credit risk charges.

These entities would incur cost to develop, maintain, document and audit models, and seek model approval."

Perhaps, but incurring these costs would allow an SD or MSP with *no* uncleared swap or uncleared security-based swap with a flip clause, walkaway or similar provision to "to more efficiently deploy capital in other parts of its operations" compared to an SD or MSP that is party to one more uncleared swaps or uncleared security-based swaps with a flip clause, walkaway or similar provision.

"iv. Liquidity Requirement and Equity Withdrawal Restrictions"

"How much additional costs would SDs incur resulting from the proposed liquidity requirements given their current practice? The Commission requests that commentators quantify the extent of the additional cost the proposed minimum liquidity requirement would incur based on its portfolios and financials, and provide the Commission with such data. The Commission also requests comments on alternative approaches to liquidity requirements to achieve the same policy goal."

Unfortunately, the "Commission's proposed liquidity requirements" *don't* adequately "address the potential risk that an SD may not be able to efficiently meet both expected and unexpected current and future cashflow and collateral needs as a result of adverse events impacting the SD's daily operations or financial condition."

Each aspect of the proposed liquidity requirements ignores the 100% exposure to itself that an SD bears under a flip clause, walkaway or similar provision in an uncleared swap or an uncleared security-based swap. These provisions enable the counterparty to an uncleared swap or an uncleared security-based swap to write off all payments that would otherwise be due an SD simply because it is bankrupt, insolvent, non-performing or similarly impaired.

As example, a key aspect of the proposed liquidity requirements for SDs — the liquidity stress test — typically entirely ignores the 100% loss that a credit-impaired SD will incur under an uncleared swap that is in-the-money or an uncleared security-based swap that is in-the-money if the counterparty activates a flip clause, walkaway or similar provision.

Similarly, the provision that "inflows that can be included to offset outflows are limited to 75% of the outflows" to mirror "losses from derivatives positions" is inadequate. This stress to inflows only partially reflects the 100% loss that a credit-impaired SD will incur under an uncleared swap that is in-the-money or an uncleared security-based swap that is in-the-money if the counterparty activates a flip clause, walkaway or similar provision.

Moreover, the correlation of activation of all flip clauses, walkaways or similar provisions will be 100%, i.e. 100% of counterparties to uncleared swaps and uncleared security-based swaps with these clauses and provisions that are in-the-money to an SD will simultaneously activate them against the SD when it is bankrupt, insolvent, non-performing or similarly impaired.

This omission is entirely inconsistent with the bedrock assumptions in a liquidity stress test that is governed either by common sense or simply the first term in footnote 103 of the Commission proposal. "The assumptions would include (1) a decline in creditworthiness of the SD severe enough to trigger contractual related commitment provisions of counterparty agreements."

Such a "decline in creditworthiness" of an SD would prompt 100% of its counterparties to uncleared swaps and uncleared security-based swaps with flip clauses, walkways or other provisions that are in-the-money to the SD to gear up simultaneously to activate these clauses and provisions.

As a result, the SD in question could suddenly find itself having to write off 100% of the payments that it had been scheduled to receive under these uncleared swaps and uncleared security-based swaps in the subsequent 30 days.

In other words, the proposed liquidity requirements would *not* "ensure that SD is maintaining sufficient liquidity and is not overly reliant on inflows." In fact, the presence of flip clauses, walkaways or similar provisions in the uncleared swaps and uncleared security-based swaps of an SD can both contribute to and exacerbate "adverse events impacting the SD's daily operations or financial condition."

The contingency funding plan that an SD will be required to produce must address the 100% losses that an SD will incur under uncleared swaps and uncleared security-based swaps that are in-the-money when counterparties activate flip clauses, walkaways and similar provisions.

The bankruptcy of Lehman Brothers provided a real-world example of a bankrupt swap provider that received USD 0.00 per USD 1.00 owed under 100% of in-the-money, uncleared swaps that contained flip clauses with 44 securitization issuers. In this real-world example, the correlation of counterparties that activated flip clauses against the swap provider was 100%.

United States Bankruptcy Judge Shelley C. Chapman detailed this 100% correlation of individual "payments" of USD 0.00 in a ruling on *Lehman Brothers Special Financing Inc. vs. Bank of America National Association et al of 28 June 2016.*

"Upon providing notice of an Event of Default under the Swaps and the Indentures, the Trustees liquidated the assets, including the Collateral securing the Issuers' obligations under the Swaps and Indentures, and deposited the proceeds into accounts held by each Trustee for that purpose. The Trustees subsequently distributed the proceeds pursuant to the applicable Waterfall (the "Distributions"). In each instance, the Trustees applied Noteholder Priority because the Early Terminations were the result of an Event of Default and LBSF was the Defaulting Party. *The amount of the proceeds of the liquidation of the Collateral was insufficient to make any payment to LBSF [italics added] under the Waterfall after proceeds were paid pursuant to Noteholder Priority*."

To "ensure the safety and soundness of an SD" that is exposed to a flip clause, walkaway or similar provision in an uncleared swap or an uncleared security-based swap, the CFTC must adjust each aspect of the capital rule and liquidity requirements to reflect the 100% exposure to itself that an SD bears.

The adjustments must require that an SD that is exposed to a flip clause, walkaway or similar provision in an uncleared swap or an uncleared security-based swap to hold capital equal to the following for each such swap and security-based swap.

The maximum of: [0, 100% of the "uncleared swap margin" as defined in footnote 25 of the CFTC proposal + 100% of the market value of the swap or security-based swap on the books of the SD].

With respect to equity withdrawal restrictions, the Commission must amend the proposal with respect to an SD or MSP that is party to an uncleared swap or uncleared security-based swap with a flip clause, walkway or similar provision.

"For SDs that elect a bank-based capital approach, the Commission" *should* propose "to require the SD to maintain each day an amount of high quality liquid assets ("HQLAs"), that is no less than 100% of the SDs total net cash outflow" (the measurement of such net cash outflow to exclude all cash inflows under an uncleared swap or uncleared security-based swap with a flip clause, walkaway or similar provision) "over a prospective 30 calendar-day period.…Total net cash outflow amounts are calculated by applying outflow and inflow rates" (the measurement of such inflow rates to exclude all cash inflows under an uncleared swap or uncleared security-based swap with a flip clause, walkaway or similar provision), "which reflect certain standardized stressed assumptions, against the balances of an SD's funding sources, obligations, transactions, and assets over a prospective 30 day period."

"For SDs that elect a net liquid assets capital approach, the Commission is proposing a liquidity stress test to be conducted by SDs that elect a net liquid asset capital approach at least monthly that takes into account certain assumed stressed conditions" (including a cessation of all cash inflows under an uncleared swap or uncleared security-based swap with a flip clause, walkaway or similar provision) "lasting for 30 consecutive days. The proposed minimum elements" (including the cessation of all cash inflows under an uncleared swap or uncleared security-based swap with a flip clause, walkaway or similar provision) "are designed to ensure that SDs employ a stress test that is severe enough to produce an estimate of a potential funding loss of a magnitude that might be expected in a severely stressed market."

Under these proposed adjustments, SDs that are party to one or more uncleared swaps or uncleared security-based swap with a flip clause, walkway or similar provision *will* incur higher costs and these higher costs are necessary to promote the "safety and soundness" of the respective SD as well as the financial system as a whole.

Moreover, an SD that is party to one or more uncleared swaps or uncleared security-based swap with a flip clause, walkway or similar provision *should* incur higher costs than an SD that is not party to such an uncleared swap or uncleared security-based swap.

The SDs that are counterparties to Navient and Navient-sponsored securitizations (listed above in the section "Responses to Request for Comment, p. 91302") can offer detailed projections of the additional costs under a liquidity test that adjusts inflows to exclude all those "under an uncleared swap or uncleared security-based swap with a flip clause, walkaway or similar provision."

Fortunately, these SDs are large, well-capitalized entities and can easily absorb these additional costs.

"v. Other Considerations"

The Commission Proposal is correct with respect to several points.

"The proposed requirements should reduce the risk of a failure of any major market participant in the swap market, which in turn reduces the possibility of a general market failure, and thus promotes confidence for market participants to transact in swaps for investment and hedging purposes."

The risk of failure of one or more major market participants in the swap market, which could require more taxpayer bailouts, is a major concern to the public at large. Unfortunately, uncleared swaps and uncleared security-based swaps are tailor made for saddling SDs and other swap providers with excessive market, credit and idiosyncratic risks that can lead to more bailouts.

The public at large is alert to the problem — the more complicated the finance the more likely it is to harm and not help the economy. In other words, it is the undercapitalization of SDs and not their overregulation that "could hinder the ability of global firms to most efficiently allocate capital" to the most productive investments.

The market for uncleared swaps is still very young — less than 30 years old — and neither swap providers nor end users have established best practice templates for risk management or for accountability.[161]

Uncleared swaps and uncleared security-based swaps with flip clauses, walkaways and similar provisions are among the most egregious examples of uncleared swaps that saddle an SD, MSP, FCM, covered swap entity or other swap provider with one of the most idiosyncratic of risks — exposure to its own insolvency, bankruptcy, non-performance or similar impairment.

AIG and the Bear Stearns DPC BSFP provided two instances of major providers of uncleared swaps with flip clauses, walkways and similar provisions that required explicit government support, implicit government support and capital from third parties to avoid incurring the 100% losses under 100% of swaps with flip clauses that were in-the-money assets.

AIG was party to deep-in-the-money interest rate swaps with flip clauses to 50+ CDO and ABS issuers in 2009. Some of the CDO issuers had also borrowed money from AIG via these swaps and were repaying the loans through particularly high swap rates. These swaps were particularly large mark-to-market assets for AIG.

AIG had not fulfilled the "replace or guarantee" provisions in the swaps that were mandated by the company's downgrades in 2008. This was serious because the flip clauses in the swap contracts allowed the respective CDO and ABS issuers (both those that had and had not borrowed from AIG) to terminate the swaps without paying anything to AIG.[162]

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[161] Several industry groups made a self-inculpatory admission in early 2017 that underscored the sector's lack of best practices. *As of February 2017, less than 6% of financial end users could comply with the looming implementation date for the swap margin rules of 1 March 2017, even though the CFTC and prudential regulators had set this date 14 and 16 months earlier, respectively*. In response, the CFTC issued the CFTC Letter No. 17-11 of 13 February 2017, which extended the implementation date to 1 September 2017. This letter is available at: http://www.cftc.gov/idc/groups/public/@lrlettergeneral/documents/letter/17-11.pdf.

[162] See William J. Harrington, 'Re: Rule Comment Number 466-1,' Comment to the SEC (3 June 2013). PDF-numbered page 58. This submission is available at https://www.sec.gov/comments/4-661/4661-28.pdf. "On October 3, 2008, AIG had been downgraded to A3 which constituted a 'replacement' rating for interest-rate swaps with 40+/- issuers of CDOs. The swaps were deep-in-the-money assets to AIG (although in many cases senior CDOs had been downgraded significantly.) AIG was at risk of losing the assets entirely owing to 'flip clauses' that were being

If AIG had not been bailed out and the CDO and ABS issuers had exercised these flip clauses, the issuers would have removed a large liability from the top of their waterfalls to the benefit of the securitization debt. Conversely, AIG would have recorded a 100% loss on each of the deep-in-the-money swap assets.

BSFP was a major provider of a particularly risky type of uncleared swap with a RAC provision and a flip clause — a balance-guaranteed, uncleared swap with a RAC provision and a flip clause — to issuers of US cashflow RMBS. In 2006, BSFP management concluded that the replacement assumption did not apply to these swaps. This posed an existential threat to BSFP after it incurred a trigger event upon the downgrade of The Bear Stearns Companies Inc. on 14 March 2008.[163]

Fortunately for both BSFP and investors in RMBS with issuers that were BSFP counterparties, BSFP was guaranteed by JPMorgan Chase & Co. on 17 March 2008[164] and merged into JPMorgan Chase Bank NA on 28 May 2009.[165]

The guarantee and merger both applied to the entire BSFP portfolio of uncleared swaps and options. In other words, these extraordinary actions by JPM Chase Bank affiliates were not limited to the BSFP balance-guaranteed, uncleared swaps with RAC provisions and flip clauses and did not validate the replacement assumption as a mitigation against the flip clause.

Without these extraordinary actions, both BSFP and RMBS investors would have incurred much larger losses in the financial crisis.

Robust capital and liquidity requirements may result in few if any SDs providing new uncleared swaps with flip clauses, walkaway or similar provisions in the future.

This will be a boon for economic growth and financial stability. Uncleared swaps with RAC provisions and flip clauses facilitated the issuance of whole sectors of undercapitalized securitization debt — cashflow CDOs, cashflow TRuPS CDOs, cashflow CDO-squared, cashflow RMBS, repackaged securitizations of all sectors, structured credit default swaps, structured notes of all securitization sectors, synthetic CDOs and synthetic RMBS — that fueled the last financial crisis.

Moreover, the remaining securitization sectors — e.g., those backed by auto loans, credit cards, equipment leases, levered loans and student loans — were also undercapitalized owing to the presence of uncleared swaps with RAC provisions and flip clauses.

These sectors benefited indirectly from the explicit bailouts and other support that the US government provided to global counterparties after Lehman Brothers failed. Without this government support, the undercapitalization of these remaining securitization sectors might have also caused them to collapse.

activated by AIG failure to 'replace.' With no 'replacement' counterparties willing to 'replace,' AIG was negotiating with Bank of America to use MLDP as a highly-rated intermediary between the CDO issuers and AIG."

[163] Ibid. See PDF-numbered page 38.
[164] Ibid. See PDF-numbered page 40.
[165] Ibid. See PDF-numbered page 52.

The Commission Proposal correctly states that "SDs subject to a particular regulatory regime might be advantaged or disadvantaged if corresponding requirements in other regimes are substantially more or less stringent."

This is a basic fact of life. Different countries have different legal regimes. Different countries have different currencies that their respective central banks can lend. Different countries have different tolerances for government involvement in the economy. Different countries have different tolerances for bailouts of national champions.

Different countries have different beliefs as to whether one stubby little tail (i.e., the market for uncleared swaps) should wag not only the attached dog (i.e., financial regulation) but the entire kennel as well (i.e., domestic and international commerce).

At any rate, SDs will face no lasting harm from being shut out of the markets to provide uncleared swaps with RAC provisions and flip clauses to non-US issuers of securitizations. This business is great business to lose!

SDs will do better than just fine by providing *no* uncleared swaps with RAC provisions and flip clauses to non-US issuers of securitizations.

For a start, many domiciles such as the UK unambiguously uphold the validity of a flip clause.[166] In these domiciles, an SD is fully exposed to the losses of 100% of asset value that it will simultaneously incur under 100% of the uncleared swaps that are in-the-money assets upon becoming bankrupt, insolvent, non-performing or similarly credit-impaired.

Ratcheting up the *scale* of such losses, non-US issuers of securitizations would likely seek out SDs to provide cross-currency swaps.[167] These swaps expose an SD to much larger and much longer-lived risk than interest rate swaps or basis swaps.

Furthermore, the uncertain outlook for the UK in light of Brexit and for the EU in light of many factors are likely to ratchet currency volatility even higher.

In short, providing uncleared *currency* swaps with RAC provisions and flip clauses to non-US issuers of securitizations is even worse business for an SD than providing uncleared interest rate or basis rate swaps with RAC provisions and flip clauses to US issuers of USD securitizations. Providing uncleared *currency* swaps with RAC provisions and flip clauses to non-US issuers of securitizations is the *BEST* business for an SD to lose.

More generally, higher currency volatility also obligates the CFTC to adopt rigorous capital requirements for *all* types of uncleared swaps and not only uncleared swaps with RAC provisions and flip clauses. The dense linkages between global counterparties means that the

[166] Karen O'Flynn and Flora Innes, 'The Courts flip-flopping (again) on the validity of 'flip clauses,' Clayton Utz (1 September 2016). This note is available at: https://www.claytonutz.com/knowledge/2016/september/the-courts-flip-flopping-again-on-the-validity-of-flip-clauses.

[167] This is likely to be the case regardless of whether a non-US issuer securitizes non-USD assets and issues USD debt or vice-versa, i.e., securitizes USD assets and issues non-USD debt.

failure of one could impose losses on most other global counterparties and the respective home economies.

Furthermore, the slow EU growth that has persisted since the financial crisis reinforces the imperative for the CFTC to adopt rigorous capital requirements for *all* types of uncleared swaps. Weak capital requirements have *harmed* and not helped EU growth.

As a prime example, *the EU has cited the need to jumpstart the securitization markets as rationale for requiring an SD or equivalent entity to minimally capitalize the self-referencing credit risk of a flip clause in an uncleared swap. Citing the same rationale, the EU has effectively exempted securitization and structured product issuers from exchanging and variation margin.*[168]

However, the EU greenlight for EU swap providers to undercapitalize uncleared swaps with flip clauses, which in turn greenlights EU issuers of securitizations to bring undercapitalized deals to market, has proved self-defeating. EU securitization sectors have not rebounded since the financial crisis.[169] The many intrinsic deficiencies of the EU securitization sector, including the uncleared swap with RAC provisions and a flip clause, have permanently soured investors.

As I wrote to Fitch derivative analysts, the CFTC Office of Inspector General and CFTC, SEC and SFIG staff in an email of 22 December 2016: "Lax margin rules for the EU [securitization] sector have done nothing to revive it. Moreover, not requiring swap dealers to fully capitalize their self-referencing risk under flip clauses is a gimmick that rests on rating arbitrage and undermines systemic stability. Fortunately [for the US], the daily, two-way exchange of variation margin makes flip clauses irrelevant."[170]

However, the swap margin rules only apply to swaps that a financial end user enters into or amends after 1 March 2017. A securitization or structured product issuer and an SD that entered into an uncleared swap with RAC provisions and a flip clause prior to 1 March 2017 will never have to exchange margin unless the two parties amend the swap.

Moreover, SFIG is lobbying the CFTC and prudential regulators to exempt all US issuers of securitizations and structured products from the respective swap margin rules.

For this reason, an SD or MSP that is party to an uncleared swap or an uncleared security-based swap with a flip clause, walkaway or similar provision must hold additional capital equal to the maximum of: [0, 100% of the "uncleared swap margin" as defined in footnote 25 of the CFTC proposal + 100% of the market value of the swap or security-based swap on the books of the SD].

The Commission Proposal correctly states that "[t]he proposals that are ultimately adopted could have a substantial impact on domestic and international commerce and the relative competitive

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[168] Edward Manchester and Heidi J. Schmid, 'Proposed Changes to Moody's Rating Criteria Reflect New Swap Margin Rules,' Moody's Investors Service (22 March 2017). "The EU margin rules affect a small number of S[structured] F[inance] swaps: Under the EU margin rules, SPVs are 'non-financial counterparties' (NFCs). A swap entered into by an NFC entity is not subject to margining unless that entity is categorized as an NFC+ by reason of exceeding a threshold level of derivatives exposure."

[169] 'Europe's Securitisation Market Remains Stunted' *The Economist* (23 February 2017), available at: http://www.economist.com/news/finance-and-economics/21717426-efforts-pep-it-up-are-looking-increasingly-lacklustre-europes-securitisation.

[170] This email of 22 December 2016 comprises part of the correspondence that is contained in Appendix A to this response.

position of SDs operating under different requirements of various jurisdictions…This could affect the ability of US SDs to compete in the domestic and global markets."

"Substantial" is the operative word. Certainly, the Capital Requirements of Swap Dealers and Major Swap Participants that CFTC ultimately adopts will have *some* impact on domestic and international commerce.

After all, this commerce is simply all the actions that the world's people and firms take every nano-second after having reconsidered all previous actions taken in the last nano-second, day, year, decade, etc.

The capital rules *will* inform this relentless decision making of the world's people and firms by impacting the price of uncleared swaps and uncleared security-based swaps which in turn will impact the extent to which end users enter into these swaps. However, the ultimate impact that the pricing and volumes of uncleared swaps might have on domestic and international commerce, like other big picture economic questions, cannot be known with precision.[171]

Accordingly, the CFTC should adopt rules that reflect a deep understanding of the structures of uncleared swaps and uncleared security-based swaps — i.e., informed commonsense — rather than rules that are based on the construct of precise cost/benefit analysis.

For a start, precise cost/benefit analysis is not tenable with respect to uncleared swaps and uncleared security-based swaps because there is a pronounced asymmetry between the impacts on domestic and international commerce from undercapitalized swaps on one hand and adequately capitalized swaps on the other.[172] Undercapitalized swaps hurt domestic and international commerce to a much greater extent than adequate capitalization can help, at least in the short term.

This is because the persistent undercapitalization of uncleared swaps in the last 20 years has already *lowered* the baselines for domestic and international growth and *lessened* the resilience of the global economic system.

More undercapitalized swaps will simply undermine growth even more at a time when slow growth has already disadvantaged many sectors of domestic and international commerce. Undercapitalized swaps are artificially cheap swaps that enable lenders and debt issuers to extend credit on artificially cheap terms. In turn, artificially cheap credit distorts price signals that inform the world's people and firms in making economic decisions and directs capital to suboptimal uses.

[171] Professor Stephen Mihm, Associate Professor of History at University of Georgia, observes that the causes and global impacts of the Great Depression are subject to "fierce" debate 88 years after its onset. "For scholars and popular writers alike, the Great Depression has long been a kind of economic Rorschach test…The divergence of opinions concerning the Depression makes the task of writing a comprehensive history about it difficult. Add to that the fact that it played out on a global stage, with very different consequences for different countries." Stephen Mihm, 'When Europe Sneezed. A new history of the Depression looks beyond Wall Street to the global roots of the crisis.' [Review of the book *A Rabble of Dead Money. The Great Crash and the Global Depression: 1929-1939,* by Charles R. Morris.] *The New York Times Book Review* (23 April 2017).

[172] See the earlier section entitled "Responses to Request for Comment, p. 91302" pp. 98-106 for a description of the commonsense adjustments to the algorithmic output of capital and collateral requirements that my Moody's team specified for structured finance operating companies with asymmetric exposures to market and credit indices.

Adequately capitalized swaps will most likely mean fewer swaps, more accurately-priced credit and more optimal lending. Domestic and international commerce will adjust and establish higher baselines for growth.

However, this adjustment will take time. There is no shortcut but plenty of pitfalls.

For instance, the interconnections among individuals and firms that inform decision making are not static. Each iteration of simultaneous decision making activates a feedback loop that strengthens some interconnections and weakens others.

Currently, these feedback loops are harming domestic and international commerce and financial instruments and contracts that are unnecessarily complicated are a main problem. The extremely dense interconnections in the financial sector with the behemoths at the center are crowding out other interconnections such as those among large parts of the US population.

This mirrors a pattern that was prominent in the Great Depression.

"[T]here is growing literature within economics that examines the possibility that inequality, household debt and financial crises may be related,"[173] according to Professor Stephen Mihm.

"As in our own age, the growing dominance of finance in the 1920s went hand in hand with another trend: rising inequality…it's hard to read these as anything but a misallocation of economic resources. In each instance, the metastatic growth of finance, along with staggering amounts of debt, yielded towers of leverage that came crashing down. And then, as now, this had real effects on the larger economy."

Undercapitalized swaps are one "metastatic growth of finance" that facilitates overly dense interconnections among financial firms.[174] This is another indicator that domestic and international commerce need *fewer* rather than more undercapitalized, uncleared swaps.

One loser will be the SDs and MSPs themselves. This will be a gain for domestic and international commerce in the medium and long terms. For too long, SDs have acted as if providing more uncleared swaps was synonymous with helping the domestic and international commerce.

The Commission Proposal correctly states that "substantial differences between the US and foreign jurisdictions in the costs of complying with these requirements for swaps between US and foreign jurisdictions could reduce cross-border capital flows."

"This is a good outcome" is an apt response.

Cross-border capital flows are not in themselves good or bad. More cross-border capital flows are not unequivocally good for domestic and international commerce. Conversely, fewer cross-border capital flows are not unequivocally bad for domestic and international commerce.

Cross-border capital flows that are in fact money laundering are bad for domestic and international commerce. Cross-border capital flows that represent informed investment decisions

[173] Ibid.

[174] Many industry groups made a self-inculpatory admission in early 2017 that underscored the unwieldy state of the market for uncleared swaps. *As of February 2017, less than 6% of financial end users could comply with the looming implementation date for the swap margin rules of 1 March 2017, even though the CFTC and prudential regulators had set this date 14 and 16 months earlier, respectively.* In response, the CFTC issued the CFTC Letter No. 17-11 of 13 February 2017, which extended the implementation date to 1 September 2017. This letter is available at: http://www.cftc.gov/idc/groups/public/@lrlettergeneral/documents/letter/17-11.pdf.

on one side and useful investment on the other are good for domestic and international commerce.

Unfortunately, the Commission Proposal correctly states that “substantial differences between the US and foreign jurisdictions in the costs of complying with these requirements for swaps between US and foreign jurisdictions could…hinder the ability of global firms to most efficiently allocate capital among legal entities.”

Uncleared swaps that are undercapitalized and artificially cheap do “efficiently allocate capital among legal entities.” This is called regulatory gaming and is a very different undertaking than directing capital to the optimal benefit of domestic or international commerce.

Regulatory gaming represents a major “metastatic growth of finance,” to re-quote Professor Stephen Mihm. “[i]t’s hard to read these as anything but a misallocation of economic resources.[175]

Finally, the Commission Proposal correctly states that “SDs may pass on additional capital, liquidity, and operational costs resulting from the proposal” — including the proposed adjustment for uncleared swaps and uncleared security-based swaps with flip clauses, walkaways and other provisions — “to end users in the form of higher fees and wider spreads. Thus, end users may experience increased cost of using swaps for hedging and investing purposes.”

For instance, a US securitization or structure product issuer may well respond to a robust capital requirement for an uncleared swap that increases its cost by buying an option or securitizing additional assets instead.

Accurate pricing for each of these three approaches will direct the issuer to choose the approach that works best considering the transaction attributes rather simply opting for the artificially cheap, uncleared swaps with RAC provisions and flip clauses that rest on government support.

As many securitization and structured product issuers confront the same choice, capital will flow to the most effective uses.

Well, that’s capitalism! Accurate prices that increase choice and economic utility are not necessarily convenient prices.

That’s how free markets are supposed to work — users get what they pay for.

Sincerely yours,

William J. Harrington

cc: The Honorable Thomas J. Curry, Comptroller of the Currency
The Honorable Janet Yellen, Chair, Board of Governors of the Federal Reserve System
The Honorable Martin J. Gruenberg, Chairman, Federal Deposit Insurance Corporation
The Dallas B. Tonsager, Board Chair and Chief Executive Officer, Farm Credit Administration
The Honorable Melvin Watt, Director, Federal Housing Finance Agency
The Honorable J. Christopher Giancarlo, Acting Chairman, Commodity Futures Trading Commission

175 Op. cit. (Mihm).

The Honorable Michael S. Piwowar, Acting Chairman, U.S. Securities and Exchange Commission
Ms. Harriet Orol, Office of Credit Ratings, U.S. Securities and Exchange Commission
Mr. **Michael C. Dawley, Chairman, National Futures Association**
Mr. Richard Johns, Executive Director, Structured Finance Industry Group
Mr. Patrick Dolan, Chair of the Structured Finance Committee of the New York City Bar Association
Mr. John Berisford, President, S&P Global Ratings
Mr. Jim Nadler, President and CEO, Kroll Bond Rating Agency
Mr. Dan Curry, Chief Executive Officer and Director, DBRS Limited
Mr. Paul Taylor, President and CEO, Fitch Group
Mr. Kunal Kapoor, Chief Executive Officer, Morningstar
Mr. Raymond McDaniel Jr., Chief Executive Officer, Moody's Corporation
Ms. Sondra L. Mills, United States Department of Justice
Mr. Thomas J. Strong, Assistant United States Attorney, United States Attorney Office, District of New Jersey
Mr. George Jepsen, Attorney General for the State of Connecticut

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Appendix A* — WJH Correspondence with Staff of Fitch Ratings, the CFTC, the SEC, and the Structured Finance Industry Group (SFIG) from 17 November 2016 to 11 January 2017 Regarding:
1. Empirical and Legal Basis for Fitch "Replacement" Assumptions; and
2. Fitch Public Call for CFTC to Issue a No-Action Letter Regarding Legacy ABS Swaps.

------- *Appendix A comprises pp. ###-### of this response -------

Fw: Request for Comment on Fitch Lobbying for CFTC No-Action Letter on Swap Margin Rules in Violation of SEC Policy for NRSROs

----- Forwarded Message -----
From: Bill Harrington <[redacted]>
To: Daniel Noonan <[redacted]>; Sandro Scenga <[redacted]>; Andreas Wilgen <[redacted]>; "[redacted]" <[redacted]>; Kevin Duignan <[redacted]>
Cc: "[redacted]" [redacted]>; Thomas J. Smith [redacted]>; Frank Fisanich [redacted]>; "[redacted]" [redacted]>; Gretchen Morgenson <[redacted]>; "[redacted]" <[redacted]>; Bill Harrington <[redacted]>
Sent: Wednesday, January 11, 2017 9:08 AM
Subject: Request for Comment on Fitch Lobbying for CFTC No-Action Letter on Swap Margin Rules in Violation of SEC Policy for NRSROs

Dear All,

I am writing a blog post on replacement and the Fitch announcement of 17 November. My deadline is today, 11 January at 5:00 EST.

My theme is that timely replacement has occurred in too few instances since 2008 to justify Fitch in assigning a AAA or AA rating to an ABS with an issuer that is party to a swap contract.

The US swap margin rules that are scheduled to take effect on 1 March 2017 are the last rather than the first nail in the replacement coffin.

Fitch should have long ago stricken replacement from the set of "effective counterparty risk mitigants" that justify a high rating for an ABS when an issuer is party to a swap contract.

In short, Fitch is long overdue in not having downgraded ABS where issuers are parties to swap contracts.

The following statement is one of many inculpatory ones in the Fitch announcement of 17 November.

"Fitch's structured finance ratings rely on effective counterparty risk mitigants, among which the assumption that counterparties will implement remedial actions upon becoming ineligible. If the likelihood of appropriate remedial actions is substantially reduced, potential rating actions could follow.

Here are my questions.

1. The Fitch announcement of 17 November states that "[c]ounter to existing market practice, Fitch expects structured finance issuers will start to face two-way margin requirements on their derivative exposures."

   Has the "existing market practice" that excludes two-way margin posting produced robust ABS?

   Have robust ABS spurred robust economic growth since 2008?

2. The Fitch announcement of 17 November states that "[o]ne concern of this regulatory change is that the two-way collateral posting could make the future use of derivative contracts such as interest rate swaps uneconomical or impossible in Structured Finance."

   Why the concern? The above-mentioned interest rate swaps – uncleared swap contracts with RAC provisions and flip clauses – are intrinsically uneconomical save for the rating arbitrage that Fitch and other rating agencies preserve.

   Does Fitch consider that ABS issuers offset the relative depreciation of a pool of securitized assets viz-a-viz liabilities by entering into an uncleared swap contract with RAC provisions and a flip clause to take advantage of a rating arbitrage?

   Won't the daily exchange of two-way margin instill free-market pricing in the ABS sector?

   Under free-market pricing with no rating arbitrage, an ABS issuer will be indifferent between the following: entering into an "existing market practice" swap contract, buying an option and securitizing additional assets.

   Does Fitch consider that the "existing market practice," – i.e., a Fitch rating arbitrage -- makes the latter two options uneconomically expensive relative to the first?

3. How many ABS that are backed by a swap contract does Fitch rate?

4. Other than private student loan ABS that Navient Corp. sponsors and many CLOs with flip clauses, what ABS sectors use swap contracts?

5. How many successful instances of replacement has Fitch observed from 2008 to the present date?

6. In each instance of successful replacement, how much time elapsed between the breaching of a rating trigger and the effecting of replacement?

   If this time was often several months or even years – i.e., much longer than a typical swap contract specifies – did Fitch misinform the marketplace with this statement of 17 November?

   "In the event that an issuer can only replace a counterparty on differing terms it would raise the requirement to seek consent from other parties to the transaction. The requirement to obtain relevant consent would extend the time in which replacement counterparty can be sought exposing the transaction to increased risk in the intervening period."

   In misinforming the marketplace, is Fitch in violation of its or SEC guidelines?

7. How many instances of failed replacement has Fitch observed from 2008 to the present date?

   In other words, what is the baseline "replacement risk" that has been present since the financial crisis and is in no way attributable to "the upcoming regulation" regarding the daily, two-way exchange of variation margin?

8. Please list each factor that has created a "significant barrier to the ability of transaction parties to find suitable replacement entities on equivalent economic terms" from 2008 to the present date. Please do not include "the upcoming regulation" regarding the daily, two-way exchange of variation margin.

9. Is the 2016 ruling in Lehman Brothers Special Financing Inc. v. Bank of America National Association (Case No. 10-3547) one such "significant barrier?"

   This ruling largely upheld the validity of a flip clause and could dissuade stronger counterparties from bidding to replace. In recognition, why didn't Fitch update methodologies and downgrade ratings of ABS where issuers were parties to swap contracts? https://www.claytonutz.com/knowledge/2016/september/the-courts-flip-flopping-again-on-the-validity-of-flip-clauses

10. The Fitch announcement of 17 November states that "[i]n structured finance transactions rated by Fitch to date, collateral is typically posted under a one-way agreement in favor of the issuer."

    In how many instances since 2008 did a swap counterparty that was obligated to post collateral under the original terms of a swap contract not do so?

11. When a swap provider unilaterally amended a derivative contract with an ABS issuer or obtained RAC to duck contractual obligations such as posting collateral or effecting replacement, what compensation or other form of consideration did the ABS issuer receive?

If none, are the amendments to the uncleared swap contracts with RAC provisions and flip clauses enforceable?

12. The Fitch announcement of 17 November states that "the swap counterparty is required to take credit risk to the issuer, usually in exchange for seniority in the ranking of payments due it, as stipulated in the transaction's priority of payments."

    This statement omits the subordination from a flip clause and thus misinforms the marketplace. My research shows that most private student loan ABS that Navient sponsors and approximately half of new US CLOs contain a flip clause in the priority of payments.

    In publishing this misinformation, is Fitch in violation of its or SEC guidelines?

    Does Fitch reflect the all-or-nothing risk of a flip clause in the rating of a swap provider?

    Has Fitch properly apprised or alternatively misinformed the CFTC of the self-referencing, all-or-nothing credit risk that a flip clause poses to a swap provider?

13. Is Fitch assigning derivative counterparty ratings to mask the baseline "replacement risk" and failure to collateralize?

Best regards,

Bill Harrington
Wikirating Experts Board -- Key Expert on Structured Finance Topics
[redacted]

From: Bill Harrington <[redacted]>
To: Daniel Noonan <[redacted]>
Cc: '[redacted]" <[redacted]>; Thomas J. Smith <[redacted]>; Frank Fisanich <[redacted]>; "[redacted]" <[redacted]>; Gretchen Morgenson <[redacted]>; "oig@cftc.gov" <oig@cftc.gov>
Sent: Thursday, December 22, 2016 4:43 PM
Subject: Re: Fitch Request for CFTC No-Action Letter on Swap Margin Rules in Violation of SEC Policy for NRSROs

Dear Mr. Noonan,

Thank you for your prompt reply. This email exchange will form an appendix to my upcoming comment letter to the CFTC regarding the capital treatment of the non-cleared swap contracts with RAC provisions and flip clauses that are the subject of the Fitch announcement of 17 November.

The moribund ABS sector in the EU provides a bad example that the US should not follow. Lax margin rules for the EU sector have done nothing to revive it. Moreover, not requiring swap dealers to fully capitalize their self-referencing risk under flip clauses is a gimmick that rests on rating arbitrage and undermines systemic stability. Fortunately, the daily, two-way exchange of variation margin makes flip clauses irrelevant.

SFIG had a meeting of its Derivatives in Securitization Task Force on 5 December that followed up on the Fitch announcement.

I should note that I was a member of this task force in 2013 and would have continued as one had SFIG not declined to renew my membership for 2014. Even so, members of this task force have periodically contacted me regarding margin posting and non-cleared swap contracts with RAC provisions and flip clauses.

I should also note that in the teleconference that a colleague and I had with Mr. Smith and Mr. Fisanich of the CFTC, we were clear that SFIG had lied to the CFTC about non-cleared swap contracts with RAC provisions and flip clauses. My colleague and I also expressed concern and bafflement that the CFTC Letter No. 15-21 of 31 March 2015 simply recited those lies.

Why has Fitch not downgraded affected ABS to reflect the lifetime linkage to existing counterparties that will commence on 1 March 2017? Taking timely, forward-looking rating actions are one of the few responsibilities that NRSROs acknowledge. Why is Fitch failing to perform even this simple task?

Further, why has Fitch not addressed the swap margin rules in any of its ABS or derivative methodologies or proposed updates? I have read all these documents and stand by my assertion that Fitch is derelict in its responsibilities as an NRSRO.

Does Fitch have a hotline where I can report these violations in detail, deal-by-deal and with respect to the methodologies, page-by-page?

Unfortunately, the same is true of the other NRSROs, based on my close review of their respective ABS ratings, methodologies and update proposals. Once again, the SEC is negligent in its oversight of NRSROs.

I asked SEC Commissioner Piwowar about margin posting and non-cleared swap contracts with RAC provisions and flip clauses during the open question session at the Cato Institute Summit on Financial Regulation in New York City on 2 June 2015. He replied that that was a good question and offered no analysis.

CFTC Commissioner Giancarlo spoke at the Cato summit and was in attendance when I posed my question to Commissioner Piwowar. I followed up repeatedly with staff of each commissioner.

Commissioner Piowar and other SEC officials attended the lunch provided by the Tepper School at its Economics of Credit Ratings Conference from 8-10 December 2015. At the open question session, I asked about margin posting and non-cleared swap contracts with flip clauses and RAC provisions.

Best regards,

Bill Harrington

From: Daniel Noonan <[redacted]>
To: Bill Harrington <[redacted]>
Cc: [redacted]" <[redacted]>; Thomas J. Smith <[redacted]>; Frank Fisanich <[redacted]>; [redacted]" [redacted]>; Gretchen Morgenson <[redacted]>; "oig@cftc.gov" <oig@cftc.gov>
Sent: Thursday, December 22, 2016 3:17 PM
Subject: FW: Fitch Request for CFTC No-Action Letter on Swap Margin Rules in Violation of SEC Policy for NRSROs

Bill,

Thank you for your note. While you are certainly welcome to your own opinions, please do not distort Fitch's position in the process. Fitch has not, and has no intention of requesting anything from the CFTC or any other regulator on this subject. We stand by our published commentary, which others may wish to read for themselves. Thank you.

Dan Noonan
Managing Director, Corporate Communications
Fitch Ratings

----- Forwarded Message -----
From: Bill Harrington <[redacted]>
To: '[redacted]" <[redacted]>; Thomas J. Smith <[redacted]>; Frank Fisanich <[redacted]>; '[redacted]" [redacted]>
Cc: [redacted]" <[redacted]>; Gretchen Morgenson [redacted]>; "oig@cftc.gov" <oig@cftc.gov>
Sent: Wednesday, December 21, 2016 5:32 PM
Subject: Fitch Request for CFTC No-Action Letter on Swap Margin Rules in Violation of SEC Policy for NRSROs

Dear All,

Further below in this email, please find the Fitch announcement entitled "Fitch: Pending US Swap Rules Could Impact Structured Finance Transactions" of 17 November.

The Fitch announcement posits that a CFTC no-action letter -- the CFTC Letter No. 15-21 of 31 March 2015 -- could conceivably "be extended to the two-way margin posting requirements" that take effect on 1 March 2017.

Why? A "possible 'no-action position' from the CFTC could, in Fitch's view, make the replacement of legacy swaps more likely and therefore reduce replacement risk arising from the upcoming regulation."

As the Fitch announcement notes, the margin posting requirements, which apply to new swaps entered into from 1 March 2017 onward, may also apply to legacy swaps that are amended.

I made the same point in my Debtwire article "Existing ABS also caught in swap margin net," which was published on 12 August and subsequently released on the public Debtwire Exclusives site. I have distributed this article to the SEC Office of Credit Ratings and recognized credit rating agencies (NRSROs), including Fitch.

Unlike Fitch's view, my evaluation showed that the swap margin requirements will improve protections for ABS investors and the financial system as a whole. The article enumerates why in the last section under the sub-heading "**Rorschach test — maybe the margin rules are a great solution?**"

Existing ABS swaps also caught in swap margin net — ANALYSIS - Debtwire

The Fitch announcement of 17 November also states that the Structured Finance Industry Group (SFIG) "requested and received" the CFTC Letter No. 15-21 of 31 March 2015.

I enumerated 14 misrepresentations that the SFIG made in its successful request for the no-action letter in an email to Mr. Smith of the CFTC, Ms. Orol of the SEC and Mr. Flintermann of the ESMA dated 15 May 2015. A colleague and I discussed this letter with Mr. Smith and Mr. Frank Fisanich of the CFTC in a teleconference on 28 May 2015.

I also sent an email that articulated enforcement implications for NRSROs that flow from the CFTC Letter No. 15-21 to Mr. Smith, other CFTC staff and Mr. Richard Johns of SFIG on 7 April 2015.

My comment letter to the prudential regulators of 31 January 2016 contains both my letter of 15 May 2015 and email of 7 April 2015. Please see Appendix A (pp. 6-22) and Appendix B (pp. 23-24), respectively.
https://www.fdic.gov/regulations/laws/federal/2015/2015-covered_swap_entities_3064%E2%80%93AE21-c02.pdf

The linkage of the swap margin requirements and the CFTC Letter No. 15-21 in the Fitch announcement of 17 November begs many questions.

1. Why is Fitch lobbying the CFTC for a no-action letter with respect to swap margin requirements rather than downgrading ABS with swap exposures?
2. In lobbying for a no-action letter, has Fitch undermined its First Amendment protections as a mere publisher of information?
3. Why have other NRSROs *not* downgraded ABS with swap exposures?

4. Why has Fitch not proposed a methodology update to reflect the swap margin requirements?
5. Why have other NRSROs *not* proposed methodology updates to reflect the swap margin requirements?
6. Has the SEC Office of Credit Ratings asked NRSROs about the impact of the swap margin requirements on ABS ratings and methodologies?

NRSROs had have 14 months to reflect the swap margin requirements in ABS ratings and methodologies. The prudential regulators adopted the relevant rule on 22 October 2015 and the CFTC adopted a parallel rule on 18 Dec 2015. Moreover, I contacted each NRSRO with detailed questions regarding its respective ABS and swap methodology in light of the swap margin requirements in April 2016.

In submitting questions to each NRSRO, I included my Debtwire article "US margin rules for swaps obliges securitization issuers to overhaul structures, add resources, and rethink capital structures" of 4 November 2015. I did the same in asking questions of the SEC Office of Credit Ratings.

ANALYSIS: US margin rule for swaps obliges securitization issuers to overhaul structures, add resources, and rethink capital structures - Debtwire

I will also send this email to each of you individually to minimize the chance that spam filters block it.

Best regards,
Bill Harrington

From: Sandro Scenga [[redacted]]
Sent: Thursday, November 17, 2016 9:10 AM
To: Bill Harrington <[redacted]>
Subject: Fitch: Pending U.S. swap rules could impact structured finance transactions

Fitch: Pending US Swap Rules Could Impact Structured Finance Transactions

Pending derivative regulations including swap margin posting requirements are creating uncertainties for both new and existing structured finance transactions, according to Fitch Ratings. Scheduled to go into effect in March 2017, the new rules require daily posting of two-way variation margin on affected derivatives.

While new swaps executed after March 1, 2017 would clearly be affected, Fitch's interpretation of the current proposals is that in the event of a replacement of a derivative counterparty in an existing transaction, the consequent contractual agreement between issuer and replacing derivative counterparty would have to obey two-way daily variation margining. In Fitch's view, this aspect has the potential to create a significant barrier to the ability of transaction parties to find suitable replacement entities on equivalent economic terms.

The Structured Finance Industry Group (SFIG) has previously requested and received a 'no action position' from the U.S. Commodity Futures Trading Commission (CFTC) for certain commission regulations applicable to swaps with legacy special purpose vehicles (see CFTC Letter No. 15-21).

Given the nature of this no-action position it is conceivable that it will be extended to the two-way margin posting requirements.

Background:

Fitch's structured finance ratings rely on effective counterparty risk mitigants, among which the assumption that counterparties will implement remedial actions upon becoming ineligible. If the likelihood of appropriate remedial actions is substantially reduced, potential rating actions could follow. The U.S. Prudential Regulators' non-cleared margin requirements for covered swap entities are scheduled to be effective for all financial end users of derivative contracts by March 1, 2017. The impact of these rules on structured finance will be substantial with all in-scope derivatives requiring daily posting of two-way variation margin; this is in contrast to European regulations, which to date have sought to exempt structured finance issuers from similar margin posting requirements. Counter to existing market practice, Fitch expects structured finance issuers will start to face two-way margin requirements on their derivative exposures.

Fitch understands that the scope of the requirements extend to all U.S. issuers as well as a U.S. financial institution facing non-U.S. issuers. The extent to which a non-U.S. bank with significant U.S. operations facing a non-U.S. issuer would be impacted remains unclear. In addition Fitch understands that existing derivatives, to the extent that no changes are made to the contractual agreements in place, will remain outside of the margin requirements. In contrast, modifications to existing transaction terms or novation to a replacement counterparty would bring that transaction into scope and therefore, subject to the two-way margin posting requirement.

In structured finance transactions rated by Fitch to date, collateral is typically posted under a one way agreement in favour of the issuer. This allows for the issuer to mitigate its credit risk whilst avoiding the introduction of a volatile, and potentially large, obligation to the transaction. By contrast, the swap counterparty is required to take credit risk to the issuer, usually in exchange for seniority in the ranking of payments due to it, as stipulated in most transaction's priority of payments.

Fitch considers that, in the absence of specific mechanisms dealing with the margin posting requirement, the introduction of a daily variation margin obligation on the issuer could be incompatible with the relatively predictable cashflows received by an issuer and owed under its debt securities. One concern of this regulatory change is that two-way collateral posting could make the future use of derivative contracts such as interest rate swaps uneconomical or impossible in Structured Finance. Some transactions rated by Fitch use instruments, such as interest rate caps, which do not have as volatile a mark to market. By definition a purchased option will never have a liability to the buyer once any associated premium has been settled. The requirement for variation margin to be paid by an issuer would arise only if the mark to market of its derivative position becomes, from its own perspective, a value less than zero. As a purchased option has a floor in its value to the buyer of zero, these instruments do not present a potential margin outflow for issuers and are consequently not a concern for collateral implications.

In its 'Counterparty Criteria for Structured Finance and Covered Bonds' Fitch considers a commitment to remedial action as a key mitigant against counterparty risk. Many securitisation derivatives contain obligations to replace a counterparty upon downgrade below a defined minimum level. Fitch's interpretation of the current proposals is that in the event of a replacement of a derivative counterparty, the consequent contractual agreement between issuer and replacing derivative counterparty would have to obey two-way daily variation margining. In Fitch's view, this aspect has the potential to create a significant barrier to the ability of transaction parties to find suitable replacement entities on equivalent economic terms. In the event that an issuer can only replace a counterparty on differing terms it would raise the requirement to seek consent from other parties to the transaction. The requirement to obtain relevant consent would extend the time in which replacement counterparty can be sought exposing the transaction to increased risk in the intervening period.

Fitch considers the extent to which the requirements may impact the potential for an issuer to source a replacement counterparty to be dependent on the jurisdiction of the issuer. While the full extent of any impact remains unclear, Fitch considers the greatest impact is likely to be felt in the U.S. where it may become more difficult to transfer some existing arrangements to a new counterparty. In Europe Fitch considers that the implications are likely to be felt through a reduction in the number of available market participants, the scope of which will be dependent on the breadth of the definition of a U.S. entity imposed.

Fitch will continue to monitor developments as these regulatory changes are brought into effect. In particular Fitch will continue to review challenges to its assumptions with regards to the replacement of counterparties and will comment further as appropriate. In the U.S., a possible 'no action position' from the CFTC could, in Fitch's view, make the replacement of legacy swaps more likely and therefore reduce replacement risk arising from the upcoming regulation.

Contact:

Andreas Wilgen
Managing Director
[redacted]
Fitch Ratings, Inc.
33 Whitehall Street
New York, NY 10004

Duncan Paxman
Director
[redacted]

Kevin Duignan
Managing Director
[redacted]

Media Relations: Sandro Scenga, New York, Tel: +1 [redacted], Email: [redacted].

Additional information is available at www.fitchratings.com

Appendix B* — WJH Correspondence of May 2011 with Derivatives Analysts and Managers at Moody's Investors Services Regarding Deficient "Replacement" Assumptions for Uncleared, Unmargined Swaps with RAC Provisions and Flip Clauses

------- *Appendix B comprises pp. ###-### of this response --------

From: "Cantor, Richard" <[redacted]>
To: Bill Harrington <[redacted]>
Sent: Monday, May 16, 2011 3:48 PM
Subject: RE: Recognizing the Market Loss That a Bank Agrees to Bear Under a Swap with a Securitization

Bill,

Thank you for your comments concerning Moody's bank rating methodology. We appreciate your sharing them with us and will give them appropriate consideration. We understand that you have contacted several Moody's employees to provide your comments on this topic. You are welcome to direct any further comments directly to me, and I will make sure that they are shared with the relevant rating and credit policy personnel.

Richard
MIS Chief Credit Officer

From: "Kimball, Andrew" <[redacted]>
To: Bill Harrington <[redacted]>
Sent: Saturday, May 14, 2011 9:29 AM
Subject: RE: Recognizing the Market Loss That a Bank Agrees to Bear Under a Swap with a Securitization

Thanks, Bill. We'll take a look at this.

Andy

-----Original Message-----

From: Bill Harrington [mailto:[redacted]]

Sent: Thursday, May 12, 2011 10:02 PM

To: Jesse (1) Eisinger; Jesse (2) Eisinger; Jake Bernstein; Me, Myself and I; Leibholz, Maria; Jiang, Ivan; Remeza, Algis; Fu, Yvonne; Bunja, Rudolph; [redacted]; Rosa, David; Cantor, Richard; Young, Robert; Jones, Sean; Nerby, Peter; Kimball, Andrew; Madelain, Michel; Lioce, Stephen; McDaniel, Raymond; Kanef, Michael; Teicher, David; Kornfeld, Warren; Araya, Rodrigo

Subject: Recognizing the Market Loss That a Bank Agrees to Bear Under a Swap with a Securitization

All:

Attached is a brief discussion of above topic. To-date, regulators have not considered these market losses when measuring bank capital, nor have rating agencies done so in monitoring bank ratings. It is my hope that each group begins to do so.

Articulating this topic represents a direct continuation from my responsibilities at Moody's Investors Service. As that is no longer a platform available to me, I attach my credentials regarding this topic.

I am happy to discuss with all interested parties. Please forward to others who may be interested, cc'ing me as well. If you prefer, provide me with contact info - I intend to continue reaching out to all who may have interested.

Best regards,

Bill Harrington

Appendix C* — WJH Correspondence from 4 March 2016 to 17 October 2016 with CFTC Staff and Office of the Inspector General Regarding a Request for an Intake Call to Discuss Securitization Issuers and the TRIPRA Exemption from Margin Posting

------- *Appendix C comprises pp. ###-### of this response --------

Fw: Intake Call for Comment on Margin Requirements for Uncleared Swap Dealers and Major Swap Partcipants: Interim Final Rule

----- Forwarded Message -----
From: Bill Harrington <[redacted]>
To: Bill Harrington [redacted]>; "oig@cftc.gov" <oig@cftc.gov>
Cc: "Lawton, John C." [redacted]>; "Smith, Thomas J." [redacted]>; "Kuo, Francis" <[redacted]>; "Kane, Stephen A" <[redacted]>; "Schlichting, Paul" [redacted]>; "McPhail, Lihong" <[redacted]>; Rafael Martinez <[redacted]>; Chris Kirkpatrick <[redacted]>
Sent: Monday, October 17, 2016 4:38 PM
Subject: Re: Intake Call for Comment on Margin Requirements for Uncleared Swap Dealers and Major Swap Partcipants: Interim Final Rule

Dear All,

My article "Existing ABS swaps also caught in the swap margin net" discusses the losses that accrue to an ABS issuer, a covered swap entity, or both under a swap with a flip clause or other type of walkaway provision.

"[M]argin posting may well consign flip clauses to where they belong — the dustbin of discredited schema that issuers used to construct deals that failed during the financial crisis. Litigation will continue for as long as flip clauses are included in ABS because a flip clause can't possibly work for both an issuer and a swap provider. One or the other will take a significant loss even before the legal fees kick in."

Accordingly, preserving the integrity of the swap margin rule as written is necessary to preserve the rule's effectiveness. Exemptions for either the swaps of SPVs of captive finance companies or amended swaps for any ABS issuer will gut this effectiveness.

I will make this point as a comment response should the CFTC adopt the suggestions of Chair Masad and Commissioner Bowen to re-propose the capital charges for swap dealers. This exchange will comprise an appendix to my comment.

Best regards,

Bill Harrington

[Existing ABS swaps also caught in swap margin net — ANALYSIS - Debtwire]

From: Bill Harrington [redacted]>
To: "oig@cftc.gov" <oig@cftc.gov>
Cc: "Lawton, John C." [redacted]>; "Smith, Thomas J." [redacted]>; "Kuo, Francis" <[redacted]>; "Kane, Stephen A" <[redacted]>; "Schlichting, Paul" <[redacted]>; "McPhail, Lihong" <[redacted]>; Rafael Martinez <[redacted]>; Chris Kirkpatrick <[redacted]>; Bill Harrington <[redacted]>
Sent: Thursday, March 31, 2016 11:52 AM
Subject: Re: Intake Call for Comment on Margin Requirements for Uncleared Swap Dealers and Major Swap Partcipants: Interim Final Rule

To the Office of Inspector General,

Per the suggestion of Mr. Martinez and his colleagues, I have reviewed Federal Register/Vol. 81, No. 3/Wednesday, January 6, 2016/Rules and Regulations/Commodity Futures Trading Commission 17 CFR Parts 23 and 140 RIN 3038-AC97 'Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants. I have also reviewed cftc.gov for policies regarding comment letters and intake calls.

My review has not found the policies cited by Mr. Martinez and his colleagues, namely refusing to schedule an intake call from a knowledgeable person who can aid rulemaking (see further below in this email.)

Accordingly, I request that the Office of Inspector General investigate whether Mr. Martinez and his colleagues have abused their discretion with respect to rulemaking.

I also request that the Office of Inspector General investigate whether Mr. Martinez and his colleagues have violated their own ad-hoc policy by conducting intake calls or other discussions with outside parties that did not submit comment letters regarding 'Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants: Interim Final Rule' by 5 February.

To aid your inquiry, I include the link to the CFTC posting of comments with respect to 'Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants: Interim Final Rule'. If Mr. Martinez and his colleagues have had an intake call or other discussion regarding the Interim Final rule with a person or organization that does not have a comment letter posted here (e.g., representatives of the Structured Finance Industry Group), then this would represent an abuse of discretion that has disadvantaged me.

Comments for General CFTC 81 FR 636 - CFTC

Best regards,

William J. Harrington
[redacted]

From: Bill Harrington <[redacted]>
To: "Martinez, Rafael" <[redacted]>; Chris Kirkpatrick <[redacted]>
Cc: "Lawton, John C." [redacted]; "Smith, Thomas J." <[redacted]>; "Kuo, Francis" <[redacted]>; "Kane, Stephen A" <[redacted]>; "Schlichting, Paul" <[redacted]>; "McPhail, Lihong" <[redacted]>
Sent: Wednesday, March 9, 2016 1:42 PM
Subject: Re: Intake Call for Comment on Margin Requirements for Uncleared Swap Dealers and Major Swap Partcipants: Interim Final Rule

Mr. Martinez,

Per the CFTC Letter No. 15-27, an ABS issuer has CFTC sanction to classify itself as a captive finance company, i.e., the possibility that I have raised is not hypothetical.

CFTC Exempts Certain Wholly-Owned Securitization SPVs from Mandatory Clearing

CFTC Exempts Certain Wholly-Owned Securitization SPVs...

On May 4, 2015, the Division of Clearing and Risk of the Commodity Futures Trading Commission (the "CFTC") issued a no-action letter (the "Letter")[1] clarifying th...

View on **blogs.orrick.com** Preview by Yahoo

As clearly laid out in my letter to Secretary Kirkpatrick of 6 February, Title III of TRIPRA does not exempt a swap with a flip clause or RAC provision.

1. Accordingly, given that a swap with a flip clause or RAC provision does not qualify for an exemption under Title III of TRIPRA, the final rule that will become effective on 1 April 2016 and which will have followed consideration of comments received with respect to the CFTC Interim Final Rule should contain the following language: "For the avoidance of doubt, a swap with either a flip clause or a RAC provision does not qualify for an exemption from either the Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants; Final Rule or the Margin and Capital Requirements for Covered Swap Entities."

2. In notifying "the Commodity Futures Trading Commission how it meets financial obligations associated with entering into non-cleared swaps", a company seeking an exception must file with the CFTC an affidavit signed by a senior officer that states that all swaps that are included in the exemption do not have: (1) a flip clause; (2) any other clause that can be reasonably classified as a walk-away provision; or (3) a RAC provision.

3. The CFTC and the prudential regulators should obligate any swap dealer, major swap participant, or covered swap entity to post both initial margin and variation margin to its guarantor or hedging affiliate against a swap that contains a (1) a flip clause; or (2) any other clause that can be reasonably classified as a walk-away provision. In this way, the losses that arise under the entry into a flip clause or walk-away provision will be fully absorbed by the swap dealer, major swap participant, or covered swap entity that recklessly agreed to the flip clause or walk-away provision and will not be transmitted to its affiliates such as an FDIC-insured subsidiary.

Best regards,
Bill Harrington
[redacted]

From: "Martinez, Rafael" <[redacted]>
To: 'Bill Harrington' <[redacted]>
Cc: "Lawton, John C." [redacted]>; "Smith, Thomas J." [redacted]>; "Kuo, Francis" <[redacted]>; "Kane, Stephen A" <[redacted]>; "Schlichting, Paul" <[redacted]>; "McPhail, Lihong" [redacted]>
Sent: Wednesday, March 9, 2016 12:23 PM
Subject: RE: Intake Call for Comment on Margin Requirements for Uncleared Swap Dealers and Major Swap Partcipants: Interim Final Rule

Mr. Harrington,

Thank you for your interest and offer to have a call. I appreciate you noting for us the hypothetical possibility that an ABS issuer could think it is a captive finance company. We will not be taking more of your time on this matter.

It is our standard procedure to address every comment in the preamble (except the odd, obvious prank letters), regardless of usefulness, as long as it was submitted following the procedures and timelines set out in the Federal Register releases. Last year we relaxed our process but that may have been a mistake. The comment period for the IFR closed before your letter was submitted so it will not be part of the record nor posted in our public site.

Regards,

/rafael

Rafael Martinez
Div. of Swaps and Intermediary Oversight
Commodity Futures Trading Commission

[redacted]
+1[redacted] (office)
+1[redacted] (mobile)

From: Bill Harrington [mailto:[redacted]]
Sent: Tuesday, March 08, 2016 4:35 PM
To: Martinez, Rafael
Cc: Lawton, John C.; Smith, Thomas J.; Kuo, Francis; Kane, Stephen A; Schlichting, Paul; McPhail, Lihong
Subject: Re: Intake Call for Comment on Margin Requirements for Uncleared Swap Dealers and Major Swap Partcipants: Interim Final Rule

Hi Mr. Martinez,

Thanks for your prompt response.

My question differs from the one of your paraphrasing -- this discrepancy highlights the need for an intake call.

My question: Can a securitization entity be both an ABS issuer and a "captive finance company"? If so, would such a securitization entity be: (1) subject to the final rule on margin requirements for uncleared swaps (i.e., be classified as an "ABS issuer"); or (2) exempt from the final rule with respect to swaps that hedge commercial risk (i.e., be classified as a "captive finance company").

Commentary by ABS participants such as major law firms that represent securitization issuers and the Structured Finance Industry Group states that a securitization entity that is owned by a "captive finance company" will benefit from its TRIPRA exemption, i.e., will also be treated as a "captive finance company." Possible examples of such securitization entities include John Deere Capital Corp. and the finance companies of auto manufacturers.

(Separate comments by SFIG and Representative Scott Garrett also show that they are acting in concert to delay implementation of the final rule on margin requirements for uncleared swaps as it applies to ALL ABS issuers. In other words, SFIG is lining up with Representative Garrett to gut the margin rule with respect to ABS issuers as soon as it is finalized by the CFTC and prudential regulators. Hence the usefulness of the CFTC letter No. 15-21 in illustrating the many, many systemic deficiencies with the swaps most commonly used in the ABS sector.)

If a securitization entity can be both an "ABS issuer" and a "captive finance company," then the CFTC and prudential regulators will have to classify such securitization entities as one or the other. Including these classifications in the interim rule, along with an airtight margin rule with respect to swaps with flip clauses, will provide the market with maximum clarity and transparency.

I have already contacted each of the prudential regulators individually to request an intake call -- my comment to each of them was submitted in advance of the joint deadline of 31 January.

It is true that, after submitting my five comments to the five separate prudential regulators on 21 January, I incorrectly marked the analogous CFTC deadline as being 6 February rather than 5 February.

However, this difference of one day should not be a bar to an intake call with the CFTC. With respect to the previous outstanding rule proposal and my 12 May intake call (which the CFTC found sufficiently useful to cite in the December rule), I had in fact submitted no letter at all.

Most pertinently, the obligation of the CFTC in its rulemaking is to use all available information to produce the best output possible.

Best regards,

Bill Harrington

[redacted]

From: "Martinez, Rafael" <[redacted]>
To: 'Bill Harrington' <[redacted]>
Cc: "Lawton, John C." <[redacted]>; "Smith, Thomas J." <[redacted]>; "Kuo, Francis" <[redacted]>; "Kane, Stephen A" <[redacted]>; "Schlichting, Paul" <[redacted]>; "McPhail, Lihong" <[redacted]>
Sent: Monday, March 7, 2016 5:01 PM
Subject: RE: Intake Call for Comment on Margin Requirements for Uncleared Swap Dealers and Major Swap Partcipants: Interim Final Rule

Hello Mr. Harrington,

Thank you for sharing your views.

As far as I understand, your letter requests that issuers of Asset Backed Securities ("ABS") are required to exchange margin according to the final rule on margin requirements for uncleared swaps ("the rule") . This is the case already. If you read the relevant rules you will find that ABS issuers do not meet the requirements for an exception or exemption from clearing, so TRIPRA would not exempt them from it. The rule itself did not exclude ABS issuers from the definition of financial end user who have to exchange margin. I am sorry if this was not clear to you and you had to spend your time preparing your comments.

I would also note that the comment period for the interim final rule closed on February 5th, 2016. Your letter was submitted after this date and thus we are not taking in your comment and will not hold an intake call.

Regards,

/Rafael
Rafael Martinez
Div. of Swaps and Intermediary Oversight
Commodity Futures Trading Commission

[redacted]

+1.[redacted] (office)
+1.[redacted] (mobile)

From: Bill Harrington [mailto:[redacted]]
Sent: Friday, March 04, 2016 4:21 PM
To: Lawton, John C.; Smith, Thomas J.; Kuo, Francis; Kane, Stephen A; Martinez, Rafael; Schlichting, Paul; McPhail, Lihong
Subject: Intake Call for Comment on Margin Requirements for Uncleared Swap Dealers and Major Swap Partcipants: Interim Final Rule

Dear All,

I am following-up on my 4 March voicemails to Mr. Lawton, Mr. Smith and Mr. Martinez in which I requested an intake call with the rule writing team for the Interim Final Rule.

Best regards,

Bill Harrington

[redacted]

Appendix D* — WJH Comment on the CFTC Interim Final Rule on Margin Requirements for Uncleared Swap Dealers and Major Swap Participants Dated 6 February 2016

(This comment of 6 February 2016 includes two appendices.
Appendix A is the WJH Letter "Re: CFTC Letter No. 15-21 of March 31, 2015, Division of Swap Dealer and Intermediary Oversight "No-Action Position: Certain Commission Regulations Applicable to Swaps with Legacy Special Purpose Vehicles" Dated 15 May 2015. See pages 149-165.

Appendix B is the April 7, 2015 e-mail to Mr. Thomas Smith, Acting Director, Division of Swap Dealer and Intermediary Oversight: "CFTC Letter No. 15-21 & Inaccurate Representations of Delinking Criteria"). See pages 166-167.

------- *Appendix D comprises pp. ###-### of this response --------

William J. Harrington
[redacted]

February 6, 2016

VIA ELECTRONIC MAIL

Mr. Christopher Kirkpatrick
Secretary of the Commission
Commodities Futures Trading Commission
Three Lafayette Centre
1155 21st Street NW
Washington, DC 20581

Re: Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants; Interim Final Rule (Federal Register Vol 81, No. 3, Pages 636-638)
- **Commodity Futures Trading Commission (§ 23.150(b))**

Margin and Capital Requirements for Covered Swap Entities;
Interim Final Rule to Exempt Commercial End Users and Small Banks
(Federal Register Vol. 80, No. 229, Pages 74916-74924)
- **Department of the Treasury, Office of the Comptroller of the Currency, 12 CFR Part 45 [Docket No. OCC–2015–0023] RIN 1557–AD00**
- **Federal Reserve System, 12 CFR Part 237 [Docket No. R–1415] RIN 7100–AD74**
- **Federal Deposit Insurance Corporation, 12 CFR Part 349 RIN 3064–AE21**

- **Farm Credit Administration,12 CFR Part 624 RIN 3052–AC69**
- **Federal Housing Finance Agency, 12 CFR Part 1221 RIN 2590–AA45**

Dear Mr. Kirkpatrick,

I am a private US citizen. The comments contained herein with respect to the CFTC Interim Final Rule are mine alone and do not represent the views of any other person, my employer, or other entities.

On 31 January, I submitted a comment to the prudential regulators regarding their analogous Interim Final Rule.

After submitting this comment, I will contact the CFTC to arrange a joint call with its rule-writing team and the rule-writing team of each prudential regulator to discuss my comments.

On 12 May 2015, I led a joint conference call with Mr. Rick Michalek and the rule writing teams from the CFTC and prudential regulators regarding the proposed rule 79 FR 59898 (i.e., the rule proposal that preceded the respective final rules for margin posting of uncleared swaps: "Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants;" and "Margin and Capital Requirements for Covered Swap Entities")

The following link accesses the CFTC notice of the joint conference call and contains the materials that I used to lead the call and the overarching point conveyed by Mr. Michalek and me, which is quoted below.
https://www.cftc.gov/node/157371.

> "Commenters argue against an exemption from margin requirements for issuers of asset backed securities. Commenters believe ABS issuers' current practice for dealing with counterparty credit risk is inadequate by construction and presents a systemic risk."

"Flip clauses" and "RAC" provisions mask capital inadequacies of ABS and swap dealers and major swap participants

"Flip clauses" and "RAC" provisions are commonly placed into swaps by ABS issuers to address counterparty credit but are inadequate for this purpose.

For a start, few if any ABS issuers have ever obtained a legal opinion from U.S. counsel with respect to the enforceability of a flip clause in a priority of payments. The inability to obtain an opinion regarding the enforceability of a flip clause is attributable in large part to the similarity of a flip clause to a walk-away provision.

The ratcheting up of ABS risk and systemic risk that accumulates from flip clauses and RAC provisions can by gauged both by examining the respective mechanics of flip clauses and RAC provisions and by tracking outcomes for ABS issuers that were pre-crisis counterparties to Lehman Brothers Holdings Inc. and affiliates under swaps.

Swaps with flip clauses and RAC provisions have long underpinned the ABS sector and, in common with other practices by ABS issuers, contributed to the inadequate capitalization of ABS that was a central contributor to the financial crisis. Neither the swaps with flip clauses and RAC provisions nor the ABS that are structured with these swaps can be viewed in isolation from each other.

But for the bailouts that prevented other counterparties from following Lehman Brothers Holdings Inc. into bankruptcy and the extraordinary measures by the U.S. government to buy ABS and other structured products, the inadequate capitalization of ABS that is attributable to a swap with a flip clause and RAC provisions would be more generally appreciated.

Equally, but for the bailouts and other government programs, the systemic risks that accrue from swap dealers and major swap participants being party to swaps with flip clauses would also be more generally appreciated. Being party to these swaps represents extremely reckless behavior on the part of swap dealers and major swap participants, as well as a failure of corporate and regulatory governance, given the many attributes that a flip clause has in common with a "walk-away" provision.

Appendix A and B to this letter contain my assessment of the deficiencies of flip clauses and RAC provisions in conjunction with my examination of the CFTC Letter No. 15-21 of March 31, 2015: "No-Action Position: Certain Commission Regulations Applicable to Swaps with Legacy Special Purpose Vehicles", which was issued by the Division of Swap Dealer and Intermediary Oversight. On 28 May 2015. Mr. Rick Michalek and I discussed these deficiencies with the CFTC staff that issued the CFTC Letter No. 15-21.

Title III of TRIPRA does not exempt a swap with a flip clause or RAC provision
I have read and re-read Title III of the Terrorist Risk Insurance Program Reauthorization Act TRIPRA). I have also read and re-read the Bill Summary & Status, 114th Congress (2015-2016), H.R.26, CRS Summary.

Neither Title III of TRIPRA nor the CRS Summary states that, to quote from the latter, the exemption "from the rules of the prudential regulators for swap dealers and major swap participants with respect to initial and variation margin requirements for swaps not cleared by a registered derivatives clearing organization, those swaps in which one of the counterparties: (1) is eligible for an exception from clearing requirements because it is not a financial entity, uses swaps to hedge or mitigate commercial risk, and notifies the Commodity Futures Trading Commission how it meets financial obligations associated with entering into non-cleared swaps" applies to a swap with a flip clause or a RAC provision.

Moreover, the Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants; Final Rule notes that "One commentator, however, argued that requiring SPVs and other asset-backed security issuers to post full margin against all swap contracts would defuse commonly used "flip clauses" and decrease the loss exposure of investors in asset-backed securities."

1. Accordingly, given that a swap with a flip clause or RAC provision does not qualify for an exemption under Title III of TRIPRA, the final rule that will become effective on 1 April 2016 and which will have followed consideration of comments received with respect to the CFTC Interim Final Rule should contain the following language: "For the avoidance of doubt, a swap with either a flip clause or a RAC provision does not qualify for an exemption from either the Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants; Final Rule or the Margin and Capital Requirements for Covered Swap Entities."

2. In notifying "the Commodity Futures Trading Commission how it meets financial obligations associated with entering into non-cleared swaps", a company seeking an exception must file with the CFTC an affidavit signed by a senior officer that states that all swaps that are included in the exemption do not have: (1) a flip clause; (2) any other clause that can be reasonably classified as a walk-away provision; or (3) a RAC provision.

3. The CFTC and the prudential regulators should obligate any swap dealer, major swap participant, or covered swap entity to post both initial margin and variation margin to its guarantor or hedging affiliate against a swap that contains a (1) a flip clause; or (2) any other clause that can be reasonably classified as a walk-away provision. In this way, the losses that arise under the entry into a flip clause or walk-away provision will be fully absorbed by the swap dealer, major swap participant, or covered swap entity that recklessly agreed to the flip clause or walk-away provision and will not be transmitted to its affiliates such as an FDIC-insured subsidiary.

Credentials

On 18 October 2015, I joined 'Debtwire ABS' as a senior ABS analyst. Debtwire ABS is a subscription-based, online provider of news and commentary on the US, EU, and other markets for ABS and structured products.

In my role, I write articles on the capitalization, regulation, and ratings of ABS and structured products. On 21 October 2015, the prudential regulators began the process of adopting the joint swap margin rule. The timing was fortuitous for me, as I was new to both Debtwire ABS and journalism, but interested and well-versed in the application of the swap margin rule to ABS and structured product issuers.

My first articles at Debtwire ABS covered the swap margin rule. These articles addressed the implications for the standard swap contacts with flip clauses and RAC provisions that have long been used by ABS and structured product issuers, the need for credit rating agencies to overhaul methodologies for rating ABS and structured debt when an issuer enters into a swap contract with margin posting, and pushback to margin posting that was being organized by the Structured Finance Industry Group.

After giving subscribers significant time to review these articles, Debtwire ABS posted this article of mine on its public site. http://www.debtwire.com/info/2015/11/04/analysis-us-margin-rule-swaps-obliges-securitization-issuers-overhaul-structures-add-resources-rethink-capital-structures/

From 2011 until joining Debtwire ABS in 2015, I had engaged in a fulltime, self-financed effort to alert regulators, market participants, credit rating agencies, and the media to the deficient processes for assigning credit ratings to debt issued by entities that are party to derivative contracts such as uncleared swaps with flip clauses and RAC provisions. These rating deficiencies enable an entity such as an ABS or structured product issuer to misrepresent its credit profile to providers of derivative contracts and, in tandem with this misrepresentation, issue debt that is under-capitalized relative to its credit rating.

In January 2016, Capital Markets Law Journal published the following article by my co-author Norbert Gaillard and me. This article traces relates the problems with flip clauses and RAC provisions to the major deficiencies that continue to exist with respect to the methodologies and rating practices of credit rating agencies.

Efficient, commonsense actions to foster accurate credit ratings
Norbert J. Gaillard; William J. Harrington
Capital Markets Law Journal 2016 11 (1): 38-59
doi: 10.1093/cmlj/kmv064

An extract can be accessed from this link.
http://cmlj.oxfordjournals.org/content/11/1/38.extract and the full article can be accessed from my LinkedIn profile (William J. Harrington).

From 1999 to 2010, I worked as an analyst in the derivatives group of Moody's Investors Service where I evaluated the impact of flip clauses and RAC provisions to both parties to a swap, i.e., an ABS issuer and a derivative counterparty. In July 2010, I resigned as a senior vice president. Prior to Moody's, I worked as derivative structurer at Merrill Lynch and a currency analyst at Wharton Econometrics.

Sincerely yours,

William J. Harrington

cc: The Honorable Thomas J. Curry, Comptroller of the Currency
The Honorable Janet Yellen, Chair, Board of Governors of the Federal Reserve System
The Honorable Martin J. Gruenberg, Chairman, Federal Deposit Insurance Corporation
The Honorable Kenneth A. Spearman, Board Chair and Chief Executive Officer, Farm Credit Administration
The Honorable Melvin Watt, Director, Federal Housing Finance Agency
The Honorable Timothy G. Massad, Chairman, Commodity Futures Trading Commission

Appendix A—15 May 2015 Letter to Mr. Thomas Smith of the U.S. Commodity and Futures Trading Commission, Ms. Harriet Orol of the U.S. Securities and Exchange Commission, and Mr. Felix Flinterman of the European Securities and Market Authority: "Letter No. 15-21 & Rating Agency Overrides of Published Methodologies for Swap Contracts"

William J. Harrington
[redacted]

May 15, 2015

VIA ELECTRONIC MAIL

Mr. Thomas Smith
Acting Director
Division of Swap Dealer and Intermediary Oversight
U.S. Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

Ms. Harriet Orol
Office of Credit Ratings
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20002-4224

Mr. Felix Flinterman
Head of Unit CRA Supervision
European Securities and Markets Authority
103 Rue de Grenelle CS 60747 Paris
75345 CEDEX 07 France

Re: CFTC Letter No. 15-21 of March 31, 2015
Division of Swap Dealer and Intermediary Oversight
"No-Action Position: Certain Commission Regulations Applicable to Swaps with Legacy Special Purpose Vehicles"

Dear Mr. Smith, Ms. Orol, and Mr. Flinterman:

I am writing with respect to the CFTC Letter No. 15-21 that was issued on March 31, 2015.

For several days in May 2015, the CFTC Letter No. 15-21 could not be accessed on the CFTC website. Accordingly, my letter today quotes the entirety of key passages from the CFTC Letter No. 15-21 in the event that it again becomes inaccessible or is withdrawn. My letter also uses several terms that were defined in the CFTC Letter No. 15-21, such as Legacy SPV Swap, Remedial Action, and Delinking Criteria.

Today's letter follows up on my April 7, 2015 e-mail "CFTC Letter No. 15-21 & Inaccurate Representations of De-Linking Criteria," which is contained herein as an Appendix.

As my April 7 e-mail stated, the CFTC Letter No. 15-21 provides the SEC and the U.S. Department of Justice with grounds to bring enforcement actions against Fitch, Moody's, and S&P. From 2006 onward, each of these credit rating agencies ignored its respective Delinking Criteria in assigning ratings to debt issued by SPVs that were party to swap contracts. These swap contracts are the same Legacy SPV Swap contracts that are the subject of the CFTC Letter No. 15-21.

The CFTC Letter No. 15-21 also provides ESMA with grounds to bring enforcement actions against Fitch, Moody's, and S&P. From 2006 onward, each of these credit rating agencies ignored its respective Delinking Criteria in assigning and subsequently monitoring ratings to debt issued by SPVs in the EU that were party to swap contracts.[176]

Ignoring published criteria to assign and monitor the ratings of SPV debt is a violation of the respective procedures of each credit rating agency and the regulatory rules of both the SEC and ESMA. Investors in SPV debt (e.g., residential mortgage-backed securitizations, collateralized debt obligation transactions, credit-linked note transactions, and other financial asset repackage transactions) that were originated or restructured in as late as 2009 suffered losses, as did U.S. and EU taxpayers. Accordingly, a U.S. action under the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 may be commenced as late as 2019.

Furthermore, each credit rating agency compounded its violations of internal policies and external rules by greenlighting amendments to the Legacy SPV Swap contracts and similar SPV swap contracts in the EU that stripped them of existing protections for investors in SPV debt. As of this writing, the credit rating agencies were continuing to greenlight these amendments. As a result, a U.S. action under the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 may be commenced on any date up to and including the earlier of either May 15, 2025 or 10 years after the last date on which a credit rating agency greenlighted an amendment to a

[176] See Norbert J. Gaillard and William J. Harrington, "Efficient, Commonsense Steps to Foster Rating Accuracy," *Capital Markets Law Journal* (in press 2015), footnote 109. Moody's applied its Delinking Criteria to assign ratings to debt issued by an SPV established by Greece so that it could mask borrowings of Euro 5 billion under swap contracts with Goldman Sachs.

Legacy SPV Swap contract. In the EU, both ESMA and investors have multiple grounds for bringing actions.[177]

The CFTC Letter No. 15-21 cites as rationales a series of representations that were made by the SFIG with respect to the operations of SPVs and the content of Delinking Criteria. Many of these representations are inaccurate and, as a consequence, the CFTC Letter No. 15-21 provides a safe harbor for the Legacy SPV Swap contracts to be amended in ways that will strip them of still more investor protections.

To preserve what investor protections still remain in the Legacy SPV Swap contracts, the CFTC should revise the definition of a Remedial Action[178] as follows:

"The taking of any Remedial Action will not affect the material economic terms of the Legacy SPV Swap, ***nor increase the exposures of investors in SPV debt to the credit quality of SDs that may be attributable to the non-enforcement, nullification, or vitiation of a flip clause.***

"*A 'Remedial Action' means* ***either*** *of the following:*

1. *Posting of collateral; or*
2. *Replacing the downgraded SD with an entity who satisfies the* ***currently*** *applicable credit rating requirements of the Legacy SPV Swap,* ***with the rating or ratings of such entity classified by the respective credit rating agencies as "fundamental" and provided that such entity is not an SPV, a structured finance operating company, or an entity with a structured finance rating.***

"For the avoidance of doubt, no other actions are Remedial Actions."

Attached to the e-mail delivering today's letter is "Efficient, Commonsense Steps to Foster Rating Accuracy," written by my Wikirating colleague Norbert J. Gaillard and me (GH2015). This paper has been accepted for publication by the *Capital Markets Law Journal* and is being presented at several conferences this year.

Today's letter cites passages, footnotes, and sources from GH2015. Sources are identified using the abbreviations established in GH2015 (e.g., Harrington (2014), p. #.) Collectively, these passages, footnotes, and sources (most of which have been posted on sec.gov for at least two years) memorialize the development and content of the two Moody's Delinking Criteria that are, whether in whole, in part, or in tandem, present in most Legacy SPV Swap contracts and similar SPV swap contracts in the EU.

I was a co-author of both of Moody's Delinking Criteria (as well as a third, analogous criteria for application in assigning and monitoring ratings of credit-linked note transactions and other

[177] Ibid., pp. 8-10.
[178] Remedial Actions are defined on p. 5 of the CFTC Letter No. 15-21.

financial asset repackage transactions and a fourth, separate methodology for application in assigning and monitoring the ratings of counterparties to SPVs under swap contracts).[179]

In developing the second of the two Delinking Criteria for Moody's, my U.S. and EU colleagues and I actively solicited the input of SDs by meeting with individual SDs[180] and their regulators[181] and by issuing several comment requests.[182] We also announced the key provisions of the Delinking Criteria in succinct press releases[183] and worked closely with SDs, SPVs, and their respective counsels in incorporating the Delinking Criteria into what have become the Legacy SPV Swap contracts.[184]

Our team had a big-picture goal of approving a standard swap contract with each SD[185] as an efficient means to codifying several best practices for the benefit of investors, SDs, and Moody's. Investors in all types of SPV debt would benefit from the same protections. Rating teams could focus most of their analysis on the assets being securitized. SDs could accurately price the costs of Remedial Actions. And all SDs would face a level playing field.[186]

The second of the two Moody's Delinking Criteria, "Framework for De-Linking Hedge Counterparty Risks from Global Structured Finance Cashflow Transactions" (Moody's Hedge Framework), was in worldwide effect from December 15, 2006 until November 12, 2013. Moody's Hedge Framework was in development from 2003 until its publication on May 25, 2006.

The forerunner to Moody's Hedge Framework, "Guidelines for CDO Hedge Counterparties," was in effect in North America from November 2, 2002 until its ostensible withdrawal on December 15, 2006.[187] However, in violation of both its published guidelines and SEC

[179] See Harrington (2014), pp. 1-2 and footnote 9.
[180] Moody's U.S. and EU teams met with the following SDs: Bank of America, Bank of New York, Barclays Bank, Bear Stearns and Bear Stearns Financial Products, CSFB, Deutsche Bank, Lehman Brothers and the two Lehman Brothers Derivative Product Companies, Merrill Lynch Derivative Products, Nomura Derivative Products Inc., Royal Bank of Scotland, SwissRe, Wachovia, and UBS. From 2004 to 2006, Moody's teams were rebuffed in their repeated offers to meet with Goldman Sachs. Three years later, in 2009, as SD downgrades loomed and Remedial Actions were being activated, Goldman Sachs offered to discuss the Delinking Criteria.
[181] In 2006, I discussed Moody's new Delinking Criteria with Paul Tucker of the Bank of England during his visit to Moody's offices in New York. Afterwards, I forwarded a copy of the framework to Mr. Tucker with a cc: to my London colleagues, as they were best suited to provide further updates.
[182] See PDF-numbered pages 35-36 of the document cited in footnote 9 of Harrington (2014). See also "Moody's Requests Comments on Proposals for Swaps in Highly-Rated Structured Finance Cash-flow Transactions" (December 7, 2005).
[183] Ibid., PDF-numbered pages 34 and 37.
[184] Ibid., PDF-numbered pages 25-29.
[185] Ibid. See PDF-numbered pages 24-29 with respect to the standard swap contract approved for Bear Stearns Financial Products and SPVs that issued debt backed by residential mortgage-backed securities. Similarly, my Moody's colleagues Nicolas Weill (Chief Credit Officer, Global Structured Finance) and Michael Kanef (Chief Regulatory Affairs and Compliance Officer) and I approved a standard form for UBS to use when entering into swap contracts with SPVs that issued debt backed by student loans.
[186] Ibid., PDF-numbered pages 35-37.
[187] See Moody's Hedge Framework, p. 1.

regulations, Moody's accommodated requests by SDs to apply this Delinking Criteria on a piecemeal basis in assigning ratings to new collateralized debt obligations,[188] credit-linked note transactions,[189] and residential mortgage-backed securities.[190] Moreover, Moody's continued its practice of applying the criteria on a piecemeal basis for at least three years after December 15, 2006.[191]

Based on my 15-year experience in developing and evaluating Moody's Delinking Criteria, as well as on the analogous criteria of Fitch and S&P with respect to both SPV investors and SDs,[192] I offer the following observations regarding the SFIG representations cited in the CFTC Letter No. 15-21.

SFIG Representation #1. *"SFIG states that an SD would not be able to comply with the Specified Regulations because restrictions in SPVs' governing documentation may prevent an SPV from taking certain actions required by the SD to comply with the Specified Regulations."* (CFTC Letter No. 15-21, pp. 1-2.)

The *"restrictions in SPVs' governing documentation"* do not *"prevent an SPV from taking certain actions required by the SD to comply with the Specified Regulations."* The trustee of an SPV can amend governing documentation either by obtaining the consents of SPV noteholders or by paying a modest fee to a credit rating agency to induce it to issue a RAC.[193] However, the trustees of an SPV should not need to obtain a RAC in order for an SD to perform a Remedial Action; these contractual obligations should have been undertaken by SDs when they began being downgraded in 2009.[194]

To find examples of trustees having amended SPVs' governing documentation by obtaining RACs that relate directly to the CFTC Letter No. 15-21, one needs only to examine the amendments to the governing documentation of 100 SPVs that unilaterally stripped investor protections from Legacy SPV Swap contracts and similar SPV swap contracts in the EU for the

[188] See "Guidelines for CDO Hedge Counterparties," pp. 1 and 3, and Harrington (2011), pp. 25-29 and 63-64. Moody's Delinking Criteria for CDOs stipulated higher rating triggers for an SD that provided a hedge "*whose market risk is potentially greater than that of a single-currency, interest rate swap that is on market at initiation.*" In direct violation of this criteria, Moody's assigned ratings to more than 50 CDOs issued by SPVs that had entered into swap contracts that were off-market at initiation but that did not contain the higher ratings triggers. AIG was, and remains, the SD for most of these off-market swap contracts. See also PDF-numbered pages 27 and 57-59 of the document cited in footnote 9 of Harrington (2014).
[189] See Harrington (2011), pp. 21-24.
[190] See PDF-numbered pages 25-29 of the document cited in footnote 9 of Harrington (2014). I led a series of Moody's committees that exempted Bear Stearns Financial Products Inc. from complying with a key provision of Moody's Hedge Framework. These exemptions violated both Moody's internal guidelines and SEC regulations.
[191] Ibid. See also Harrington (2011), Item 4a on p.62 and PDF-numbered page 27 of the document cited in footnote 9 of Harrington (2014).
[192] See also PDF-numbered pages 1-6 and 89-152 of the document cited in footnote 9 of Harrington (2014).
[193] See GH2015, p. 7.
[194] See Moody's Hedge Framework, p. 6: "*None of these obligations may be contingent upon issuance of Rating Agency Confirmation by Moody's prior to being activated.*"

benefit of SDs.[195] The RACS issued by Moody's increased the expected losses of SPV debt and thus violated a key provision in Moody's Hedge Framework.[196]

In contrast, amending governing documentation to allow SPVs to take "*certain actions required by the SD to comply with the Specified Regulations"* that would not reduce protections for investors in SPV debt would be noncontroversial. Trustees could effectuate these amendments either by obtaining the consents of SPV noteholders or by obtaining RACs from credit rating agencies.

SFIG Representation #2. *"Of note in relation to this letter, a number of the Commission's rules under the External BCS require SDs and MSPs to provide or obtain specific information from their counterparties and to perform certain due diligence inquiries with respect to their counterparties prior to entering into (or in some cases, offering to enter into) a swap with such counterparties."* (CFTC Letter No. 15-21, p. 2.)

In relation to the CFTC Letter No. 15-21, the Commission's rules do not, but should, *"require SDs and MSPs to provide or obtain specific information from their counterparties"* that are SPVs in regard to investor protections and the enforceability of flip clauses in their swap contracts and priorities of payments. Similarly, the Commission's rules do not, but should, require SDs and MSPs *"to perform certain due diligence inquiries with respect to their counterparties prior to entering into (or in some cases, offering to enter into) a swap with such counterparties"* that are SPVs in regard to investor protections and the enforceability of flip clauses in their swap contracts and priorities of payments.

The flip clause, which subordinates swap payments owed by an SPV to an SD or MSP that has defaulted or is bankrupt, was an integral part of Moody's Hedge Framework.[197] However, the well-publicized nullification of a flip clause in 2010[198] has left SPVs that are parties to out-of-the-money swap contracts fully exposed to the credit quality of SDs.[199] Owing to very low interest rates, the vast majority of Legacy SPV Swap contracts are in fact out-of-the-money and expose investors in SPV debt to the credit quality of SDs and MSPs.

The Delinking Criteria of Moody's, S&P, and Fitch either glossed over or entirely ignored the loss of investor protections and the increase in exposures of SPV debt to the credit quality of SDs and MSPs that occurred with nullification of a flip clause in 2010.[200] As a result, most SPVs

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[195] See GH2015, footnote 38.
[196] See Moody's Hedge Framework, footnote 5: *"Governing documents of most cashflow transactions enable an existing hedge to be adjusted, or a new one entered into, if modeling shows the expected losses of rated liabilities to be unimpaired by the proposed hedge."*
[197] Ibid., p. 16, "*Priority of Termination Payments to Counterparty*."
[198] See GH2015, footnote 40.
[199] See Harrington (2011), pp.24-34 and PDF-numbered pages 57-59 of the document cited in footnote 9 of Harrington (2014).
[200] See Harrington (2011), pp. 30-34, S&P's "Counterparty and Supporting Obligations Methodology and Assumptions" (December 6, 2010), and Fitch's "Lehman Court Settlement Leaves Legal Conflict for Structured Finance

continue to insert flip clauses into both their priorities of payments and their swap contracts more than five years after a flip clause was nullified in 2010.

SFIG Representation #3. *"Regarding the content of swap trading relationship documentation, each SD must establish policies and procedures reasonably designed to ensure that the parties have agreed in writing to all terms governing their trading relationship, including, among other things, terms related to credit support arrangements, such as initial and variation margin requirements and custodial arrangements, and terms addressing payment obligations, netting of payments, events of default or other termination events, calculation and netting of obligations upon termination, transfer of rights and obligations, governing law, valuation, and dispute resolution. With respect to valuation of swaps, SDs must include agreement on the process for determining the value of each swap at any time from execution to the termination, maturity, or expiration of the swap, for the purposes of complying with: (1) the margin requirements under section 4s(e) of the CEA and Commission regulations; and (2) the risk management requirements under section 4s(j) of the CEA and Commission regulations. The documentation also must include either: (1) alternative methods for determining the value of the swap, in the event of the unavailability or other failure of any input required to value the swap; or (2) a valuation dispute resolution process."* (CFTC Letter No. 15-21, pp. 3-4.)

The attributes of a Legacy SPV Swap contract that are laid out in SFIG Representation #3 were all present in Moody's Hedge Framework in 2006. Each of the following three paragraphs contains a portion of SFIG Representation #3 and ends with a footnote that identifies the analogous provisions in Moody's Hedge Framework.

An SPV and an SD or MSP were to agree at the outset *"in writing to all terms governing their trading relationship, including, among other things, terms related to credit support arrangements, such as initial and variation margin requirements and custodial arrangements, and terms addressing payment obligations, netting of payments, events of default or other termination events, calculation and netting of obligations upon termination, transfer of rights and obligations, governing law, valuation, and dispute resolution."*[201]

When entering into a swap contract, SPVs and *"SDs must include agreement on the process for determining the value of each swap at any time from execution to the termination, maturity, or expiration of the swap…."*[202]

For a swap contract between an SPV and an SD, initial *"documentation also must include either: (1) alternative methods for determining the value of the swap, in the event of the unavailability or other failure of any input required to value the swap; or (2) a valuation dispute resolution process."*[203]

Derivatives: Criteria Amended (March 14, 2011). Additionally, see PDF-numbered pages 25-29 and 89-152 of the document cited in footnote 9 of Harrington (2014).

[201] For analogous provisions in Moody's Hedge Framework, see pp. 4-6 and 15-16.

[202] Ibid., pp. 7-13 and 31-45.

[203] Ibid., pp. 40-41.

In sum, with respect to *"the content of swap trading relationship documentation"* and the "*valuation of"* any Legacy SPV Swap contract associated with debt that was rated by Moody's, an SD should already be in compliance and thus not require the relief of the CFTC Letter No. 15-21.

With respect to an SD that is not in compliance and thus requires the relief of CFTC Letter No. 15-21, the credit quality of the SD is <u>linked</u> to the SPV debt rated by Moody's and moreover <u>has been linked</u> from the time of initial rating. In other words, Moody's violated—and continues to violate—its published methodology and assigned an inaccurate rating to the SPV debt by modeling it as being delinked from the credit risk of an SD.[204]

SFIG Representation #4. *"SPVs commonly enter into swaps with SDs to:…(ii) transfer the credit and/or market risk on certain underlying obligations to or from the SPV."* (CFTC Letter No. 15-21, p. 4.)

Moody's Hedge Framework was applicable to interest rate swap contracts, basis rate swap contracts, and currency swap contracts only. The framework explicitly <u>excluded</u> credit default swap contracts.[205]

"Moody's Approach for Rating Thresholds of Hedge Counterparties in CDO Transactions" stipulated that a credit default swap contract would contain higher rating triggers than those for an "on-market, interest rate swap."[206] To the extent that Moody's assigned ratings to debt issued by an SPV that entered into a credit default swap contract that did not incorporate the higher rating triggers, Moody's violated its own internal guidelines as well as SEC regulations.

SFIG Representation #5. *"SFIG represents that, in order to minimize the impact of SD credit risk on the risk profile of the obligations issued by the SPV, the rating agencies have developed criteria designed to isolate the credit risk of the SD (the "Delinking Criteria") so that the rating agencies may assign a credit rating to the obligations issued by the SPV based solely on the quality of the underlying assets of the SPV and the structural features of the SPV, without taking into account the credit quality of the SD."* (CFTC Letter No. 15-21, p. 4.)

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[204] See Moody's "Approach to Assessing Linkage to Swap Counterparties in Structured Finance Cash Flow Transactions" (November, 12, 2013). See also PDF-numbered page 16 of the document cited in footnote 9 of Harrington (2014). "Moody's warns that even full 'compliance with the de-linkage framework at closing does not ensure that de-linkage will persist throughout the life of a transaction,' although Moody's will assume persistent de-linkage in assigning new ratings of Aaa(sf)." Using different assumptions to assign new ratings and monitor existing ones (e.g., the delinkage assumption for new ratings and the linkage assumption for existing ratings) is a violation of the regulatory rules of both the SEC and ESMA.
[205] See Moody's Hedge Framework, footnote 2.
[206] See "Moody's Approach for Rating Thresholds of Hedge Counterparties in CDO Transactions" (October 23, 2002), p. 1.

The flip clause, which remains a structural feature in the priorities of payments of most SPVs, was an integral part of Moody's Hedge Framework.[207] However, the nullification of a flip clause in 2010[208] has fully exposed SPVs with out-of-the-money swap contracts to the credit risk of SDs.[209] The vast majority of Legacy SPV Swap contracts are out-of-the-money and thus expose investors in SPV debt to *"the credit quality of the SDs."*

The updated Delinking Criteria do not state that the respective credit rating agencies can "*assign a credit rating to the obligations issued by the SPV based solely on the quality of the underlying assets of the SPV and the structural features of the SPV, without taking into account the credit quality of the SD."* Nor do the credit rating agencies represent that they, in assigning *"credit ratings to the obligations issued by the SPV,"* establish whether an SPV and SD have incorporated the provisions of Delinking Criteria into a swap contract.[210]

SFIG Representation #6. *"The Delinking Criteria are prescriptive rules that aim to ensure performance by the SD."* (CFTC Letter No. 15-21, p. 4.)

Delinking Criteria are no longer "*prescriptive rules that aim to ensure performance by the SD."*[211]

With respect to the Delinking Criteria that are applicable to the Legacy SPV Swap contracts, Moody's Hedge Framework contained pro-forma language that was to be included in the formation of what are now Legacy SPV Swap contracts.[212] This pro-forma language articulated all aspects of the framework and was intended to be incorporated into a swap contract at the outset and to be binding. Otherwise, if the provisions were not present in the swap contract at the outset or were not binding, the SPV debt was not delinked from the credit profile of an SD.[213]

Rather than abide by the binding provisions of the Legacy SPV Swap contracts, SDs directed trustees to have the provisions nullified by obtaining RACs from credit rating agencies that amended the provisions without offering compensation, consideration, or other forms of protection to SPV noteholders.[214] With respect to the RACs that were issued by Moody's, the

[207] See Moody's Hedge Framework, p. 16, "*Priority of Termination Payments to Counterparties.*"
[208] See GH2015, footnote 40.
[209] See Harrington (2011), pp. 24-34, and Harrington (2014), pp. 2-8.
[210] See Fitch's "Counterparty Criteria for Structured Finance and Covered Bonds" (May 13, 2013), Moody's "Approach to Assessing Linkage to Swap Counterparties in Structured Finance Cash Flow Transactions" (November, 12, 2013), and S&P's *"Counterparty Risk Framework Methodology and Assumptions"* (May 31, 2012).
[211] Ibid. The current Delinking Criteria of Fitch, Moody's, and S&P explicitly acknowledge that key provisions are absent from new swap contracts between ABS issuers and SDs. See PDF-numbered pages 110-115 of the document cited in footnote 9 of Harrington (2014) for Moody's comments on the partial incorporation of its criteria into swap contracts between ABS issuers and SDs.
[212] See Moody's Hedge Framework, pp. 6 and 14-45.
[213] Ibid., pp. 1 and 4.
[214] See GH2015, footnote 38.

agency violated an explicit tenet of Moody's Hedge Framework and, in so doing, violated both its internal guidelines and U.S. and EU regulations.[215]

In other words, credit rating agencies proactively undermined their Delinking Criteria by assisting SDs in not performing their obligations under Legacy SPV Swap contracts.

SFIG Representation #7. *"SFIG explains that under the Delinking Criteria, certain provisions of the documents governing the Legacy SPV Swap (the "Legacy SPV Swap Documentation") require the SD to take one or more Remedial Actions (as defined below) within designated time periods (in many cases, 30 days or less) following the withdrawal, qualification, and/or downgrade of the SD's credit ratings below certain specified thresholds."* (CFTC Letter No. 15-21, pp. 4-5.)

Moody's Hedge Framework was developed in close consultation with the SDs.[216]

In part based on these consultations, Moody's Hedge Framework explicitly stated that, alone of the Remedial Actions to be undertaken by an SD, only the posting of collateral was to occur within 30 days or less.[217] Posting of collateral is a key protection for holders of SPV debt when a Legacy SPV Swap contract is in-the-money to an issuer. The collateral amounts and valuation percentages set out in Moody's Hedge Framework were calibrated to offset the maximum number of days of market risk that could elapse before initial margin was posted and between the subsequent postings of variation margin.[218]

Moody's Hedge Framework also contained several provisions to facilitate timely posting of collateral by an SD, which, when present in a swap contract from the outset as stipulated by the framework,[219] would enable an SD to easily post collateral under a Legacy SPV Swap contract within 30 days.[220] Moreover, other than in a single circumstance, failure of an SD to post collateral gave rise only to a termination event rather than an SD event of default.[221]

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[215] See Moody's Hedge Framework, footnote 5: *"Governing documents of most cashflow transactions enable an existing hedge to be adjusted, or a new one entered into, if modeling shows the expected losses of rated liabilities to be unimpaired by the proposed hedge."* See also p. 6: *"None of these obligations may be contingent upon issuance of Rating Agency Confirmation by Moody's prior to being activated."*

[216] See PDF-numbered page 36 of the document cited in footnote 9 of Harrington (2014): *"These obligations and sanctions incorporate the practical concerns aired by swap counterparties and participants in structured finance transactions, including the length of time typically required to post collateral under automatic notification, the time needed to effect replacement, and the potentially limited universe of replacement counterparties."* See also footnotes 5 and 10 in today's letter.

[217] See Moody's Hedge Framework, pp. 15-16.

[218] Ibid., pp. 11-13 and 19-28.

[219] Ibid., p. 4 and also p. 6: *"None of these obligations may be contingent upon issuance of Rating Agency Confirmation by Moody's prior to being activated."*

[220] Ibid., pp. 6-8 and 15-16.

[221] Ibid., pp. 17-18.

With respect to the other Remedial Actions—effecting replacement or obtaining a guaranty—Moody's Hedge Framework explicitly acknowledged that market realities might prevent an SD from ever complying let alone doing so within 30 days.[222] Accordingly, the framework introduced measures to maximize the likelihood of replacement occurring,[223] but provided no sanctions or penalties for an SPV to apply against an SD that had failed to either replace itself or obtain a guaranty.[224]

SFIG Representation #8. *"The purpose of any Remedial Action is to insulate the investors in obligations issued by the SPV from the credit risk of the SD. The taking of any Remedial Action will not affect the material economic terms (as represented by SFIG, for the purposes hereof, "material economic terms" means the pricing and other economic terms typically documented in a transaction confirmation that establish the amount and timing of the SPV's obligations) of the Legacy SPV Swap.*

SFIG represents that "Remedial Action" means any of the following:

1. Posting of collateral by the SD, which may require the SD and the SPV to enter into a collateral agreement and amend the Legacy SPV Swap Documentation in order to give effect thereto;" (CFTC Letter No. 15-21, p. 5.)

Moody's Hedge Framework explicitly and intentionally stipulated that an SD and an SPV were to enter into a collateral agreement at closing.[225] In other words, *"posting of collateral by the SD"* <u>should not</u> *"require the SD and the SPV to enter into a collateral agreement and amend the Legacy SPV Swap Documentation in order to give effect thereto"* at this late date.

To the extent that Moody's assigned ratings to debt issued by SPVs that had not entered into collateral agreements under the assumption that the debt was delinked from the credit risk of an SD, the debt ratings were both inaccurate and inconsistent with Moody's published methodology.

SFIG Representation #9. (Remedial Actions, continued)

"2. Replacing the downgraded SD with an entity who satisfies (or whose guarantor satisfies) the applicable credit rating requirements of the Legacy SPV Swap;

3. Obtaining a guaranty of the SD's obligations under the Legacy SPV Swap from a guarantor that satisfies the requisite credit ratings;" (CFTC Letter No. 15-21, p. 5.)

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[222] Ibid., pp. 5-6.
[223] Ibid., pp. 9-10.
[224] Ibid., pp. 16-18.
[225] See Moody's Hedge Framework, pp. 4, 6-8, and 15-16. Also note on p. 6: *"None of these obligations may be contingent upon issuance of Rating Agency Confirmation by Moody's prior to being activated."*

Moody's Hedge Framework included the flip clause as an investor protection of last resort for instances when an SD defaulted or entered bankruptcy[226] without having effected either Remedial Action #2 or #3 with respect to a swap contact that was out-of-the-money to an SPV.[227] Without a flip clause, an SPV with a swap contract that was out-of-the-money would be obligated to divert funds earmarked solely to pay SPV debt and use them to pay an accelerated termination amount to a SD counterparty that had defaulted or was in bankruptcy.

However, the nullification of a flip clause in 2010 also nullified Remedial Action #3, "*Obtaining a guaranty of the SD's obligations under the Legacy SPV Swap from a guarantor that satisfies the requisite credit ratings"* as a means of delinking SPV debt from the credit quality of an SD.

Simply put, a guaranty leaves the contractual relationship between an original SD and an SPV intact and does not relieve the SPV of its obligation to divert funds earmarked solely to pay SPV debt and use them to pay an accelerated termination amount to the SD in the event it defaults or enters bankruptcy.

A large-scale instance of ongoing linkage to the credit quality of an SD exists with respect to the 50+ guarantees that were provided by Merrill Lynch Derivative Products AG in respect of AIG obligations under Legacy SPV Swap contracts that were and remain deeply out-of-the-money to the respective CDO issuers.[228] These issuers remain fully exposed to the credit quality of AIG and will be obligated to divert funds earmarked solely to pay SPV debt and use them to pay accelerated termination amounts to AIG in the event of its default or bankruptcy.

To protect investors in SPV debt from its own credit quality, an SD must replace itself "*with an entity who satisfies the applicable credit rating requirements of the Legacy SPV Swap."* However, the new Delinking Criteria of Moody's, S&P, and Fitch continue to include *obtaining a guaranty* as a Remedial Action that is equivalent to replacement in fully protecting investors in SPV debt.[229]

SFIG Representation #10. (Remedial Actions, continued)
"*4. Taking any other action as agreed with each relevant rating agency through procedures that are specified in the Legacy SPV Swap Documentation."* (CFTC Letter No. 15-21, p. 5.)

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[226] Ibid., p. 16, "*Priority of Termination Payments to Counterparty*."
[227] Ibid., pp. 5-6, "*Replacement Drives the Framework, but Cannot be Guaranteed."*
[228] See Harrington (2011), pp. 25-29 and 63-64. See also PDF-numbered pages 57-59 of the document cited in footnote 9 of Harrington (2014).
[229] See Fitch's "Counterparty Criteria for Structured Finance and Covered Bonds" (May 13, 2013), Moody's "Approach to Assessing Linkage to Swap Counterparties in Structured Finance Cash Flow Transactions" (November, 12, 2013), and S&P's *"Counterparty Risk Framework Methodology and Assumptions"* (May 31, 2012).

Moody's Hedge Framework intentionally and explicitly ruled out Remedial Actions such as "*(T)aking any other action as agreed with each relevant rating agency through procedures that are specified in the Legacy SPV Swap Documentation.*"[230]

As I stated in my e-mail of April 7, 2015: "*I wrote this provision to mitigate the gaming of structured finance methodologies and criteria which was widespread and which has since been identified as a major source of investor losses and a key catalyst of the financial crisis. With respect to this provision, you may verify my account with Moody's Chief Credit Officer for Structured Finance Nicolas Weill.*" You may also verify my account with Moody's Chief Regulatory Affairs and Compliance Officer Michael Kanef.

All Moody's RACs that enabled an SD to forgo either posting collateral under a Legacy SPV Swap contract and similar SPV swap contracts in the EU or installing a replacement counterparty for a Legacy SPV Swap contract and similar SPV swap contracts in the EU have violated Moody's Delinking Criteria and either SEC or ESMA regulations. These Moody's RACs affected "*the material economic terms*" of the Legacy SPV Swap contracts in a way that diminished previously existing protections for SPV debt and increased the extent of their linkage to the credit quality of SDs.[231]

As I wrote in my e-mail of April 7, 2015: "*Moody's RACs have often cited Remedial Action #4 as rationale in direct violation of the Moody's delinking criteria. Under these RACs, swap dealers avoided posting collateral, avoided replacing themselves, avoided obtaining guarantees, and ratcheted up investor exposure to unenforceable flip clauses.*

"Simply put, swap dealers have obtained the blessing of Moody's and all credit rating agencies to define Remedial Action #4 as taking no action at all (i.e., to renege on existing contractual responsibilities that, if honored, would have protected investors). Contrary to the SFIG representation, the delinking criteria have NOT "proven to be prescriptive rules that aim to ensure performance by the swap dealer" (CFTC Letter No. 15-21, p. 4), but rather a very, very fluid set of protocols that swap dealers can unilaterally change simply by paying credit rating agencies to issue RAC."

Similarly, all S&P RACs with respect to Legacy SPV Swap contracts and similar SPV swap contracts in the EU issued after December 6, 2011 violated S&P's Delinking Criteria.[232] As with the Moody's RACs, the S&P RACs affected "*the material economic terms*" of the Legacy SPV Swap contracts and similar SPV swap contracts in the EU in a way that diminished previously existing protections for SPV debt and increased the extent of their linkage to the credit quality of SDs.

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[230] See Moody's Hedge Framework, p.4: "*To eliminate these distortions, the framework specifies Counterparty obligations upfront and does not contemplate their being supplanted in the future by 'other such remedies as may be agreed at a later date.' Alternatives to this framework will be considered at closing where the relevant provisions are already in place, rather than being left open-ended for future specification.*"

[231] See GH2015, footnote 38.

[232] See S&P's "Counterparty and Supporting Obligations Methodology and Assumptions" (December 6, 2011), "*Evidence of binding obligation,*" p. 8.

Additionally, RACs issued by S&P in 2015 may also violate the terms of various settlements between S&P and the SEC and the U.S. Department of Justice.[233]

SFIG Representation #11. *"The Remedial Actions required to be taken by SDs and SPVs may include amending a Legacy SPV Swap or amending and transferring the obligations of the SD under a Legacy SPV Swap to a third party or an affiliate of the SD. Although any such action will not change the material economic terms of a Legacy SPV Swap, it may cause a Legacy SPV Swap to be considered a 'new swap' or a 'swap transaction' for the purposes of the Specified Regulation."* (CFTC Letter No. 15-21, p. 5.)

SDs have created this problem for themselves by not having undertaken their contractual obligations to post collateral or to transfer "*the obligations of the SD under a Legacy SPV Swap to a third party or an affiliate of the SD"* as soon as these obligations were activated by the first of a series of downgrades of the credit ratings of SDs, beginning in 2009. The credit rating agencies signaled each series of SD downgrades well in advance. In response, SDs could have easily started posting collateral or transferring obligations under a Legacy SPV Swap contract to *"an affiliate."*

Prior to the enactment of the Specified Regulations, neither the posting of collateral nor *"transferring the obligations of the SD under a Legacy SPV Swap to a third party or an affiliate of the SD"* would have been contingent upon *"amending a Legacy SPV Swap."*[234]

Instead, the SDs have responded to their downgrades from 2009 onward by inducing SPV trustees to obtain RACs to dilute the Legacy SPV Swap contracts and similar SPV swap contracts in the EU of the obligations pertaining to the posting of collateral or "*transferring the obligations of the SD under a Legacy SPV Swap to a third party or an affiliate of the SD*." These RACs <u>did</u> change "*the material economic terms of a Legacy SPV Swap"* contract and similar SPV swap contracts in the EU in ways that impaired investor protections. With respect to the RACs it issued, Moody's issued them even though the associated amendments increased the expected losses to investors,[235] which violated an explicit provision of Moody's Hedge Framework.[236]

Similarly, staff at Fitch, Moody's, S&P, several of the prudential regulators, and the SEC were alerted as early as 2011 to the deficiencies in the Delinking Criteria that were eroding protections

[233] See GH2015, footnotes 82, 83, 84, and 96.
[234] See Moody's Hedge Framework, p. 6: *"None of the obligations may be contingent upon issuance of a Rating Agency Confirmation by Moody's prior to being activated."*
[235] See GH2015, footnote 38.
[236] See Moody's Hedge Framework, footnote 5: *"Governing documents of most cashflow transactions enable an existing hedge to be adjusted, or a new one entered into, if modeling shows the expected losses of rated liabilities to be unimpaired by the proposed hedge."*

for investors in SPV debt and increasing the extent of linkage to the credit quality of SDs.[237] In 2012, these credit rating agencies and the SEC were also alerted to the likelihood that the Legacy SPV Swap contracts would run afoul of clearing requirements.[238]

SFIG Representation #12. *"This is significant because, as discussed above, the Legacy SPV Swap may not previously have been subject to or affected by some or all of the Specified Regulations because it was entered into prior to the compliance date of such regulations. Thus, a Legacy SPV Swap may be subject to one or more Specified Regulations solely as a result of Remedial Actions taken by the SD and the SPV to remediate a credit ratings downgrade."* (CFTC Letter No. 15-21, p. 5.)

As with the SFIG Representation #11, the SDs have brought this problem on themselves by not posting collateral or obtaining replacement counterparties as the contractual obligations began being activated in 2009.[239] Moody's Hedge Framework specified provisions that, when implemented in a swap contract, would have prevented surprises such as a Legacy SPV Swap contract being *"subject to one or more Specified Regulations solely as a result of Remedial Actions taken by the SD and the SPV to remediate a credit ratings downgrade."*[240]

SFIG Representation #13. *"Consequently, SFIG represents that it is highly likely that service providers will take the position that it is, at best, unclear whether they have the authority or discretion to take the steps on behalf of SPVs that may be necessary to enable the SD to comply with its regulatory obligations under the Specified Regulations."* (CFTC Letter No. 15-21, p. 6.)

Service providers such as trustees and rating agencies have already demonstrated with more than 100 RACs that they don't lack *"the authority or discretion to take the steps on SPVs that may be necessary to enable the SD to comply with its regulatory obligations under the Specified Regulations."*[241]

In particular, credit rating agencies, by having issued the RACs and weakened the investor protections in their updated Delinking Criteria,[242] have demonstrated that they have both the authority and discretion to take all steps requested by SDs even when these steps harm the interests of investors in SPV debt.

SFIG Representation # 14. *"Due to the legal and practical impediments described above, SFIG represents that SDs have a reasonable basis to believe that SPVs will not be able to agree*

[237] See Harrington (2011), pp. 24-25. See also PDF-numbered pages 1-6 of the document cited in footnote 9 of Harrington (2014).
[238] See PDF-numbered page 103 of the document cited in footnote 9 of Harrington (2014).
[239] Ibid.
[240] See Moody's Hedge Framework, p. 4.
[241] See GH2015, footnote 38.
[242] See Harrington (2014), pp. 4-5.

to: (i) provide information necessary to satisfy an SD's onboarding procedures required to comply with the Specified Regulations; (ii) further amend their Legacy SPV Swaps, either via an industry-wide protocol or on a bilateral basis, to incorporate contractual provisions; or (iii) enter into new agreements (e.g., agreements related to portfolio reconciliation) that may be required to enable the SD to comply with its regulatory obligations under the Specified Regulations. (CFTC Letter No. 15-21, p. 6.)

For the reasons already stated in today's letter, there is no *"reasonable basis"* for the SD's beliefs.

By obtaining noteholder consents or RACs,[243] the trustees of SPVs can easily and costlessly "*agree to: (i) provide information necessary to satisfy an SD's onboarding procedures required to comply with the Specified Regulations; (ii) further amend their Legacy SPV Swaps, either via an industry-wide protocol or on a bilateral basis, to incorporate contractual provisions; or (iii) enter into new agreements (e.g., agreements related to portfolio reconciliation) that may be required to enable the SD to comply with its regulatory obligations under the Specified Regulations*."

Sincerely yours,

William J. Harrington
Experts Board, Wikirating.org – Key Expert, Structured Finance Topics

cc: Ms. Regina Thoele, Compliance, National Futures Association, Chicago
Ms. Jamila A. Piracci, OTC Derivatives, National Futures Association, New York
Mr. Frank Fisanich, Division of Swap Dealer and Intermediary Oversight, CFTC, Washington, D.C.
Mr. Christopher Kirkpatrick, Secretary, CFTC, Washington, D.C.
Mr. Brian O'Keefe, Division of Clearing and Risk, CFTC, Washington, D.C.
Ms. Verena Ross, Executive Director, European Securities and Markets Authority, Paris, France
Mr. Adam Ashcraft, Credit Risk Management, Federal Reserve Bank of New York, New York
Mr. Andy Haldane, Bank of England, London, UK
Ms. Allison Parent, Bank of England, London, UK
Mr. Michael Hume, Bank of England, London, UK
Mr. Richard Johns, Executive Director, Structured Finance Industry Group, Washington, D.C.
Mr. Michel Madelain, President, Moody's Investors Services, New York
Mr. Michael Kanef, Chief Regulatory Affairs and Compliance Officer, Moody's Investors Services, New York

[243] See GH2015, p. 7.

Mr. Nicolas Weill, Chief Credit Officer – Global Structured Finance, Moody's Investors Services, New York

Appendix B—April 7, 2015 e-mail to Mr. Thomas Smith, Acting Director, Division of Swap Dealer and Intermediary Oversight: "CFTC Letter No. 15-21 & Inaccurate Representations of Delinking Criteria"

From: Bill Harrington <[redacted]>

To: '[redacted]" [redacted]>; [redacted]" <[redacted]>

Cc: Brian EO'Keefe <[redacted]>; [redacted]" <[redacted]>; '[redacted]" <[redacted]>; [redacted]>; '[redacted]" <[redacted]>; [redacted]" <[redacted]>; [redacted]" [redacted]>; [redacted]" [redacted]>

Sent: *Tuesday, April 7, 2015 12:58 PM*

Subject: *CFTC Letter No. 15-21 & Inaccurate Representations of Delinking Criteria*

Dear Mr. Smith:

I am writing in regard to CFTC Letter No. 15-21 dated March 31, 2015. This no-action letter cites several representations by the Structured Finance Industry Group (SFIG) which, if correct, provide the US Securities and Exchange Commission (SEC) with grounds to bring an action against at least one of the credit rating agencies. As a result, amendments to existing swap contracts that rely on CFTC Letter No. 15-21 may become evidence in an SEC enforcement against one or more credit rating agencies.

In preparing CFTC Letter No. 15-21, did the CFTC consult with the credit rating agencies or simply rely upon representations by SFIG?

For the entirety of the period covered by CFTC Letter No. 15-21, the delinking criteria of Moody's Investors Service ("Framework for De-Linking Hedge Counterparty Risks from Global Structured Finance Cashflow Transactions") contained an explicit provision that ruled out Remedial Action #4 (CFTC Letter No. 15-21, p.5). I wrote this provision to mitigate the gaming of structured finance methodologies and criteria which was widespread and which has since been identified as a major source of investor losses and a key catalyst of the financial crisis. With respect to this provision, you may verify my account with Moody's Chief Credit Officer for Structured Finance Nicolas Weill.

Next week, I will submit a letter that lays out my points more fully. In the interim, attached please find "Efficient, commonsense steps to foster rating accuracy" by my Wikirating colleague Norbert Gaillard and me. This paper, which has been accepted for publication by the Capital Markets Law Journal, details the rating agency processes that are cited in CFTC Letter No. 15-21 -- most notably, the issuance of rating agency condition or confirmation (RAC) to dealer proposals to strip investor protections from existing swap contracts. Moody's RACs have often cited Remedial Action #4 as rationale in direct violation of the Moody's delinking criteria. Under *these RACs, swap dealers avoided posting collateral, avoided replacing themselves, avoided obtaining guarantees, and ratcheted up investor exposure to unenforceable flip clauses.*

Simply put, swap dealers have obtained the blessing of Moody's and all credit rating agencies to define Remedial Action #4 as taking no action at all (i.e., to renege on existing contractual responsibilities that, if honored, would have protected investors). Contrary to the SFIG representation, the delinking criteria have NOT "proven to be prescriptive rules that aim to ensure performance by the swap dealer" (CFTC Letter No. 15-21, p. 4), but rather a very, very fluid set of protocols that swap dealers can unilaterally change simply by paying credit rating agencies to issue RAC.

Best regards,

William J. Harrington
[redacted]

Appendix E* — WJH Comment on the Prudential Regulators' Interim Final Rule to Exempt Commercial End Users and Small Banks, Dated 31 January 2016.

------- *Appendix E comprises pp. ###-### of this response --------

William J. Harrington
[redacted]

January 31, 2016

VIA ELECTRONIC MAIL

Mr. Bobby R. Bean
Associate Director, Capital Markets Branch
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429.

Re: Margin and Capital Requirements for Covered Swap Entities; Interim Final Rule to Exempt Commercial End Users and Small Banks (Federal Register Vol. 80, No. 229, Pages 74916-74924)
- **Department of the Treasury, Office of the Comptroller of the Currency, 12 CFR Part 45 [Docket No. OCC–2015–0023] RIN 1557–AD00**
- **Federal Reserve System, 12 CFR Part 237 [Docket No. R–1415] RIN 7100–AD74**
- **Federal Deposit Insurance Corporation, 12 CFR Part 349 RIN 3064–AE21**
- **Farm Credit Administration,12 CFR Part 624 RIN 3052–AC69**
- **Federal Housing Finance Agency, 12 CFR Part 1221 RIN 2590–AA45**

Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants; Interim Final Rule (Federal Register Vol 81, No. 3, Pages 636-638)
- **Commodity Futures Trading Commission (§ 23.150(b))**

Dear All,

I am a private US citizen. The comments contained herein with respect to the Interim Final Rule of the prudential regulators are mine alone and do not represent the views of any other person, my employer, or other entities.

I will also submit a comment to the CFTC regarding its analogous Interim Final Rule. The CFTC deadline for submission is 6 February 2016.

After submitting these comments, I will contact the CFTC to arrange a joint call with its rule-writing team and the rule-writing team of each prudential regulator to discuss my comments.

On 12 May 2015, I led a joint conference call with Mr. Rick Michalek and the rule writing teams from the CFTC and prudential regulators regarding the proposed rule 79 FR 59898 (i.e., the rule proposal that preceded the respective final rules for margin posting of uncleared swaps: "Margin and Capital Requirements for Covered Swap Entities"; and "Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants.")

The following link accesses the CFTC notice of the joint conference call, the materials that I used to lead the call, and the overarching point conveyed by Mr. Michalek and me, which is quoted below. http://comments.cftc.gov/PublicComments/ViewExParte.aspx?id=1016

> "Commenters argue against an exemption from margin requirements for issuers of asset backed securities. Commenters believe ABS issuers' current practice for dealing with counterparty credit risk is inadequate by construction and presents a systemic risk."

"Flip clauses" and "RAC" provisions mask capital inadequacies of ABS and covered swap entities

"Flip clauses" and "RAC" provisions are commonly placed into swaps by ABS issuers to address counterparty credit but are inadequate for this purpose.

For a start, few if any ABS issuers have ever obtained a U.S. legal opinion with respect to the enforceability of a flip clause in a priority of payments. The inability to obtain an opinion regarding the enforceability of a flip clause is attributable in large part to the similarity of a flip clause to a walk-away provision.

The ratcheting up of ABS risk and systemic risk that accumulates from flip clauses and RAC provisions can by gauged both by examining the respective mechanics of flip clauses and RAC provisions and by tracking outcomes for ABS issuers that were pre-crisis counterparties to Lehman Brothers Holdings Inc. and affiliates under swaps.

Swaps with flip clauses and RAC provisions have long underpinned the ABS sector and, in common with other practices by ABS issuers, contributed to the inadequate capitalization of ABS that was a central contributor to the financial crisis. Neither the swaps with flip clauses and RAC provisions nor the ABS that are structured with these swaps can be viewed in isolation from each other.

But for the bailouts that prevented other counterparties from following Lehman Brothers Holdings Inc. into bankruptcy and the extraordinary measures by the U.S. government to buy ABS and other structured products, the inadequate capitalization of ABS that is attributable to a swap with a flip clause and RAC provisions would be more generally appreciated.

Equally, but for the bailouts and other government programs, the systemic risks that accrue from covered swap entities being party to swaps with flip clauses would also be more generally appreciated. Being party to these swaps represents extremely reckless behavior on the part of covered swap entities, as well as a failure of corporate and regulatory governance, given the many attributes that a flip clause has in common with a "walk-away" provision.

Appendix A and B to this letter contain my assessment of the deficiencies of flip clauses and RAC provisions in conjunction with my examination of the CFTC Letter No. 15-21 of March 31, 2015: "No-Action Position: Certain Commission Regulations Applicable to Swaps with Legacy Special Purpose Vehicles", which was issued by the Division of Swap Dealer and Intermediary Oversight. On 28 May 2015. Mr. Rick Michalek and I discussed these deficiencies with the CFTC staff that issued the CFTC Letter No. 15-21.

Title III of TRIPRA does not exempt a swap with a flip clauses or RAC provision
I have read and re-read Title III of the Terrorist Risk Insurance Program Reauthorization Act TRIPRA). I have also read and re-read the Bill Summary & Status, 114th Congress (2015-2016), H.R.26, CRS Summary.

Neither Title III of TRIPRA nor the CRS Summary states that, to quote from the latter, the exemption "from the rules of the prudential regulators for swap dealers and major swap participants with respect to initial and variation margin requirements for swaps not cleared by a registered derivatives clearing organization, those swaps in which one of the counterparties: (1) is eligible for an exception from clearing requirements because it is not a financial entity, uses swaps to hedge or mitigate commercial risk, and notifies the Commodity Futures Trading Commission how it meets financial obligations associated with entering into non-cleared swaps" applies to a swap with a flip clause or a RAC provision.

Moreover, the Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants; Final Rule notes that "One commentator, however, argued that requiring SPVs and other asset-backed security issuers to post full margin against all swap contracts would defuse commonly used "flip clauses" and decrease the loss exposure of investors in asset-backed securities."

1. Accordingly, given that a swap with a flip clause or RAC provision does not qualify for an exemption under Title III of TRIPRA, the final rule that will become effective on 1 April 2016 and which will have followed consideration of comments received with respect to the Interim Final Rule should contain the following language: "For the avoidance of doubt, a swap with either a flip clause or a RAC provision does not qualify for an exemption from either the Margin and Capital Requirements for Covered Swap Entities; Final Rule or the Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants; Final Rule."

2. In notifying "the Commodity Futures Trading Commission how it meets financial obligations associated with entering into non-cleared swaps", a company seeking an exception must file with the CFTC an affidavit signed by a senior officer that states that all swaps that are included in the exemption do not have: (1) a flip clause; (2) any other clause that can be reasonably classified as a walk-away provision; or (3) a RAC provision.

3. The prudential regulators and the CFTC should obligate any covered swap entity, swap dealer, or major swap participant to post both initial margin and variation margin to its guarantor or hedging affiliate against a swap that contains a (1) a flip clause; or (2) any other clause that can be reasonably classified as a walk-away provision. In this way, the losses that arise under the entry into a flip clause or walk-away provision will be fully absorbed by the covered swap entity, swap dealer, or major swap participant that

recklessly agreed to the flip clause or walk-away provision and will not be transmitted to its affiliates such as an FDIC-insured subsidiary.

Credentials

On 18 October 2015, I joined 'Debtwire ABS' as a senior ABS analyst. Debtwire ABS is a subscription-based, online provider of news and commentary on the US, EU, and other markets for ABS and structured products.

In my role, I write articles on the capitalization, regulation, and ratings of ABS and structured products. On 21 October 2015, the prudential regulators began the process of adopting the joint swap margin rule. The timing was fortuitous for me, as I was new to both Debtwire ABS and journalism, but interested and well-versed in the application of the swap margin rule to ABS and structured product issuers.

My first articles at Debtwire ABS covered the swap margin rule. These articles addressed the implications for the standard swap contacts with flip clauses and RAC provisions that have long been used by ABS and structured product issuers, the need for credit rating agencies to overhaul methodologies for rating ABS and structured debt when an issuer enters into a swap contract with margin posting, and pushback to margin posting that was being organized by the Structured Finance Industry Group.

After giving subscribers significant time to review these articles, Debtwire ABS posted this article of mine on its public site. http://www.debtwire.com/info/2015/11/04/analysis-us-margin-rule-swaps-obliges-securitization-issuers-overhaul-structures-add-resources-rethink-capital-structures/

From 2011 until joining Debtwire ABS in 2015, I had engaged in a fulltime, self-financed effort to alert regulators, market participants, credit rating agencies, and the media to the deficient processes for assigning credit ratings to debt issued by entities that are party to derivative contracts such as uncleared swaps. These rating deficiencies enable an entity such as an ABS or structured product issuer to misrepresent its credit profile to providers of derivative contracts and, in tandem with this misrepresentation, issue debt that is under-capitalized relative to its credit rating.

In January 2016, Capital Markets Law Journal published the following article by my co-author Norbert Gaillard and me. This article traces relates the problems with flip clauses and RAC provisions to the major deficiencies that continue to exist with respect to the methodologies and rating practices of credit rating agencies.

Efficient, commonsense actions to foster accurate credit ratings
Norbert J. Gaillard; William J. Harrington
Capital Markets Law Journal 2016 11 (1): 38-59
doi: 10.1093/cmlj/kmv064

An extract can be accessed from this link. http://cmlj.oxfordjournals.org/content/11/1/38.extract and the full article can be accessed from my LinkedIn profile (William J. Harrington).

From 1999 to 2010, I worked as an analyst in the derivatives group of Moody's Investors Service where I evaluated the impact of flip clauses and RAC provisions to both parties to a swap, i.e., an ABS issuer and a derivative counterparty. In July 2010, I resigned as a senior vice president. Prior to Moody's, I worked as derivative structurer at Merrill Lynch and a currency analyst at

Wharton Econometrics.

Sincerely yours,

William J. Harrington

cc: The Honorable Thomas J. Curry, Comptroller of the Currency
The Honorable Janet Yellen, Chair, Board of Governors of the Federal Reserve System
The Honorable Martin J. Gruenberg, Chairman, Federal Deposit Insurance Corporation
The Honorable Kenneth A. Spearman, Board Chair and Chief Executive Officer, Farm Credit Administration
The Honorable Melvin Watt, Director, Federal Housing Finance Agency
The Honorable Timothy G. Massad, Chairman, Commodity Futures Trading Commission

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- Federal Reserve System, 12 CFR Part 237 [Docket No. R–1415] RIN 7100–AD74
- Federal Deposit Insurance Corporation, 12 CFR Part 349 RIN 3064–AE21
- Farm Credit Administration,12 CFR Part 624 RIN 3052–AC69
- Federal Housing Finance Agency, 12 CFR Part 1221 RIN 2590–AA45
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