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October 5, 2022

Mr. Christopher Kirkpatrick
Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Centre
11 55 21st Street NW
Washington, DC 20581

Ms. Vanessa Countryman
Secretary, Office of the Secretary
U.S. Securities and Exchange Commission
100 F St. NE
Washington, DC 20549-1090

Copy: Office of Credit Ratings, U.S. Securities and Exchange Commission; Supervision of Credit Rating Agencies, European Securities and Markets Authority; and Credit Rating Supervision, UK Financial Conduct Authority; Japanese FCA; Bank of America; Goldman Sachs; and Morgan Stanley

Via Electronic Mail

Re: U.S. Commodity Futures Trading Commission Japan Swap Dealer Capital Comparability Determination, AND 'Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants—Cross-Border Application of the Margin Requirements,'' Collection Number 3038–0111, AND Market Risk Advisory Committee, AND Request for Information on Climate-Related Financial Risk
AND
U.S. Securities and Exchange Commission Petition for Rulemaking "File No. 4-790"
("I seek a rulemaking by the Commission that prohibits a security-based swap dealer or other entity subject to Commission regulation from predicating a security-based swap or other financial instrument subject to Commission regulation on a flip clause, walk-away, or variable subordination.")

Dear Mr. Kirkpatrick and Ms. Countryman,

My name is Bill Harrington. I am senior fellow at the non-profit research and action entity Croatan Institute.[1] The Institute posts my work.[2]

The entirety of today's letter is a joint submission to the CFTC and to the SEC on the five matters that Page 1 cites.

The SEC will maintain this submission as public comment to rulemaking petition "File No. 4-790."[3]

> "*I seek a rulemaking by the Commission that prohibits a security-based swap dealer or other entity subject to Commission regulation from predicating a security-based swap or other financial instrument . . . on a flip clause, walk-away, or variable subordination.*"

I will build up SEC "File No. 4-790" into a comprehensive, *public* repository of critiques of the swap contract with flip clause and no margin posting by submitting public comments until either (1) an SEC rulemaking proposal per my petition; or (2) my incapacitation by illness or demise.[4]

For its part, the CFTC fails its mission, the common good, and all Americans by failing to maintain an analogous public file of § 13.1 petitions for rulemaking. On May 26, 2020, I filed a petition for the CFTC "*to issue a rule that prohibits a Swap Dealer, Major Swap Participant, or other regulated entity from predicating a swap obligation on a flip clause, walk-away, or variable subordination.*"[5]

The CFTC purposely compounds § 13.1 failures by failing to remedy or even concede flip clause failures. True to form, the CFTC would not acknowledge my petition until shamed into doing so.[6]

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1 (https://croataninstitute.org/).

2 (https://croataninstitute.org/2021/05/30/injecting-accountability-into-the-u-s-and-global-financial-systems/ and https://croataninstitute.org/william-j-harrington/).

3 Harrington, Bill, "Joint Submission 'Re: Petition for Rulemaking Submitted to the SEC / Moody's Investors Service Request for Comment 'General Principles for Assessing ESG – Structured Finance'"", July 21, 2022, (https://www.sec.gov/rules/petitions/2022/petn4-790.pdf).
(For intact links (https://croataninstitute.org/wp-content/uploads/2022/07/WJH-Joint-Submission-to-SEC-and-Moodys-Re-Flip-Clause-July-21-2022.pdf)).

4 All posted rulemaking petitions at: https://www.sec.gov/rules/petitions.htm.

5 Harrington, William J. "Joint Submission to CFTC 'Re: '§ 13.1 Petition . . .' / 'Comment to Global Markets Advisory Committee Subcommittee on Margin Requirements for Non-Cleared Swaps . . . . ' / 'Capital Requirements of Swap Dealers and Major Swap Participants . . .' / 'Cross-Border Application of the Registration Thresholds and Certain Requirements Applicable . . .', May 26, 2020, (https://comments.cftc.gov/PublicComments/ViewComment.aspx?id=62638&SearchText=).

6 Kirkpatrick, Christopher J, "Letter to WJH 'Re Petition for a Rule that Bars an Entity from Agreeing to a Flip Clause . . .'", June 26, 2020, (https://croataninstitute.org/wp-content/uploads/2022/06/CFTC-WJH-2020-6-26-Sec-13.1-Rulemaking-Petition-Acknowledgment_WJHarrington_06-26-2020.pdf).

The Imperative: **The CFTC and the SEC must prevent every regulated swap provider globally from providing a swap contract with a flip clause, walkaway, or variable subordination.**

Rationale: **The zero-sum flip clause enables both contracting parties to misclassify the clause as "win-win" and thereby grossly under-resource the respective contract exposures. With every swap contract with flip clause and no margin posting ("swap contract with flip clause"), counterparties undermine themselves, sap economic efficiency, and corrode financial stability.**

Capital Rules: **Must reinforce beneficial U.S. swap margin rules for the swap contract with flip clause and offset injurious non-U.S. swap margin rules for the contract.**

Swap Margin Rules and Swap Contract with Flip Clause: **The five U.S. prudential regulators enforce a joint rule that is best-in-class globally.[7] The CFTC enforces an analogous rule that is second-best-in-class globally.[8] The SEC enforces an analogous rule that is third-best-in-class globally. The swap margin rules of most non-U.S. domiciles are worst-in-class globally.**

Beneficial U.S. Swap Margin Rules Viz-a-Viz Injurious Non-U.S. Swap Margin Rules:

1. **U.S. swap margin rules oblige a U.S. swap provider to collect and post variation margin under a new swap contract with a securitization or structured debt issuer. Margin posting generates the immense benefit of inducing U.S. securitization and structured debt issuers to forswear all swap contracts, both with and without a flip clause.**

   Non-U.S. swap margin rules de-facto *exempt* a swap provider from collecting or posting variation margin under a new contract with most securitization and structured debt issuers. As a result, non-U.S. providers grossly undercapitalize themselves and non-U.S. issuers routinely under-resource deals by entering the swap contract with flip clause.

2. **U.S. swap margin rules generally exclude all private-label securitizations and structured debt from eligible collateral. In contrast, non-U.S. rules generally allow private-label securitizations and structured debt as eligible collateral.**

Credit Ratings: **Per the public good, economic efficiency, financial stability, climate resiliency, and U.S. law, the CFTC and the SEC cannot cite, use, or otherwise rely on credit ratings.[9] Credit ratings, by design, *exclude* exposures to derivative contracts and climate events and transition.**

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[7] Harrington, Bill, "US margin rule for swaps obliges securitization issuers to overhaul structures, add resources, and rethink capital structures", *Debtwire ABS*, 5 November 2015, (https://www.sec.gov/rules/petitions/2022/petn4-790-ex2.pdf).

[8] Harrington, Bill, "CFTC swap margin rule denies relief for ABS; shines light on 'flip clauses'", *Debtwire ABS*, 18 December 2015, (https://www.sec.gov/rules/petitions/2022/petn4-790-ex3.pdf).

[9] Pimbley, Joe and Bill Harrington, "Federal Reserve Trashes Dodd-Frank Restrictions on Credit Ratings", *Croatan View*, May 20, 2020, (https://croataninstitute.org/2020/05/20/federal-reserve-trashes-dodd-frank-restrictions-on-credit-ratings/).

Today's letter draws on two plain facts about the swap contract with flip clause.

1. The contract is intrinsically and intentionally destructive; and
2. Gross governance failures by financial sector practitioners the world over—including but not limited to academicians, accountants, bond, credit rating, and derivative contract analysts, counsel, investors, issuers, journalists, regulators, risk managers, and traders—perpetuate the contract.

The two facts are irrefutable and, almost entirely owing to my work, extensively documented in the public domain, including on cftc.gov, sec.gov, and moodys.com. Today's letter treats the two facts as given.

For comprehensive and exhaustively referenced supporting work, please see my:

1. SEC petition for rulemaking File No 4-790;
2. Collective filings to the U.S. Court of Appeals for the Second Circuit regarding a high-profile, ten-year case concerning hundreds of flip clause swap contracts that Lehman Brothers provided;[10] and
3. Assessment / Questionnaire to range of practitioners that perpetuate the contract.[11]

"Everyone knows" that the swap contract with flip clause undermines economic efficiency and financial stability, with "*everyone*" including the CFTC, the SEC, other U.S. regulators, non-U.S. regulators, and financial practitioners globally. Financial institutions the world over, both U.S. and non-U.S. alike, used the swap contract with flip clause to birth and turbo-charge the 2008 financial debacle. Since 2008, non-U.S. financial institutions and securitization and structured debt issuers have wrecked economic efficiency in and across local domiciles by routinely entering swap contracts with flip clauses.

> ***"The flip clause subjects a swap dealer to its own credit risk, in addition to the credit risk of a structured debt counterparty. In fact, the rating of structured debt depends on the flip clause imposing a [total] loss on the swap dealer."***[12]

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[10] (https://croataninstitute.org/wp-content/uploads/2021/06/18-1079-bk-WJH-08-08-19-Letter-to-US-Court-of-Appeals-for-Second-Circuit-Proposed-Amicus-Curiae-Brief-Re-Case-No-18-1079.pdf and https://croataninstitute.org/wp-content/uploads/2021/06/WJH-Motion-to-File-Amicus-Brief-in-2nd-Circuit-Case-18-1079-bk-Lehman-Brothers-vs-the-World.pdf).

[11] (https://croataninstitute.org/wp-content/uploads/2021/09/20201228_Harrington_J_William_Flip_Clause_Questions_to_CFTC-SEC-LSTA-SFA-DBRS-Fitch-Moodys-SP.pdf).

[12] CFTC, "Response to WJH FOIA Request Re: Flip Clause Rulemaking", January 5, 2021, p7., (https://www.sec.gov/rules/petitions/2022/petn4-790-ex5.pdf).

> ***"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."***[13]
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> ***"For a compendium of representative swaps with a flip clause, of representative structured finance transactions party to a swap with a flip clause, and of representative providers of a swap with a flip clause, please see my Croatan Institute Working Paper "Can Green Bonds Flourish in a Complex-Finance Brownfield?" (July 2018), pages 32-38. (https://croataninstitute.org/2018/07/01/can-green-bonds-flourish-in-a-complex-finance-brownfield/)"***[14]

With each swap contract with flip clause, a swap provider knowingly under-capitalizes itself and an underwriter knowingly structures and sells under-resourced securitizations or structured debt with inflated credit ratings. Compounding the systemic destruction, all manner of entities including banks and all manner of investors including the entire gamut knowingly buy the under-capitalized, over-rated securitizations and structured debt.[15] Compounding the systemic destruction further still, many entities routinely exchange the under-capitalized, over-rated securitizations and structured debt as collateral.

"*Everyone knows*" one collective result. RMBS, CDOs, and other securitizations and structured debt of issuers that were parties to swap contracts with flip clauses imploded utterly and simultaneously in 2008. Flip-clause-laden swap providers such as Lehman Brothers, which also underwrote and owned under-resourced debt of issuer counterparties, imploded and failed. Many other swap providers such as AIG and Bear Stearns also imploded but continued operating

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[13] Harrington, William J., "Submission to CFTC 'Re: RIN 3038-AD54 Capital Requirements for Swap Dealers and Major Swap Participants'", May 4, 2017, p40 and throughout, (https://comments.cftc.gov/PublicComments/ViewComment.aspx?id=61196&SearchText).

[14] Harrington, "Op. Cit. 'Joint Submission 'Re: Petition for Rulemaking Submitted to the SEC / Moody's'", p2.

[15] "*Depending on the size of the swap, the additional cost [i.e., under-resourcing from not posting margin] may be 1%-7% of the par of securitized assets for many types of basis and interest rate swaps that are often characterized as "plain vanilla;' and considerably more for long-dated or currency swaps*." Harrington, Bill, "Margin posting: swaps increase ABS issuance costs by 1%, 3%, 7% ... of deal size – ANALYSIS", *Debtwire ABS*, May 16, 2016, p2, (https://www.sec.gov/rules/petitions/2022/petn4-790-ex4.pdf).

thanks to extraordinary rescues that the American people and people the world over funded.[16] Indeed, the swap contract with flip clause is "the untold story in the collapse of AIG".[17]

By comprehensively hollowing-out providers, end-users, and public resources, the swap contract with flip clause hobbled post-crisis recovery for a decade. Contracts remained intact and providers and deals alike petrified into zombies because almost all contracts were deeply in-the-money to providers (and, conversely, deeply out-of-the-money to securitizations and structured debt deals). The extremely skewed market-to-markets in favor of providers and the imperative to return public resources immobilized providers and deals for years. Even obviously insolvent institutions could not reorganize by declaring bankruptcy because doing so would instantly activate flip clauses and thereby vaporize the mark-to-market of each contract that was an asset. On the other side, securitization and structured debt deals could not fund large payments to terminate contracts and instead coughed up swap payment after swap payment per original schedule at the expense of deal bondholders.

The Dodd-Frank Act intentionally discourages all U.S. entities, as well as any entity operating in the U.S., from entering the swap contract with flip clause. For instance, the Act explicitly disenfranchises a party that contracts a walkaway provision with a U.S. entity that in default would be subject to FDIC or FHFA receivership.[18] The Act also strips the CFTC and SEC of customary discretion viz-a-viz exempting financial end-users from respective swap margin rules.[19] In implementing Dodd-Frank, "US regulators purposefully chose not to harmonize the

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[16] "Ibid.", see "AIG" and "Bear Stearns" throughout. Likewise, see "*AIG*" and "*Bear Stearns*" throughout Felkerson, James, "$29,000,000,000,000: A Detailed Look at the Fed's Bailout by Funding Facility and Recipient", *Levy Economics Institute of Bard College*, Working Paper No. 698, December 2011, (https://www.levyinstitute.org/pubs/wp_698.pdf).

[17] And yet, despite 104 mentions of, collectively, "*ABS*", "*asset-backed*", "*CDO*", "*collateralized-debt obligation*", "*mortgage-backed*", and "*RMBS*", there is no mention of "*flip clause*" in Peirce, Hester, "Securities Lending and the Untold Story in the Collapse of AIG", *Mercatus Center, George Washington University*, Working Paper No. 14-12, May 2014, (https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2435161).

[18] "*. . . no walkway clause shall be enforceable in a qualified financial contract of a covered financial company in default.*" (Dodd-Frank Act, § 210, 124 Stat. 1488.)

[19] US Department of the Treasury, "A Financial System That Creates Economic Opportunities—Capital Markets, Report to President Donald J. Trump, Executive Order 13772 on Core Principles for Regulating the United States Financial System," October 2017, page 179. "*Dodd-Frank amended CEA Section 4(c)(1) and Exchange Act Section 36(c) to limit the agencies' ability to exempt many of the activities covered under Title VII. Limitations on the exemptive authority with respect to the swaps requirements of Dodd-Frank was perhaps a measure to ensure that the agencies, while writing rules and implementing the new regulatory framework, did not unduly grant exemptions*." (https://www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-Capital-Markets-FINAL-FINAL.pdf.)

swap margin rule with evolving EU policy that may exempt many ABS issuers from margin posting."[20]

For so long as the obtaining legislation and regulation is intact and enforced, an entity that is domiciled or otherwise operates in the U.S. is unlikely to enter a swap with flip clause, and therefore less likely to harm the American people by inciting economic mayhem or drawing on public resources.[21]

In domiciles where a regulated entity can enter the swap contract with flip clause—for instance Australia, Canada, the European Union, Japan, and the United Kingdom—the entity exposes itself to enormous losses and undermines all financial systems, local, U.S., and global. Flip-clause friendly domiciles operate deficient financial regulation both on an outright basis and compared to the U.S. The domiciles compound systemic risk by specifying under-resourced securitizations and structured debt, both with and without swap contracts, as good collateral, and by using credit ratings to calculate collateral eligibility and haircuts.

Exacting Comparability Determinations for Japan and for All Domiciles!

> "*The Commission estimates that approximately 53 CSEs may request a comparability determination pursuant to Commission Regulation 23.160(c).*"[22]

Ultimately, the CFTC expects it will have issued a total of 17 comparability determinations, 16 for G20 domiciles and one for Switzerland. The CFTC must be exacting in making each comparability determination. Neither the 53 CSEs [covered swap entities] that may request a comparability determination for any domicile nor the G-20 and Swiss financial regulators who may request a comparability determination for their respective domiciles can ringfence non-U.S. activities from

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[20] Harrington, "Op, Cit., 'Margin posting: swaps increase ABS issuance costs by 1%, 3%, 7% ... of deal size – ANALYSIS", *Debtwire ABS*, May 16, 2016, p3.

[21] Industry groups such as the Structured Finance Association and predecessor Structured Finance Industry Group have repeatedly pushed the CFTC to exempt securitization and structured debt issuers from margin posting requirements. The groups may resume the push for exemption given the increase in U.S. interest rates. The CFTC Letter No. 17-52 of October 27, 2017, in which the CFTC caved with respect to a very limited instance of potential modification of some existing swap contracts with flip clauses, is damaging precedent. See Harrington, William J., "CFTC Letter No. 17-52, No Action, 27 October 2017, Division of Swap Intermediary Oversight", February 8, 2018. *Wikirating.org* posts as "31 Misrepresentations in CFTC Letter No. 17-52", (https://www.wikirating.org/data/other/20180203_Harrington_J_William_31_Misrepresentations_in_CFTC%20_Letter_No_17-52.pdf).

[22] CFTC, "Agency Information Collection Activities: Notice of Intent To Renew Collection 3038–0111, Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants—Cross-Border Application of the Margin Requirements", August 5, 2022, (https://www.cftc.gov/sites/default/files/2022/08/2022-16774a.pdf).

a potential draw on U.S. public resources. As the 2008 debacle demonstrated, central banks, and any non-U.S. entity with out-sized losses outside the U.S., can draw U.S. public resources.[23]

The CFTC must make an "ironclad" commitment to benchmark all actions against best practice, which is "critical for sound regulation". For comparability determinations and other cross-border actions that are "essential to our global derivatives markets", the CFTC must first disavow worst-practice benchmarks such as "international comity and deference." CSEs and regulators invoke the bromides to justify actions that socialize CSE exposures, sap economic efficiency, and undermine U.S. and global financial stability.[24]

> "*Clear-sighted regulation of derivative contracts is vital to the well-being of our Country. The Commission must respect above all else the well-being of US human beings and the preservation of the US financial system. Deference is a joke given our pre-eminence in derivatives, which will grow post-BREXIT. The CFTC must restrict 'international comity and deference' to the proper spheres, e.g., when Chair Emeritus Giancarlo next attends a Downton Abbey tea party or beseeches His Holiness to beatify credit default swaps with flip clauses.*"[25]

A CSE that is party to a swap contract with flip clause anywhere in the world has "*a direct and significant connection with activities in . . . [and] . . . effect on, commerce of the United* States."[26] The CSE plies deficient accounting to under-resource itself by under-resourcing each contract and obtains inflated credit ratings to conceal the under-resourcing from local and U.S. regulators, markets, and investors. Likewise, *any* CSE that exchanges as margin collateral *any* private-label securitization or structured debt regardless of whether the issuer is party to a swap contract with flip clause. The CSE has "*a direct and significant connection with activities in . . . [and] . . . effect*

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[23] See "*central bank*" and "*Fortis Bank SA/NA*" in Felkerson, James, "$29,000,000,000,000: A Detailed Look at the Fed's Bailout by Funding Facility and Recipient", *Levy Economics Institute of Bard College*, Working Paper No. 698, December 2011, (https://www.levyinstitute.org/pubs/wp_698.pdf).

[24] "*International comity and deference as well as clarity in our supervisory activities are critical for sound regulation. Because they are essential to our global derivatives markets, my commitment to them is ironclad.*" CFTC Chairman Heath P. Tarbert, March 4, 2020, (https://www.cftc.gov/PressRoom/PressReleases/8125-20).

[25] Harrington, William J. "Joint Submission to CFTC 'Re: '§ 13.1 Petition . . .' / 'Comment to Global Markets Advisory Committee Subcommittee on Margin Requirements for Non-Cleared Swaps . . . . ' / 'Capital Requirements of Swap Dealers and Major Swap Participants . . .' / 'Cross-Border Application of the Registration Thresholds and Certain Requirements Applicable . . .' May 26, 2020, (https://comments.cftc.gov/PublicComments/ViewComment.aspx?id=62638&SearchText=).

[26] CFTC, "Op. Cit. (CFTC Margin Collection Number 3038–0111)." "*Section 2(i) of the CEA provides that the provisions of the CEA relating to swaps that were enacted by the Wall Street Transparency and Accountability Act of 2010 (including any rule prescribed or regulation promulgated under that Act), shall not apply to activities outside the United States unless those activities (1) have a direct and significant connection with activities in, or effect on, commerce of the United States . . .*"

on, commerce of the United States" because it over-estimates collateral performance to under-resource itself and obtains inflated credit ratings to conceal the under-resourcing from local and U.S. regulators, markets, and investors.

Fortunately for the American public, the CFTC can oblige CSEs to start adequately resourcing non-U.S. activities by adhering to a common precept for swap margin in each comparability determination.[27] *A CSE will comply with the more stringent of either the U.S. swap margin rules or the equivalent local rules in providing a new swap contract with clause to a securitization or structured debt issuer and in exchanging margin under any contract.*

Each comparability determination must specify the following best-practices for swap margin for a swap contract with flip clause.
— A CSE and securitization or structured debt issuer exchange variation margin daily.
— Whichever party has the mark-to-market asset holds haircut variation margin with value at least equal to mark-to-market.
— Thresholds are de minimis and transfer amounts low.

Each comparability determination must specify the following best-practices for margin for all derivative contracts, including but not limited to the swap contract with flip clause.
— Eligible collateral is tightly constrained and excludes all private-label securitization and structured debt.
— Collateral calculations do not use credit ratings.

CFTC Comparability Determinations Must Protect the U.S, not CSE Earnings
The CFTC must not greenlight injurious finance that serves only to maximize CSE earnings and compensation. In benchmarking actions to best practice, the CFTC will summarily reject self-serving schemes to saddle the American public with intentionally under-resourced CSE exposures. The CFTC can easily dismiss proposals that would harm the U.S. by posing two simple questions. *Has the CSE sacrificed to the same extent that is being asked of the American people? Has the CSE cut compensation to minimize the burden that would be foisted on the American people?*

There are ***NO*** meaningful "*burdens associated with the following aspects of the Commission's Final Rule: (1) requesting a comparability determination from the Commission; (2) maintaining policies and procedures for compliance with the Commission's special provisions for non-netting jurisdictions and non-segregation jurisdictions; and (3) maintaining books and records properly*

[27] "Ibid.", "*Once a comparability determination is made for a jurisdiction, it applies for all entities or transactions in that jurisdiction to the extent provided in the comparability determination, as approved by the Commission and subject to any conditions specified by the Commission [emphasis added]*.

documenting that all of the requirements of the special provisions for non-netting jurisdictions and non-segregation jurisdictions are satisfied."[28]

Let's be crystal clear: CSEs face few if any undue "burdens" today, and would likewise face few if any undue "burdens" if suddenly obligated to enact best-practices around the world tomorrow. The U.S. public directly and indirectly subsidizes CSE finance, which allows CSEs to generate outsized earnings and pay outsized compensation. The U.S. public bears undue CSE burdens. CSEs themselves do not.

"Requesting a comparability determination from the Commission" is something a "CSE that is eligible for substituted compliance" can do in its sleep, given that CSEs may "individually or collectively" make the request. Each of the 53 CSEs, as well as parents, affiliates, and industry groups, devote infinitely more resources to offloading CSE exposures onto the U.S. public by pressing to block new regulations and roll-back existing ones.[29] By comparison, *requesting* a comparability determination is easy peasy.

By the same American-subsidized token, every CSE can easily and must maintain *best-practice* policies and procedures to comply with CFTC special provisions for non-netting jurisdictions and non-segregation jurisdictions, and maintain books and records to document said compliance.

Finally, "requesting a comparability determination from the Commission" is among the basic tasks of "a foreign regulatory agency that has direct supervisory authority over one or more CSEs and that is responsible for administering the relevant foreign jurisdiction's margin requirements." "Foreign regulatory" agencies routinely and continuously communicate with each other and U.S. regulators. Moreover, the CFTC and all U.S. and non-U.S. regulators convene regularly via IOSCO and other bodies to decide and assess policy, including for CSEs and swap margin. Lastly, all financial regulators, not excluding the CFTC, other U.S. regulators, and non-U.S. regulators, are inherently *political* entities that first and foremost implement priorities of domestic power structures.

For instance, the respective power structures in Australia, the EU, Japan, and the UK obligate local regulators to greenlight worst-practices such as de-facto exempting a CSE from exchanging variation margin under a new swap contract with a securitization or structured debt issuer,

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[28] Unless noted otherwise, this section quotes CFTC, "Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants—Cross-Border Application of the Margin Requirements, Collection Number 3038–0111", August 5, 2022, (https://www.cftc.gov/sites/default/files/2022/08/2022-16774a.pdf).

[29] Harrington, William J., "CFTC Letter No. 17-52, No Action, 27 October 2017, Division of Swap Intermediary Oversight." February 8, 2018. *Wikirating.org* posts as "31 Misrepresentations in CFTC Letter No. 17-52", (https://www.wikirating.org/data/other/20180203_Harrington_J_William_31_Misrepresentations_in_CFTC%20_Letter_No_17-52.pdf).

allowing all entities to exchange securitization and structured debt as good collateral, and using credit ratings to determine collateral eligibility and calculate haircuts. The expense to the U.S. public in subsidizing non-U.S. political priorities is so great that a non-U.S. regulator must assume what are at most negligible costs to request a comparability determination.

One US Person Fields *ALL* Commissioner Questions on Comparability of Japan Capital Rules

> "*I look forward to the public's submission of comments and feedback on this proposed determination and order.*"[33]

How many members of the public *can* comment on the comparability of Japan capital rules viz-a-viz CFTC capital rules?

How many members of the public can comment on the comparability of Japan capital rules viz-a-viz CFTC capital rules *in conjunction with* the analogous 2016 comparability determination for the respective swap margin requirements?[34]

How many members of the public who can comment on the comparability of Japan capital rules viz-a-viz CFTC capital rules in conjunction with the analogous 2016 comparability determination for the respective swap margin requirements *have* commented?

Of that person or persons, how many have submitted *wholly disinterested* comments?[35]

I know of *one* member of the public who has submitted a wholly disinterested comment on the comparability of Japan capital rules viz-a-viz CFTC capital rules in conjunction with the analogous 2016 comparability determination for the respective swap margin requirements.

> "*The CFTC approved a 'comparability determination' that permits 'substituted compliance' with the swap margin rules of Japan on 8 September.*
> *II*
> *"U.S. dealers that are operating in the ABS sector in Japan cannot ignore the CFTC margin rule, based on a close read of the commission vote and supporting materials, including: commissioner statements and questions; staff responses and analysis; 85 pages of*

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[33] "CFTC, "Notice of Proposed Order and Request for Comment on an Application for a Capital Comparability Determination From the Financial Services Agency of Japan", "*Appendix 2—Statement of Support of Chairman Rostin Behnam",* August 8, 2022, (https://www.cftc.gov/sites/default/files/2022/08/2022-16684a.pdf).

[34] CFTC, "Comparability Determination for Japan: Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants", September 15, 2016, (https://www.cftc.gov/LawRegulation/FederalRegister/OrdersandOtherAnnouncements/2016-22045.html).

[35] The rule docket posted ***ZERO*** comments from natural persons, ***ZERO*** comments from corporate persons, and ***ZERO*** comments industry spokesperson as of October 5 at 2:00 PM.

comparison with the JFSA [Japanese Financial Services Agency] rules; and the CFTC margin rule itself.
II
"Debtwire ABS conducted this extensive review because the CFTC declined to respond to the following questions after spending three months closely reviewing the JFSA rules:

"Do the JFSA rules differ from the CFTC rules with respect to:

"asset-backed securities, securitization instruments or special-purpose vehicle instruments as eligible collateral for either variation or initial margin;

"issuers of asset-backed securities, or securitizations or special-purpose vehicles and the daily posting and collecting of variation margin; or

"treatment of uncleared swaps that contain a walk-away provision or a flip clause?" [36]

The comparability determination for Japan capital rules will immediately impact three Japanese affiliates of U.S. mega-banks—BofA Securities Japan Co. Ltd, Goldman Sachs Japan Co Ltd, and Morgan Stanley MUFG Securities Co Ltd, respectively.

"Currently, this proposal would apply to Japanese affiliates of Bank of America, Morgan Stanley and Goldman Sachs—three systemically important institutions and three of the largest TARP recipients having collectively received $60 billion in TARP capital injections. Therefore, it is vital that the CFTC ensures that these swap dealers have adequate amounts of high-quality capital. Public comment will be helpful on whether the CFTC is correct in its preliminary determinations of comparability."[37]

Commonsense argues that the proposed comparability determination for Japan capital rules would allow Bank of America, Goldman Sachs, and Morgan Stanley to *instantaneously* under-capitalize themselves by under-capitalizing the respective Japanese CSE affiliates. What prompts the CFTC to facilitate Bank of America, Goldman Sachs, and Morgan Stanley in under-capitalizing themselves? Likewise, common sense argues that the proposed comparability determination would allow Bank of America, Goldman Sachs, and Morgan Stanley to *perpetually* under-capitalize themselves by greenlighting the respective Japanese CSE affiliates to perpetually undertake under-resourced activities that the CFTC capital rules discourage. What prompts the CFTC to facilitate Bank of America, Goldman Sachs, and Morgan Stanley in perpetually

[36] Harrington, Bill. "CFTC lets ABS sector guess on global implementation of swap rules", *Debtwire ABS*, 14 September 2016. Available on request.

[37] "Op. Cit. (CFTC Proposed Comparability Determination Japan Capital Rules)", "*Appendix 4—Statement of Support of Commissioner Christy Goldsmith*".

undercapitalizing themselves via Japanese CSE affiliates that perpetually accumulate more under-resourced exposures?

Informed commonsense argues that a comparability determination on Japan capital rules must consider the analogous 2016 comparability determination on Japan swap margin requirements. Taken together, the two Japan comparability determinations would allow Bank of America, Goldman Sachs, and Morgan Stanley to under-resource themselves by under-resourcing the respective Japanese CSE affiliates providing non-U.S. securitization and structured finance issuers with swap contracts, including the swap contracts with flip clause. What prompts the CFTC to greenlight Bank of America, Goldman Sachs, and Morgan Stanley to under-capitalize themselves by grossly under-capitalizing the respective Japan CSE affiliates, and thereby also allowing securitization and structured debt issuers to under-resource deals?

Finally, the comparability determination, for however long it is outstanding, will impact every additional Japanese non-bank entity that becomes a CSE. Commonsense argues that the proposed comparability determination might incentivize other Japanese entities to follow the example of the three Japanese CSE affiliates and register with the CFTC. What prompts the CFTC to facilitate additional CSEs in under-capitalizing themselves by perpetually accumulating under-resourced exposures?

CSE Incurs 100% Counterparty Risk to *Itself* with Each Swap Contract with Flip Clause

> "*Capital protects the solvency of the swap dealer from unexpected losses such as counterparty defaults and margin collateral failures. Capital requirements are aimed at ensuring a swap dealer has the ability to absorb losses and they prevent market disruption by helping to ensure that swap dealers continue to perform their critical function to provide liquidity and market making.* ***Capital along with margin requirements for uncleared swaps reduces the potential for contagion, thereby lowering systemic risk in the financial system, and promoting financial stability*** *[emphasis added]*."[38]
>
> "*Capital requirements play a critical role in fostering the safety and soundness of financial markets. As indicated in the Commodity Exchange Act, capital requirements protect market participants against risks such as* ***counterparty default*** *[emphasis added]."*[39]

[38] "Op. Cit. (CFTC Proposed Comparability Determination Japan Capital Rules)", "*Appendix 4—Statement of Support of Commissioner Christy Goldsmith*".

[39] "Op. Cit. (CFTC Proposed Comparability Determination Japan Capital Rules)", "*Appendix 3—Statement of Support of Commissioner Kristin N. Johnson*".

> ***"The flip clause subjects a swap dealer to its own credit risk, in addition to the credit risk of a structured debt counterparty. In fact, the rating of structured debt depends on the flip clause imposing a [total] loss on the swap dealer*** *[emphasis added]."*[40]
>
> "*Substituted compliance must leave U.S. markets and our economy at no greater risk than full compliance with our rules."*[41]

The CFTC must condition the comparability determination for Japan capital rules on:

1. **Stating that the 2016 comparability determination for Japan swap *margin* requirements obligates a CSE to adhere to all aspects of the *CFTC* swap margin requirements in providing a swap contract with flip clause; or**
2. **Obligating a CSE to adhere to all aspects of the CFTC swap margin requirements in providing a swap contract with flip clause; or**
3. **Prohibiting a CSE from entering a new swap contract with flip clause or extending an existing one; or**
4. **Enacting my petition for rulemaking of May 26, 2020, by issuing a "*rule that prohibits a Swap Dealer, Major Swap Participant, or other regulated entity from predicating a swap obligation on a flip clause, walk-away, or variable subordination.*"**

Apart from the CFTC swap margin requirements, no aspect of CFTC oversight nor any aspect of Japanese oversight obligates a CSE to adequately resource a swap contract with flip clause by offsetting the 100% self-exposure that each contract imposes. For instance, the *Japan swap margin requirements* set a large threshold for securitization and structured debt issuers that de-facto *exempts most issuers* from exchanging any variation margin with a CSE. The CFTC comparability determination for Japan margin requirements upholds the de-facto exemption by merely noting the threshold and not specifying CSE mitigation.[42]

Similarly, *neither CFTC nor Japan capital requirements* obligate a CSE to adequately *capitalize* the 100% self-exposure that each swap contract with flip clause imposes. The CFTC exclusion is a spectacular failure in all respects, not least a failure of common sense given the common

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[40] CFTC, "Response to WJH FOIA Request Re: Flip Clause Rulemaking", January 5, 2021, p7. (https://www.sec.gov/rules/petitions/2022/petn4-790-ex5.pdf).

[41] "Op. Cit. (CFTC Proposed Comparability Determination Japan Capital Rules)", "*Appendix 4—Statement of Support of Commissioner Christy Goldsmith*".

[42] Harrington, "Op. Cit., CFTC lets ABS sector guess on global implementation of swap rules", *Debtwire ABS*, 14 September 2016. "*Any Japanese financial end-user with less than USD 3bn in average notional of derivatives, which presumably covers most ABS [asset-backed security] issuers, is effectively exempt from margin posting under the FSA regime. 'In general, the threshold for variation margin is whether the average total amount of the notional principal of OTC Derivatives for a one-year period . . . exceeds JPY 300 bn', states the CFTC commentary."*

knowledge that crisis-causing swap dealers spectacularly undermined themselves by spectacularly under-capitalizing each swap contract with flip clause.[43]

> "*The decision by the United States Bankruptcy Court for the Southern District of New York plainly shows that 100% of the flip clauses in 100% of the 44 CDOs ipso facto modified LBSF's [Lehman Brothers Special Financing] rights by 100%.*
>
> ***'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.'*** *(Memorandum Decision, Page 11. Emphasis added.)*"[44]

The CFTC exclusion is also a spectacular failure of governance because the initial proposal for capital requirements elicited a spectacularly easy-to-implement treatment for the swap contract with flip clause.

> "*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,*

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[43] Harrington, William J., "Submission to CFTC 'Re: RIN 3038-AD54 Capital Requirements for Swap Dealers and Major Swap Participants'", May 4, 2017, pp44-51, (https://comments.cftc.gov/PublicComments/ViewComment.aspx?id=61196&SearchText).

[44] Harrington, William J, "Proposed Amicus Curiae Brief to the US 2nd Circuit re: Case No. 18-1079 (:ehman vs 250 Financial Entities Re Flip Clause Enforceability", 25 June 2019, p47, (https://croataninstitute.org/wp-content/uploads/2021/06/18-1079-bk-WJH-08-08-19-Letter-to-US-Court-of-Appeals-for-Second-Circuit-Proposed-Amicus-Curiae-Brief-Re-Case-No-18-1079.pdf).

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."[45]

Moreover, the treatment was both spectacularly comprehensive and spectacularly adaptable, as evidenced by the proposed additions to and rationales for, respectively, the:

1. Requirements for "*SDs to meet defined liquidity and funding requirements and is proposing certain limitations on the withdrawal*";
2. Ensuring "*the safety and soundness of the SDs subject to its jurisdiction*";
3. Differentiation between "*categories of counterparties [that] present different levels of risk*";
4. "*Belief that financial firms generally present a higher level of risk than non-financial firms*";
5. "*Capital . . . 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*";
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*";[46]
7. "*Proposed bank-based capital approach*";
8. "*Proposed USD 20mm fixed amount of tier 1 capital*";
9. "*Proposed minimum capital requirement based on an SD's common equity tier 1 capital*";
10. "*Proposed minimum capital requirement based upon eight percent of the SD's risk weighted assets*";[47]
11. "*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"*;[48]
12. Inclusion of "*cleared swaps*" in the capital calculation requirements;
13. Inclusion of "*uncleared swaps*" in the capital calculation requirements;[49]
14. "*Proposed USD 20mm fixed-dollar amount of net capital*";
15. "*Proposed minimum USD 100mm fixed dollar amount of tentative net capital*";

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[45] Harrington, William J., "Submission to CFTC 'Re: RIN 3038-AD54 Capital Requirements for Swap Dealers and Major Swap Participants'", May 4, 2017, p2 and throughout, (https://comments.cftc.gov/PublicComments/ViewComment.aspx?id=61196&SearchText).

[46] "Ibid.", pp3-4 and throughout.

[47] "Ibid.", p24.

[48] "Ibid.", p24 and throughout.

[49] "Ibid.", p25.

16. "*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)*";
17. "*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"*;[50]
18. "*All aspects of the proposed tangible net worth capital approach for SDs that are predominantly engaged in non-financial activities*"; [51]

    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.*"[52]
19. "*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*";
20. "*Market risk and credit risk associated with the SD's security-based swap positions*";[53]
21. "*Proposed capital requirements for MSPs*";
22. "*Tangible net worth test*";
23. "*Net liquid assets approach*";
24. "*Bank-based capital approach*"
25. "*Proposed minimum capital requirement for MSPs*";
26. "*Proposed Regulation 23.101(b)*";[54]
27. "*All aspects of the proposed amendments to the FCM capital requirements*";
28. "*Proposed minimum adjusted net capital requirement of USD 20mm*";
29. "*Proposed minimum net capital requirement of USD 100mm*";
30. "*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*";[55]
31. "*All aspects of the proposed model approval process and the computation of the credit risk charges*."[56]

    "*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*

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[50] "Ibid.", pp29-30.
[51] "Ibid.", p31.
[52] "Ibid.", p31 and throughout.
[53] "Ibid.", p32.
[54] "Ibid.", pp34-36.
[55] "Ibid.", pp37-38.
[56] "Ibid.", pp40-51.

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.*"[57]

32. "*Proposed models*";
33. "*Proposed model review process*";[58]
34. "*Commission and NFA consideration of "a prudential regulator's or foreign regulator's review and approval of capital models that are used in the corporate family*";[59]

"***Prudential regulators' respective reviews and approvals of capital models*** [emphasis added] *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.' A flip clause operates very similarly to a walkaway provision and may be categorized as one.

"B. The '<u>Margin and Capital Requirements for Covered Swap Entities</u>' 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."[60]

35. "*Capital models already approved by a prudential or foreign regulator*";[61]

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[57] "<u>Ibid.</u>", p40 and throughout.
[58] "<u>Ibid.</u>", p52.
[59] "<u>Ibid.</u>", pp52-53 and throughout.
[60] "<u>Ibid.</u>", pp52-53 and throughout.
[61] "<u>Ibid.</u>", pp52-53 and throughout.

"***Foreign regulators may have conducted their respective reviews and approvals of capital models*** [emphasis added] *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.*

"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."[62]

36. "*Other approaches available to facilitate the timely review of applications from SDs to use internal models*";
37. "*Proposed methods of computing the credit risk charge*";
38. "*Method of computing the counterparty exposure charge*";
39. "*Conditions for taking netting agreements into account when calculating the credit equivalent amount*";
40. "*Method of computing the counterparty concentration charge*";
41. "*Method of computing the portfolio concentration charge*";[63]
42. "*All aspects of the proposed capital rule and liquidity requirements*";
43. "*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*";
44. "*Alternative approaches to the proposed liquidity requirements*";[64]
45. *"All aspects of the proposed financial reporting, recordkeeping and notification requirements*";[65]
46. "*Any aspect of the proposed information collection requirements*";[66]
47. "*Protection of market participants and the public*";[67]

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62 "Ibid.", p53 and throughout.
63 "Ibid.", pp55-57.
64 "Ibid.", pp58-61.
65 "Ibid.", pp62-68.
66 "Ibid.", pp69-71.
67 "Ibid.", pp72-75.

48. "*Mitigation of harmful impact on efficiency, competitiveness and integrity of the US swaps market, the US financial system and the US economy*";[68]
49. "*Efficiency, Competitiveness, and Financial Integrity of Swaps Markets*";[69]
50. "*Improvement of price discovery*";[70]
51. "*Sound management risk practices*";[71]
52. "*Other public interest considerations*";[72]
53. "*Cost-benefit analysis*";[73]
    i. "*The cost/benefit analysis produces a defensible finding*.
    ii. "*The CFTC Proposal, if in place in 2003, would have moderated or even prevented the financial crisis.*
    iii. "*The CFTC Proposal would have survived this cost/benefit analysis in 2003*."[74]
54. "*Estimation [of] precise costs of these proposed requirements and . . . comments on how the proposed rule would impact the capital structure and the cost of doing business*";[75]
55. "*Capital for uncollateralized swap exposures to counterparties*";
56. "*Margin vs capital*";
57. "*Model vs table*";
58. "*Liquidity requirement and equity withdrawal restrictions*"; and
59. "*Other considerations*.[76]

Likewise, the CFTC exclusion is a spectacular failure of governance because the follow-up re-proposal for capital requirements elicited an even easier-to-implement treatment for the swap contract with flip clause.

"*The CFTC Must Eradicate the Flip Clause*."[77]

The CFTC exclusion is a spectacular failure of self-respect given the number of CFTC and other U.S. regulatory professionals drafting swap margin rules whom a colleague and I briefed on the spectacular, designed-to-fail attributes of the swap clause with flip clause in 2015.

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[68] "Ibid.", p76 and throughout.
[69] "Ibid.", pp75-81.
[70] "Ibid.", pp82-86.
[71] "Ibid.", pp87-93.
[72] "Ibid.", pp94-95.
[73] "Ibid.", pp96-97, and 107-110.
[74] "Ibid.", pp96-97, and 107-110.
[75] "Ibid.", pp98-109.
[76] "Ibid.", p110-122.
[77] Harrington, William J., "Submission to CFTC 'Re: RIN 3038-AD54 Capital Requirements for Swap Dealers and Major Swap Participants (A Proposed Rule by the CFTC on 12/19/2019)'", March 3, 2020, p2 and throughout, (https://comments.cftc.gov/PublicComments/ViewComment.aspx?id=62366&SearchText=).

"*A flip clause is (pick one or more metaphors):*

1. *the sole province of the ABS sector and unavailable to other end-users of swap contracts such as municipalities and corporations;*
2. *not a disclosure requirement for ABS issuers under Reg AB II;*
3. *a lynchpin of most ABS worldwide;*
4. *a ticking time bomb;*
5. *an original sin of the ABS sector;*
6. *a traffic light that simultaneously signals red and green;*
7. *a prime example of rating agency conflict of interest;*
8. *a systemic problem that grows with each new ABS and doesn't dissipate over time;*
9. *a natural outcome when investors assume they'll be bailed out again;*
10. *a provision that can't withstand close scrutiny with respect to fiduciary responsibility, risk management, capital requirements, governance, sustainability, or commonsense;*
11. *catnip for legal counsel who can opine until the cows come home on the differences between US and UK bankruptcy law;*
12. *an embarrassment for legal counsel whose enforceability opinions carve-out flip clauses;*
13. *an indication that neither the US nor the EU knows how to revive growth and is trotting out securitization in desperation; and/or*
14. *something that will be dealt with after a bank counterparty fails. [Footnote 7] After all, no one could have seen it coming and sayin' anything different is just bein' a Monday-morning quarterback.*"[78]

Finally, the CFTC exclusion violates the Administrative Procedure Act by being *arbitrary, capricious, and an abuse of discretion*, as the rule itself demonstrates.

For a start, the rule omitted any mention of my first submission of May 4, 2017, and thus its application to at least 59 elements of the proposal, including: differentiation between categories of counterparties; a key aim of the proposal that 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; various minimum capital requirements; inclusion of cleared and uncleared swaps in capital calculation requirements; various capital approaches; proposed model approval process and the computation of the credit risk charges; Commission and NFA consideration of a prudential regulator's or foreign regulator's review and approval of capital models that are used in the corporate family; capital models

[78] Harrington, William J, "External Meeting for Proposed Rule 79 FR 59898 Presentation to Rule Writing Teams from the CFTC, FCA, FDIC, FHFA, FRB, and OCC", May 12, 2015, p8, (https://www.federalreserve.gov/newsevents/rr-commpublic/harrington-michalek-call-20150512.pdf).

already approved by a prudential or foreign regulator; computing the credit risk charge; computing the counterparty exposure charge; conditions for taking netting agreements into account when calculating the credit equivalent amount; computing the counterparty concentration charge; computing the portfolio concentration charge; alternative approaches to the proposed liquidity requirements; protection of market participants and the public; improvement of price discovery; sound management risk practices; cost-benefit analysis; capital for uncollateralized swap exposures to counterparties; margin vs capital; and model vs table.

Instead, the rule mentioned only my March 2, 2020, response to the re-proposal and minimized the import by misrepresenting the proposal as merely a "charge" plus an add-on for "market risk."[79]

> "*Another commenter stated that a covered SD that enters into a swap with uncleared swap contracts containing a flip-clause should require a charge for required margin on such contract plus market risk. [Footnote] 87*
>
> *"[Footnote] 87 Letter from William Harrington (3/3/2020) (Harrington 3/3/2020 Letter)."*[80]

The exclusion rationale further winnows the misrepresentation of my proposal for CSE self-exposure under a swap contract with flip clause by pigeonholing it solely under "market risk" rather than as integral to counterparty exposure, portfolio concentration, and at least 56 other categories. In other words, the CFTC performed a "bait-and-switch" as follows. The CFTC baited the rationale with "*standardized market risk capital charges*", fatuously added "*Commission's long experience*", made the switch in eliding CSE counterparty self-exposure and portfolio concentration altogether, and blithely concluded "*appropriately accounts for . . . required capital in these firms*".[81]

> "*The standardized market risk capital charges being adopted are generally based on existing Commission and SEC standardized market risk charges for positions in foreign currencies, commodities, U.S. treasuries, equities and other instruments, which, in the Commission's long experience, have generally proven to be effective and appropriately*

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[79] My submission to the re-proposal clearly identifies both submissions. "*Attachment contains my second comment (March 3, 2020. My first comment is dated May 4, 2017.)*" Harrington, William J., "Submission to CFTC 'Re: RIN 3038-AD54 Capital Requirements for Swap Dealers and Major Swap Participants (A Proposed Rule by the CFTC on 12/19/2019)'", March 3, 2020, (https://comments.cftc.gov/PublicComments/ViewComment.aspx?id=62366&SearchText=).

[80] CFTC, "17 CFR Parts 1, 23, and 140, RIN 3038–AD54, 'Capital Requirements of Swap Dealers and Major Swap Participants'", Federal Register / Vol. 85, No. 179 / Tuesday, September 15, 2020 / Rules and Regulations 57475, (https://www.cftc.gov/sites/default/files/2020/09/2020-16492a.pdf).

[81] "Ibid."

calibrated to address potential market risk in the positions. ***The Commission believes at this time that this approach, in conjunction with other charges discussed herein, appropriately accounts for the wide variety of possible uncleared swap transactions that FCMs, FCM–SDs, and covered SDs may engage in, including bespoke swap transactions involving flip-clauses or other unique features*** *[emphasis added]. Overtime, the Commission may consider adjusting these charges as a result of experience with their impacts on required capital in these firms and as market developments may warrant."*[82]

I certainly provided the CFTC with ample information and analyses that the opposite was the case, namely, that nothing in either the "*existing Commission and SEC standardized market risk charges"* or "*other charges discussed*" in the initial and follow-up rule proposals "*appropriately accounts for . . . swap transactions with flip-clauses*". In fact, I have been the only person anywhere, either inside or outside the CFTC, to provide the CFTC with flip clause information and analyses, as CFTC materials that I obtained via a Freedom of Information Act request demonstrate. Review of the materials entirely undo the CFTC rationale for excluding flip clause treatment from the capital rule.[83]

"***The Commission rationale for not imposing a 100% capital charge on an uncleared swap with a flip clause is <u>arbitrary</u>****. The flip clause subjects a swap dealer to its own credit risk, in addition to the credit risk of a structured debt counterparty. In fact, the rating of structured debt depends on the flip clause imposing a [total] loss on the swap dealer. No other 'bespoke' component of any swap contract that the Commission regulates subjects a swap dealer to its own credit risk. 'Existing Commission and SEC standardized market risk charges' entirely ignore the self-referencing credit risk that a swap dealer assumes in booking a swap with a flip clause.*

"***The Commission rationale for not imposing a 100% capital charge on an uncleared swap with a flip clause is <u>capricious</u>.*** *The 'Commission's long experience' with swap contracts with a flip clause does not even cover the 2008 crisis when the contracts started and fueled the financial crisis. In fact, the Commission did not begin evaluating swap contracts with a flip clause until a former Moody's legal colleague and I challenged the*

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[82] "<u>Ibid.</u>"

[83] CFTC, "<u>Response to WJH FOIA Request Re: Flip Clause Rulemaking</u>", January 5, 2021, p2, (<u>https://www.sec.gov/rules/petitions/2022/petn4-790-ex5.pdf</u>). "*This is in response to your request dated December 17, 2020, under the Freedom of Information Act seeking access to [all information pertaining to 'swap transactions involving flip clauses' that the Commission either used or uses in establishing that it 'believes' that the 'standardized market risk capital charges' in Commodity Futures Trading Commission 'Capital Requirements of Swap Dealers and Major Swap Participants' (September 15, 2020) 85 FR 57465 are 'effective and appropriately calibrated' . . .]*"

Commission to do so in 2015. Only a capital charge of 100% can address the market risk of a swap asset that loses 100% of its value on the day that a swap dealer enters bankruptcy or is declared insolvent.

"***The Commission rationale for not imposing a 100% capital charge on an uncleared swap with a flip clause is an abuse of discretion.*** *I have provided the Commission with a wealth of information on the correct method to capitalize a flip clause swap contract. I imposed the method on swap dealers such as Merrill Lynch Derivative Products, Nomura Derivative Products, and Lehman Brothers Financial Products from 2000 to 2010. The Commission belief that its 'approach, in conjunction with other charges discussed herein, appropriately accounts for the wide variety of possible uncleared swap transactions that FCMs, FCM-SDs, and covered SDS may engage in, including bespoke swap transactions involving flip clauses' is as unfounded as President Trump's core belief that the coronavirus will 'just disappear.'*

II

"*The Country cannot expect the Commission to do anything but undermine the financial system. However, I can help the Country understand the full extent to which the financial sector has co-opted the Commission by flushing out Commission rationales that are arbitrary, capricious, and an abuse of discretion.*"[84]

To finish answering Commissioner questions regarding the proposed comparability determination for Japan capital rules, the latter cannot be compared to CFTC capital rules in isolation but rather must be evaluated in tandem with the respective CFTC and Japan swap margin rules, as well as comparisons of other areas of CFTC and Japan FSA oversight. As the proposed comparability determination demonstrates, no element of the CFTC capital rules or the Japan capital rules address the 100% self-exposure that a CSE incurs under each swap contract with flip clause.

"*I look forward to commenters' response on the question as to whether Japan's capital requirement in an amount equal to 25% of operating expenses is comparable in purpose and effect to the CFTC's capital requirement equal to 8% of the uncleared swap margin amount.*"[85]

[84] "Ibid." pp7-9.

[85] "Op. Cit. (CFTC Proposed Comparability Determination Japan Capital Rules)", "*Appendix 4—Statement of Support of Commissioner Christy Goldsmith*".

Cancelled Commenter Calls-Out CSE Currency Coddling by Commissioner Pham

Finance practitioners, like people in all sectors where firms routinely socialize exposures to record out-sized earnings and pay out-sized compensation, ostracize the few out-spoken practitioners who publicly articulate the extent of exposure offload. Ostracization protects financial practitioner privileges by channeling industry discourse to trivial matters of corporate convenience and away from societally vital matters of corporate responsibility and the public good. The overriding concern for CSE convenience that Commissioner Caroline D. Pham demonstrated in comments and questions on the proposed comparability determination for Japan capital rules is an unfortunately perfect example of repudiating corporate responsibility and undermining the public good.

> "*As I mentioned in my opening statement, the CFTC should take an outcomes-based approach to substituted compliance that appropriately balances and recognizes the nature of cross-border regulation of global markets and firms, and that preserves access for U.S. persons to other markets. I appreciate the Chairman's remarks and I welcome comments, particularly on operational issues with additional reporting requirements given the time difference, language translation, conversion to USD, local governance and regulatory requirements, and differences in financial reporting.*"[86]

Opining as a life-long currency practitioner (economist, option trader, structurer of U.S. and non-U.S. fixed-income derivative contracts, credit analyst of the same, and journalist covering currency exposures in securitization and structured debt), "*conversion to USD"* and the other concerns that Commissioner Pham posits *for a Japanese CSE* are preposterous.

To be very, very clear, Bank of America, Goldman Sachs, Morgan Stanley, and all U.S. entities with a draw on U.S. public resources must be ***denied*** all access to entirely self-destructive contrivances, such as the "market" for the swap contract with flip clause anywhere in the world, including Japan. In forming "*an outcomes-based approach to substituted compliance*", the CFTC must ensure only one outcome regarding the swap contract with flip clause, namely that no CSE provide a new contact or extend an existing one.

To be equally clear regarding Japanese markets for other derivative contracts, Bank of America, Goldman Sachs, and Morgan Stanley would face ***ZERO*** "*operational issues with additional reporting requirements given the time difference, language translation, conversion to USD, local governance and regulatory requirements, and differences in financial reporting*." Should any of the mega-banks find the requirements to be inconvenient, i.e., costly compared to CFTC

[86] "Op. Cit. (CFTC Proposed Comparability Determination Japan Capital Rules)", "*Appendix 5—Concurring Statement of Commissioner Caroline D. Pham*".

requirements, the bank will simply continue to capitalize the Japanese CSE affiliate according to CFTC capital rules and forego substituted compliance with Japanese capital rules.

Moreover, Bank of America, Goldman Sachs, or Morgan Stanley could not possibly complain to the CFTC about "*operational issues with additional reporting requirements given the time difference, language translation, conversion to USD, local governance and regulatory requirements, and differences in financial reporting*." The mega-banks would gladly undertake the very same "*operational issues*" and much, much more to obtain new business with a valued Japanese end-user such as one that reports to an affiliate in the U.S., U.K., Ireland, or other English-speaking domicile. Indeed, the FDIC and Federal Reserve must immediately investigate the capabilities of Bank of America, Goldman Sachs, Morgan Stanley, or any U.S. entity that may draw on U.S. public resources and transacts Japanese derivative contracts but pleads *operational issues with additional reporting requirements given the time difference, language translation, conversion to USD, local governance and regulatory requirements, and differences in financial reporting*."

> "*I urge a pragmatic approach with sufficient time to implement conditions before any compliance date, and I appreciate the thought that the staff have been putting into that. I speak from my past experience as a global head of swap dealer compliance who had to implement global regulatory reforms. I'll also note that in a crisis, such as during the early days of the COVID–19 pandemic, there was timely and effective engagement between and amongst CFTC registrants and U.S. regulators. I have been on many calls and spoken to many regulators all over the world, not only during COVID–19, but also during times of market disruption or potentially material events. There is a difference between a phone call and a formal written notice, and that's just one example of the conditions in this proposal. So, I appreciate receiving comments on this and any other operational issues and the careful consideration by the staff and the Commission of how to take a practical approach to achieving appropriate oversight and mitigation of risk to the United States and to our markets.*"[87]

To reiterate, Bank of America, Goldman Sachs, and Morgan Stanley would "*implement conditions"* tomorrow at the behest of a new customer. Moreover, the mega-banks would instantly sideline or terminate a compliance person who balked at nstant implementation. The CFTC must not greenlight Bank of America, Goldman Sachs, and Morgan Stanley to treat American people via the CFTC worse than a new customer.

Sincerely yours,

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[87] "Op. Cit. (CFTC Proposed Comparability Determination Japan Capital Rules)", "*Appendix 5 — Concurring Statement of Commissioner Caroline D. Pham*".

Bill Harrington