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October 20, 2022

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

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

Copy: Japanese Financial Services Agency; Office of Credit Ratings, U.S. Securities and Exchange Commission; Supervision of Credit Rating Agencies, ESMA; Credit Rating Supervision, UK FCA; International Bankers Association of Japan; IIB; SIFMA; ISDA; Better Markets; Bank of America; Goldman Sachs; Morgan Stanley; Golub Capital; and Moody's Investors Service

Via Electronic Mail

Re: 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.")*
AND
U.S. Commodity Futures Trading Commission § 13.1 Petition for Rulemaking ("prohibit a swap dealer . . . from predicating a swap obligation on a flip clause, walkaway, or variable subordination") AND "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"

Dear Ms. Countryman and Mr. Kirkpatrick,

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 SEC and the CFTC on the six 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 willfully compounds § 13.1 failures by failing to remedy or even concede flip clause failures. True to form, the CFTC did 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 (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).

<u>The Imperative:</u> 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.

<u>Rationale:</u> 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 each swap contract with flip clause and no margin posting ("swap contract with flip clause"), counterparties undermine themselves, sap economic efficiency, and corrode financial stability.

<u>Capital Rules:</u> 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.

<u>Swap Margin Rules and Swap Contract with Flip Clause:</u> 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.

<u>Beneficial U.S. Swap Margin Rules Viz-a-Viz Injurious Non-U.S. Swap Margin Rules:</u>

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.**

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

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

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

Two Plain Facts and Lots of Plain Talk About the Swap Contract with Flip Clause

1. The contract is intrinsically 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, industry advocates, investors, issuers, journalists, lobbyists, regulators, risk managers, spokespeople, traders, and trustees—perpetuate the contract.

The two facts are irrefutable and, almost entirely owing to my work since 1999, extensively documented in the public domain, including on cftc.gov, sec.gov, moodys.com, and sifma.org.

For comprehensive and exhaustively referenced corroboration, please see:

1. Petition for SEC rulemaking File No 4-790;
2. My filings to the U.S. Court of Appeals for the 2nd Circuit regarding a decade-long, industry-wide litigation of hundreds of Lehman Brothers swap contracts with flip clauses;[10]
3. My assessment / questionnaire to range of practitioners that perpetuate the contract;[11] and
4. Moody's global credit rating methodology for the swap contract with flip clause that colleagues and I co-developed and co-memorialized in 2006.[12]

Since at least 2010, Moody's management and analysts have known that Moody's credit rating methodologies for the swap contact with flip clause allow CSEs the world over to undercapitalize the contract and deal-makers the world over to under-resource securitizations and structured debt, thereby wrecking economic efficiency and undermining financial stability everywhere.[13] And, for twelve-years-and-counting, Moody's managers and analysts have not publicly conceded the damage, acted to stop it, or publicly answered irrefutable methodology critiques. Right now,

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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] Manchester, Edward, Bill Harrington, and Nicholas Lindstrom, "Framework for De-Linking Hedge Counterparty Risks from Global Structured Finance Cashflow Transactions", *Moody's Methodology*, May 25, 2006. See "*Appendix A*" in Securities Industry and Financial Markets Association (SIFMA) and International Swaps and Derivatives Association, Inc (ISDA), "Proposed Brief of Amicus Curiae SIFMA and ISDA in Support of Defendants Appellees and Affirmance in Lehman Brothers Special Financing, Inc. versus Bank of America National Association et al., (Case No. 17-cv-1224-LGS, Document 87)", (https://www.sifma.org/wp-content/uploads/2017/06/LehmanBrothers061617.pdf).

[13] 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).

Moody's is ducking the legal obligation to publicly address my response to the proposed credit rating methodology for assessing ESG exposures in structured finance credit ratings, i.e., to address my petition for SEC rulemaking File No 4-790.[14]

> "*Lastly, no industry group discusses the flip-clause-swap-contract without lying, parroting irrelevancies, or presenting "market information" that is alarmist, fatuous, and outdated.*"[15]

Moody's is not alone in ducking accountability for the swap contract with flip clause, or even for the flip clause itself on a standalone basis. No financial practitioner anywhere in the world claims ownership of the flip clause because "*everyone knows*" that the flip clause is a convoluted catastrophe.[16] Likewise, *"everyone knows"* that the whole flip clause concoction, i.e., the swap contract with flip clause, undermines economic efficiency and financial stability. "*Everyone*" includes the CFTC, the SEC, other U.S. regulators, non-U.S. regulators, and financial practitioners globally.

CFTC Chair Behnam Has Golden Opportunity to School the World on Flip Clause Failures

> "*'IOSCO is recognized globally as a prominent organization in our markets, and I am honored to continue elevating the CFTC within this important international standard-setting body particularly during this time,' said Chairman Behnam. 'I look forward to working with my counterparts to further IOSCO's mandates of protecting investors, and maintaining fair, efficient, and transparent markets and addressing systemic risk.'*"[17]

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. Indeed, the respective title pages of two industry amicus curiae briefs corroborate all elements of my submission herein by identifying many, but by no means all, financial entities around the world that used the swap

[14] Moody's had not posted the structured finance credit rating methodology for ESG exposures, nor my or any other feedback to the June 6, 2022, proposal, as of 5:00 PM, October 20. See (https://www.moodys.com/researchandratings/research-type/methodologies-frameworks/-/003006/003006/-/-1/0/-/0/-/-/-/-/-/-/-/-/global/pdf/-/rra).

[15] Harrington, William J, "Proposed Amicus Curiae Brief to the US 2nd Circuit 'Re: Case No. 18-1079 (Lehman vs 250 Financial Entities Re Flip Clause Enforceability)'", 25 June 2019, p22, (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).

[16] As demonstration of individual and collective bad faith regarding the flip clause, ***ZERO*** financial practitioners had commented on petition for SEC rulemaking File No. 4-790 as of 5:00 PM, October 20.

[17] CFTC, "IOSCO Board Appoints CFTC Chair Behnam as Vice Chair", October 19, 2022. (https://www.cftc.gov/PressRoom/PressReleases/8611-22).

contract with flip clause to undercapitalize themselves and under-resource securitizations and structured debt.[18]

Since 2008, non-U.S. financial institutions, securitization issuers, and structured debt issuers have wrecked economic efficiency both in local domiciles and across them by routinely entering the swap contract with flip clause.

> **"*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/)"**[19]

With each swap contract with flip clause, *a swap provider* intentionally undercapitalizes to the maximum extent possible, namely by 100% of asset value should the provider become bankrupt, insolvent, or otherwise unable to perform. For all swaps with flip clauses, the degree of undercapitalization is 100% cumulative, i.e., the sum of 100% of asset value for 100% of contacts should the provider become bankrupt, insolvent, or otherwise unable to perform.

> *"**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.**"*[20]

> "***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.***"[21]

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[18] See the respective multi-page titles of two amicus curiae briefs that industry groups submitted over the course of the decade-long Lehman Brothers flip clause case. "SIFMA and ISDA Op. Cit. 'Proposed Amicus Curiae Brief in Support of Defendants and Affirmance in LBSF vs Bank of America NA et al., (Case No. 17-cv-1224-LGS, Document 87)'" and Structured Finance Industry Group, "Amicus Curiae Brief in Support of Defendants-Appellees and Affirmance in LBSF vs Branch Banking et al., (U.S. Court of Appeals for the 2nd Circuit, Case No. 18-1079)", November 1, 2018, (https://structuredfinance.org/wp-content/uploads/2018/11/SFIG_Lehman_amicus_brief_Nov_2018.pdf

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

[20] 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).

[21] "Harrington Op. Cit. 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).

With each swap contract with flip clause, *an underwriter and issuer* knowingly structure and sell under-resourced securitizations or structured debt with inflated credit ratings. The extent of deal under-resourcing is "1%, 3%, 7% . . . [or more] of deal size", depending on contract parameters.[22] Compounding the systemic destruction, all manner of entities including banks and all manner of investors including the entire gamut knowingly buy the undercapitalized, overrated securitizations and structured debt. Compounding the systemic destruction *exponentially*, many entities routinely exchange the undercapitalized, overrated 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, overrated debt of issuer counterparties, imploded and failed.

> "***As Lehman alleges, it is suing over billions of dollars in swap termination payments in connection with 47 different CDO transactions. Compl. ¶ 2. Those transactions were structured and marketed—by Lehman—so that in the event of a Lehman default, the invested capital would be returned to the CDO investors. This structure was used to avoid triggering a payment obligation to Lehman that would wipe out billions of dollars in CDO investments in the event of a tactical default by Lehman under market conditions favorable to it, a Lehman bankruptcy, or certain other circumstances. . . . II "Lehman benefited, moreover, from the high credit ratings associated with this structure."***[23]

Many other swap providers such as AIG and Bear Stearns also imploded but continued operating thanks to extraordinary rescues that the American people and people the world over funded.[24] Indeed, the swap contract with flip clause is a major "untold story in the collapse of AIG".[25]

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[22] Harrington, Bill, "Margin posting: swaps increase ABS issuance costs by 1%, 3%, 7% ... of deal size", *Debtwire ABS*, May 16, 2016, p2, (https://www.sec.gov/rules/petitions/2022/petn4-790-ex4.pdf).

[23] "SIFMA and ISDA Op. Cit. 'Proposed Amicus Curiae Brief in Support of Defendants and Affirmance in LBSF vs Bank of America NA et al., (Case No. 17-cv-1224-LGS, Document 87)'", pp2-3.

[24] "Harrington Op. Cit. Submission to CFTC 'Re: RIN 3038-AD54 Capital Requirements for Swap Dealers and Major Swap Participants' (May 4, 2017)", see "*AIG*" and "*Bear Stearns*" throughout. (https://comments.cftc.gov/PublicComments/ViewComment.aspx?id=61196&SearchText). See also "*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).

[25] Yet, despite 104 collective mentions of "*ABS*", "*asset-backed*", "*CDO*", "*collateralized-debt obligation*", "*mortgage-backed*", or "*RMBS*", "***flip clause*" is not mentioned** 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).

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 zombified 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 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.

G-1 = Great Governance: U.S. Law Suppresses Swap Contract with Flip Clause (So Far)!
G-19 = Garbage Governance: Other G-20 Plus Switzerland Flip-Clause-Captivated!

> "*US regulators purposefully chose not to harmonize the swap margin rule with evolving EU policy that may exempt many ABS issuers from margin posting.*"[26]

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.[27] The Act also strips the CFTC and SEC of customary discretion viz-a-viz exempting financial end-users from respective swap margin rules.[28]

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. However, suddenly higher U.S. interest rates are likely to induce industry groups

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[26] "Harrington Op. Cit., 'Margin posting increases ABS issuance costs by 1%, 3%, 7% ... of deal size'", p3.

[27] "*. . . 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.)

[28] 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.)

such as the Structured Finance Association (SFA) to resume urging policy reversal that revives the swap contract with flip clause.

Congress knew what it was doing in stripping the CFTC of customary discretion viz-a-viz exempting financial end-users from respective swap margin rules. The CFTC has always maintained an open-door policy to industry groups such as SFA and predecessor Structured Finance Industry Group (SFIG) that repeatedly push to exempt securitization and structured debt issuers, i.e., the swap contract with flip clause, from margin posting requirements.[29] Moreover, the CFTC has accommodated the SFA-SFIG wish list where possible. On October 27, 2017, the CFTC caved to pressure by issuing Letter No. 17-52, which exempts the *comparatively few* existing swap contracts with flip clauses from swap margin rules in limited instances that are more hypothetical than realistic. Commissioner Giancarlo tried but *failed to go all the way* and revive the contacts forever by enacting a Dodd-Frank around.

> "*On April 26, 2018, CFTC Chair Giancarlo co-published a White Paper that proposed to reverse many Dodd-Frank rules. Giancarlo did make good on many proposals by ushering the respective rule reversals to adoption. However, a backdoor protection of the flip-clause-swap-contract that SFIG had long sought, a reinterpretation of 'financial entity in the Commodity Exchange Act' to exempt 'a variety of end users, including . . . special purpose vehicles,' never materialized. The reinterpretation would have exempted flip-clause-swap-contracts from the CFTC-Swap-Margin-Rule.*"[30]

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.

> *"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*

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[29] Harrington, William J, "Submission to CFTC 'Re CFTC Letter No. 17-52 . . . No-Action Position: Variation Margin Requirements Applicable to Swaps with Legacy Special Purpose Vehicles'", February 2, 2018, "*2017 At Bats at CFTC Field: SFIG = 6/Bill Harrington = 0*", p113. Wikirating posts as (https://www.wikirating.org/data/other/20180203_Harrington_J_William_31_Misrepresentations_in_CFTC%20_Letter_No_17-52.pdf).

[30] "Harrington Op. Cit. Proposed Amicus Curiae Brief to the US 2nd Circuit 'Re: Case No. 18-1079 (Lehman vs 250 Financial Entities Re Flip Clause Enforceability)'", 25 June 2019, p43, (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 interest rate swaps that are often characterized as "plain vanilla;' ***and considerably more for long-dated or currency swaps*** *[emphasis added]*."

II

"*Pushing the risk estimate of the swaps higher still, each is also '****balance guaranteed*** *[emphasis added];' a swap type that has been used by a range of ABS issuers. Under a balance-guaranteed swap, parameters such as the notional amount or maturity date are determined at least in part by the performance of the deal rather than solely by adherence to a set schedule that is established at closing. In other words, a balance-guaranteed swap has an embedded option that operates with respect to deal performance rather than pure cost/benefit and transforms even a widely used type of swap, let alone one in a moribund sector, into a one-off transaction."*

II

"*Add* ***balance-guaranteed features*** *[emphasis added], such as those that were often used in pre-crisis RMBS, to a fixed-for-floating swap and the potential exposure increases. "****Finally, for currency swaps, which can be used in any sector and are common in re-packagings, the potential exposure could easily be 20% or higher*** *[emphasis added]."*[31]

"A real world example exists with respect to the re-packaging of US ABS such as the AAA rated tranches of 14 CLOs that were repackaged and issued as AAA rated JPY instruments in Japan between March 2014 and January 2016. CLOs aside, 'the term repack applies to a wide range of structured instruments' with both cashflow and synthetic structures, according to 'Moody's Approach to Rating Repackaged Securities' dated 15 June 2015.

"Moody's methodology states that an interest rate or currency swap is central to most repacks. In general, Moody's evaluates a repack swap as having negligible risk based in large part on 'replacement' and other assumptions for existing swaps that the CFTC margin rule invalidates, as reported." [32]

"Moody's assigns a definitive rating to repackaged notes of US CLO: Class A Notes issued by GC Repackaging 2018-10 Ltd.

II

"Rating: Aaa (sf)

II

"Arranger: Mitsubishi UFJ Morgan Stanley Securities Co., Ltd.

[31] "Harrington Op, Cit., 'Margin posting increases ABS issuance costs by 1%, 3%, 7% ... of deal size'", pp1-2, 4, and 5, respectively.

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

*"**Swap Counterparty: Mitsubishi UFJ Morgan Stanley Securities Co., Ltd.***
"RATINGS RATIONALE
"GC Repackaging 2018-10 Ltd. is a repackaging into Japanese yen of an entire portion (the "Repack Portion") of U.S. $248,000,000 Underlying Notes issued by the CLO,
*"**The rating reflects the risks due to default on the Underlying Notes, the existence of a balance guaranteed currency swap hedging foreign currency exchange risk**, the credit risk of the currency swap counterparty, and the transaction's structure [emphasis added throughout]."* [33]

Exacting Comparability Determinations for Japan, Other G-19 Domiciles, Switzerland, and All Regulated Entities = No Swap Contract with Flip Clause, No Credit Rating-Dependent Collateral!

"*The Commission estimates that approximately 53 CSEs may request a comparability determination pursuant to Commission Regulation 23.160(c).*"[34]

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 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.[35]

The CFTC must oblige CSEs to adequately resource non-U.S. activities by adhering to a common precept for swap margin in each comparability determination.[36] *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*

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[33] Moody's Investors Service, "Rating Action: 'Moody's assigns a definitive rating to repackaged notes of US CLO: Class A Notes issued by GC Repackaging 2018-10 Ltd.'", 22 Aug 18. See Appendix A herein or (https://www.moodys.com/research/Moodys-assigns-a-definitive-rating-to-repackaged-notes-of-US--PR_388048).

[34] 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).

[35] Better Markets, "Submission to CFTC 'Re Application for a Capital Comparability Determination from the Financial Services Agency of Japan'", October 7, 2022, p3, (https://comments.cftc.gov/PublicComments/ViewComment.aspx?id=70844&SearchText=). See also "*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).

[36] "CFTC Op. Cit. (Collection 3038–0111)." "*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].*

contract with clause to a securitization or structured debt issuer and in exchanging margin under any contract.

Specifically, 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.

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.[37]

> "*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.*"[38]

[37] "*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).

[38] 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=).

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."[39] 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.[40]

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 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.

Comparability Determinations Must Protect U.S. Public Purse, not CSE Earnings

> "*Substituted compliance must leave U.S. markets and our economy at no greater risk than full compliance with our rules.*"[41]

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[39] "CFTC Op. Cit. (Collection 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* . . ."

[40] As example of Moody's inflating the counterparty instrument rating [CIR] of a swap contract with flip clause, see "Rating Action: 'Moody's upgrades Class A-2's currency swap CIR from Interstar Millennium Series 2004-1E Trust'", 28 September 2022, (https://www.moodys.com/research/Moodys-upgrades-Class-A2s-currency-swap-CIR-from-Interstar-Millennium--PR_469884). "*First, Moody's calculates the expected loss and the corresponding rating under the assumption that the counterparty will not default. Second, Moody's assesses the degree of linkage to the counterparty and, where appropriate, cap the CIR accordingly***.**" **Re the first step, Moody's must set swap receipts as expected loss denominator**. **Also, Moody's double-counts issuer proceeds** in paying both swap provider and notes when, as Moody's models in rating the notes, the flip clause deeply subordinates proceeds to NatWest. **Re the second step, Moody's must (1) use the default rate of swap provider** (and provisionally registered swap dealer) NatWest Markets PLC; **and (2) lower the recovery for the NatWest corporate rating** because in default, NatWest will recover less than an institution that does not provide the swap contract with flip clause**. (Indeed, Moody's should lower the respective recoveries for all providers of the swap contract with flip clause.) Finally, Moody's double-counts NatWest credit** by setting the CIR "*one notch above the A1 rating of NatWest . . . [to account] for the possibility that NatWest could be out-of-the money at the time of default.*" The CIR is meaningless when a contract is "out-of-the-money" to a swap provider at any time, including its default. **As in first step, Moody's should but does not set expected swap receipts as the denominator for swap expected loss.**

[41] "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 4—Statement of Support of Commissioner Christy Goldsmith Romero*", August 8, 2022, (https://www.cftc.gov/sites/default/files/2022/08/2022-16684a.pdf).

> "*Future determinations by the prudential regulators and the CFTC on comparability with the EU margin regime may have a significant carve-out compared to the JFSA determination. The EU list of possible collateral for margin posting includes senior tranches of many ABS."*[42]

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?*

The CFTC may also pose the two questions to the three industry group—the Institute of International Bankers (IIB), International Swaps and Derivatives Association (ISDA), and Securities and Financial Markets Association (SIFMA)—that replied jointly to the proposed comparability determination for Japan capital rules.[43] *Have IIB, ISDA, and SIFMA members sacrificed to the same extent that is being asked of the American people? Have IIB, ISDA, and SIFMA members cut compensation to minimize the burden that they advocate imposing on the American people?*

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 overseas earnings and pay outsized compensation. The U.S. public bears undue CSE burdens. CSEs themselves do not.

To answer key Commission questions, there CSEs and non-U.S. regulators face ***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 documenting that all of the requirements of the special provisions for non-netting jurisdictions and non-segregation jurisdictions are satisfied.*"[44]

"Requesting a comparability determination from the Commission" is something a "CSE that is eligible for substituted compliance" can do in its sleep, given that each of the 53 CSEs may

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[42] "Harrington Op. Cit. 'CFTC lets ABS sector guess on global implementation of swap rules'".

[43] IIB, ISDA, and SIFMA, "Submission to CFTC 'Re: Notice of Proposed Order and Request for Comment on an Application for a Capital Comparability Determination From the Financial Services Agency of Japan'", October 7, 2022, (https://comments.cftc.gov/PublicComments/ViewComment.aspx?id=70840&SearchText=).

[44] Unless noted otherwise, this section quotes "CFTC Op. Cit. (Collection 3038–0111)".

"individually or collectively" make the request. 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.[45] By comparison, *requesting* a comparability determination is easy peasy.

In a closely-related instance of financial practitioners devoting resources to offload CSE exposures onto the U.S. public, the IIB, SIFMA, and ISDA urge the CFTC to not only approve a deficient comparability determination for Japan capital rules, but also to produce "the same answer in reference to the currently pending capital substituted applications for Mexico, the European Union and the United Kingdom."[46] Meanwhile, SIFMA and ISDA have also devoted significant resources to advocate that the flip clause impose 100% loss of contact value on a defaulted swap provider.[47] The logical conclusion of the latter SIFMA-ISDA argument supports the entirety of this submission. Every SIFMA and ISDA member that provides the swap contract with flip clause anywhere in the world negligently undercapitalizes itself since no member offsets the 100% loss of mark-to-market asset that each contract imposes.

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.[48] 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

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45 "Harrington Op. Cit., '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).

46 "IIB, ISDA, and SIFMA Op. Cit. 'Re: CFTC Japan Capital Comparability Determination'", p3.

47 "SIFMA and ISDA Op. Cit. 'Proposed Amicus Curiae Brief in Support of Defendants and Affirmance in LBSF vs Bank of America NA et al., (Case No. 17-cv-1224-LGS, Document 87)'", p5. "*SIFMA's and ISDA's members do not have a uniform financial interest in the outcome of this lawsuit. Indeed, should they one day find themselves in bankruptcy, certain of SIFMA's and ISDA's members might well benefit from rulings in this proceeding favorable to Lehman. SIFMA and ISDA nonetheless submit this brief as amici curiae supporting the position of the Appellees because they and their members seek the certainty, finality and assurances of market stability that the Bankruptcy Code safe harbor provisions were intended to provide*."

48 Indeed, the Japan Financial Services Agency not only requested the comparability determination for capital rules but also replied to the CFTC proposal. See "Submission to CFTC 'Re: Japan Swap Dealer Capital Comparability Determination, 87 Federal Register 48092, dated on August 8th, 2022'", October 7, 2022, (https://comments.cftc.gov/PublicComments/ViewComment.aspx?id=70818&SearchText=).

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, 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, by comparison, CSE and regulator "costs" to request a comparability determination are negligible.

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

> "*I look forward to the public's submission of comments and feedback on this proposed determination and order.*"[49]
>
> *"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."*[50]

The CFTC has many tools including capital and swap margin rules to prevent a regulated entity from entering a swap contract with flip clause. The proposed comparability determination for Japan capital rules must evaluate *all* oversight and regulation, including the respective CFTC and Japan swap margin rules, rather than consider the CFTC and Japan capital rules in isolation.

[49] "CFTC Op. Cit. (Proposed Comparability Determination Japan Capital Rules)", "*Appendix 2—Statement of Support of Chairman Rostin Behnam*".
[50] "Ibid.", "*Appendix 4—Statement of Support of Commissioner Christy Goldsmith Romero*".

I helped the CFTC and the five prudential regulators develop the respective swap margin rules that properly render the swap contract with flip clause commercially obsolete.[51] I did the same for the SEC.[52] I also submitted multiple responses to CFTC proposals for capital rules.[53]

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?[54]

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?

No member of the public other than me 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.[55]

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

[52] SEC, "Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital and Segregation Requirements for Broker-Dealers", June 21, 2019, pp175-176, (https://www.sec.gov/rules/final/2019/34-86175.pdf). Mr. Harrington urged a "*100% haircut to a structured product, asset-backed security, re-packaged note, combination security, and any other complex instrument. In response, the final margin rule requires margin collateral to have a ready market. This is designed to exclude collateral that cannot be promptly liquidated*."

[53] "*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=).

[54] 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).

[55] The rule docket posts ***ONE*** comment from a natural person (me), ***ONE*** comment from the progressive public interest entity Better Markets, ***ZERO*** comments from any of the three impacted CSEs, namely, Bank of America, Goldman Sachs, and Morgan Stanley, ***TWO*** comments from industry spokespersons, and ***ONE*** comment from the Financial Services Agency, Government of Japan. Only my comment addresses the swap contract with flip clause and documents use by Japanese structured debt issuers.

"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 comparison with the JFSA 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?"[56]

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.

Commonsense argues that the proposed comparability determination for Japan capital rules would allow Bank of America, Goldman Sachs, and Morgan Stanley to *instantaneously* undercapitalize themselves by undercapitalizing the respective Japanese CSE affiliates. What prompts the CFTC to facilitate Bank of America, Goldman Sachs, and Morgan Stanley in undercapitalizing themselves? Likewise, common sense argues that the proposed comparability determination would allow Bank of America, Goldman Sachs, and Morgan Stanley to *perpetually* undercapitalize 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 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 in current form, the two Japan comparability determinations would allow Bank of America, Goldman Sachs, and Morgan Stanley to under-resource themselves by under-

[56] "Harrington Op. Cit. 'CFTC lets ABS sector guess on global implementation of swap rules'".

resourcing the respective Japanese CSE affiliates that provide non-U.S. securitization and structured finance issuers with swap contracts, including the swap contracts with flip clause.

The concern is real-world! The provisionally registered swap dealer Morgan Stanley MUFG Securities Limited Co has cornered the market for underwriting yen-denominated repacks of EU and US CLOs, as well as the allied market for providing each repack with the swap contract with flip clause with largest potential exposure, namely a long-dated, balance-guaranteed, cross-currency swap contract with flip clause.[57] Moreover, for at least three of the long-dated, balance-guaranteed, cross-currency swap contracts with flip clauses, the Morgan Stanley affiliate has paid Moody's Investors Service to issue a "counterparty instrument rating" that negligently misrepresents contract risk to interested parties such as the Japan Financial Services Authority by carving out the 100% self-exposure incurred under each contract.[58]

> "*A Counterparty Instrument Rating (CI Rating) assesses the obligations of an SF [structured finance] issuer to make scheduled payments under a swap contract but* ***carves out termination payments****.* II "*Moody's assigns three interconnected evaluations of an SF swap contract with a flip clause: the CR Assessment of the derivative provider, the CI Rating of a subset of the payment obligations of the SF issuer to the derivative provider and the ratings of SF debt.* ***Together, the two ratings and the assessment mask losses under the swap contract from the flip clause and other early termination events rather than tally the losses and allocate them between the derivative provider and SF debt*** *[emphasis added throughout]."*[59]

Bank of America and Goldman Sachs have played the same Morgan Stanley game, namely grossly under-resourcing affiliates that book swap contracts with flip clauses, including long-dated, balance-guaranteed, cross-currency swap contracts with flip clauses.[60] What prompts the CFTC

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[57] Moodys.com shows Mitsubishi UFJ Morgan Stanley Securities Co as arranger and swap counterparty for 23 repackaged CLOs: GC **Repack**aging 2017-1; GC **Repack**aging 2017-2; GC **Repack**aging 2018-1; GC **Repack**aging 2018-2; GC **Repack**aging 2018-3; GC **Repack**aging 2018-4; GC **Repack**aging 2018-5; GC **Repack**aging 2018-6; GC **Repack**aging 2018-7; GC **Repack**aging 2018-8; GC **Repack**aging 2018-9; GC **Repack**aging 2018-10; **Repack**aged CLO, Series AP-V; Repackaged CLO Series CL 2014-2; **Repack**aged CLO Series GG-A1; **Repack**aged CLO, Series KK-1; **Repack**aged CLO, Series KK-2; **Repack**aged CLO, Series KK-3; **Repack**aged CLO, Series KK-4; **Repack**aged CLO, Series FBSL III; **Repack**aged CLO, Series OT-I-A1; **Repack**aged CLO, Series OT-I-A2; and Repackaged CLO Series CL 2014-2.

[58] Moody's Investors Service, "Rating Action: 'Moody's upgrades three Counterparty Instrument Ratings'", 15 June 2016, (https://www.moodys.com/research/Moodys-upgrades-three-Counterparty-Instrument-Ratings—PR_350650).

[59] Gaillard, Norbert J. and William J. Harrington, "Efficient, commonsense actions to foster accurate credit ratings" *Capital Markets Law Journal*, Volume 11, Issue 1, January 2016, Pages 38–59, Footnotes 23 and 119, (https://doi.org/10.1093/cmlj/kmv064). See also Footnote 40 herein.

[60] "Harrington Op. Cit., '31 Misrepresentations in CFTC Letter No. 17-52'". See "*Bank of America*", "*Goldman*", "*GSMMDP*", "*Merrill Lynch Derivative Products*", and "*Morgan Stanley*" throughout,

to greenlight Bank of America, Goldman Sachs, and Morgan Stanley to undercapitalize themselves by grossly undercapitalizing the respective Japan CSE affiliates that provide long-dated, balance-guaranteed, cross-currency swap contracts with flip clauses? Furthermore, what prompts the CFTC to greenlight end-user issuers of the same contract to grossly under-resource securitization and structured debt deals?

> "*I am mindful that this proposal is the first of its kind—the first substituted compliance determination for the CFTC's capital rules. Therefore, we should proceed carefully, as we are establishing precedent.*"[61]

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 may 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 undercapitalizing themselves by perpetually accumulating under-resourced exposures?

Finally, the capital comparability determination for Japan will also impact the capital comparability determination for every other domicile that the CFTC issues. Indeed, the IIB, ISDA, and SIFMA jointly urge the CFTC to not only approve the deficient proposal that allows CSEs to grossly under-resource the 100% self-exposure that each swap contract with flip clause imparts, but also to produce "the same answer in reference to the currently pending capital substituted applications for Mexico, the European Union and the United Kingdom."[62]

CSE is 100% Exposed 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]*."[63]

(https://www.wikirating.org/data/other/20180203_Harrington_J_William_31_Misrepresentations_in_CFTC%20_Letter_No_17-52.pdf).

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

[62] "IIB, ISDA, and SIFMA Op. Cit. 'Re: CFTC Japan Capital Comparability Determination'", p3,

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

"*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].*"[64]

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"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]."[65]

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"*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.*"[66]

Japan CSEs Cherry Pick Comparability to Under-Resource 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.*"[67]

"*Our strong view is that the requirements under the Japanese Capital Rules are comparable in purpose and effect to the Commission's requirement for non-bank SD to hold regulatory capital equal to or greater than 8% of its uncleared swap amount . . .*"[68]

My "strong view" is exactly opposite that of the International Bankers Association of Japan (IBA-Japan) because no element of either the CFTC or Japan capital rules addresses the 100% self-

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64 "Ibid.", "*Appendix 3—Statement of Support of Commissioner Kristin N. Johnson*".

65 "CFTC Op. Cit. Response to WJH FOIA Request Re: Flip Clause Rulemaking", p7. (https://www.sec.gov/rules/petitions/2022/petn4-790-ex5.pdf).

66 Harrington Op. Cit. 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).

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

68 International Bankers Association of Japan, "Submission to CFTC 'Re: Japan Swap Dealer Capital Comparability Determination, 87 Fed. Reg. 48092 (August 8, 2022)'", October 6, 2022, p2. (https://comments.cftc.gov/PublicComments/ViewComment.aspx?id=70812&SearchText=).

exposure that a CSE incurs with each swap contract with flip clause, as the comparability determination itself demonstrates.[69]

Therefore, the Japanese Capital Rules are ***NOT*** comparable in either purpose or effect to the totality of Commission margin and capital rules with respect to a CSE that is party to a swap contract with flip clause. No provision in the Japanese Capital Rules either singly or in conjunction with other provisions in the Japanese Capital Rules or the Japanese Swap Margin Rules obligates a CSE to come to close to fully capitalizing the 100% self-referencing counterparty exposure that each contract imposes.

For instance, a CSE that is party to a swap contract with flip clause that merely holds *"regulatory capital equal to or greater than 8% of its uncleared swap amount"* grossly under-resources "*all of its obligations as a SD to market participants," as well as "potential operational risk, legal risk and liquidity risk, in addition to the risks associated with its trading portfolio*."[70]

Likewise, a CSE that is party to a swap contract with flip clause that merely deducts "*balance sheet carrying value of fixed assets*" grossly under-resources liquidity.

Furthermore, a CSE that is party to a swap contract with flip clause that merely employs a "*a simplified but conservative approach to calculate a proxy for operational risks under the Basel 3 capital framework*" grossly under-resources "*operational risk and legal risk*".

Moreover, a CSE that is party to a swap contract with flip clause that merely maintains "*capital equal to 120% of market risk, credit risk and basic risk equivalent amounts*", which "*translates into an effective capital requirement of 9.6 percent of risk weighted assets"* grossly under-resources itself, despite being "*higher than that required by the Basel 3 capital framework or CFTC Capital Rules."*

Also, a CSE that is party to a swap contract with flip clause that merely maintains "*qualifying capital in an amount equal to 25% of its defined annual operating expenses*" grossly

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[69] The strong disagreement is unsurprising given the composition of IBA-Japan. Consider the 14 Executive Committee members, starting with Chair and CFTC submission signatory Mr. Phillipe Avril, "Senior Advisor, BNP Paribas, Tokyo Branch" (https://www.ibajapan.org/our-committees/executive-committee). Mr. Avril and the other 13 members each work for a separate global financial institution that provides, or is trustee for, the swap contract with flip clause. See Moody's Investors Service, "Rating Action: 'Moody's assigns provisional ratings to RMBS notes to be issued by BRASS NO 11 plc'", 22 September 2022. "*Currency Risk: The USD denominated A1 Notes will benefit from **a balance guaranteed cross-currency swap with BNP Paribas**. A collateral trigger is set at a loss of A3(cr) rating, and a counterparty replacement trigger is set at a loss of Baa1(cr) rating [emphasis added]*." (https://www.moodys.com/research/Moodys-assigns-provisional-ratings-to-RMBS-Notes-to-be-issued--PR_469288).

[70] "IBA-Japan Op. Cit. (CFTC Submission)" throughout this section unless otherwise noted.

undercapitalizes "*its obligations to market participants, potential operational risk, legal risk and liquidity risk as well as market risk and credit risk*" notwithstanding "*the CFTC requirement for a nonbank SD to hold qualifying capital in an amount at least equal to 8% of the nonbank SD's uncleared swap margin amount.*"

Finally, a CSE that is party to a swap contract with flip clause that merely maintains "*qualifying capital in an amount equal to 25% of its defined annual operating expenses*" grossly undercapitalizes its "*trading portfolio, as well as non-trading assets.*"

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

1. **Specifying that a CSE that is party to a swap contract with flip clause hold capital equal to the following for each contract: The maximum of: [0, 100% of uncleared swap margin + 100% of the contract market value on the CSE books.] (N.B. Using the contract market value is critical to ensuring CSE safety and soundness. Otherwise, the second term may converge to USD 0.00 for even a deeply in-the-money swap contract as a CSE approaches bankruptcy, insolvency, non-performing status or similar credit impairment); or**
2. **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**
3. **Obligating a CSE to adhere to all aspects of the CFTC swap margin requirements in providing a swap contract with flip clause; or**
4. **Prohibiting a CSE from entering a new swap contract with flip clause or extending an existing one; or**
5. **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. Regarding swap margin, "*the BCBS/IOSCO regulations are applied to Japanese financial institutions*"— meaning merely that the Japan regulations set a large threshold for securitization and structured debt issuers that de-facto exempts most issuers from exchanging any variation margin with a CSE.[71] The CFTC

[71] "Japan FSA Op. Cit. CFTC Submission 'Re: Japan Swap Dealer Capital Comparability Determination'", p1. "*Regarding comparability analysis for the minimum capital requirement, the Commission especially seeks comments on the point whether the requirements under Japanese Capital Rules are comparable in outcome base to the Commission's requirement for non-bank Swap Dealers to hold their capital equal to or greater than 8 percent of its uncleared swap margin amount.*" II "*We would like to note the facts that, (1) operational risk is taken into account in Japan's capital adequacy ratio, as is the case with the Commission's capital requirements; and (2)* ***the margin regulations in line with the BCBS/IOSCO regulations are applied to Japanese financial institutions, including non-bank SDs, to ensure financial***

comparability determination for Japan margin requirements upholds the de-facto exemption by blandly noting the threshold and not specifying CSE mitigation.[72] 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.

CFTC Capital Rule Fails to Specify *ANY* Extra Capital for Swap Contact with Flip Clause

The CFTC failure is a spectacular failure on all fronts, not least a spectacular failure of common sense given the spectacular degree to which crisis-causing swap dealers spectacularly undermined themselves by spectacularly undercapitalizing each swap contract with flip clause by a factor of 100%.[73]

> "*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.)*"[74]

Likewise, the CFTC failure is also a spectacular failure of self-respect, given widespread, first-hand industry knowledge that Lehman lost 100% of asset value for 100% of in-the-money swap contracts with flip clauses. Indeed, Bank of America, Goldman Sachs, and Morgan Stanley, along with other major global swap dealers and trustees such as AIG, ANZ, Bank of New York Mellon, Citigroup, Deutsche Bank, JP Morgan, and State Street, were *defendants* in the above-mentioned, decade-long Lehman Brothers litigation.[75] Furthermore, many Lehman defendants such as AIG, Bank of America, Citigroup, Deutsche Bank, Goldman Sachs, JP Morgan, and Morgan Stanley

***soundness in case of unexpected events at counterparties of uncleared derivatives transactions** [emphasis added].*"

[72] "Harrington Op. Cit. 'CFTC lets ABS sector guess on global implementation of swap rules'". "*Any Japanese financial end-user with less than USD 3bn in average notional of derivatives, which presumably covers most ABS 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 CFTC commentary.*"

[73] 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).

[74] "Harrington Op. Cit. Proposed Amicus Curiae Brief to the US 2nd Circuit 'Re: Case No. 18-1079 (Lehman vs 250 Financial Entities Re Flip Clause Enforceability)'", 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).

[75] "Ibid.", Title pages pp3-6.

separately *provided* swap contracts with flip clauses.[76] However, even contract-providing defendants argued that, for them to simply break even on the Lehman contacts, Lehman must lose 100% of asset value for 100% of in-the-money swap contracts with flip clauses.

Doubling down, industry groups such as SIFMA, ISDA, and SFIG submitted respective amicus curiae briefs that claimed broad industry mandates in support of Lehman defendants.[77]

> "***SFIG has over 350 members, including investors; issuers; financial intermediaries; accounting, law, and technology firms; rating agencies; servicers; and trustees****. . . .*
>
> *" . . . SFIG's members thus have an interest in ensuring that the Priority Provisions are enforced in accordance with their terms and, and . . . that the Priority Provisions will be enforced even in the event of a bankruptcy.* ***SFIG's members are therefore united in a belief that the decision of the United States Bankruptcy Court for the Southern District of New York (the Bankruptcy Court) should be upheld****, along with the decision of the United States District Court for the Southern District of New York (the District Court, and, together with the Bankruptcy Court, the Lower Courts) affirming the Bankruptcy Court's decision [emphasis added]."*[78]

SIFMA and ISDA went further still in asserting an inflexible proposition for the future. Any CSE that defaults or becomes insolvent, even one that is a SIFMA or ISDA member as many Lehman Brothers entities were, must *also* lose 100% of asset value for 100% of in-the-money swap contracts with flip clauses.

> "*Accordingly, the parties agreed that in the event of an early termination triggered by a Lehman default, the liquidation of the swap agreements would include the distribution of the collateral proceeds to the CDO investors. This is what the parties intended and what they contracted for. Those contracts should be enforced as written."*
> II
> "*Thus, SIFMA's and ISDA's members do not have a uniform financial interest in the outcome of this lawsuit. Indeed, should they one day find themselves in bankruptcy, certain of SIFMA's and ISDA's members might well benefit from rulings in this proceeding favorable to Lehman. SIFMA and ISDA nonetheless submit this brief as amici curiae supporting the position of the Appellees because they and their members seek the*

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[76] "Harrington Op. Cit., '31 Misrepresentations in CFTC Letter No. 17-52'", pp2-4. (https://www.wikirating.org/data/other/20180203_Harrington_J_William_31_Misrepresentations_in_CFTC%20_Letter_No_17-52.pdf).

[77] "SIFMA and ISDA Op. Cit. 'Proposed Amicus Curiae Brief in Support of Defendants and Affirmance in LBSF vs Bank of America NA et al., (Case No. 17-cv-1224-LGS, Document 87)'".
"SFIG Op. Cit. 'Amicus Curiae Brief in Support of Defendants-Appellees and Affirmance in LBSF vs Branch Banking et al., (U.S. Court of Appeals for the 2nd Circuit, Case No. 18-1079)'".

[78] "Ibid.", pp1-2.

certainty, finality and assurances of market stability that the Bankruptcy Code safe harbor provisions were intended to provide."[79]

No "G" in CFTC ESG: CFTC Capital Rule Failure is a Spectacular Governance Failure!

The CFTC failure is a 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, 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.*"[80]

Moreover, the spectacularly easy-to-implement capital treatment for the swap contract with flip clause was both spectacularly adaptable and spectacularly comprehensive, 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*";

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[79] "SIFMA and ISDA Op. Cit. 'Proposed Amicus Curiae Brief in Support of Defendants and Affirmance in LBSF vs Bank of America NA et al., (Case No. 17-cv-1224-LGS, Document 87)'", p3.

[80] Harrington Op. Cit. 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).

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*";[81]
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*"; [82]
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*"; [83]
12. Inclusion of "*cleared swaps*" in the capital calculation requirements;
13. Inclusion of "*uncleared swaps*" in the capital calculation requirements;[84]
14. "*Proposed USD 20mm fixed-dollar amount of net capital*";
15. "*Proposed minimum USD 100mm fixed dollar amount of tentative net capital*";
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*";[85]
18. "*All aspects of the proposed tangible net worth capital approach for SDs that are predominantly engaged in non-financial activities*"; [86]

    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*

[81] "Ibid.", pp3-4 and throughout.
[82] "Ibid.", p24.
[83] "Ibid.", p24 and throughout.
[84] "Ibid.", p25.
[85] "Ibid.", pp29-30.
[86] "Ibid.", p31.

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."[87]

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*";[88]
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)*";[89]
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*";[90]
31. "*All aspects of the proposed model approval process and the computation of the credit risk charges*."[91]

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

    "*Moreover, the correlation of activation of all flip clauses, walkaways or similar provisions will be 100%, i.e., 100% of counterparties to uncleared swaps and uncleared security-based swaps with these clauses and provisions that are in-the-money to an SD will simultaneously activate them against the SD when it is bankrupt, insolvent, non-performing or similarly impaired.*"[92]
32. "*Proposed models*";
33. "*Proposed model review process*";[93]

[87] "Ibid.", p31 and throughout.
[88] "Ibid.", p32.
[89] "Ibid.", pp34-36.
[90] "Ibid.", pp37-38.
[91] "Ibid.", pp40-51.
[92] "Ibid.", p40 and throughout.
[93] "Ibid.", p52.

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*";[94]

"***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."[95]

35. "*Capital models already approved by a prudential or foreign regulator*";[96]

"***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.

[94] "<u>Ibid.</u>", pp52-53 and throughout.

[95] "<u>Ibid.</u>", pp52-53 and throughout.

[96] "<u>Ibid.</u>", pp52-53 and throughout.

"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."[97]

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*";[98]
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*";[99]
45. *"All aspects of the proposed financial reporting, recordkeeping and notification requirements*";[100]
46. "*Any aspect of the proposed information collection requirements*";[101]
47. "*Protection of market participants and the public*";[102]
48. "*Mitigation of harmful impact on efficiency, competitiveness and integrity of the US swaps market, the US financial system and the US economy*";[103]
49. "*Efficiency, Competitiveness, and Financial Integrity of Swaps Markets*";[104]
50. "*Improvement of price discovery*";[105]
51. "*Sound management risk practices*";[106]
52. "*Other public interest considerations*";[107]
53. "*Cost-benefit analysis*";[108]
    i. "*The cost/benefit analysis produces a defensible finding*.

[97] "Ibid.", p53 and throughout.
[98] "Ibid.", pp55-57.
[99] "Ibid.", pp58-61.
[100] "Ibid.", pp62-68.
[101] "Ibid.", pp69-71.
[102] "Ibid.", pp72-75.
[103] "Ibid.", p76 and throughout.
[104] "Ibid.", pp75-81.
[105] "Ibid.", pp82-86.
[106] "Ibid.", pp87-93.
[107] "Ibid.", pp94-95.
[108] "Ibid.", pp96-97, and 107-110.

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*."[109]

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*";[110]
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*.[111]

CFTC Capital Rule Fails to Heed Plain-Spoken American Speaking Plainly

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

"The CFTC Must Eradicate the Flip Clause."[112]

The CFTC exclusion is also a spectacular failure of institutional self-awareness 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.

"*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;*

[109] "Ibid.", pp96-97, and 107-110.
[110] "Ibid.", pp98-109.
[111] "Ibid.", p110-122.
[112] "Harrington Op. Cit. 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)'", p2 and throughout, (https://comments.cftc.gov/PublicComments/ViewComment.aspx?id=62366&SearchText=).

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.*"[113]

CFTC Capital Rule Failure is "*Arbitrary, Capricious, and an Abuse of Discretion*"

The CFTC capital rule demonstrates that it violates the Administrative Procedure Act. 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.

The 59 proposal elements include: 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 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 that response by misrepresenting it as merely a "charge" plus an add-on for "market risk."[114]

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[113] 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).

[114] 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.,

"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"[115]

The rule amplified the misrepresentation by pigeonholing my response as pertaining to "market risk" only rather than as integral to at least 58 categories including counterparty exposure and portfolio concentration. In short, the CFTC performed the following "bait-and-switch." 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*".

"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 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."*[116]

CFTC FOIA Response Reveals NO "Long Experience" with Flip Clause

I 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

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"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=).

[115] "CFTC Op. Cit '17 CFR Parts 1, 23, and 140, RIN 3038–AD54, 'Capital Requirements of Swap Dealers and Major Swap Participants''", (https://www.cftc.gov/sites/default/files/2020/09/2020-16492a.pdf).

[116] "Ibid."

materials entirely undo the CFTC rationale for excluding flip clause treatment from the capital rule.[117]

> "***The Commission rationale for not imposing a 100% capital charge on an uncleared swap with a flip clause is arbitrary****. 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 capricious.*** *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 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

[117] "CFTC Op. Cit. Response to WJH FOIA Request Re: Flip Clause Rulemaking", p2. "*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 CFTC either used or uses in establishing that it 'believes' that the 'standardized market risk capital charges' in CFTC 'Capital Requirements of Swap Dealers and Major Swap Participants' (September 15, 2020) 85 FR 57465 are 'effective and appropriately calibrated' . . .]*" (https://www.sec.gov/rules/petitions/2022/petn4-790-ex5.pdf).

> *"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."*[118]

Cancelled Commenter Calls-Out Commissioner Pham CSE Coddle

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."*[119]

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*

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[118] "Ibid." pp7-9.

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

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 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.*"[120]

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 instant 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.

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[120] "Ibid."

Basic Information for CFTC Re Climate-Related Financial Risk: *IGNORE* NRSRO Credit Ratings and *IGNORE* Climate Ratings of NRSRO Affiliates!

NRSRO credit ratings omit credit exposures to climate events and transition as thoroughly as the credit ratings omit credit exposures to the flip clause swap contract. The omissions are intentional. NRSRO credit rating companies avoid downgrading important constituencies, whether a CSE party to a swap contract with flip clause, securitization or structured debt where an issuer is party to the contact, or an entity exposed to credit losses from climate events and transition.

The CFTC must undo the damage that the CFTC Climate Related Market Risk Subcommittee perpetrated in endorsing "NRSRO ESG non-analysis" in its report "Managing Climate Risk in the U.S. Financial System" of September 9, 2020.[121]

> "*The CFTC Climate Subcommittee failed its own self-governance by justifying unwarranted praise for NRSRO ESG efforts with brazen dissembling. To wit, the CFTC report buried the underlying source (an NRSRO ESG report), overstated the report's conclusions, lumped together the comparatively modest observations of 'climate-related risks' and the vast majority of other 'ESG risks,' and conflated 'sovereign and municipal bond ratings' with 'private sector rating actions.'*"[122]

The entirety of my SEC submission of June 14, 2021, comprises part of my response today. Pages 12-14 of the SEC submission detail the credit rating adulteration that the CFTC Climate Related Market Risk Subcommittee intentionally included in its report by intentionally ignoring my own CFTC climate submission. The entirety of my CFTC climate submission is part of my response today.[123]

> "*NRSRO credit rating companies divert capital flows from debt issuers, derivatives end-users, derivatives providers, exchanges, and other rated entities that mitigate exposures to physical risk, such as inundation by fire and water.*

[121] CFTC Market Risk Advisory Committee, "Managing Climate Risk in the U.S. Financial System", September 9, 2020, (https://www.cftc.gov/sites/default/files/2020-09/9-9-20%20Report%20of%20the%20Subcommittee%20on%20Climate-Related%20Market%20Risk%20-%20Managing%20Climate%20Risk%20in%20the%20U.S.%20Financial%20System%20for%20posting.pdf).

[122] Harrington, William J., "Submission to SEC 'Re: Public Input Welcomed in Climate Change Disclosures'", June 14, 2021, p13, (https://croataninstitute.org/wp-content/uploads/2021/06/William-J.-Harrington-Croatan-Institute-Comments-on-Climate-Change-Disclosures.pdf).

[123] Harrington, Bill. "Submission to CFTC Climate-Related Market Risk Subcommittee 'Re Inundate NRSRO Credit Rating Companies with Comments to FIX Methodologies so that Measurements of Ability to Pay Derivative & Debt Obligations FULLY Incorporate Exposure to Climate Events'", April 9, 2020, (https://comments.cftc.gov/PublicComments/ViewComment.aspx?id=62485&SearchText=).

"*Likewise, NRSRO credit rating companies divert capital from debt issuers, derivatives end-users, derivatives providers, exchanges, and other rated entities that are adapting to the transition from carbon."*[124]

Following are recent materials that support the contention that the CFTC must ignore credit ratings, as well as climate and other ESG ratings of NRSRO affiliates, in assessing the exposures of financial entities, clearinghouses, and other entities that enter or trade derivative contracts to climate events and transition.

1. Li, Xuanbo, Yun Lou, and Liandong Zhang, "Do Commercial Ties Influence ESG Ratings? Evidence from Moody's and S&P",
   (https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4190204).
   The paper demonstrates that the two largest NRSROs don't simply avoid downgrading credit rating clients that are exposed to climate events and transition, the companies push climate affiliates to upgrade climate evaluations of credit rating clients!
   "*We provide the first evidence that conflicts of interest arising from commercial ties lead to ESG rating optimism. After the acquisition of Vigeo Eiris and RobecoSAM by Moody's and S&P, respectively, the ESG rating agencies issue higher ratings to existing paying clients of Moody's or S&P, relative to firms without commercial ties to the ESG rating agencies. The effect is greater for firms that have more intensive business relationships with Moody's (S&P), issue green bonds, discloses less ESG information, or have lower pension fund ownership. The optimistic ESG ratings are less informative, but they help Moody's (S&P) maintain credit rating business."*

2. Waite, Marilyn, Daniel Cash, and Bill Harrington, "The Wild West of Regulating ESG Investments", *The Hill*, July 12, 2022,
   (https://thehill.com/opinion/energy-environment/3556053-the-wild-west-of-regulating-esg-investments/).
   "*The CRA model is rife with conflicts and has illustrated that companies paying to be rated generally receive more favorable ratings. . . . It's imperative that ESG rating providers not be allowed to sell ancillary services to those they rate; in addition, these providers should disclose whether a rating has been solicited and whether the entity being rated has paid for the rating." II "There is rapid consolidation in the ESG rating field, most concerningly by CRA parents and affiliates. Morningstar acquired Sustainalytics, Moody's acquired Four Twenty Seven, S&P acquired Trucost, and* the list goes on."

[124] "Ibid.", p2.

3. Waite, Marilyn, Daniel Cash, and Bill Harrington, "Submission to the European Commission In Response to the Public Consultation: ESG Ratings and Sustainability Risks in Credit Ratings (Ref. Ares [2022] 2507921)", June 7, 2022, (https://croataninstitute.org/wp-content/uploads/2022/06/Joint-letter-Call-for-Evidence-ESG-and-credit-ratings.pdf).

   We "*ask the EU regulator to explore any available means to prevent the issuer pays model, whereby ESG rating providers take revenue from the companies they rate. It is well-documented that this dangerous practice, endemic within the CRA industry, gives rise to serious conflicts of interest and can reduce economic efficiency. Moreover, there is new evidence that the CRA issuer pays model also induces CRA affiliates to inflate ESG ratings. Although we appreciate it is difficult to eradicate issuer pays entirely, we would be remiss if we were not to highlight the point in this context. At a minimum, we recommend forbidding ESG rating providers from providing ancillary services to those they also charge for rating services."*

   II

   "*IOSCO members, including the U.S. Securities and Exchange Commission and ESMA, follow the IOSCO credit rating blueprint. Collectively and individually, the blueprint undermines economies and financial systems by greenlighting CRAs to assign credit ratings that buttress commercial interests at the expense of analytical robustness.*

   "*Propelled by the IOSCO blueprint, CRAs intentionally inflate the credit ratings of constituent entities to minimize their financing costs and to boost CRA franchises and earnings. As a result, economic efficiency can suffer. Credit rating inflation directly distorts the prices of rated debt such as bonds and loans and indirectly distorts prices of equities and non-rated debt to favour CRA clients and misallocate investment away from projects of maximum utility, such as ones that boost sustainability. Credit rating inflation also disproves CRA claims that ESG credit rating methodologies specify rigorous assessment of credit exposures to ESG factors*."

4. Harrington, Bill, "Moody's ESG overhaul won't have any actual effect on credit ratings", *Responsible Investor*, October 19, 2020, (https://www.responsible-investor.com/moody-s-esg-overhaul-won-t-have-any-actual-effect-on-credit-ratings/).

Sincerely/ yours,

Bill Harrington

APPENDIX A

MOODY'S INVESTORS SERVICE RATING ACTION 22 AUG 2018

Emphasis added as yellow-shaded text

Rating Action: Moody's assigns a definitive rating to repackaged notes of US CLO: Class A Notes issued by GC Repackaging 2018-10 Ltd.

22 Aug 2018

JPY27.5 billion in Debt Securities affected

Tokyo, August 22, 2018 -- Moody's SF Japan K.K. ("Moody's") has assigned a definitive rating to one class of notes issued by GC Repackaging 2018-10 Ltd.

The rating addresses the expected loss posed to investors by the final maturity date. The structure allows for timely payments of interest (dividend) and the ultimate payment of principal by the final maturity date.

The complete rating action is as follows:

Issuer: GC Repackaging 2018-10 Ltd. (the "Repackaging Issuer")

Class: Class A Notes (the "Repackaged Notes")

Rating: Aaa (sf)

Issue Amount: JPY27,500,000,000

Coupon: Floating

Issue Date: August 22, 2018

Maturity Date: August 2, 2030

Collateral Asset: Class A-1 Notes due 2030 (the "Underlying Notes") issued by Golub Capital Partners CLO 37(B), Ltd.(the "CLO")

Arranger: Mitsubishi UFJ Morgan Stanley Securities Co., Ltd.

Swap Counterparty: Mitsubishi UFJ Morgan Stanley Securities Co., Ltd. (the "Swap Counterparty")

RATINGS RATIONALE

GC Repackaging 2018-10 Ltd. is a repackaging into Japanese yen of an entire portion (the "Repack Portion") of U.S. $248,000,000 Underlying Notes issued by the CLO.

The rating reflects the risks due to default on the Underlying Notes, the existence of a balance guaranteed currency swap hedging foreign currency exchange risk, the credit risk of the currency swap counterparty, and the transaction's structure.

The Underlying Notes subject the Repackaged Notes to little credit risk, consistent with the assigned rating:

The Underlying Notes subject the Repackaged Notes to little credit risk because of the strong credit quality of the Underlying Notes to which we have assigned a Aaa (sf) rating. The CLO is a managed cash flow collateralized loan obligation transaction which has closed in August 2018. It is collateralized primarily by broadly syndicated first lien senior secured corporate loans. OPAL BSL LLC will manage the CLO. The CLO will have an approximately 5-year reinvestment period.

The Swap Agreement mitigates foreign currency risk:

A balance guaranteed currency swap mitigates foreign currency risk resulting from the structure of the Repackaging Issuer. The Repackaging Issuer will receive payments from the Repack Portion of the Underlying Notes in U.S. dollars and will make payments on the Repackaged Notes in Japanese yen, exposing the Repackaged Notes to foreign currency risk. To mitigate this risk, the Repackaging Issuer has entered into a balance guaranteed currency swap (the "Swap Agreement") with the Swap Counterparty.

The risk of the Repackaging Issuer becoming unhedged is remote:

Additionally, provisions in the Swap Agreement and the Repackaging Issuer's indenture mitigate counterparty risk from the Swap Counterparty by making remote the risk that the Repackaging Issuer will become unhedged. The risk of becoming unhedged is remote given (1) the Swap Counterparty's current credit quality, as reflected in its A1 long-term issuer rating, (2) its obligation under the swap documentation to post credit support collateral to the Repackaging Issuer and (3) its obligation to replace itself as swap counterparty in the event of its downgrade below specified rating levels.

The transaction's structure mitigates operational risk associated with the timing of cash flows. Under the Swap Agreement, the Repackaging Issuer will make a payment in U.S. dollars to the Swap Counterparty equal to the interest and principal amount it receives on the Underlying Notes after deducting a fixed amount of administrative expenses. The Repackaging Issuer will receive from the Swap Counterparty a payment in Japanese yen equal to the interest amount due on the Repackaged Notes, plus any principal amount calculated on the basis of an exchange rate determined by the transaction.

The Repackaging Issuer is structured to limit the bankruptcy risk and tax liabilities of the entity:

The Repackaging Issuer has been established as a special purpose vehicle under Cayman Islands law and is subject to certain contractual restrictions in the repack indenture. The contractual limitations on the Repackaging Issuer's activities and the customary limited recourse and non-petition provisions relating to the Repackaged Notes, minimize the risk of the Repackaging Issuer becoming subject to a bankruptcy proceeding. The legal structure also reduces the likelihood of the Repackaging Issuer incurring any significant tax liability.

The principal methodology used in this rating was "Moody's Approach to Rating Repackaged Securities" (Japanese) published in June 2015. Please see the Rating Methodologies page on www.moodys.com for a copy of this methodology.

Factors that Would Lead to a Downgrade of the Rating:

The rating of the Repackaged Notes is based primarily on the rating of the Underlying Notes and the credit quality of the Swap Counterparty. Accordingly, any change in the rating of the Underlying Notes or any change in the rating of the Swap Counterparty may impact the rating of the Repackaged Notes.

Loss and Cash Flow Analysis:

Our quantitative analysis focuses on the risks relating to the credit quality of the underlying notes and the swap counterparty. We determine the expected loss posed to securities holders by adding together the severities for loss scenarios arising from underlying notes default and swap counterparty default, each weighted according to its respective probability. We then translate the expected loss to a rating using our idealized loss rates.

REGULATORY DISCLOSURES

For further specification of Moody's key rating assumptions and sensitivity analysis, see the sections Methodology Assumptions and Sensitivity to Assumptions of the disclosure form.

Moody's describes its loss and cash flow analysis in the section "Ratings Rationale" of this press release.

Moody's quantitative analysis entails an evaluation of scenarios that stress factors contributing to sensitivity of ratings and take into account the likelihood of severe collateral losses or impaired cash flows. Moody's weights the impact on the rated instruments based on its assumptions of the likelihood of the events in such scenarios occurring.

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