RIN: 3038-AE85, 1557-0061, 2590-AB02,
3052-AD34, 3064-AF00, and 7100-AF42

William J. Harrington
51 5TH Avenue, Apartment 16A
New York, NY 10003
212-620-8139
wjharrington@yahoo.com

May 31, 2019

VIA ELECTRONIC MAIL

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

Re: RIN 3038-AE85
Commodity Futures Trading Commission “Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants” (In the Event of No-Deal Brexit)

RIN: 1557-0061, 2590-AB02, 3052-AD34, 3064-AF00, and 7100-AF42
***Prudential Regulators*, i.e., collectively the:**
Comptroller of the Currency (OCC), Docket ID OCC-2019-0002;
Federal Reserve System (Board), Docket No. R-1654;
Federal Deposit Insurance Company (FDIC);
Farm Credit Administration (FHA);
and
Federal Housing Finance Agency (FCC);
“Margin and Capital Requirements for Covered Swap Entities” (In the Event of No-Deal Brexit)

Dear Mr. Kirkpatrick and Prudential Regulator Counterparts,

My name is William J. Harrington. I am a private US citizen who investigates the capitalization and regulation of complex finance, publicly reports findings, and disseminates them widely.

Herein are my respective responses to the two rules cited above (***CFTC No-Deal Brexit Rule*** and ***Prudential Regulators No-Deal Brexit Rule***, respectively).

> *The CFTC must amend the CFTC No-Deal Brexit Rule to **exclude** a swap contract with a **flip clause**, other walkaway provision, or rating agency condition / confirmation (**RAC**) that is transferred to an affiliate, branch, or other entity domiciled in the US.*

*The prudential regulators must amend the Prudential Regulators No-Deal Brexit rule to **exclude** a swap contract with a **flip clause**, other walkaway provision, or rating agency condition / confirmation (**RAC**) that is transferred to an affiliate, branch, or other entity domiciled in the US.*

My credentials include 20 years of specifying and evaluating the exposures of the two parties to an uncleared swap contract with a flip clause, RAC, or both (***flip clause swap contract***.) Most commonly, the two parties are a swap dealer or covered swap entity (***regulated swap contract provider***) on one hand and an issuer of securitized or structured debt (***ABS***) on the other hand.

I do this work fulltime without compensation. My aim is to boost the sustainability of the US financial system by improving price-making, by reducing the likelihood of bailouts, and by eliminating the flip clause swap contract.

In short, I live the life and produce the work that CFTC Chairman Giancarlo and CFTC Chief Economist Tuckman lauded in their letter to the "***Congregation for the Doctrine of the Faith, Dicastery for Promoting Integral Human Development, Secretary of the Vatican City, Holy See***," July 21, 2018. "We write to you as finance professionals striving to lead moral lives." (Available at: https://www.cftc.gov/PressRoom/SpeechesTestimony/giancarloresponsetobollettino072118.)

Chairman Giancarlo and Director of the FHFA Mark Calabria have known of my work since at least June 2, 2015. Both, along with then SEC Commissioner Michael Piwowar, spoke at "***Capital Unbound: The Cato Summit on Financial Regulation***," in New York City on June 2, 2015. (The itinerary is available at: https://www.cato.org/events/capital-unbound-cato-summit-financial-regulation.)

> **Luncheon Address, Commissioner Michael Piwowar, US SEC.** (Available at: https://cdn.cato.org/archive-2015/cca-06-02-15-03.mp3.)
>
> **Minute 42:10 – 43:00**, **William J. Harrington Question to Commissioner Piwowar**: "*Hi. Right now, the SEC, the CFTC, and the prudential regulators are working on rules for uncleared swap contracts and margin posting. Given the centrality of the securitization industry in the financial crisis, and particularly subprime mortgage securitizations, should securitization issuers post margin against uncleared swap contracts, particularly uncleared swap contracts with flip clauses?*"
>
> **Commissioner Piwowar response**: "*That is a very difficult question that I'll have to think about. Honestly, it's, it's one, it's a real difficult one, I, I, I don't have an answer for you right now, but I'll certainly get back to you on that. Yah.*
>
> *Do you want to do one more? Something less technical, please.*"

I am a senior fellow at Croatan Institute, an "independent, nonprofit research institute whose mission is to harness the power of investment for social good and ecological resilience by working

at the critical nexus where sustainability, finance, and economic development intersect." My Croatan Institute biography lists my work and links to much of it.

I am also a Key Expert on Structured Finance Topics for the Experts Board of Wikirating.org. The platform posts my work on credit ratings, derivative contracts, and structured finance. See both the main page and https://wikirating.org/wiki/UserWiki:WilliamHarrington.

Your colleagues and you are all well informed on my conclusion that the flip clause swap contract was an integral cause of the financial crisis, harms both a regulated swap contract provider and end-user, cannot be fixed, and must be banished from the US financial system.

Following are links to 37 works that I have previously provided to you, beginning with the most recent. Each cites short, representative passages that support my respective responses to the CFTC No-Deal Brexit Rule and the Prudential Regulators No-Deal Brexit Rule. Yellow shading represents that portion of each work that is particularly compelling.

For the purposes of clarity and transparency, all of this letter, including the entirety of each of the 37 following items, forms my response. All must be posted on the respective regulatory websites. None is extraneous.

1. "***Proposed Amicus Brief to the US Court of Appeals for the Second Circuit Regarding Lehman Brothers Special Financing Inc, Plaintiff-Appellant Versus Branch Banking Trust Company et al, Defendants-Appellees***," Case No. 18-1079 (forthcoming, June 2019.)

   "Dealmakers have always had better, albeit costlier, alternatives to a flip clause swap contract. As examples, dealmakers can accept lower debt ratings, align the payment characteristics of assets and liabilities, buy options, enter into a swap contract with two-way margin posting rather than a flip clause, increase deal resources, or let foreign currency investors such as those that buy US collateralized loan obligations (***CLOs***) mitigate exposures themselves."

   "The decision by the United States Bankruptcy Court for the Southern District of New York detailed the 100% loss of contract values that Lehman Brothers Special Financing Inc. (***LBSF***) incurred under 100% of a "multitude" of in-the-money, flip-clause-swap-contracts.

   "'The amount of the proceeds of the liquidation of the Collateral was insufficient to make any payment to LBSF under the Waterfall after proceeds were paid pursuant to Noteholder Priority.'"

   "Under a separate, very large in-the-money contract, LBSF may have lost 67%.[1] Partly

[1] Moody's Announcement on Ballyrock ABS CDO 2007-1, March 4, 2010. "…the Issuer has just over $137MM in cash while the credit default swap termination payments due to LBSF is approximately $405MM." (https://www.moodys.com/research/Moodys-downgrades-the-ratings-of-two-classes-of-Notes-issued--PR_195797.)

owing to outsized losses on the LBSF flip-clause-swap-contract portfolio, LBSF creditors received less viz-a-viz creditors of other Lehman entities."[2]

"Conversely, one European deal lost 34% under a flip-clause-swaps contract that was in-the-money to it and out-of-the-money to a Lehman entity.[3] Collectively, European flip-clause-swap-contracts with a variety of swap dealers undermined national economies, most notably Greece."[4]

2. **"*Preserve Rigorous Policy with Respect to the ABS Sector in Making Comparability Determinations for the UK at the CFTC Open Commission Meeting of March 25, 2019*,"** March 22, 2019.

"The agenda for the above-titled meeting includes two new items that pertain to Brexit. I urge the Commission to draft the Brexit items so that they do not exempt flip clause swap contracts from the US swap margin rules."

"I will distribute today's letter to Ms. Allison Parent, Executive Direct of the Global Financial Markets Association. Ms. Parent was a senior policy advisor and counsel at the Bank of England from 2013 to 2015. I discussed flip clause swap contracts and the CFTC development of swap margin rules with Ms. Parent and her Bank of England colleague Mr. Michele Marzano in London on March 18, 2015. Appendix B to today's letter (pages a-h) contains eleven emails regarding flip clause swap contracts that I exchanged with Ms. Parent and her Bank of England colleagues between March 9, 2015 and May 13, 2015."

"Of particular relevance to the CFTC Open Commission Meeting of March 25, please note the pre-Brexit regulatory priorities of the Bank of England as conveyed by Ms. Parent in her email of May 13, 2015 (Email 11, page a.)"

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2 "Creditor Recovery in Lehman's Recovery," *Federal Reserve Bank of New York,* January 14, 2019. The third chart compares recovery rates for creditors of Lehman entities, including LBSF. (https://libertystreeteconomics.newyorkfed.org/2019/01/creditor-recovery-in-lehmans-bankruptcy.html.)

3 Fitch Ratings Announcement on Eurosail-UK 2007-4BL PLC, December 17, 2014. "[P]roceeds of USD116m received by the issuer represent approximately 66% of the stipulated claim amount." (https://www.businesswire.com/news/home/20141217005430/en/Fitch-Takes-Rating-Actions-Eurosail-UK-2007-4BL-PLC.)

4 Story, Louise, Landon Thomas Jr. and Nelson D. Schwartz, "Wall St. Helped to Mask Debt Fueling Europe's Crisis," *New York Times*, February 13, 2010. (https://www.nytimes.com/2010/02/14/business/global/14debt.html?partner=MOREOVERNEWS&ei=5040.) Also, Durden, Tyler and Marla Singer, "Is Titlos PLC (Special Purpose Vehicle) the Downgrade Catalyst Trigger Which Will Destroy Greece?" *Zero Hedge*, February 15, 2010. (https://www.zerohedge.com/article/titlos-llc-special-purpose-vehicle-downgrade-catalyst-trigger-which-will-destroy-greece.)

"The debate around cross-border regulation for all areas (tax, financial reform, accounting, etc.) will always be a complicated topic for many reasons, including political uncertainty. **Thank you for flagging the uncertainty the US regulators see related to the referendum question in regards to cross border derivatives reform** [emphasis added.]"

"Ms. Parent was replying to my email of May 12, 2015 (Email 10, pages a-b), in which I argued that US regulators could not harmonize regulations for swap margin with either the UK or the EU while the Brexit uncertainty loomed."

"Four years later, Brexit uncertainty still looms. Neither UK regulatory entities nor US swap dealers that operate in the UK have prepared for Brexit. The lack of preparedness is an embarrassment given that derivatives practitioners laud themselves often and pay themselves handsomely for the fiction that they relentlessly and continually evaluate all information in real time."

"The Commission must not compound the lapses by UK regulators and swap dealers by honoring the latter's request for a blanket exemption from the US swap margin requirements when re-booking flip clause swap contracts in the US. The US rules of both the prudential regulators and the CFTC properly classify securitization and structured product issuers as a "financial end user" that must exchange full variation margin at least daily under a swap contract entered into, or amended in any way, on or after March 1, 2017."

3. **"*Preserve Rigorous Policy with Respect to the ABS Sector in Making Comparability Determinations for Japan and Australia*,"** March 1, 2019. (Available at: https://wikirating.org/data/other/20190302_Harrington_J_William_CFTC_Open_Meeting_March7_2019_JPY&AUD_Flip_Clause_Swap_Contracts.pdf.)

   "I am writing to urge the CFTC to preserve the rigorous policy with respect to the securitization sector in deciding the first two agenda items of the Open Commission Meeting of March 7, 2019, namely: (1) the amendment to the comparability determination for Japan; and (2) the comparability determination for Australia."

   "Of critical importance, and in accordance with the US swap margin rules: (1) securitization issuers must exchange full variation margin daily and with a de minimus threshold under a new or amended swap, especially a flip clause swap; and (2) all non-GSE securitization debt, i.e., private-label securitization debt, must be excluded from eligible collateral and haircut by 100% if posted."

4. **"*Helping the US SEC Answer Sen Elizabeth Warren Inquiry into Leveraged Loans, CLOs Volcker Rule, and NRSRO Credit Ratings*,"** December 4, 2018. (Available at: https://www.wikirating.org/data/other/20181205_Harrington_J_William_Sen_Elizabeth_Warren_Questions_Re_Leveraged_Loans-CLOs-Volcker_Rule-

NRSRO_Credit_Ratings.pdf.)

"'A sizable number of CLO dealmakers have also been betting on a revival of flip clause swaps, as evidenced by their placing flip clauses in the priorities of payments of new deals. The deals are not yet party to flip clause swaps owing to the US swap margin rules. However, the flip clauses, which are presumably placeholders should the US bank regulators and the CFTC exempt CLO deals from the swap margin rules at a later date, represent a clear-cut choice and not happenstance. Many new CLOs have flip clauses and the remainder do not. **Moreover, no CLO deal with a flip clause can enter into a swap that complies with the swap margin rules because none of the CLO deals have the capital, legal, and operation capacities to exchange daily margin** [bold added].'"

"'Rating agencies also seem to be betting on a policy revival of flip clause swaps, as evidenced by the companies assigning top ratings to CLO notes irrespective of whether a deal has flip clauses in the priorities of payments. **The widespread rating practice may well violate SEC rules, but the SEC generally overlooks rating violations** [bold added]. With respect to Moody's, the practice may also violate the company's settlement with the US Department of Justice and the attorneys general of 21 states and the District of Columbia of January 13, 2017.'"

"'The flip clause in the priorities of payment of many US CLOs is one mechanism by which the respective CLOs can leverage any changes to the Volcker Rule that allow CLOs to securitize, among other assets, ones that are: denominated in a second currency; fixed-rate; re-securitizations; or synthetic securities. Investors will certainly have a much more difficult time assessing CLOs that securitize the above-mentioned types of assets. In contrast, each NRSRO [credit rating agency] could easily make accurate assessments, but instead will continue to inflate the associated CLO ratings in order to preserve CLO rating franchises.'"

5. "***Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker Dealers***," November 19, 2018. (Available at: https://www.sec.gov/comments/s7-08-12/s70812-4663154-176520.pdf.)

   "**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.**"

   "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."

6. "***Can Green Bonds Flourish in a Complex-Finance Brownfield?***" Croatan Institute Working Paper, July 2018. (Available at: http://www.croataninstitute.org/publications/publication/can-green-bonds-flourish-in-a-complex-finance-brownfield.)

   "This working paper argues that some financial products labelled 'green' or 'ESG' embed features that undermine financial sustainability and are thus at odds with the sustainability principles implied in green and ESG product ratings. This paper provides a critical correction to the green and ESG sector that has been sorely needed."

   "The financial sustainability scores that this working paper proposes aim to measure the impact of a financial product on what has not been measured to date, namely 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."

   "Scoring a product on contribution to financial sustainability is both long overdue and very timely. Long overdue because the 10th anniversary of the Lehman bankruptcy looms in October 2018. Very timely because the US Administration is acting to resuscitate crisis-causing sectors such as residential-mortgage-backed securities, crisis-causing contracts such as non-margined swap contracts, and an exceptionally harmful type of the swap contract (a flip clause swap)."

7. **"*S&P Violations of SEC rules in Rating US CLOs with Waterfall Flip Clauses, US SLABS with Flip Clauses, and Navient*,"** May 10, 2018. (Available at: https://www.wikirating.org/data/other/20180521_Harrington_J_William_S&P_Violations_of_SEC_rules_in_Rating_US_CLOs_w_Waterfall_Flip_Clauses_US_SLABS_w_Flip_Cause_Swaps_&_Navient.pdf.)

   "**1.** In assigning ratings to notes of US CLO deals with waterfall flip clauses, S&P does not:
   1.a. perform forward-looking analysis of the CLO deals;
   1.b. review the respective CLO deals' legal opinions, including ones that carve out flip clause enforceability;
   1.c. interview a CLO manager on its derivatives business plan, given that the manager

can enter into a flip clause swap but cannot enter into a swap that complies with the swap margin rules because the deal lacks the necessary capital, operational, and legal capacities;

1.d. challenge a CLO manager on its competency, ethics, and compliance considering the manager's clear plan to skirt US swap margin regulations;

1.e. evaluate the trustworthiness of a CLO manager considering the above lapses in competency, ethics, and compliance;

1.f. apply rating criteria consistently to all notes of all US CLO deals, i.e., ones with and without waterfall flip clauses; or

1.g. fact check and update rating criteria, for instance with respect to the impact of LIBOR reform on CLOs, combination securities, and flip clause swaps."

8. "***William J. Harrington CFTC MRAC Nomination and Topic Submission***, March 28, 2018. (Available at: https://www.wikirating.org/data/other/20180329_Harrington_J_William_MRAC_Nomination_and_Topic_Submissions.pdf.)

"My name is Bill Harrington. I am writing to nominate myself as a member of the CFTC Market Risk Advisory Committee (MRAC). I provide biographical information further below in this letter.

"At least 30 of my colleagues, professional contacts, friends, and family have also nominated me to be a MRAC member.[5] These endorsements of my advocacy to rectify a root cause of the financial crisis — under-capitalized derivative contracts and asset-backed securities (ABS) — are deeply gratifying."

"More importantly, these endorsements demonstrate what is both best in our country and critical to its wellbeing — people who pro-actively build their futures and everyone else's. To build these futures, the MRAC must include people such as me who are dedicated to examining the financial crisis clearly, free of blinders such as professional and partisan affiliations."

CODAS

A. June 22, 2018.

"Dear Mr. Harrington,
II
"Upon careful review of the nominations received and consideration of the MRAC's potential priorities over the next three years, I am writing to inform you that you were not selected for consideration for an appointment to serve as a member of the MRAC."
II
"Rostin Behnam"

B. May 30, 2019.

[5] In the end, 45 colleagues, professional contacts, and friends nominated me.

"CFTC's Market Risk Advisory Committee to Meet June 12 to Discuss Climate-related Financial Risk"
(Available at: https://www.cftc.gov/PressRoom/PressReleases/7931-19.)

"CFTC Commissioner Rostin Behnam is the sponsor of MRAC."

"At this meeting, the MRAC will focus on climate-related financial risks. In a series of panels, MRAC members and guests will discuss (1) the impact of climate change on the future stability of the global financial system; (2) current domestic and international initiatives addressing financial risks related to climate change; (3) financial industry approaches to the management and mitigation of such risks, including key risk management, governance, and disclosure considerations; and (4) the challenges ahead for regulators and market participants in the derivatives industry."

"'The impacts of climate change affect every aspect of the American economy – from agriculture to manufacturing. Assessing climate-related market risk that could impact the stability of our nation's financial system must be a priority. It's time for the United States to take a more active leadership role and join our international counterparts in addressing this issue," said Rostin Behnam, CFTC Commissioner and MRAC sponsor."

9. "***US Financial Regulators Balk at Examining Complex Finance***," February 8, 2018. (Available at: http://www.croataninstitute.org/latest/news/us-financial-regulators-balk-at-examining-complex-finance.)

   "The main US regulator for complex finance — the CFTC — intentionally got many basic features of a complex type of derivative contract exceptionally wrong in its recent No-Action Letter from late October of last year on margin requirements for swaps used by 'special purpose vehicles.'"

   "The numerous misrepresentations that underlie the CFTC's decision not to take action on these complex, undercapitalized swaps raise serious concerns regarding the CFTC's mission, competency, and trustworthiness. The same goes for other US financial regulators such as the US Department of the Treasury, the US Securities and Exchange Commission (SEC), and the National Futures Association."

   "The type of complicated derivative product that the CFTC intentionally got all wrong — an 'ABS flip clause swap' — started and fueled the financial crisis. Moreover, ABS flip clause swaps remain embedded in many student loan ABS deals, as I described in a Croatan Institute 'Views' column on 18 January."

10. "***31 Misrepresentations in CFTC Letter No. 17-52***," February 2, 2018. (Available at: https://www.wikirating.org/data/other/20180203_Harrington_J_William_31_Misrepresen

tations_in_CFTC%20_Letter_No_17-52.pdf.)

"I am writing to urge the Commission to withdraw the CFTC Letter No. 17-52 of 27 October 2017."

"The CFTC Letter No. 17-52 was void upon issuance. As a result, neither swap dealers that are provisionally registered with the CFTC (Swap Dealers), nor investors in US and EU asset-backed securities (ABS), nor Commission staff, including those of the Division of Swap Intermediary Oversight (DSIO), can rely on the no-action position that the CFTC Letter No. 17- 52 ostensibly provides on pages 6-7."

"*DSIO will not recommend that Commission take an enforcement action against an SD for a failure to comply with the V[ariation] M[argin] Requirements as such regulations may apply to a Legacy SPV Swap*."

"My letter of today lists and corrects 31 misrepresentations that the CFTC Letter No. 17-52 cites as rationales for the no-action position. Each of the 31 misrepresentations voids either some of or the entire no-action position. The CFTC Letter No. 17-52 explains the self-voiding mechanism on page 7."

"'*Further, this letter, and the positions taken herein, is based upon the representations made to DSIO. Any different, changed, or omitted material facts or circumstances might render this no-action position void.*'"

11. "***A Welcome if Belated Victory for Financial Stability***," January 16, 2018. (Available at: http://www.croataninstitute.org/latest/news/a-welcome-if-belated-victory-for-financial-sustainability.)

"At the nexus of complex finance, poor regulatory oversight, and predatory practices regarding lending and debt servicing, inflated credit ratings played a critical role in enabling the mortgage meltdown a decade ago. With little reform of the ratings industry's embedded conflicts of interest, similar problems of overinflated ratings have largely persisted since the financial crisis. Could the recent downgrade by Moody's Investors Service (Moody's) of bonds in nine complex deals that are backed by US student loans herald a welcome change in the assessment of complexly structured asset-backed securities (ABS)? As a former industry insider, I remain skeptical, but let's hope the trend toward more sober assessments of undercapitalized ABS continues during 2018."

"The Moody's downgrades of 11 January address an extremely complicated financial contract that is embedded in each of the nine student loan ABS (SLABS) deals. This type of financial contract — 'an ABS flip clause swap' — was a key feature of many of the ABS deals that ignited and fueled the financial crisis."

12. "***PWIPC (Persistent Well-Informed Private Citizen) to CFTC: 'Deny SFIG Request for Margin Exemption for ABS Swaps,'***" July 14, 2017. (Available at: https://www.linkedin.com/pulse/pwipc-persistent-well-informed-private-citizen-tells-cftc-harrington/.)

   "Unfortunately, you have not responded to a key aspect of my request."

   "I requested a meeting with '***all*** CFTC staff who have had discussions with SFIG staff and members regarding an unmargined, uncleared swap with RAC provisions and a flip clause" in 2017.'"

   "My tally of these CFTC staff — i.e., those copied here — may be incomplete."

   "Accordingly, please provide me with the name and email of each remaining member of CFTC staff who had one or more 'discussions with SFIG staff and members regarding an unmargined, uncleared swap with RAC provisions and a flip clause' in 2017.'"

   "Alternatively, please confirm that '***all*** CFTC staff who have had discussions with SFIG staff and members regarding an unmargined, uncleared swap with RAC provisions and a flip clause' in 2017 are copied here."

   "Your reply will enable me to contact '***all*** CFTC staff who have had discussions with SFIG staff and members regarding an unmargined, uncleared swap with RAC provisions and a flip clause' in 2017 and request that they meet with me.'"

   "I want to offer practical insights regarding the *implementation* of the CFTC rule regarding margin posting against an uncleared swap with RAC provisions and a flip clause just as I offered practical insights during the rule making progress."

13. "***Capital Requirements for Swap Dealers and Major Swap Participants***," May 4, 2017. (Available at: https://comments.cftc.gov/PublicComments/ViewComment.aspx?id=61196&SearchText.)

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

14. "***Republicans Immunize Rating Agencies from Accountability in Financial Choice Act***," May 2, 2017. (Available at: https://blog.wikirating.org/2017/05/01/republicans-immunize-rating-agencies-from-accountability-in-financial-choice-act/.)

    "No government regulation will ever apply to any rating agency that the government regulates, according to the Financial Choice Act. This bill would eliminate accountability for nationally recognized statistical rating organizations (NRSROs), i.e., credit rating agencies that SEC *ostensibly* oversees."

    "**Four blatant give-aways to rating agencies**"

    "1. Rating numbers don't have to tally — No one at an NRSRO needs attest to the integrity of any aspect of the rating process (Section 853)."

    "2. What conflict of interest? — Sales and marketing staff can *always* communicate with rating staff (Section 856)."

    "3. Re-write history — Congress *never* found that the rating agencies failed big time ahead of the financial crisis. (Section 857)."

    "4. Elections have consequences but bad ratings don't — Immunize NRSROs from expert liability forever. (Section 857, again)."

15. "***ABS Margin Posting – 500 Days Late and How Many USD Millions Short?***" February 12, 2017. (Available at: https://www.linkedin.com/pulse/abs-margin-posting-500-days-late-how-many-usd-short-bill-harrington?trk=portfolio_article-card_title.)

    "**Don't blame the swap margin rules for too much RAC and too little replacement**"

    "Technical modeling and legal analysis aside, commonsense dictates that ABS ratings, prices and valuations *should* assume that an issuer will 'retain its swap provider until maturity of the swap.' Commonsense also dictates that ABS ratings, prices and valuations

will reflect both the credit profile of a swap provider and the risk parameters of the swap."

"However, the ABS world is very short on commonsense and dangerously long on rating arbitrages. This combination fueled the financial crisis and may also have hampered the subsequent recovery."

"ABS ratings, prices and valuations embed a long-repudiated assumption that a suite of rating provisions in a swap will fully insulate an ABS from a swap provider. This suite of assumptions incentivizes an ABS issuer to enter into an uncleared and unmargined swap rather than buy options or additional collateral."

"Hence the desperate lobbying from all corners of the ABS world to preserve the rating arbitrage for uncleared and unmargined swaps. Fitch paved the way in an announcement of 17 November 2016 that posited that the CFTC might exempt ABS issuers with legacy swaps from the swap margin rule."

"'In the U.S., a possible 'no action position' from the CFTC could, in Fitch's view, make the replacement the of legacy swaps more likely and therefore reduce replacement risk arising from the upcoming regulation.'"

16. "***Moody's DOJ Settlement Won't Stop Fake Rating Analysis & Derivatives Denial,***" January 14, 2017. (Available at: https://www.linkedin.com/pulse/moodys-doj-settlement-wont-stop-fake-rating-analysis-bill-harrington?trk=portfolio_article-card_title.)

"**The raters' dilemma – AAA cash-and-carry swaps *end* a rating arbitrage**"

"The US rules for posting swap margin do distinguish between a *new* swap contract – one that is entered from 1 March 2017 onward – and a pre-existing swap contract."

"Under a new swap contract, a financial end user such as an ABS issuer and swap provider must exchange variation margin daily so that the party that is in-the-money holds margin equal to the full mark-to-market of the contract."

"In this way, a new swap contract will be cash-and-carry. In the event of the non-performance of a swap provider, an ABS issuer can quickly close out a new swap contract and enter into a comparable one with a stronger entity."

"In other words, a new swap contract will insulate an ABS from the non-performance of a swap provider to a AAA standard, i.e., succeed where existing swap contracts have failed."

"Of course, an ABS investor that benefits from this insulation will pay for it in the form of less leverage. In closing an ABS that will be backed by a new swap contract, an ABS issuer must include the operational and financial capacity to support margin posting in

the capital structure."

"Given the cost of establishing these swap capacities, an ABS issuer may buy an option or securitize additional assets rather than enter into a new swap contract. Well, that's capitalism! Accurate prices that increase choice are not necessarily convenient."

17. "***Moody's bets Germany will support Deutsche Bank derivative contracts above all else***," October 12, 2016. (Available at: https://www.debtwire.com/info/moody%E2%80%99s-bets-germany-will-support-deutsche-bank-derivatives-above-all-else-%E2%80%94-analysis.)

    "Is Deutsche Bank the next Lehman Brothers or merely another Bear Stearns?"

    "Given the size of Deutsche Bank, does the distinction between a possible insolvency or liquidity crunch matter? In either event, taxpayers in Germany and potentially elsewhere are already expected to bail out all or parts of the bank."

    Why does this matter? The counterparty assessments and ratings allow banks such as Deutsche Bank AG to enter into financial contracts — such as derivative trades — while postponing any penalties which may come along with the lower senior unsecured credit rating. This is already the case in the structured finance and covered bond sectors. How long before these sectors' bad practices seep into the wider financial system, again?"

    "Even so, Moody's doesn't obligate itself to price just how expensive the proposition may be or even differentiate the types of counterparty obligations."

    "'Our approach to government support is similar to that for determining support from an affiliate. Our assessment is designed to be qualitative and flexible in nature, enabling us to incorporate the often subtle real-world shifts that define attitudes to support for bank creditors.'"

18. "***Existing ABS swaps also caught in swap margin net***," August 12, 2016. (Available at: https://www.debtwire.com/info/existing-abs-swaps-also-caught-swap-margin-net-%E2%80%94-analysis.)

    "[R]eview of the swap margin rules indicates that the margin requirements will apply to existing swaps that are amended *in any way* after the relevant compliance date — 1 March 2017 for most financial end users including ABS issuers."

    "Accordingly, an ABS issuer that is party to an existing swap as of 1 March 2017 is likely to retain its swap provider until maturity of the swap so as to continue shielding it from the margin requirements. To do otherwise, i.e., change a swap provider midstream, an ABS issuer would have to either: 1. amend the existing swap; or 2. terminate it and enter into a new swap. Either course will obligate a swap provider to ensure that the swap

complies with the margin requirements immediately."

"**Rorschach test — maybe the margin rules are a great solution?**"

"Time is running out for the ABS world writ large — issuers, investors, rating agencies, swap providers, underwriters and at least some regulators — to paint itself out of the swap margin corner."

"The ticking clock might be a boon, rather than a problem. Did ignoring the risk of a swap provider ever help investors? Why shouldn't investors distinguish between both types of swaps and providers and buy deals accordingly?"

"Won't margin posting by both an ABS issuer and a swap provider force deals to capitalize to reflect the risks to noteholders and allow them to decide whether to accept less risk and reward or vice-versa?"

"Lastly, margin 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."

19. "***Efficient, commonsense actions to foster accurate credit ratings***," *Capital Markets Law Journal* 11, no. 1 (2016): 38-59 doi: 10.1093/cmlj/kmv064). Presented at the 2015 annual meeting of the American Political Science Association in San Francisco (with Norbert J. Gaillard). (Available at: https://academic.oup.com/cmlj/article-abstract/11/1/38/2366006.)

    "A RAC provision enables the third-party trustee to a seasoned S[tructured] F[inance] transaction to effect a change to its structure, governing documents, or non-investor parties without obtaining noteholder consent by instead obtaining a written affirmation from an NRSRO [credit rating agency] that the change, when considered in isolation, will not result in an immediate downgrade of the rating of any class of SF debt. Non-investor parties to an SF transaction, such as a collateral manager or a derivative counterparty, can direct a trustee to submit a request to an NRSRO for a RAC with respect to one or more changes even if they unequivocally disadvantage investors. An NRSRO is never obligated to issue a RAC, but is paid out of transaction funds to do so regardless of whether the associated changes enhance investor protections, leave them intact, or unilaterally strip them away without providing offsetting compensation such as alternative investor protections, remuneration or other forms of consideration."

20. "***Margin and Capital Requirements for Covered Swap Entities; Interim Final Rule to Exempt Commercial End Users and Small Banks***," January 13, 2016. (Available at: https://www.federalreserve.gov/SECRS/2016/February/20160217/R-1415/R-

1415_013116_130180_508327057758_1.pdf.)

"'**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."

21. "***CFTC Letter No. 15-21 & Rating Agency Overrides of Published Methodologies for Swap Contracts***," May 15, 2015. (Available at: https://www.wikirating.org/data/other/20180203_Harrington_J_William_31_Misrepresentations_in_CFTC%20_Letter_No_17-52.pdf, pages 94-110.)

    "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."

"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."

22. "***Orderly Resolution, Systemic Stability, and Sustainable Economic Growth—Why Issuers of ABS Must Post Full Margin Against All Swap Contracts***," May 12, 2015. (Available at: https://www.cftc.gov/node/157371.)

CFTC Staff Summary
"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. See attached presentation.~~~ ~~~Conference call was joint with staff of Prudential Regulators."

Accompanying Presentation. (Available at: https://www.cftc.gov/sites/default/files/idc/groups/public/@swaps/documents/dfsubmission/dfsubmission_051215_2376_0.pdf.)

"No swap contract between an ABS issuer and a financial counterparty that references an interest rate, basis rate, or currency is 'plain vanilla.'"

"Forget financial engineering and just read the swap contract and governing documents of an ABS, particularly its priority of payments, to evaluate the undercapitalization of ABS when an issuer is party to a swap contract."

"A swap contract with a flip clause between an ABS issuer and a financial counterparty is more akin to a huge banana split that has somewhere beneath the maraschino cherries, whipped cream, caramel sauce, melted chocolate, chopped nuts, bananas, pineapples, jimmies, strawberry ice cream, and chocolate ice cream, a dollop of vanilla ice cream."

"Requiring ABS issuers to post full margin against all swap contracts that reference interest rates, basis rates, and currencies will simplify these contracts, provided that eligible collateral does not include other ABS."

23.
24. "***SEC — Teleconference of Staff of Commissioner Kara Stein and Office of Credit Ratings with William J. Harrington***," December 2, 2014. (Available at: https://www.sec.gov/comments/s7-08-10/s70810-310.pdf.)

"On December 2, 2014, Michael Spratt, Allison Lee, Michelle Stasny, and Harriet Orol had a teleconference with William J. Harrington. The parties discussed, among other things, rules concerning Asset-Backed Securities Disclosure and Registration, and Nationally Recognized Statistical Rating Organizations."

"1. Introduction for briefing for staff of SEC Commissioner Kara Stein on unenforceable, walkaway flip clauses in asset-backed security (ABS) waterfalls by William J. Harrington, former Senior Vice President, Derivatives Group of Moody's Investors Services
a. My credentials available
b. SEC unlikely to find a more knowledgeable analyst of "uncleared swap contracts with unenforceable, walkaway flip clauses and no margin posting." These swap contracts, which may reference currencies, interest rates, or basis rates underpin most ABS sectors worldwide
(i) Big picture take-away: walkaway flip clause cannot be risk managed by either ABS issuers or their counterparties
c. From outset in 2002, my Moody's publications with respect to derivative contracts, ABS, and derivative counterparties made top ratings for ABS and derivative counterparties harder to obtain
d. Work of last four years--correct bogus post-mortem of rating failure, ABS failure, and systemic failure
e. SEC work on ABS/NRSROs equivalent to "GM Nod," VA wait times, & flawed 2013 roll-out of Affordable Care Act
(i) Exhibit Number 1 = No-Action Letter to Ford Motor Credit Company LLC
(ii) My May 29, 2014 comment letter on derivative disclosures by ABS issuers and proposed rules for NRSROs details my 2011-2014 outreach to SEC staff in all divisions"

"5. One enabler of rating inflation of ABS and other sectors is deficient assessment of derivative contracts. All NRSROs uniformly assume that derivative contracts deliver benefits to issuers without exposing them to any counterparty risk
a. i.e., misrating is real-world concern that conceals real world losses, not ivory tower musings
b. Rating inflation most egregious for ABS
c. Again, derivative contract is a contract, not an asset
d. No empirical data to show that derivative contracts make life better; like evolution, just a theory
e. Cross-border capital flows = cross-currency swap = riskiest of contract."

"7. ABS rating inflation extends credit too cheaply
a. Financing by ABS should cost more
b. No free lunch; too cheap financing today = bailouts tomorrow

c. D-F preamble: "To promote the financial stability of the United States by improving accountability and transparency in the financial system, to end ''too big to fail'', ***to protect the American taxpayer by ending bailouts***, to protect consumers from abusive financial services practices, and for other purposes"

"9. Who in ABS industry (defined at its widest?) will speak on record regarding unenforceable, walkaway flip clauses, let alone defend them?
(i) Mr. Abe Losice, Assistant Director of the SEC? After discussing these issues, and other limitation of swap contracts used by ABS issuers, Mr. Losice replied these insights weren't news to the SEC."

"11. Reviving RMBS with "uncleared, balance-guaranteed, interest rate swap contracts with unenforceable, walkaway flip clauses and no margin posting" will be a systemic disaster.
a. I undertook my self-appointed, self-funded work four years ago in part to be ready to counter RMBS lobbying when it materialized
b. Moody's would not have paid me to critique the basic guts of most ABS, particularly the highly tainted sector of RMBS
c. Fortunately, Treasury efforts to revive RMBS seem to be going nowhere for many reasons"

"12. Ask experts in housing finance, securitization, credit risk management, investing, or regulation about RMBS and "uncleared, balance-guaranteed interest rate swap contracts with unenforceable, walkaway flip clauses and no margin posting"
a. None will defend these swap contract, though they underpin securitizations of all pre-payable, fixed rate mortgages of all tenors, including 30-years
b. Effectively, "uncleared, balance-guaranteed interest rate swap contracts with unenforceable, walkaway flip clauses and no margin posting" are a jerry-rigged construct of the ABS industry that would have failed spectacularly in 2008 but for the bail-outs
(i) WJH experience in evaluating major providers of these contracts that were saved only by 2008 financial consolidation & bail-outs"

"14. Nightmare template for one-world financial regulation
a. EU regulators don't understand flip clauses either
b. In UK, a flip clause has been upheld against Lehman Brothers, i.e., UK banks at grace risk of write-offs
c. Flip clauses a problem of poor risk management both by ABS issuers and their counterparties; harmonization of international l law with respect to flip clauses a side show"

25. "***SEC — Teleconference of Paul Gumagay (Office of Commissioner Luis A. Aguilar) and William J. Harrington***," June 30, 2014. (Available at: https://www.sec.gov/comments/s7-08-10/s70810-304.pdf.)

"On June 30, 2014, Paul A. Gumagay, Counsel to the Commissioner, had a

teleconference with William J. Harrington. Mr. Harrington discussed, among other things, the Commission's Reproposal of Shelf Eligibility Conditions for Asset-Backed Securities and Other Additional Requests for Comment (Release Nos. 33-9244; 34-71611; File No. S7-08-10); Proposed Rules for Nationally Recognized Statistical Rating Organizations (Release No. 34-64514; File No. S7- 18-11); and his comment letter dated May 29, 2014. He also provided the attached document."

"1. Most ABS carry inflated ratings from all NRSROs; widespread downgrades should have already occurred
 - Derivative contracts (i.e., real world risk and not ivory-tower, theoretical concerns) drive inflated ratings
 - ABS dodged the bullet of counterparty risk thanks to the 2008 bailouts
 - Derivatives contracts are contracts that impose new obligations on counterparties such as ABS issuers; derivative contracts are not outright assets that 'transform' cashflows
 - Cross-border capital flows occur via cross-currency swap contracts; these swap contracts are among the riskiest of derivative contracts."

"2. Alesco Preferred Funding Series I-XVI are cases in point for significant derivative risk that is ignored in ratings
 - These TruPS CDOs have self-referencing, nested counterparty risk in which one Merrill Lynch/BoA entity (MLDP) assumes the guarantee of a second Merrill Lynch/BoA entity (ML & Co.) with respect to the payment, posting & replacement/guarantee obligations of a third Merrill Lynch/BoA entity (MLIB)
 - Effectively, the guarantee is bogus and does not mitigate counterparty risk of Merrill Lynch/BoA, particularly with respect to swap termination payments & nullification of flip clauses
 - Even so, Moody's upgraded Alesco Preferred Funding V, VI, VIII, IX, X, & XVI on June 26, 2014."

"4. Commissioner Piwowar's statements on Reg AB disclosures are flat out wrong
 - Reg AB must address nascent revival of PLS RMBS as well as larger ABS sectors such as student loans, auto loans, CLOs and CMBS.
 - Private-label RMBS has riskiest derivative contracts of all—balance-guaranteed swaps with flip clauses that offset both interest rate risk and prepayments
 - U.S. Treasury request for comment of June 26, 2014 indicates administration support for revival of private-label RMBS?"

"8. Discuss pp. 1-2 of my May 29, 2014 comment letter to the SEC proposing new rules for NRSROs
 - To date, the SEC has enabled NRSROs to assign inaccurate ratings with impunity
 - Ford Motor Credit Company No-Action Letter nullifies Dodd-Frank penalties for inflating ABS ratings
 - 2011 proposed rules for NRSROs would empower NRSROs to continue rating across all sectors— municipal, state, sovereign, supra-national, corporate, financial, as well as ABS."

26. "***Request for Securities and Exchange Commission Re-proposal Relating to Nationally Recognized Statistical Rating Organizations***," May 29, 2014. (Available at: https://www.sec.gov/comments/s7-18-11/s71811-84.pdf.)

"Of particular concern, the proposed rules would enable NRSROs to continue awarding credits to both parties to a derivative contract (e.g., an ABS issuer and a large bank). By not applying any derivative debits at all, let alone balancing derivative debits and credits, NRSROs appease issuers and exploit earnings franchises, particularly in the ABS and financial sectors."

"**Unenforceable flip clauses prop up AAA ratings of ABS 'liar loans'**"

"NRSROs have known since at least January 2010 that their derivative assessments for ABS are wildly inaccurate but still treat a derivative contract as 100.00% risk-free in assigning AAA ratings to new ABS; to do otherwise, for instance by applying even a minuscule rating debit of 0.01% to an ABS, places a AAA rating out of reach. Most flagrantly, 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."

"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. On its own, a swap contract generally costs nothing to enter and, to make a good thing even better, adding a flip clause ostensibly insulates ABS against the risk that an insolvent swap counterparty will claim a termination payment and siphon funds from an ABS."

"**Flip side of a flip clause: A derivative provider's rating should be debited twice**"

"With respect to the rating of a derivative provider, an NRSRO should apply two (non-zero) debits to the swap contract: a first debit that reflects the credit profile of an ABS issuer and a second, much larger debit that reflects the punitive losses that a derivative provider inflicts upon itself in the event of insolvency. As an alternative to incurring the second derivative debit, a derivative provider can set aside significant reserves that must be augmented upon being downgraded."

"In their present form, ABS and NRSRO rule proposals would codify longstanding practice by ABS issuers, underwriters, NRSROs, auditors, and counsel, as well as by the Commission itself, to conceal risks under derivative contracts with respect to individual ABS, counterparties, and the ABS sector as a whole. As a result, no investor or other interested parties—be they bank regulators, corporate risk managers, ABS analysts, bank analysts, valuation consultants, independent researchers, financial journalists, private

U.S. citizens, or the Commission itself— will have enough information to price ABS accurately, to measure bank capital accurately, to track systemic risks accurately, or to gauge the scale of the next bailout accurately."

27. "***SEC — Teleconference of Office of Structured Finance and Division of Corporate Finance with Marc Joffee and William J. Harrington,***" April 30, 2014. (Available at: https://www.sec.gov/comments/s7-08-10/s70810-301.pdf.)

    "On April 30, 2014, Kathy Hsu, Robert Errett, Hughes Bates, Michelle Stasny, and Kayla Florio of the Division of Corporation Finance and Igor Kozhanov of the Division of Economic and Risk Analysis had a teleconference with William Harrington and Marc Joffe. The participants discussed topics relating to the Commission's April 7, 2010 proposing release regarding asset-backed securities and related releases. Mr. Harrington provided the attached memorandum."

    "But for the 2008 bailouts, large counterparties such as AIG might well have been cautionary tales for ABS exposure to derivative risk and, correspondingly, counterparty exposure to ABS issuers. For instance, had AIG not been propped up, issuers in all ABS sectors would have found that a flip clause did not nullify obligations to accelerate swap payments owed to AIG, losses in all ABS sectors would have been larger, ABS in all sectors would have been downgraded more steeply, and the financial crisis would have been more severe."

    "In other words, disclosure of derivative assets such as options and swap contracts with flip clauses is, to use the standard of Commissioner Piwowar: 'necessary for investors to independently perform due diligence.' Moreover, not only investors, but also third-party evaluators, regulators, and other interested parties track ABS risk."

    "The disclosures serve a key aim of Regulation AB, namely that of facilitating independent scrutiny of ABS, both on an individual basis and in aggregate by issuer, sector, counterparty, counterparty guarantor, and industry as a whole."

    "Moreover, an issuer can make the disclosures, and update them, at minimal cost and without raising gatekeeping or privacy concerns."

28. "***Entire Financial System Needs Commonsense Review of Derivative Contracts. Let's Start with ABS***," March 1, 2014. (Available at: https://wikirating.org/data/other/20140301_Harrington_J_William_Entire_Financial_System_Needs_Commonsense_Review.pdf.)

    "Derivative overload will periodically erupt into more fiascos that will later be portrayed by the principals involved as having been 'unforeseeable.' Fiascos aside, mispriced derivative contracts continually distort market signals and, in doing so, wreak havoc on investment decisions. Future generations will marvel at our proliferation of derivatives

and wonder, as we do at the follies of previous generations, 'What were they thinking?'"

"As with most bilateral contracts, a derivative contract engenders highly wishful thinking on the part of both parties. From initial negotiation to final payment, an issuer and a counterparty each price a derivative contract under the assumption that it will deliver finely honed benefits that will cure what ails without imposing unforeseen costs or losses."

"Industry practice of treating a derivative contract as a low-cost panacea, rather than, first and foremost, a binding contract with trade-offs, is justifiable only under the assumption that the parties will not exit the contract ahead of schedule. Derivative contracts specify significant costs for early exit, regardless of whether the exit is voluntary or involuntary (e.g., after one party has become insolvent)."

"Nonetheless, analysts, regulators, policy makers, and rating agencies egg on issuers and counterparties in wishfully thinking that entering into a derivative contract is always beneficial, both for the parties themselves and for the wider economy as a whole. With every new derivative contract, a sovereign entity taps more markets, a corporation smooths earnings, a municipality reduces borrowing costs, an ABS issuer securitizes more assets, and, in win-win fashion, a counterparty books a profit up front."

29. "***Reg AB Disclosures for Securitization Swaps and Other Derivative Contracts***," February 17, 2014. (Available at: https://wikirating.org/data/other/20140217_Harrington_J_William_Reg_AB_Disclosures_for_Securitization_Swaps_and_Other_Derivative_Contracts.pdf.)

"**Disclosure of derivative assets and liabilities under Regulation AB**"

"ABS issuers make few disclosures with respect to derivative contracts, counterparties, or counterparty guarantors, even though the parameters of a derivative contract and the credit profiles of a counterparty and guarantor underpin the likelihood that an can pay ABS interest and principal."

"A sophisticated, institutional investor can form an independent assessment of ABS exposure to counterparty insolvency with the following disclosures.
1. Type of derivative contract
2. Notional amount of contract
3. Legal final maturity of contract
4. Upfront payment paid or received by ABS issuer
5. Counterparty to contract
6. Guarantor of counterparty to contract
7. Mark-to-market of contract on counterparty books and records
8. Collateral posted by counterparty to issuer
9. Presence of flip clause in contract or in priority of payments
10. Provisions that enable a counterparty to modify the contract without obtaining

consent of ABS investors (often termed "RAC" provisions, shorthand for obtaining rating agency confirmation/satisfying rating agency condition)
11. RAC provisions obtained to-date"

30. "***Securitization Swaps and the CFTC Clearing Mandate for Interest Rate Swaps***," February 3, 2014. Available at: https://www.sec.gov/comments/s7-08-10/s70810-256.pdf, HTML pages 23-31.)

"**Big Picture** – A securitization swap is much less effective than a cleared swap (or a non-cleared swap with two-way collateral posting) in mitigating counterparty exposure for either a swap provider or an ABS issuer."

"Although both an ABS issuer and a swap provider are linked until maturity of a securitization swap, neither holds reserves against the other's non-performance. Moreover, a swap provider does not reserve against its own insolvency, a risk posed by a 'flip clause' in the ABS priority of payments."

"A flip clause, a linchpin of securitization swaps since their inception, encourages an ABS issuer and a swap provider to ignore insolvency risk altogether by masking unresolved issues of law, risk management, and governance. The 2008 bail-outs propped up providers of securitization swaps, such as AIG, and in so doing left flip clauses dormant (and other deficiencies of securitization swaps unexamined). In the absence of bail-outs, ABS losses and downgrades would have been worse."

"A swap provider incorrectly treats a securitization swap as plain-vanilla, i.e., as having a robust secondary market and minimal counterparty exposure, and marks-to-market accordingly. (The assessment of minimal exposure to an ABS issuer is validated by reference to the rating of senior ABS, which represents circular reasoning, given that the ABS rating itself rests on a bedrock assumption that the ABS are not exposed to insolvency of a swap provider.) No counterweight offsets the optimistic mark-to-market of a securitization swap by a provider; an ABS issuer doesn't mark a securitization swap to-market at all."

31. "***Questions for SEC Open Meeting of February 5, 2014***," February 2, 2014. (Available at: https://www.sec.gov/comments/s7-08-10/s70810-256.pdf.)

"I have several questions regarding the Open Meeting that will be held on February 5, 2014 at 3:00 PM by the Securities and Exchange Commission."

"3. Will securitization swaps, a key component of most cash-flow, asset-backed securities, be examined as the Commission considers whether to adopt rules revising the disclosure, reporting, and offering process for asset-backed securities? In particular, will an issuer be required to disclose the presence of a "flip clause" in a securitization swap, given that such a clause was held to be unenforceable against Lehman Brothers in 2010?"

"On two separate occasions in 2013, I briefed the SEC on the risks that securitization swaps (and, in particular, flip clauses) posed to investors in asset-backed securities, as well as to the financial system as a whole. On October 16, 2013, I met with staff from the Office of Credit Ratings and, on November 12, 2013, I met with staff from the Division of Trading and Markets. (http://www.sec.gov/comments/s7-18-11/s71811-76.pdf.)"

"In the latter briefing, I recommended that flip clauses, lynchpins to almost all securitization swaps, be counted prominently among 'any other factor or characteristic of the assets that would be material to the likelihood that the issuer of the ABS will pay interest and principal according to its terms and conditions.' When a flip clause is not upheld against an insolvent counterparty, as occurred with respect to Lehman Brothers, an ABS issuer must divert funds that had been earmarked for timely payment of interest and principal towards paying a lump-sum termination amount to the insolvent counterparty, instead."

"Fortunately, Lehman Brothers provided very few securitization swaps to issuers of cash-flow, asset-backed securities. AIG, however, provided such swaps to many, many issuers who, but for the 2008 bail-outs, would have been obligated to pay large, lump-sum termination amounts to AIG, rather than pay "interest and principal according to its terms and conditions.'"

32. "***SEC — Meeting of Division of Trading and Markets and Office of Credit Ratings with William J. Harrington***," November 12, 2013. (Available at: https://www.sec.gov/comments/s7-18-11/s71811-76.pdf.)

    "On November 12, 2013, representatives from the Securities and Exchange Commission ("Commission") met with William J. Harrington to discuss the Commission's proposed rules and rule amendments in accordance with Title IX, Subtitle C of the Dodd-Rank Wall Street Reform and Consumer Protection Act (Release No. 34- 64514). Participating on behalf of the Commission were Randall Roy, Mark Attar and Rachel Yura, from the Division of Trading and Markets; and Harriet Orol, from the Office of Credit Ratings."

33. "***Inaccurate ABS & DPC Ratings Attributable to Securitization Swaps***," October 20, 2013. (Available at: https://wikirating.org/data/other/20131020_Harrington_J_William_Email_Inaccurate_ABS&DPC_Ratings_Attributable_to_Securization_Swaps.pdf.)

    "The third attachment contains two Moody's announcements of no-downgrade letters that were issued to counterparties of securitization swaps that opted not to fulfill contractual obligations to ABS issuers. The first Moody's announcement impacts 11 CDOs whose issuers remained counterparty to Goldman Sachs after it obtained Moody's permission not to replace itself after having been downgraded to a replacement trigger. As a result, each of the 11 CDOs faces increased risk of making a termination payment in the event

of a Goldman insolvency. The second Moody's announcement details a no-downgrade letter issued to Bank of America N.A. (BANA) that allows BANA to obtain a guarantee of its obligations under a securitization swap from MLDP, a DPC that, in circular fashion, is itself guaranteed by BANA."

34. "***Losses Attributable to Securitization Swaps***," September 11, 2013. (Available at: https://wikirating.org/data/other/20130911_Harrington_J_William_ABS_Losses_Attributable_to_Securitization_Swaps.pdf.)

"In the U.S., the ABS industry pitches the indispensability to housing finance reform of reviving residential mortgage-backed securities (RMBS) and ignores the highly idiosyncratic risks of 'balance guarantee' securitization swaps that underpin the whole sector. In Europe, the industry hinges economic revival upon increased securitization of corporate receivables and reduced capital penalties for ABS, glossing over outsized market risk of ubiquitous securitization swaps that hedge depreciation of asset pools attributable to currency mismatches."

"**Breaking bad ABS math apart**"

"An insolvent counterparty will deplete an ABS issuer's cash by either failing to make hedge payments (when an asset pool has depreciated) or claiming a lump-sum termination amount (when an asset pool has appreciated). Additionally, the estate of an insolvent counterparty will saddle an ABS issuer with litigation expenses and lengthy operational uncertainties, e.g., by contesting the validity of securitization swaps that do not conform to local regulations."

"An ABS priority of payments locks in ABS losses when cash runs short or assets are written down, and the impact may be magnified in the wake of a major counterparty becoming insolvent. Interest proceeds that have been depleted by a relative depreciation of the asset pool or springing legal fees may divert principal proceeds to pay senior ABS coupons, leaving senior principal outstanding and junior ABS with cashless, in-kind coupons. Funding a termination payment can force an ABS issuer to liquidate assets at fire sale prices (other ABS issuers will be liquidating similar assets for the same reason), eroding support for all tranches irreversibly."

"Moreover, an ABS issuer with an in-the-money securitization swap may never receive collateral, leaving ABS fully exposed to relative depreciation of an asset pool after a counterparty becomes insolvent. Following an industry-wide downgrade of banks in 2012, counterparties unilaterally deferred posting collateral to ABS issuers or voided the obligation to do so altogether by again obtaining no-downgrade letters from Moody's."

"**Sometimes, saying nothing is saying something**"

"Clearing houses are rejecting securitization swaps without comment."

35. "***Comment on the Securities and Exchange Commission Credit Ratings Roundtable for ABS***," June 3, 2013. (Available at: https://www.sec.gov/comments/4-661/4661-28.pdf.)

    "In a particularly egregious instance, NRSRO methodologies specify that the same individual derivative contract be modeled in one manner for an asset-backed security and in a second, mutually exclusive manner for a Derivative Product Company. Without the double-counting, NRSROs would be obligated both to downgrade most asset-backed securities worldwide and to allow the Derivative Product Company sector to fade away."

    "Bank bail-outs kept upright the ABS domino of event risk from failure of a counterparty to an ABS issuer. Event risk is sizable given the few derivative providers to ABS issuers, the failure of the 'replacement' market and the non-enforceability of 'flip clauses' under U.S. bankruptcy law."

    Non-enforceability of 'flip clauses' will obligate ABS issuers to pay unscheduled termination payments on a senior basis to FDIC-insured bank counterparties. Had a major hedge provider entered bankruptcy in 2008 (Lehman was not a major hedge provider to cashflow ABS issuers), senior RMBS debt that fell to $0.30 would have fallen further to $0.10 or less."

36. "***Moody's Approach to Rating Derivative Product Companies***," April 1, 2013. (Available at: https://www.sec.gov/comments/4-661/4661-28.pdf, HTML pages 16-99.)

    "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 and none bring an additional loss of even a single basis point to any ABS anywhere in the world."

    "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."

    "In the real world, downgraded banks are balking at 'replacing' themselves as counterparties to ABS issuers. Essentially, a 'replacing' bank is a distressed liquidator that books an irreversible loss on each contract that is 'replaced' and retains remaining contracts that cannot be 'replaced' at any price. Where "replacement" does not occur (the majority of cases), back-up provisions obligate a downgraded counterparty to post collateral to an ABS issuer or alternatively to terminate at costs that range from

unfavorable to prohibitive."

"Under a derivative contract that is subject to a 'flip clause,' a D[erivative] P[products] C[ompany] is exposed chiefly to its own credit risk rather than that of an ABS issuer. Prime examples are counterparties to issuers of CDOs that have been downgraded to Caa but continue to receive derivative payments on schedule. Bail-outs kept banks solvent and let sleeping 'flip clauses' lie dormant."

"'Flip clauses' are the most onerous termination provisions and, where valid, obligate a DPC to write-off 100% of mark-to-market assets with ABS issuers. Where the validity of 'flip clauses' has not been established, a DPC must do still more and not only write-off 100% of mark-to-market assets with ABS issuers but also hold additional reserves to pay legal fees. 'Flip clauses' have been upheld under U.K. law, struck down under U.S. law and have unclear status in other domiciles such as Switzerland and France."

"The presence of 'flip clauses' in derivative contracts clouds the determination of whether a DPC is solvent or insolvent in the first place, inviting still more legal inquiry. Crediting mark-to-market assets that are subject to 'flip clauses' as money-good receivables may suggest that a DPC is solvent whereas writing-off the same assets may suggest that the DPC is insolvent and thus entitled to relief under the relevant bankruptcy code."

37. "***Comment on Securities and Exchange Commission Proposed Rules for Nationally Statistical Rating Organizations***," August 8, 2011. (Available at: https://www.sec.gov/comments/s7-18-11/s71811-33.pdf.)

"**Financial Institutions Mismanaged Risk All By Themselves, Can't Pin That on NRSROs**"

"Commissioner Shapiro is not entirely correct that rating agencies contributed 'significantly to the mismanagement of risks by financial institutions.' The financial institutions that issued structured finance transactions mismanaged their risks entirely on their own. On one hand these large financial institutions rewarded employees (and outside counsel) to obtain ever more worthless opinions from the rating agencies and, on the other hand, their treasury and risk management functions treated the same worthless opinions at full face value. The CEO of a bank holding company did not need deep knowledge of synthetic CDOs to discern this tendency."

Sincerely yours,

William J. Harrington