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August 28, 2023 (V2)

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

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

Copy: Office of Credit Ratings, U.S. Securities and Exchange Commission; Supervision of Credit Rating Agencies, European Securities and Markets Authority; Credit Rating Supervision, UK Financial Conduct Authority; Executive Director for Financial Stability Strategy, Bank of England; Institute of International Bankers; International Swaps and Derivatives Association; Securities Industry and Financial Markets Association; Fitch Ratings; Moody's Investors Service; and S&P Global Ratings

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*")[1]
AND

[1] **(https://www.sec.gov/rules/petitions/2022/petn4-790.pdf).**

U.S. Securities and Exchange Commission Petition for Rulemaking "File No. 4-799" ("*Policy Clarification on Credit Rating Agencies*")[2]

AND

U.S. Commodity Futures Trading Commission "§ 13.1 Petition for Rulemaking of May 26, 2020" ("*prohibit a swap dealer . . . from predicating a swap obligation on a flip clause, walkaway, or variable subordination*")[3]

AND

U.S. Commodity Futures Trading Commission "Notice of Proposed Order and Request for Comment on an Application for a Capital Comparability Determination Submitted on Behalf of Nonbank Swap Dealers Domiciled in the French Republic and Federal Republic of Germany and Subject to Capital and Financial Reporting Requirements of the European Union (EU Swap Dealer Capital Comparability Determination)"[4]

AND

U.S. Commodity Futures Trading Commission RIN 3038-AF36 "Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants (Seeded Funds and Money Market Funds Proposal)"[5]

AND

U.S. Commodity Futures Trading Commission "Global Markets Advisory Committee"[6]

Fitch Ratings Active Rating Criteria "CLOs and Corporate CDOs Rating Criteria"[7]

AND

Fitch Ratings Active Rating Criteria "Corporate Hybrids Treatment and Notching Criteria"[8]

AND

Fitch Ratings Active Rating Criteria "Non-Bank Financial Institutions Rating Criteria"[9]

AND

Fitch Ratings Active Rating Criteria "Sovereign Rating Criteria"[10]

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2 **(https://www.sec.gov/rules/petitions/2023/petn4-799.pdf).**

3 **(https://croataninstitute.org/wp-content/uploads/2022/06/CFTC-WJH-2020-6-26-Sec-13.1-Rulemaking-Petition-Acknowledgment_WJHarrington_06-26-2020.pdf).**

4 **(https://www.cftc.gov/sites/default/files/2023/06/2023-13446a.pdf).**

5 **(https://www.cftc.gov/sites/default/files/2023/08/2023-16572a.pdf).**

6 **(https://www.cftc.gov/sites/default/files/2023/09/2023-19409a.pdf).**

7 **(https://www.fitchratings.com/research/structured-finance/clos-corporate-cdos-rating-criteria-21-07-2023).**

8 **(https://www.fitchratings.com/research/corporate-finance/corporate-hybrids-treatment-notching-criteria-12-11-2020).**

9 **(https://www.fitchratings.com/research/non-bank-financial-institutions/non-bank-financial-institutions-rating-criteria-05-05-2023).**

10 **(https://www.fitchratings.com/research/sovereigns/sovereign-rating-criteria-06-04-2023).**

AND
Moody's Investors Service In-Use Rating Methodology "Moody's Global Approach to Rating Collateralized Loan Obligations"[11]
AND
Moody's Investors Service In-Use Rating Methodology "Repackaged Securities Methodology"[12]
AND
Moody's Investors Service In-Use Rating Methodology "Sovereigns"[13]
AND
S&P Global Ratings In-Use Criteria "CDOs: Global Methodology and Assumptions For CLOs and Corporate CDOs"[14]
AND
S&P Global Ratings In-Use Criteria "Sovereigns Rating Methodology"[15]

Dear All,

My name is Bill Harrington and I affiliate as Senior Fellow at Croatan Institute, a non-profit research and action institute.[16] I am among the few worldwide who publicly and candidly evaluate needlessly complex finance, most notably credit-rated asset-backed securities (ABS), structured debt, and derivative contracts such as the swap-contract-with-flip-clause.[17]

I work to boost the sustainability of the U.S. financial system with the dual aims of optimizing economic decision-making and preventing bailouts.[18] Most crucially, I advocate protecting the public interest by establishing robust governance in the financial sector, particularly regarding the capitalization, regulation, and credit ratings of needlessly complex finance.

Today's letter and the five other documents that the delivering email attach comprise a joint submission to the U.S. Securities Exchange Commission, to the U.S. Commodity Futures Trading Commission, to the Bank of England, and to the credit rating oligopoly Fitch Ratings, Moody's Investors Service, and S&P Global Ratings regarding each of the fifteen title-line matters. Please post the entirety of today's submission on all applicable websites.

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11 **(https://ratings.moodys.com/api/rmc-documents/74832).**
12 **(https://www.moodys.com/research/Repackaged-Securities-Methodology--PBS_1345683).**
13 **(https://www.moodys.com/research/Rating-Methodology-Sovereigns--PBC_1346995).**
14 **(https://disclosure.spglobal.com/ratings/en/regulatory/article/-/view/sourceId/11020014).**
15 **(https://disclosure.spglobal.com/ratings/en/regulatory/article/-/view/sourceId/10221157).**
16 **(https://croataninstitute.org/).**
17 Harrington, Bill, "Sometimes, Holding the Line *is* Progress", *Croatan Institute View*, November 17, 2022. **(https://croataninstitute.org/2022/11/17/sometimes-holding-the-line-is-progress/).**
18 **(https://croataninstitute.org/2021/05/30/injecting-accountability-into-the-u-s-and-global-financial-systems/) and (https://croataninstitute.org/william-j-harrington/).**

Today's joint submission urges three actions regarding the most noxious of needlessly complex, credit-rated finance — namely, the flip-clause-swap-contract.

(1) The CFTC and the SEC must permanently ban the flip-clause-swap-contract in the U.S.

(2) The CFTC must condition a capital comparability determination for regulated entities that operate in the EU on an outright prohibition against the regulated entities providing the flip-clause-swap-contract in the EU.

(3) In assigning credit ratings to U.S. and non-U.S. Collateralized Loan Obligations (CLOs), re-packaged securities, and all debt that references a second, separate obligor, the credit rating companies Fitch Ratings, Moody's Investors Service, and S&P Global Ratings must overhaul respective in-use and active criteria / methodologies to *significantly decrease recovery rates for a bank, swap contract dealer, or other entity that provides a flip-clause-swap-contract*.

Today's joint submission also urges fourth, fifth, and sixth actions regarding CFTC enactment of demonstrably harmful policies that prioritize tertiary considerations such as "*amplifying international comity*" and "*advancing international harmonization*" rather than implementation of best-practice policies that amplify, advance, and protect the U.S. public interest. Chief among best-practice policies that amplify, advance, and protect the U.S. public interest are the U.S. prudential regulators' swap margin and capital rules.

(4) To protect U.S. persons, U.S. regulated entities, and the U.S. economy, the CFTC must scrap tertiary considerations such as *"amplifying international comity*" and "*advancing international harmonization*" as rationales for enacting policies that both harm the U.S. public interest and diverge from U.S, prudential regulator policies.

(5) To protect U.S. persons, regulated entities, and economy, the CFTC must prioritize "*amplifying U.S. regulator comity*" and "*harmonizing with U.S. prudential regulators best practice*" in policymaking for swap margin and capital such as that for the flip-clause-swap-contract, and for the Seeded Funds and Money Market Funds Proposal. *Therefore, the CFTC must withdraw both the EU Swap Dealer Capital Comparability Determination and the Seeded Funds and Money Market Funds Proposal.*

(6) In assigning credit ratings to sovereigns, the credit rating oligopoly Fitch Ratings, Moody's Investors Service, and S&P Global Ratings must overhaul respective criteria / methodologies to *significantly increase credit losses and default probabilities where policymakers prioritize the tertiary considerations "amplifying international comity" and "advancing international harmonization" to enact deficient policies that harm their people, regulated entities, economies, and public interest.*

Once More, Into the Flip-Clause-Swap-Contract Breach!

> **"***Partly owing to the outsized losses that the Lehman Brothers Special Financing [LBSF] flip-clause-swap-contract portfolio incurred, LBSF creditors received lower recoveries than other Lehman creditors.*"[19]

On October 20, 2022, I made the same points in my joint submission to the SEC and the CFTC regarding the CFTC Japan Swap Dealer Capital Comparability Determination and five related matters. The entirety of my October 20, 2022, submission supports today's submission.[20]

Today's joint submission irrefutably demonstrates that the flip-clause-swap-contract is, by intentional design, grossly under-capitalized and thereby intrinsically destructive. The contract undermines social compacts around the world by directing investment to sub-optimal uses, by eroding value of ABS and other structured debt, by incentivizing swap dealers to self-sabotage by under-resourcing themselves, and by generating public bail-outs.

Today's joint submission also irrefutably demonstrates that nearly all financial regulators, credit rating staff, and complex-finance practitioners worldwide have ***knowingly and intentionally*** undermined social compacts for decades by mutely going with the flip-clause flow rather than speaking out and applying what they know.

The five additional documents that comprise today's submission are:

(1) *Moody's Investors Service* Pre-Sale Report "Liberty Series 2023-2", 28 February 2023
(2) *Moody's Investors Service* Rating Action "Moody's assigns definitive ratings to prime RMBS to be issued by Fortified Trust", 31 January 2023
(3) *S&P Global Ratings* New Issue: "Finance Ireland RMBS No. 4 DAC", February 3, 2022
(4) *S&P Global Ratings* Presale "Bluestone NZ Prime 2022-2 Trust", December 12, 2022 and
(5) *Moody's Investors Service* Pre-Sale Report "Elstree Funding No.3 PLC", 9 March 2023

Each of the five presales details an EU or other non-U.S. residential mortgage-backed security (RMBS) deal where a financial institution has self-sabotaged in providing a grossly under-capitalized and thereby intrinsically destructive flip-clause-swap-contract.

Please make today's joint submission — all six documents — publicly available on the respective sites for the fifteen title-line matters.

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

[20] Harrington, William J., "Joint Submission to the SEC and the CFTC Regarding Six Topics Pertaining to the Flip-Clause-Swap-Contract", October 20, 2022. **(https://www.sec.gov/comments/4-790/4790-20147063-312602.pdf).**

"The Big Short" Shortchanged the Flip-Clause-Swap-Contract that Shortchanges the World

Dealmakers outside the U.S. use the flip-clause-swap-contract to assemble ABS and other structured deals on the cheap.[21] From the get-go, each artificially "cheap" deal with an under-capitalized contract distorts price signals and investment for all types of projects. As in 2008, the deals and contracts can implode and tax everyone with bail-outs, deferred investment, and accelerated social fragmentation.[22]

> "*The flip-clause-swap-contract was a root cause of the 2008 global financial catastrophe. The flip-clause-swap-contract was an integral component of the under-capitalized structured debt that started, fueled, and pro-longed the 2008 financial catastrophe. The flip-clause-swap-contract was a tool that financial institutions such as AIG, Bear Stearns, Lehman Brothers, and many others used to under-capitalize themselves.* ***The flip-clause-swap-contract was a tool that Greece, with the active assistance of Goldman Sachs, used to crash its own economy*** [emphasis added]."[23]

> "*The flip-clause-swap-contract was central to the EU financial crisis. Even so, EU issuers of RMBS and other ABS use the flip-clause-swap-contact under policy that the US has prudently rejected. As evidence, the US economy habitually outperforms the EU. Also, our social compact rejects bailing out financial companies again, whereas the EU tolerates public support for private entities.*"[24]

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[21] The following 30 EU and other swap dealers provided one (or more) *new* swap-contracts with-flip-clauses during the period October 2022 to May 2023, based on WJH daily review of Moody's Investors Service Pre-Sale Reports and S&P Global Ratings Presales: ABN AMRO (1); ANZ (2); Barclays (1), BMO (1); BNP Paribas (8); BNZ (2); Citi (1); Coventry Building Society (2); Credit Agricole (2); DZ Bank (2); HSBC (1); ING (7); Investec (15); J.P. Morgan (2); Lloyds Bank (3); Merrill Lynch International (1); National Australia Bank (9); Natixis (2); NatWest (1); Nedbank (1); RBC (3); RCI Bank and Services (4); Santander (3); Scotiabank (3); SEB (7); SMBC Group (1); Standard Chartered Bank Korea (1); Toronto Dominion (1); UniCredit (1); and Westpac (1).

[22] "Op. Cit. Harrington Motion to File 'Lehman vs 250 Financial Entities Re Flip Clauses'", in total.

[23] Harrington, William J., "Electronic Letter to U.S. Commodity Futures Trading Commission, European Securities and Markets Authority, DBRS Morningstar, Fitch Ratings, Moody's Investors Service, and S&P Global Ratings 'Re: Deficient Accounting, Capitalization, Credit Ratings, and Regulation of EVERY Party to a Swap Contract with a Flip Clause or Other Walk-Away Provision", December 28, 2020, "Questions for the CFTC, the SEC, the SFA, LSTA, DBRS, Fitch, Moody's, and S&P Global", p3. **(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).**

[24] Harrington, William J, "Proposed Amicus Curiae Brief to the US 2nd Circuit 'Re: Case No. 18-1079-bk (Lehman vs 250 Financial Entities Re Flip Clause Enforceability)'", 25 June 2019, p38. **(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)**.

Welcome Flip-Clause-Swap-Contract Trainees New and Old, One and All!

> "*Does every structured issuer around the world still undercapitalize debt when party to a flip-clause-swap-contract?*
>
> "*Does every provider of a flip-clause-swap-contract around the world still undercapitalize its self-referencing exposure to 100% loss of contract value under each flip clause?*"[25]

I am pleased to add new addressees to my two-decades-and-counting tutorial on the systemically disastrous flip-clause-swap-contract.[26]

Chins up, Newbies! Stay strong though today's submission shows that you degrade the public good day in and decade out. After all, permanent rookies such as Ms. Stephanie Webster (General Counsel, Institute of International Bankers (IIB)), Mr. Steven Kennedy (Global Head of Public Policy, International Swaps and Derivatives Association (ISDA)), Ms. Kyle Brandon (Managing Director, Head of Derivatives Policy, Securities Industry and Financial Markets Association (SIFMA)), Ms. Sarah Breeden (Executive Director for Financial Stability Strategy at the Bank of England), all credit rating addressees, and many, many other practitioners the world over do exactly that, namely degrade the public good day in and decade out![27]

As Ms. Webster, Mr. Kennedy, Ms. Brandon, Ms. Breeden, former Moody's chums, their credit rating "competitors", and all reluctant leaners can attest, I am among the few worldwide to rigorously assess the proliferation of gaping credit exposures that a flip-clause-swap-contract generates for an EU or other non-U.S. ABS or structured debt issuer, for an EU or other non-U.S. swap dealer, for an EU or other non-U.S. economy, for broader financial systems, and for other sovereigns. Further, I am the *only* one worldwide who publicly posts and disseminates *all* rigorous assessments of the proliferation of gaping credit exposures that a flip-clause-swap-contract generates for an EU or other non-U.S. ABS or structured debt issuer, for an EU or other non-U.S. swap contract dealer, for an EU or other non-U.S. economy, and for broader financial systems and other sovereigns.[28]

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[25] "Op. Cit. Harrington Electronic Letter to CFTC, ESMA, and Four NRSROs, December 28, 2020", "Questions for the CFTC, the SEC, the SFA, LSTA, DBRS, Fitch, Moody's, and S&P Global" Nos. 2 and 3, p15. **(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).**

[26] "Op. Cit. Harrington Motion to File 'Lehman vs 250 Financial Entities Re Flip Clauses'", in total. Also, Harrington, Bill, "Can Green Bonds Flourish in a Complex-Finance Brownfield?", Croatan Institute *Working Paper*, July 2018, in total. **(https://croataninstitute.org/2018/07/01/can-green-bonds-flourish-in-a-complex-finance-brownfield/).**

[27] Regarding Ms. Sarah Breedon as permanent rookie viz-a-viz the flip-clause-swap-contract, see "WJH and Bank of England Staff -- Flip Clause Meeting and Correspondence -- 31 May 2014 to 26 June 2019". **(https://www.sec.gov/comments/4-790/4790-195119-387602.pdf).**

[28] **See Footnote 18.**

Financial Practitioners Worldwide Honor My Best-Practice Work in the Breach

> "*Since resigning [as Moody's Investors Service senior vice president] in 2010, I have taught myself to be a public-citizen advocate by following financial practitioner leads in speaking to media, co-authoring academic papers and op-eds, and submitting public responses to proposals to regulate and assign credit ratings to complex-finance bonds. However, I break from industry practice in working entirely in the public domain, whereas industry representatives augment public relations with closed-door, off-the-record meetings with policymakers.*"[29]

Almost solely owing to my work, the Bank of England, the CFTC, the SEC, Fitch Ratings, Moody's Investors Service, S&P Global Ratings, the IIB, ISFA, SIFMA, and many, many, many other entities and people worldwide who should fully appreciate the proliferation of gaping credit exposures that a flip-clause-swap-contract generates for an EU or other non-U.S. ABS or structured debt issuer, for an EU or other non-U.S. swap contract dealer, for an EU or other non-U.S. economy, for broader financial systems, and for other sovereigns ***do*** fully appreciate the proliferation of gaping credit exposures.

Unfortunately for EU and other non-U.S. peoples, for EU and other non-U.S. economies, for EU and other non-U.S. swap contract dealers, for EU and other non-U.S. ABS and structured debt issuers, for broader financial systems, and for other sovereigns, the Bank of England, Fitch Ratings, Moody's Investors Service, S&P Global Ratings, the IIB, ISDA, SIFMA, and many, many, many other entities and people worldwide who should and do fully appreciate the proliferation of gaping credit exposures that each flip-clause-swap-contract generates ***will not*** mitigate the exposures, not even by a little bit.[30]

> "*Among complex-finance practitioners such as accountants, bankers, bond analysts, and legal counsel, the swap-contract-with-flip-clause is an unacknowledged open secret. No financial practitioner does defensible work on the contract because all practitioners that use the contract deliberately ignore deficiencies that stare them in the eye. The global credit rating companies Fitch Ratings, S&P Global Ratings, and my former employer Moody's Investors Service amplify the 'see no evil' approach in posting credit ratings and methodologies for practitioners the world over to exploit. Extending the systemic damage, Fitch, Moody's, and S&P are swamping ESG rating and analyses with the same 'see no evil' methods.*"[31]

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[29] "Op. Cit. Harrington 'Sometimes, Holding the Line *is* Progress'". **(https://croataninstitute.org/2022/11/17/sometimes-holding-the-line-is-progress/).**

[30] "Op. Cit. Harrington Electronic Letter to CFTC, ESMA, and Four NRSROs, December 28, 2020", "*Financial Sector Apologists, Enablers, Cowering ChurchMice, and Fence-Sitters Also Know All About All the Myriad Flip Clause Problems*", pp7-11. (**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).**

[31] "Op. Cit. Harrington 'Sometimes, Holding the Line *is* Progress'". **(https://croataninstitute.org/2022/11/17/sometimes-holding-the-line-is-progress/).**

Goldman, JPM, BoA & Citi Don't Need *EXEMPTIONS* to Flout CFTC Rules

> "*This week, the CFTC issued three orders imposing civil monetary penalties of over $50 million combined in actions involving several of the largest financial institutions in our nation and several of the most significant institutions in global swaps markets—**JP Morgan Chase Bank, N.A.** and affiliated entities; **Bank of America, N.A.** and **Merrill Lynch International**; and **Goldman Sachs & Co. LLC.**"* [32]

To protect U.S. persons, U.S. regulated entities, and the U.S. economy, the CFTC must withdraw both the EU Swap Dealer Capital Comparability Determination and the Seeded Funds and Money Market Funds Proposal.

To protect U.S. persons, U.S. regulated entities, and the U.S. economy, the CFTC must prioritize "*amplifying U.S. regulator comity*" and "*harmonizing with U.S. prudential regulators best practice*" in policymaking for swap margin and capital such as that for the flip-clause-swap-contract, for the EU Swap Dealer Capital Comparability Determination, and for the Seeded Funds and Money Market Funds Proposal.

To protect U.S. persons, U.S. regulated entities, and the U.S. economy, the CFTC must insist that Goldman Sachs, JP Morgan, Citi, Bank of America, and all swap dealers scrupulously respect existing rules for the next few decades.

To protect U.S. persons, U.S. regulated entities, and the U.S. economy, the CFTC must determine that Goldman Sachs, JP Morgan, Citi, Bank of America, and all swap dealers have scrupulously respected existing rules for the past few decades. Then, and only then, may the CFTC propose policies that depart from prudential regulators' best-practice.

> "*I support this CFTC enforcement case against Goldman Sachs, the fourth case against Goldman in my 18-month tenure at the CFTC. I commend our staff for uncovering the pervasive and persistent violations of the law by Goldman in its over-the-counter derivatives business known as swaps.* ***However, I cannot support the settlement, as it is not strong enough to achieve the goals of law enforcement—justice, accountability, and deterrence*** *[emphasis added].*
>
> **"*Over and Over Again: Goldman's Corporate Culture of Violating Federal Laws, Getting Caught, and Settling Federal Enforcement Cases***
>
> "*As a longstanding federal enforcement official, I am significantly concerned that Goldman is a repeat defendant in federal enforcement cases. Goldman has a long*

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[32] CFTC, "Statement of Commissioner Kristin N. Johnson on Mitigating the Systemic Risks of Swap Data Reporting Compliance Failures and Enhancing the Effectiveness of Enforcement Actions", *Public Statements and Remarks*, September 29, 2023. **(https://www.cftc.gov/PressRoom/SpeechesTestimony/johnsonstatement092923b).**

history of violating federal laws, getting caught, and then settling with federal agencies."[33]

Regulated entities that routinely flout existing CFTC "*mandates*" and "*anti-evasion provisions*" will just as routinely flout whatever other "*certain requirements*" the CFTC has in store.

"*In addition, the CFTC proposes to make the eligible seeded fund exception available only with respect to funds that have a bona fide business and economic purpose, meaning that the funds are not created for the sole purpose of evading the IM compliance thresholds. Rather, the exception is intended for funds that engage in genuine efforts to test their investment strategy and distribute the funds' shares to third-party* investors. ***To that end, in addition to relying on anti-evasion provisions already existing in the Commission regulations to address the potential circumvention of the IM compliance thresholds, the CFTC proposes to limit the availability of the proposed treatment for seeded funds to entities that meet certain requirements*** *[emphasis added].*"[34]

"***In addition, section 4s(j)(2) of the CEA requires CSEs to adopt a robust and professional risk management system that is adequate for the management of their swap activities, and Commission Regulation 23.600 mandates that CSEs establish a risk management program to monitor and manage risks associated with their swap activities including, among other things, credit and liquidity risks*** *[emphasis added]. In particular, pursuant to Commission Regulation 23.600(c)(4), credit risk policies and procedures should provide for the regular valuation of collateral used to cover credit exposures and the safeguarding of collateral to prevent loss, disposal, rehypothecation, or use unless appropriately authorized, and liquidity risk policies and procedures should provide for, among other things, the assessment of procedures for liquidating all non-cash collateral in a timely manner and without a significant effect on price, and the application of appropriate collateral haircuts that accurately reflect market and credit risk.*"[35]

Negative interest rates are *sooo* 2020! Out-dated rationale for indefensible proposal

"*Moreover, the [2020 GMAC Margin] Report stated that the use of MMF securities as collateral may enable market participants to* ***avoid potential negative interest rate charges*** *[emphasis added] that may be applied by custodian banks on cash collateral.*"[36]

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[33] CFTC, "Concurring Statement of CFTC Commissioner Christy Goldsmith Romero on CFTC v. Goldman Sachs Over and Over Again", *Public Statements and Remarks*, September 29, 2023. **(https://www.cftc.gov/PressRoom/SpeechesTestimony/romerostatement092923c).**

[34] "Op. Cit. 'CFTC Seeded Funds and Money Market Funds Proposal'", pp53413-4. **(https://www.cftc.gov/sites/default/files/2023/08/2023-16572a.pdf).**

[35] "Ibid.", p53418.

[36] "Ibid.", p53417.

ISDA and SIFMA *ENDORSED* My Flip-Clause-Swap-Contract Work; *STILL* Push CFTC to Okay Needlessly Complex EU Finance for BoA, Citi, Goldman Sachs, and Morgan Stanley

In 2005-2006, Moody's colleagues and I produced what is to-date the only rigorous, comprehensive credit rating methodology for the flip-clause-swap-contract ("Moody's 2006 Hedge Framework"). SIFMA and ISDA, which along with the IIB requested the CFTC comparability determination for EU swap capital rules, appended Moody's 2006 Hedge Framework to a 2017 amicus curiae brief in major litigation concerning the flip-clause-swap-contract that pitted Lehman Brothers against most other major financial entities.[37]

In short, SIFMA and ISDA argue both sides of the flip-clause coin.

> "*In a closely-related instance of financial practitioners devoting resources to offload CSE [covered swap entity] 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.' 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. 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.*"[38]

The 2017 SIFMA-ISDA brief urged the court to uphold an earlier ruling against Leman Brothers that imposed losses equal to 100% of mark-to-market for 100% of the flip-clause-swap-contracts litigated. The brief also acknowledged that banks and dealers of the flip-clause-swap-contract continue to under-resource the contracts and, by implication, may themselves create Lehman-Brothers-type havoc in the future.[39]

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[37] Manchester, Edward, Bill Harrington, and Nicholas Lindstrom, "Framework for De-Linking Hedge Counterparty Risks from Global Structured Finance Cashflow Transactions—Structured Finance Rating Methodology", *Moody's Investors Service*, May 25, 2006, in "Brief of SIFMA and ISDA in Support of Defendants-Appellees and Affirmance Re: U.S. District Court for the Southern District of New York, Case No. 17-cv-1224-LGS, Lehman Brothers Special Financing, Inc. against Bank of America, National Association and all", June 16, 2017, Exhibit A. **(https://www.sifma.org/wp-content/uploads/2017/06/LehmanBrothers061617.pdf)**.

[38] "Op. Cit. Harrington Joint SEC and CFTC Submission October 20, 2022", p15. **(https://www.sec.gov/comments/4-790/4790-20147063-312602.pdf).**

[39] "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*

To help the CFTC issue a useful EU comparability determination, SIFMA, ISDA, and the IIB ***should have*** reminded the CFTC that a flip-clause-swap-contract acts in direct opposition to Tier 2 capital. To wit, in the "*event of an entity's insolvency*", every single, solitary flip-clause-swap-contract that is an asset to the insolvent entity instantly vaporizes.[40]

To help itself issue a useful EU comparability determination, the CFTC should have asked SIFMA, ISDA< and the IIB ***something, anything*** about the flip-clause-swap-contract.[41] Likewise, the CFTC should have included ***something, anything*** about the flip-clause-swap-contract in the EU Swap Dealer Capital Comparability Determination.[42]

Credit Raters Breach Honest Evaluation of Needlessly Complex Finance & Sovereign Enablers

"Credit Rating Companies that Earn from Bad History are Groomed to Repeat It"[43]

Fitch Ratings, Moody's Investors Service, and S&P Global Ratings point-blank *refuse* to publicly post rigorous assessments of the proliferation of gaping credit exposures that a flip-clause-swap-contract generates for an EU or other ABS or structured debt issuer, for an EU or other swap dealer, for EU and other economies, for broader financial systems, and for other sovereigns, including the U.S. as ultimate stabilizer of financial systems worldwide. Instead, Fitch, Moody's, and S&P *knowingly and intentionally inflate credit ratings* for ***ALL*** ABS and other structured debt of issuers worldwide that are party to a flip-clause swap-contract, for ***ALL*** swap dealers worldwide that provide the contract, for **ALL** EU and non-U.S. sovereigns that enable issuers or dealers to enter the contract, for broader financial systems, and **for other sovereigns, including the U.S.** as ultimate stabilizer of financial systems worldwide.

I resigned as Moody's Investors Service senior vice president in July 2010 after declining an unsolicited offer to join the group that compels complex finance analysts to deliver and strictly apply *issuer-friendly* methodologies, including for the flip-clause-swap-contract. Why decline-and-resign? Because Moody's studiously *ignored* the centrality of the flip-clause-swap-contract to the 2008 calamity and just as studiously *refused* to rigorously assess the proliferation of gaping

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

40 IIB, ISDA, and SIFMA, "Re: CFTC Staff Questions Regarding Substituted Compliance Application for EU Swap Dealers from CEA Sections 4s(e)–(f) and Rules 23.101 and 23.105(d)–(e), (p)(2)", March 9, 2023, p3, in IIB, ISDA, and SIFMA, "Electronic Submission to the CFTC 'Re: Substituted Compliance Application for EU Swap Dealers from CEA Sections 4s(e)–(f) and Rules 23.101 and 23.105(d)–(e), (p)(2)'", September 24, 2021. **(https://www.cftc.gov/LawRegulation/DoddFrankAct/CDSCP/index.htm).**

41 "Ibid.", see absence of "*flip clause*" throughout.

42 "Op. Cit. EU Swap Dealer Capital Comparability Determination". See absence of "*flip clause*" throughout. **(https://www.cftc.gov/sites/default/files/2023/06/2023-13446a.pdf).**

43 You read it here first.

credit exposures that a flip-clause-swap-contract generates for an ABS or structured debt issuer anywhere in the world, for a swap dealer anywhere in the world, for local economies, for broader financial systems, and for sovereigns, especially the U.S. as ultimate financial stabilizer.

In May 2011, Moody's Investors Service refused to rigorously assess the proliferation of gaping credit exposures that a flip-clause-swap-contract generates for a swap dealer.

> "*Thank you for your comments concerning Moody's bank rating methodology [viz-a-viz credit exposures that the flip-clause-swap-contract generates]. We appreciate your sharing them with us and will give them appropriate consideration. We understand that you have contacted several Moody's employees to provide your comments . . . You are welcome to direct any further comments directly to me, and I will make sure that they are shared with the relevant rating and credit policy personnel.*"[44]

After scrapping Moody's 2006 Hedge Framework in November 2013 because the framework's comprehensive rigor hurt business, Moody's Investors Service posted increasingly diluted, willfully negligent successor methodologies that minimized the proliferation of gaping credit exposures that each flip-clause-swap-contract generated for an ABS or other structured debt anywhere in the world and *entirely ignored* the gaping credit exposures that each contract generated for a swap dealer anywhere in the world.

In September 2017, Fitch Ratings refused to rigorously assess the proliferation of gaping credit exposures that each flip-clause-swap-contract generated for student loan company Navient, for its ABS, and for its swap contract dealers, including EU dealers.

> "*Thanks for sending this along. We will look into the issue.*"[45]

In April and in May 2018, S&P Global Ratings refused to acknowledge, let alone rigorously assess, U.S. CLO credit exposures to poor governance when an issuer placed flip clauses in the priorities of payments but provided neither operational capabilities nor financial resources to comply with U.S. swap margin rules.

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[44] "Email response of Moody's Investors Service Chief Credit Officer Richard Cantor to Bill Harrington 'Re Recognizing the Market Loss That a Bank Agrees to Bear Under a Swap with a Securitization'", May 16, 2011, in Harrington, William J., "Submission to CFTC 'Re: RIN 3038-AD54 Capital Requirements for Swap Dealers and Major Swap Participants'", May 4, 2017, pp135-136. **(https://comments.cftc.gov/PublicComments/ViewComment.aspx?id=61196&SearchText)**. **N.B.,** at least one of today's Moody's Investors Service recipients also received my May 12, 2011, email that Cantor brushed off. Cantor, now Moody's Investors Service Vice Chairman, was Chief Credit Officer until April 2022, according to his LinkedIn profile on Aug 1, 2023. **(https://www.linkedin.com/in/richard-cantor-b576617/)**.

[45] Meghan Neenan, Managing Director — Financial Institutions, Fitch Ratings, email to Bill Harrington "Re Navient Solvency & Margin Rules for Uncleared Swaps", September 11, 2017. **N.B.,** Ms. Neenan also received today's submission.

"*S&P Global Ratings has not rated a new or refinanced US CLO [with a flip clause] that [also] contains a swap during the time that the margin posting rules for uncleared swaps have been effective. Specifically, the ZAIS CLO 8 Ltd./ZAIS CLO 8 LLC transaction you reference in your e-mail was not structured with a swap, and accordingly margin posting was not an analytical consideration when issuing our ratings. If the ZAIS issuer were to enter into a swap, it would be at that time that we would apply our relevant criteria to assess any impact such a swap would have on our outstanding ratings. We maintain that we abided by our relevant criteria when rating ZAIS CLO 8 Ltd./ZAIS CLO 8 LLC."*[46]

"*We did not feel the need to update our counterparty criteria following the introduction of the [U.S.] margin requirements as we continue to stand behind our methodology that incorporates reliance on replacement of counterparties.*
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"*When a swap counterparty does not replace itself, we would not automatically downgrade our rating on the applicable security. In this case, we would analyze the particular transaction and assess if there are other mitigants that would cover the increased counterparty risk. For example, our cash flow analysis may show that there is sufficient credit enhancement available to cover interest rate risk in the event that the counterparty defaults. Another example would be the counterparty providing us with a detailed action plan outlining their strategy and our determination as to whether this information may give us comfort that there is no immediate need to downgrade the notes.*"[47]

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[46] Mark Risi, Managing Director / Lead Analytical Director / Structured Finance, S&P Global Ratings email to Bill Harrington "Re NRSRO Ratings of U.S. CLOs with Flip Clauses but No Margin Posting Provisions", April 19, 2018. From WJH return email of April 19, 2018. "*I appreciate your reply, which proves my point. S&P does not abide by its methodologies when assigning ratings to US CLOs with flip clauses in the priorities of payment. II Most obviously, S&P represents that it conducts a forward-looking analysis on all features of a new deal such as ZAIS CLO 8 Ltd./ZAIS CLO 8 LLC. If so, what forward-looking analysis did S&P conduct with respect to the legal opinion on flip clause enforcement, the business plan to enter into a flip clause swap but not a margin posting swap, and manager quality? II S&P also represents that it applies applicable rating methodologies consistently across a given asset class. If so, what forward-looking comparisons did S&P conduct between US CLOs that do and do not have flip clauses in the priorities of payment?*"
N.B., at least two of today's S&P Global Ratings recipients also received my February 16, 2018, email that elicited Mr. Risi's email of April 19, 2018.

[47] Katrien Van Acoleyen — Global Structured Finance Head Methodologies, S&P Global Ratings, email to Bill Harrington "Re Your letter to CFTC dated Feb. 2, 2018 Re: CFTC No Action Letter", May 29, 2018.

C'mon Flip-Clause-Swap-Contract Trainees, Here's Your Chance!

Rip apart the S&P Global Ratings evasion line-by-lying-line. Stymied after 20-years of study? Here's a hint. The S&P response unequivocally shows that the credit rating company, like oligopolistic "competitor" Moody's Investors Service, compels complex finance analysts to deliver and strictly apply *issuer-friendly* methodologies for the flip-clause-swap-contract.

Still blocked, flip-clause-swap-contract trainees? That's fine. I'll do your work yet again for the umpteenth time since 1999.

(1) S&P Global Ratings had no analytical basis to "*continue to stand behind our methodology that incorporates reliance on replacement of counterparties."*
(2) Regarding the hundreds or more past instances of non-replacement worldwide — namely, *"[w]hen a swap counterparty does not replace itself*" — S&P Global Ratings not only did *"not automatically downgrade our rating on the applicable security."*
(3) S&P also failed to downgrade *any* EU or other swap contract dealer to reflect ballooning self-exposure to flip clause activation arising from non-replacement and increased probability "*that the counterparty defaults."*[48]

Why? Well, by this point in today's tutorial, trainees old and new alike should know the answer by heart. All together. S&P Global Ratings optimizes corporate earnings by knowingly and intentionally inflating credit ratings for all ABS and other structured debt of issuers worldwide that are party to a flip-clause swap-contract, for all swap dealers worldwide that provide the contract, for all EU and non-U.S. sovereigns that enable issuers or dealers to enter the contract, for broader financial systems, and for other sovereigns, including the U.S. as ultimate stabilizer of financial systems worldwide.

Dubious? Trainees, consider your own flip-clause-swap-contract malfeasance! Yes, your indefensible perpetuation of the flip-clause-swap-contract degrades the public good day in and decade out! Considering your collective failures, why should S&P alone do the right thing and assign accurate credit ratings to EU and other non-U.S. ABS, other structured debt, or flip-clause-swap-contract dealers?

Moreover, your bad history is S&P Global Ratings good side! By September 15, 2008, S&P must have received more than a few Lehman Brothers *"detailed action plan[s] outlining their strategy*"

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[48] Regarding 25 downgraded swap dealers — including 17 downgraded EU swap dealers — that collectively obtained 77 credit rating company permissions to unilaterally disregard replacement and other remedial obligations viz-z-viz 100-plus EU and other ABS and structured debt issuers, see Structured Credit Investors (SCI), "Counterparty Conundrums", 2 August 2013 in Harrington, William J., "Electronic Letter to the U.S. Securities and Exchange Commission and the European Securities and Markets Authority Re Inflated Credit Ratings of ABS and Derivative Product Companies", September 11, 2013, Appendix B, pp17-19. **(https://www.wikirating.com/data/other/20130911_Harrington_J_William_ABS_Losses_Attributable_to_Securitization_Swaps.pdf).**

on all fronts, including the immense portfolio of self-sabotaging flip-clause-swap-contracts. Judging by the static S&P rating history for all Lehman entities, each successive "*detailed action plan*" convinced S&P "*that there [was] . . . no immediate need to downgrade*" either Lehman Brothers itself or any Lehman subsidiary or affiliate. Likewise, S&P discerned "*no immediate need to downgrade the notes*" where Lehman Brothers provided flip-clause-swap-contracts.

Moody's: *"Market Interest in Ratings That Exclude Government Support is Currently Low*."[49] On May 11, 2023, Moody's Investors Service cited low "*market interest in ratings that exclude government support*" in doubling-down on refusing to rigorously assess the proliferation of gaping credit exposures that each flip-clause-swap-contract generated for an EU or other non-U.S. ABS or structured debt issuer and for an EU or other non-U.S. swap contract dealer. The result? Moody's continues to incentivize all EU and other non-U.S. ABS and structured debt issuers, and all EU and other non-U.S. swap dealers, to enter flip-clause-swap-contracts by assigning bank credit ratings, counterparty assessments, and counterparty instrument ratings that explicitly assume public support for bank swap dealers.

> "*Moody's Investors Service published on April 5, 2022, a Request for Comment on the proposed introduction of ratings that exclude government support (XG ratings) alongside the existing approach to assigning ratings to banks. The Request for Comment also included the proposed introduction of a Counterparty Risk Assessment Excluding Government Support (XG CR Assessment) that would have applied to the same senior operating obligations and contractual commitments as those for which Moody's already provides Counterparty Risk (CR) Assessments.*
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> *"Following the closure of the comment period and review of submitted comments, Moody's has decided that it will not update the banks methodology as proposed. . . . Moody's decision reflects its view that market interest in ratings that exclude government support is currently low."*[50]

Reflect a moment Moody's Investors Service concluded "*that market interest in ratings that exclude government support is currently low*" from just six respondents, including a mousy five who "*requested confidentiality.*" In other words, Moody's will continue long-standing practice of developing and strict applying methodologies for bank credit ratings and counterparty assessments that rest on bailout and other government support assumptions — assumptions

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[49] "Moody's concludes proposal on ratings excluding government support for banks methodology, decides not to proceed with proposal", Moody's Investors Service *Methodology RFC Announcement*, May 11, 2023. **(https://www.moodys.com/research/Moodys-concludes-proposal-on-ratings-excluding-government-support-for-banks--PBC_1364275).**

[50] "Ibid."

that make bailouts and other government support more likely and thereby harm everyone worldwide — to satisfy a handful of likely beneficiaries who won't communicate publicly.[51]

Worse still for all people and economies worldwide, Moody's Investors Service exponentially accelerates the bailout doom loop by developing and strictly applying a *sovereign* methodology that pretends bank bailouts and other government support are costless. That's right! Moody's sovereign methodology assumes that the very same assumptions of bank bailouts and other government support that inflate bank credit ratings and counterparty assessments have no credit implications for affected sovereigns, at least not for Global North sovereigns and especially not for the U.S. as ultimate stabilizer of global financial systems. In tandem, Moody's sovereign and bank methodologies make bank bailouts much more likely and harm everyone worldwide, everyone that is except flip-clause-swap-contract trainees and other credit rating company groomers worldwide.

GROSS! 100% Dealer Credit Risk to Itself Under U.S. Flip Clause Outlaw

A flip clause subjects an EU or other non-U.S. swap dealer to its own credit risk in addition to the credit risk of an ABS or structured debt issuer. Furthermore, dealer self-exposure is effectively ***gross*** (i.e., simultaneously additive for each contract around the world that may be a mark-to-market asset), rather than the much, much smaller ***netted*** (i.e., where mark-to-market liabilities and assets offset each other and can significantly reduce exposure).

Why effectively gross rather than netted? Two reasons.

(1) By design, each ABS and other structured debt issuer counterparty is a standalone entity with only one or a few flip-clause-swap-contacts. Moreover, where an issuer ***is*** counterparty to more than one contract, each contract is more likely to mirror the others than to offset them.
(2) By design, ***all*** ABS and other structured debt issuers around the world that have out-of-the-money flip-clause-swap-contracts with a provider that has filed for bankruptcy will quickly and simultaneously activate **all** relevant flip clauses.

"*Each aspect of the proposed model approval process and the computation of the credit risk charges ignores the 100% exposure to itself that a swap dealer bears under a flip clause, walkaway or similar provision in an uncleared swap or an uncleared security-based swap. These provisions enable the counterparty to an uncleared swap or an uncleared security-based swap to write off all payments that would otherwise be due a swap dealer simply because it is bankrupt, insolvent, non-performing or similarly impaired.*
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[51] "Ibid." "*Moody's received a total of six comments submitted through the Request for Comment page in response to this RFC, for which five respondents requested confidentiality.*"

"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 a swap dealer will simultaneously activate them against the swap dealer when it is bankrupt, insolvent, non-performing or similarly impaired."[52]

"*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 00were paid pursuant to Noteholder Priority."[53]

Credit Ratings: Dealer Default = *NO* Losses for Dealer or Flip-Clause-Swap-Contract Parties

Credit ratings of ABS or structured debt where an EU or other non-U.S. issuer is party to a flip-clause-swap-contract assume that the contract, and the flip clause in particular, ***never*** imposes significant losses on an issuer owing to dealer default. Likewise, and incredibly, credit ratings, counterparty assessments, and counterparty instrument ratings of the very same EU or other non-U.S. swap contract dealer assume that it incurs ***no*** significant losses from its own default, not even from the zero-sum, self-referencing flip clause. To perpetuate non-recognition of contract losses from dealer default, dealers and issuers alike rely on credit rating companies to do the following.

(1) ***Ignore*** the gaping credit exposures that each flip-clause-swap-contract generates for an EU or other non-U.S. bank or swap contract dealer.
(2) ***Minimize*** the gaping credit exposures that each flip-clause-swap-contract generates for credit-rated EU or other non-U.S. ABS or structured debt.
(3) ***Pretend*** that the public incurs no costs when EU and other sovereigns, not least the U.S. as ultimate stabilizer of global financial systems, bail-out or otherwise support banks, swap dealers, and other financial entities.

Regarding 1), Fitch Ratings, Moody's Investors Service, and S&P Global Ratings knowingly post deficient credit rating methodologies for, and knowingly assign inflated credit ratings,

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[52] "Op. Cit. Harrington CFTC Submission May 4, 2017", p40 and throughout. **(https://comments.cftc.gov/PublicComments/ViewComment.aspx?id=61196&SearchText)**.

[53] "Op. Cit. Harrington Proposed Amicus Curiae Brief to US 2nd Circuit 'Re: Case No. 18-1079-bk", 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)**.

counterparty assessments, and counterparty instrument ratings to, EU and other non-U.S. banks and swap contract dealers to accommodate ongoing provision of flip-clause-swap-contracts. Credit ratings, methodologies, and commentary completely and intentionally ignore the idiosyncratic self-sabotage that an EU or other non-U.S. bank or dealer self-inflicts in assuming full exposure to itself for full value of each flip-clause-swap-contract that may be an asset. Fitch, Moody's, and S&P should, but categorically will not, assign accurate credit ratings, accurate counterparty assessments, or accurate counterparty instrument ratings to EU and other non-U.S. banks and dealers, i.e., credit ratings that incorporate credit-self-exposure equal to 100% loss for 100% of flip-clause-swap contracts that may be in-the-money assets.

Regarding 2), Fitch Ratings, Moody's Investors Service, and S&P Global Ratings knowingly post deficient credit rating methodologies for, and knowingly assign inflated credit ratings to, EU and other non-U.S. RMBS, ABS, and other structured debt to accommodate issuers that enter swap-contracts-with-flip-clauses.

Regarding 3), Fitch Ratings, Moody's Investors Service, and S&P Global Ratings knowingly post deficient methodologies for, and assign inflated credit ratings to, EU and other non-U.S. sovereign entities that promote the use of flip-clause-swap-contracts despite the costs of bailing out or otherwise supporting banks and swap dealers. Using the same deficient methodologies, Fitch, Moody's, and S&P knowingly assign inflated credit ratings to the U.S. as ultimate stabilizer of global financial systems. Credit ratings, methodologies, and commentary completely and intentionally ignore the systemic damage that will instantly erupt from simultaneous flip clause activation by all EU and other non-U.S. ABS and structured debt issuers worldwide that are party to an out-of-the-money flip-clause-swap-contract with a defaulted, bankrupt, or otherwise insolvent EU or other non-U.S. bank or swap contract dealer. Fitch, Moody's, and S&P should, but categorically will not, assign accurate credit ratings to an EU or other non-U.S. sovereign that allows banks and dealers dealer to expose the local economy, broader financial systems, and other sovereign entities to Lehman Brothers havoc. Similarly, Fitch, Moody's, and S&P should, but categorically will not, assign accurate credit ratings to the U.S. that recognize the credit exposures that our Country, and thus the U.S. public, bears as ultimate stabilizer of global financial systems.

LUCKY US (For Now)! CFTC Swap Margin Rule Renders Flip-Clause-Swap-Contact Nonviable

> "***US Congress, markets, and regulators have consigned the flip-clause-swap-contract to the garbage heap of history. There, the contract rots away with aerosol sprays, trans-fats, asbestos tiles, and other toxic synthetics that poisoned users, producers, and our Country.***"[54]
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> "*Fortunately for U.S. persons, our law and regulation render the flip-clause-swap-contract commercially impracticable in the U.S. However, the good fortune is tenuous because financial dealmakers and industry groups periodically push for statutory and regulatory 'relief' to revive the contract. Luckily, my eleven-year-and-counting advocacy has just scored a major win that will at least slow, and might permanently block, contract revival in the U.S.*"[55]

Since 2017, U.S. swap margin rules, including the CFTC swap margin rule, have greatly benefited U.S. persons by subduing financial sector credit exposures that might otherwise draw bailouts or other U.S. government support.[56]

Of particular importance, U.S. swap margin rules subject intrinsically reckless U.S. ABS issuers, intrinsically reckless U.S. structured debt issuers, intrinsically reckless U.S. banks, and intrinsically reckless U.S. swap dealers to basic self-governance regarding the flip-clause-swap-contract. The U.S. swap margin rules, including the CFTC swap margin rule, stop U.S. ABS and other structured debt issuers from entering the flip-clause-swap-contract. Equally beneficial, the U.S. swap margin rules, including the CFTC swap margin rule, have stopped U.S. banks and swap dealers from providing the flip-clause-swap-contract in the U.S. or anywhere else in the world. Sidelined from entering flip-clause-swap-contracts, U.S. ABS issuers, structured debt issuers, banks, and swap dealers have *partially* ceased sabotaging themselves, *partially* ceased undermining the U.S. economy, *partially* ceased distorting the U.S. financial system, and *partially* ceased breaking the social compact.

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54 "Ibid.", p23.

55 "Op. Cit. Harrington 'Sometimes, Holding the Line *is* Progress'". **(https://croataninstitute.org/2022/11/17/sometimes-holding-the-line-is-progress/).**

56 Regarding *the U.S. prudential regulators'* joint swap margin rule, Harrington, Bill, "US margin rule for swaps obliges securitization issuers to overhaul structures, add resources, and rethink capital structures", *Debtwire ABS*, 5 November 2015. **(https://www.sec.gov/rules/petitions/2022/petn4-790-ex2.pdf)**. Regarding *the CFTC swap margin rule*, Harrington, Bill, "CFTC swap margin rule denies relief for ABS; shines light on 'flip clauses'", *Debtwire ABS*, 18 December 2015. **(https://www.sec.gov/files/rules/petitions/2022/petn4-790-ex3.pdf)**.

UNLUCKY EU: Their Economies Hobbled by Needlessly Complex Finance

Unfortunately for EU and other non-U.S. persons, their respective swap margin rules do the opposite of the U.S. swap margin rules, namely *generate* systemic credit exposures that in turn *increase* the likelihood that banks draw bailouts and other government support.

Deficient EU swap margin and capital rules for credit-rated complex finance in general, and for the flip-clause-swap-contract in particular, hobble EU economic performance both on an outright basis and viz-a-viz the U.S.

> "*This Policy Brief is a warning call about Europe's poor economic growth and its consequences for prosperity.*"[57]

> *"Economic growth in the Euro Area, a region that is comparable with the US, has been deeply disappointing: the region has been falling behind the US since the 1980s, lowering the EU's overall economic performance rates as a result.*"[58]

EU and other non-U.S. swap margin and capital rules *perpetuate* the flip-clause-swap-contract by allowing ABS issuers, other structured debt issuers, banks, and swap dealers to under-resource their respect contract exposures via both exemptions from margin posting and see-no-evil capital rules that treat the contract as "*plain vanilla*". As a result, EU and other non-U.S. ABS issuers, structured debt issuers, banks, and swap dealers sabotage themselves, undermine EU and other non-U.S. economies, distort financial systems, and break social compacts. Swap margin exemptions may be de-facto or de-jure. A very high threshold for posting variation margin constitutes a common type of de-facto exemption. Lumping ABS and other structured debt issuers with end users that more appropriately claim margin exemptions provides a standard de-jure exemption.[59]

As corroboration, see the priorities of payment for credit-rated debt of any EU or other non-U.S. ABS or structured debt issuer that is party to a flip-clause-swap-contract. Start with the respective priorities of payment in the five presale reports of today's submission! Not one of the five priorities of payment enables an issuer to post margin to a flip-clause-swap-contract provider. For more proof, ask any of the five deals' swap providers to report the gap between contract mark-to-market and margin exchanged. Regarding EU and other non-U.S. see-no-evil capital rules that treat the flip-clause-swap-contract as *plain vanilla*, ask any EU or other non-U.S. provider to compare two capital amounts, (1) the capital amount for one of its flip-clause-swap-

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57 Erixon, Frederik, Oscar Guinea, and Oscar du Roy, "If the EU was a State in the United Sates: Comparing Economic Growth Between EU and US States", *ECIPE Policy Brief*, July 2023, p2. **(https://ecipe.org/publications/comparing-economic-growth-between-eu-and-us-states/).**

58 "Ibid", p4.

59 Latham & Watkin, "US vs EU/UK Margin Rules", Last updated June 2, 2022, p2, "***Permanent Exemptions*** *. . . Hedging swaps related to securitisations (subject to certain conditions)*". **(https://www.lw.com/admin/upload/SiteAttachments/US-EU-UK-margin-rules-reference-guide.pdf).**

contracts, and (2) the capital amount for an otherwise identical swap contract without a flip clause, respectively.[60]

US Luck Running Out? Tone-Deaf CFTC Strains to "*Harmonize*" with Off-Pitch EU

> In *"the next two years, the Commission will consider and vote on matters for consideration that . . .* ***amplify international comity*** *[emphasis added]."*[61]
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> "*I cannot support the proposed rule.*
> II
> "*The proposed rule discusses the importance of harmonization with global regulation but not U.S. banking regulations.*
> II
> *"I have serious concerns with potentially increasing risks related to uncleared swaps, including risks to financial stability by adopting a definition that harmonizes with global regulation, but not domestic banking regulation."*[62]

Unfortunately for U.S. persons, EU and other non-U.S. counterparts who perpetuate the under-capitalization and nonexistent margin posting of needlessly complex finance both generate systemic exposures in local economies and propagate the exposures to the U.S. as the ultimate stabilizer of global financial systems.

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[60] The following 30 EU and other non-U.S. swap dealers provided one (or more) *new* swap-contracts with-flip-clauses during the period October 2022 to May 2023, based on WJH daily review of Moody's Investors Service Pre-Sale Reports and S&P Global Ratings Presales: ABN AMRO; ANZ (2); Barclays, BMO; BNP Paribas (8); BNZ (2); Citi; Coventry Building Society (2); Credit Agricole (2); DZ Bank (2); HSBC; ING (7); Investec (15); J.P. Morgan (2); Lloyds Bank (3); Merrill Lynch International; National Australia Bank (9); Natixis (2); NatWest; Nedbank; RBC (3); RCI Bank and Services (4); Santander (3); Scotiabank (3); SEB (7); SMBC Group; Standard Chartered Bank Korea; Toronto Dominion; UniCredit; and Westpac.

[61] CFTC Chair Rostin Behnam, "Testimony Before the Subcommittee on Agriculture, Rural Development, Food and Drug Administration and Related Agencies Committee on Appropriations, U.S. House of Representative", March 28, 2023. Also, "Keynote Address of Chairman Rostin Behnam at the Futures Industry Association Expo 2023, Chicago, Illinois", CFTC *Public Statements and Remarks*, October 2, 2023. "*Since my February remarks, Commission staff have been working nonstop to put forward for Commission review by the end of this year proposed and final rules covering areas such as . . .* ***amplifying international comity*** *[emphasis added] . . .*" **(https://www.cftc.gov/PressRoom/SpeechesTestimony/opabehnam35) and (https://www.cftc.gov/PressRoom/SpeechesTestimony/opabehnam37),** respectively.

[62] "Dissenting Statement of Commissioner Christy Goldsmith Romero on Notice of Proposed Rulemaking for Seeded Funds and Money Market Funds", *Policy Statement and Remark*s, July 16, 2023. **(https://www.cftc.gov/PressRoom/SpeechesTestimony/romerostatement072623e).**

Equally unfortunate for the U.S. economy and people, EU and other non-U.S. policy makers' disregard of the well-being of their respective peoples and economies supply the CFTC with a seemingly innocuous rationale — namely, to "*amplify international comity*" — to directly propagate systemic exposures by enacting harmful rules such as the EU Swap Dealer Capital Comparability Determination and the Seeded Funds and Money Market Funds Proposal, respectively.

What harmful policy will the CFTC next propose under the rubrics of *amplifying international comity* and *harmonizing* with non-U.S. regulation? Maybe, reinstating the flip-clause-swap-contract for U.S. swap dealers and for all U.S. RMBS, ABS, and structured debt issuers? CFTC failure to post my § 13.1 petition for rulemaking of May 26, 2020, strongly suggests a decision to at least preserve the option of "*amplifying international comity*" and "*harmonizing with non-U.S. regulations*" by reviving the flip-clause-swap-contract in the U.S., rather than eradicate the contract from the U.S. for good.[63]

More broadly, why does the CFTC propose to harm the U.S. people by enlisting them to backstop still more financial sector risk simply to *harmonize* with damaging EU policy that hampers the economic prospects for most people apart from flip-clause-swap trainees and other practitioners of needlessly complex finance?

[63] "*I seek a rulemaking by the Commission to prohibit a swap dealer, major swap participant, or other regulated entity from predicating a swap obligation on a flip clause, walkaway, or variable subordination.*" **(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>Response to Seeded Funds and Money Market Funds Proposal</u>
The entirety of today's submission informs below comments.

(1) To protect U.S. persons, U.S. regulated entities, and the U.S. economy, the CFTC must scrap tertiary considerations such as *"amplifying international comity"* and "*advancing international harmonization*" as rationales for enacting policies that both harm the U.S. public interest and diverge from U.S, prudential regulator policies.

(2) To protect U.S. persons, regulated entities, and economy, the CFTC must prioritize "*amplifying U.S. regulator comity*" and "*harmonizing with U.S. prudential regulators best practice*" regarding the Seeded Funds and Money Market Funds Proposal. *<u>Therefore, the CFTC must withdraw the Seeded Funds and Money Market Funds Proposal.</u>*

> *"8. … Should the Commission proceed to adopt the proposed amendments to Commission Regulation 23.151 if the prudential regulators do not adopt similar regulatory changes?"*[64]

> "*17. The Prudential Regulators Margin Rule contains an equivalent asset transfer restriction. If the Commission amends Commission Regulation 23.156, counterparties that trade with both prudentially regulated SDs and CFTC-regulated SDs may need to adjust their swap-related documentation and collateral management systems to reflect the different treatments for fund securities under the CFTC's and the prudential regulators' rules. … Should the Commission proceed to adopt the proposed amendments to Commission Regulation 23.156 if the prudential regulators do not adopt similar regulatory changes?*"[65]

(3) Regulated entities that routinely ignore existing CFTC "*mandates*" and "*anti-evasion provisions*" will just as routinely ignore whatever "*certain requirements*" the CFTC has in store.

> "*In addition, the CFTC proposes to make the eligible seeded fund exception available only with respect to funds that have a bona fide business and economic purpose, meaning that the funds are not created for the sole purpose of evading the IM compliance thresholds. Rather, the exception is intended for funds that engage in genuine efforts to test their investment strategy and distribute the funds' shares to*

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64 "<u>Op. Cit. 'CFTC Seeded Funds and Money Market Funds Proposal'</u>", p53416. **(<u>https://www.cftc.gov/sites/default/files/2023/08/2023-16572a.pdf</u>).**

65 "<u>Ibid.</u>", p53419.

third-party investors. ***To that end, in addition to relying on anti-evasion provisions already existing in the Commission regulations to address the potential circumvention of the IM compliance thresholds, the CFTC proposes to limit the availability of the proposed treatment for seeded funds to entities that meet certain requirements*** *[emphasis added]*.”[66]

“***In addition, section 4s(j)(2) of the CEA requires CSEs to adopt a robust and professional risk management system that is adequate for the management of their swap activities, and Commission Regulation 23.600 mandates that CSEs establish a risk management program to monitor and manage risks associated with their swap activities including, among other things, credit and liquidity risks*** *[emphasis added]. In particular, pursuant to Commission Regulation 23.600(c)(4), credit risk policies and procedures should provide for the regular valuation of collateral used to cover credit exposures and the safeguarding of collateral to prevent loss, disposal, rehypothecation, or use unless appropriately authorized, and liquidity risk policies and procedures should provide for, among other things, the assessment of procedures for liquidating all non-cash collateral in a timely manner and without a significant effect on price, and the application of appropriate collateral haircuts that accurately reflect market and credit risk.*”[67]

“*5. … Given that other entities such as sponsor entities or the asset manager may be incentivized to provide resources to a seeded fund in financial distress even in the absence of an explicit business arrangement or guarantee, potentially putting their own financial position at risk and thereby increasing the risk of contagion and systemic risk, what measures could the Commission take to limit the potential risks to such other entities and ultimately to the financial system?*”[68]

(4) Negative interest rates are *sooo* 2020! Out-dated rationale for indefensible proposal.

“*Moreover, the Report stated that the use of MMF securities as collateral may enable market participants to* ***avoid potential negative interest rate charges*** *[emphasis added] that may be applied by custodian banks on cash collateral.*”[69]

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66 “Ibid.”, pp53413-4.

67 “Ibid.”, p53418.

68 “Ibid.”, pp53415-6.

69 “Ibid.”, p53417.

(5) Another poor rationale for an indefensible proposal: Seeded Funds and Money Market Funds Proposal presents no rationales that advance the U.S. public interest, nor any benefits to the U.S. public interest.

The following two aspects of the proposal present ***ZERO*** protections of the U.S. public.

"*Seeded Funds Proposal (a) Protection of Market Participants and the Public*"[70]

"*Money Market Funds Proposal (a) Protection of Market Participants and the Public*"[71]

The following aspects of the proposal presents ***ZERO*** benefits for the U.S. public.

"*Request for Comments on Cost-Benefit Considerations*"[72]

(6) And another poor rationale for an indefensible proposal: Seeded Funds and Money Market Funds Proposal presents no evidence that either the existing rule or the prudential regulators' parallel rule are contrary to the public interest.

(7) Instead of presenting rationales that advance the public interest rationale, or alternatively demonstrating that the CFTC and prudential regulator status quo are contrary to the public interest, the Seeded Funds and Money Market Funds Proposal merely parrots insider, industry-friendly, concerns such as following "*regulators in other major financial markets*" and the "*Basel Committee on Banking Supervision and Board of the International Organization of Securities Commissions' Framework*".

> "*The Report noted that regulators in other major financial markets, including Australia, Canada, the EU, and Japan, have adopted the Basel Committee on Banking Supervision and Board of the International Organization of Securities Commissions' Framework for margin requirements for non-centrally cleared derivatives ('BCBS/IOSCO Framework') without requiring seeded funds to be consolidated with the sponsor and to be treated as a margin affiliate of the sponsor.*"[73]

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70 "Ibid.", p53424.
71 "Ibid.", p53425.
72 "Ibid.", p53426.
73 "Ibid.", p53411.

"*The Commission notes that the proposed eligible seeded fund exception is consistent with the approach in other countries. Jurisdictions such as Australia, Canada and the EU have adopted provisions that permit investment funds to be treated as distinct, separate entities for purposes of calculating the relevant IM thresholds, subject to conditions similar to those that the Commission intends to adopt through the proposed definition of ''eligible seeded fund'' discussed below.*

"*The proposed approach is also consistent with the BCBS–IOSCO Framework, which provides that investment funds should be treated as separate legal entities when applying the IM threshold amount provided that they are distinct legal entities that are not collateralized or otherwise guaranteed or supported by other investment funds or the investment advisor in the event of fund insolvency or bankruptcy. As such, the proposed approach would contribute to* ***global harmonization*** *[emphasis added] with respect to the treatment of investment funds, preventing potential reductions in liquidity or trading disruptions due to non-U.S. funds' limiting their trading activities to non-U.S. counterparties to take advantage of approaches to consolidation that exist in other jurisdictions.*"[74]

(8) And yet another poor rationale for an indefensible proposal: CFTC considers "*partially secured*" more than good enough for "*each party to the arrangement*".

"*However, unlike in the rehypothecation situation, where collateral might be lost at any link of the chain with the posting counterparty in the uncleared swap transaction potentially losing its collateral without any recourse, in the repurchase or similar arrangement context,* ***each party to the arrangement would be partially secured*** *[emphasis added] because the parties would exchange assets with each other under the arrangement. Hence, the risk of loss would be mitigated. If a party to the repurchase arrangement defaults by failing to return assets tendered by its counterparty, the counterparty would not lose the entire value of its assets as it would hold the assets committed by the other party under the arrangement. While acknowledging the concerns associated with repurchase and similar arrangements, the Commission preliminarily believes that the flexibility and safety that it aimed to achieve by specifically identifying assets as eligible collateral, including certain money market and similar fund securities, may be advanced even if repurchase and similar arrangements are not restricted for the purpose of qualifying money market and similar fund securities as eligible collateral.*"[75]

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[74] "Ibid.", pp53412-3.

[75] "Ibid.", p53418.

(9) Still another poor rationale for an indefensible proposal: the SEC is a minor regulator of swaps. Security-based swaps are a niche part of U.S. swap markets.

"*At the same time, the Commission notes that the removal of the asset transfer restriction would bring the CFTC's eligible collateral framework closer to the approach adopted by the SEC, which does not impose asset transfer restrictions with respect to money market and similar fund securities and expressly permits the use of government money market fund securities as collateral. Therefore, although there is the potential for greater costs as a result of divergence with the U.S. prudential regulators, there may be lower costs overall, given that many CSEs are also cross-registered with the SEC as security-based SDs."*[76]

(10) An even poorer rationale for an indefensible proposal: Abiding by best-practice margin rules requires effort, and financial practitioners don't want to expend effort.

"*The Report further observed that, given their typically small size, seeded funds are likely to encounter difficulties in establishing the necessary margin documentation and processes, as CSEs and custodians, which face competing demands for resources and services to operationalize the exchange of IM, may prioritize larger counterparties."*[77]

"*Finally, the Report stated that seeded funds that do not otherwise hold assets qualifying as eligible IM collateral under Commission Regulation 23.156 39 would need to hold larger cash reserves, which would be unavailable to implement the fund's investment strategy, or would need to incur the costs of converting fund assets into eligible IM collateral. The operational costs and potential difficulties arising in the execution of margin documentation could also either negatively impact a seeded fund's performance or inhibit its ability to trade, defeating the purpose of the original seed capital."*[78]

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[76] "Ibid.", pp53423-4.

[77] "Ibid.", p53412.

[78] "Ibid.", p53412

(11) To harmonize with the SEC and advance the U.S. public good, the CFTC must follow SEC best-practice in posting *all* petitions for rulemaking, *all* related exhibits, and *all* comments received.[79]

(12) YES!

"*3. Should the Commission impose any additional limits or conditions to the proposed eligible seeded fund exception such as: … (iii) requiring that all eligible seeded funds, consolidated within the same group on the basis of accounting principles, aggregate their exposures for purposes of calculating the MSE and IM threshold amounts that apply to such funds?*" [80]

(13) NO!

"*2. Should only the eligible seeded fund, and not its CSE counterparty, be relieved of the IM obligation?*"[81]

(14) NEGLIGIBLE!

"*4. What are the costs associated with a seeded fund calculating IM and establishing a relationship with a custodian to transfer IM?*"[82]

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[79] "Petitions for Rulemaking Submitted to the SEC", **(https://www.sec.gov/rules/petitions).** As example, please see Petition 4-790, of Jully 21, 2022, "Rulemaking petition that requests a rulemaking to prohibit 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." Please also see Exhibits I-V to the petition, and the seven comments received as of today's writing.

[80] "Ibid.", p53415.

[81] "Ibid.", p53415.

[82] "Ibid.", p53415.

Credit Rating Methodology Comment – Sovereigns

The entirety of today's submission informs the following comment on Fitch Ratings Active Rating Criteria "Sovereign Rating Criteria", Moody's Investors Service In-Use Rating Methodology "Sovereigns", and S&P Global Ratings In-Use Criteria "Sovereigns Rating Methodology".

In assigning credit ratings to sovereigns, Fitch Ratings, Moody's Investors Service, and S&P Global Ratings must overhaul respective criteria / methodologies to *significantly increase credit losses and default probabilities where policymakers prioritize the tertiary considerations "amplifying international comity" and "advancing international harmonization" to enact deficient policies that harm their people, regulated entities, economies, and public interest.*

Credit Rating Methodology Comment – Recoveries for Flip-Clause-Swap-Contract Dealers

The five presale reports that that comprise part of today's submission detail flip-clause-swap-contracts for EU and other non-U.S. credit-rated, needlessly complex finance (respectively, Australian RMBS, Canadian RMBS, Irish RMBS, New Zealand RMBS, and U.K. RMBS).

The remainder of today's letter cites each of the five EU and other non-U.S. flip-clause-swap-contracts sequentially to demonstrate why the CFTC must caveat a comparability determination on EU swap capital rules with a prohibition on any entity registered with the CFTC from providing the flip-clause-swap-contract in the EU. **The five EU and other non-U.S. flip-clause-swap-contracts also demonstrate why the credit rating companies Fitch Ratings, Moody's Investors Service, and S&P Global Ratings must overhaul respective criteria / methodologies to *significantly decrease recoveries for banks and swap contract dealers that are parties to flip-clause-swap-contracts when assigning credit ratings to CLOs, to repackaged securities, to structured notes, and to any debt that references a second, separate obligor*.**

Moody's Investors Service Pre-Sale Report "Liberty Series 2023-2", 28 February 2023

The pre-sale report informs the below comments on the three Fitch Ratings Active Rating Criteria "CLOs and Corporate CDOs Rating Criteria", "Corporate Hybrids Treatment and Notching Criteria", and "Non-Bank Financial Institutions Rating Criteria", the two Moody's Investors Service In-Use Rating Methodologies "Moody's Global Approach to Rating Collateralized Loan Obligations", and "Repackaged Securities Methodology", and S&P Global Ratings Criteria "CDOs: Global Methodology and Assumptions For CLOs and Corporate CDOs".

Fitch, Moody's, and S&P must update the respective credit rating methodologies / criteria to accurately assign lower recoveries and lower governance scores to a bank or swap dealer with self-credit-exposure of 100% loss of value under a flip-clause-swap-contract when either of the following conditions apply.

(1) A dealer exposes itself to the largest expected losses of any flip-clause-swap-contract, namely one that is both "*balance-guaranteed*" and cross-currency.
(2) A dealer may retain permanent self-exposure to 100% loss of contract value because it is not obligated to novate a flip-clause-swap-contract.

Furthermore, and crucially, Fitch, Moody's, and S&P must update the respective credit rating methodologies / criteria to do the following with utmost rigor to accurately assign lower recoveries to a bank or swap contract dealer.

(3) Track each flip-clause-swap-contract that a dealer has with an RMBS, ABS, or other structured debt issuer anywhere in the world, regardless of whether Fitch, or Moody's, or S&P, or another credit rating company, or no credit rating company assigns credit ratings to the respective RMBS, ABS, or other structured debt.
(4) Assess all contract terms.
(5) ***Assign plausible likelihood of NO NOVATION*** to each flip-clause-swap-contract, based on *realistic* evaluation of novation provisions.
(6) Assume 100% correlation of flip clause activation against a dealer for *ALL* in-the-money flip-clause-swap-contracts with RMBS, ABS, and other structured debt issuers everywhere in the world.

Moody's Pre-Sale Report "Liberty Series 2023-2", 28 February 2023 describes an Australian RMBS issuance with a cross-currency, balance-guaranteed, flip-clause-swap-contract provided by Sumitomo Mitsui Banking Corporation, Tokyo.

Moody's should, but demonstrably does not, assign lower recovery rates to Sumitomo Mitsui Banking Corporation, Tokyo that recognize the outsized credit exposures to Sumitomo itself under the balance-guaranteed, cross-currency, flip-clause-swap-contract that does not obligate a downgraded Sumitomo to novate or obtain a guarantee.

Moody's should, but demonstrably does not, assign lower recovery rates to Sumitomo Mitsui Banking Corporation, Tokyo that recognize the outsized credit exposures occasioned by the 100% correlation of flip-clause activation by *ALL* RMBS, ABS, and other structured debt issuers around the world that could have out-of-the-money flip-clause-swap-contracts should Sumitomo default, enter bankruptcy, or become insolvent.

Moody's should, but demonstrably does not, assign lower governance scores to Sumitomo Mitsui Banking Corporation, Tokyo that recognize the bank's disastrous governance in providing flip-clause-swap-contracts.

"*Allocation of payments*", pages 14-15, omits mention of swap contract receipts and payments. However, the flip clause may be inferred from the Aaa rating of the yen-denominated Class A1 Notes and other information, such as the inclusion of "*Class A1 Currency Swap SMBC*" in "*Exhibit 18—Structural Diagram*", page 13, and "*Class A1 currency swap*", page 19, below in its entirety.

> "*Liberty Funding will enter into a currency swap with SMBC to convert the proceeds from the issue of the Class A1 Notes to A$ and to hedge the currency exposure associated with its obligation to pay interest and principal on the Class A1 Notes denominated in Japanese Yen*.
>
> "*If a swap provider's Counterparty Risk Assessment falls below A3(cr), the swap provider must post collateral. If the swap provider's Counterparty Risk Assessments fall below Baa1(cr), the swap provider must also use commercially reasonable efforts to either arrange a novation or a guarantee from an entity with a Counterparty Risk Assessment of Baa1(cr) or rated Baa1 or higher.*"

The flip-clause-swap-contract is the type that exposes both credit-rated debt and swap dealer to the largest respective expected loss of any flip-clause-swap-contract, namely one that is both "*balance-guaranteed*" and cross-currency. A "balance-guaranteed" contract has an unknown, variable notional schedule rather than a predetermined, known notional schedule. A cross-currency swap contract generates enormous exposure from the outset until maturity, in contrast to the much smaller and decreasing exposures of most interest rate swap contracts.

Making already high expected losses higher still, Sumitomo Mitsui Banking Corporation, Tokyo, can avoid arranging "*a novation or a guarantee*" owing to the toothless standard "*commercially reasonable efforts*".[83] And, in further self-sabotage, Sumitomo voluntarily piles

[83] In contrast, Moody's 2006 Hedge Framework contained a suite of provisions to *"maximize the likelihood of replacement occurring."* See summary that I wrote, and that Nicolas Weill and I painstakingly line-edited, on page 5. "*Many aspects of the framework are intended to maximize the likelihood of replacement occurring. The Second Trigger is set at a level which is high enough to ensure that a Counterparty begins replacing itself where possible, prior to the emergence of potential inhibitors to its ability to do so. The collateral amounts and valuation percentages at the Second Trigger incorporate 30 additional business days in their measurement periods, to provide sufficient resources and time for the SPV to pay a replacement bid directly, should that be*

up yet more expected losses because it can obtain a "*guarantee*", which preserves flip clause exposure, rather than "*novate or transfer*" the contract, which extinguishes flip clause exposure.

In short, should Sumitomo Mitsui Banking Corporation, Tokyo default, enter bankruptcy, or become insolvent and is in-the-money under the balance-guaranteed, cross-currency, flip-clause-swap-contract, Sumitomo will lose up to 100% of contract value.[84]

The Liberty Series 2023-2 issuer enacted ***disastrous governance*** in entering the balance-guaranteed, cross-currency, flip-clause-swap-contract that does not obligate a downgraded Sumitomo Mitsui Banking Corporation to novate or obtain a guarantee. Accordingly, Moody's Investors Service fails its own self-governance by assigning "*low*" governance risks to Liberty Series 2023-2 RMBS. See the Pre-Sale report, page 2.

> "*Governance risks for this transaction are low based on the presence of transaction features such as R&W framework that support the integrity of the transaction's operations for the benefit of investors. (See 'Additional structural* analysis - ESG - Governance considerations')."

Likewise, Moody's Investors Service doubles-down on failed self-governance in imputing "*[s]trong RMBS governance*" to Liberty Series 2023-2 while *ignoring* the balance-guaranteed, cross-currency, flip-clause-swap-contract that does not obligate a downgraded Sumitomo to novate or obtain a guarantee. See the Pre-Sale report "*ESG - Governance considerations*", page 19.

> "*Strong RMBS governance relates to transaction features that promote the integrity of the operations of transaction for the benefit of investors, as well as the data provided to investors. The following are some of the governance considerations related to the transaction: Risk retention . . . Third-party reviews . . . [and] R&W framework.*"

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necessary. And the definition of Market Quotation is amended to enable replacement to occur wherever at least one eligible bidder is ready to step into an existing hedge." Moody's 2006 Hedge Framework in "Brief of SIFMA and ISDA in Support of Defendants-Appellees and Affirmance Re: U.S. District Court for the Southern District of New York, Case No. 17-cv-1224-LGS, Lehman Brothers Special Financing, Inc. against Bank of America, National Association and all", June 16, 2017, Exhibit A. **(https://www.sifma.org/wp-content/uploads/2017/06/LehmanBrothers061617.pdf)**.

[84] Sumitomo might lose *more than 100% of contract value* if, as occurred with the Lehman Brothers estate, the controller of a defaulted, bankrupt, or insolvent Sumitomo litigates flip-clause-swap-contracts with counterparties such as the Liberty 2023-2 issuer and loses.

Moody's Investors Service Rating Announcement "Moody's assigns definitive ratings to prime RMBS to be issued by Fortified Trust", 31 January 2023

The Moody's announcement informs the below comments on the three Fitch Ratings Active Rating Criteria "CLOs and Corporate CDOs Rating Criteria", "Corporate Hybrids Treatment and Notching Criteria", and "Non-Bank Financial Institutions Rating Criteria", the two Moody's Investors Service In-Use Rating Methodologies "Moody's Global Approach to Rating Collateralized Loan Obligations", and "Repackaged Securities Methodology", and S&P Global Ratings Criteria "CDOs: Global Methodology and Assumptions For CLOs and Corporate CDOs".

Fitch, Moody's, and S&P must update the respective credit rating methodologies / criteria to accurately assign lower recoveries and lower governance scores to a bank or swap contract dealer with self-credit-exposure of 100% loss of value under a flip-clause-swap-contract when either of the following conditions apply.

(1) An issuer is party to a flip-clause-swap-contract.
(2) A credit rating company cannot ascertain the likelihood that a downgraded dealer may continue as counterparty owing to novation and guarantee provisions that are unknown, ambiguous, or weak.

Furthermore, and crucially, Fitch, Moody's, and S&P must update the respective credit rating methodologies / criteria for financial institutions to do the following with utmost rigor to accurately assign lower recoveries to a bank or swap contract dealer.

(3) Track each flip-clause-swap-contract that a dealer has with an RMBS, ABS, or other structured debt issuer anywhere in the world, regardless of whether Fitch, or Moody's, or S&P, or another credit rating company, or no credit rating company assigns credit ratings to the respective RMBS, ABS, or other structured debt.
(4) Assess all contract terms.
(5) ***Assign plausible likelihood of NO NOVATION*** to each flip-clause-swap-contract, based on *realistic* evaluation of novation provisions.
(6) Assume 100% correlation of flip clause activation against a dealer for *ALL* in-the-money flip-clause-swap-contracts with RMBS, ABS, and other structured debt issuers everywhere in the world.

Moody's Investors Service Rating Announcement "Moody's assigns definitive ratings to prime RMBS to be issued by Fortified Trust", 31 January 2023 describes a Canadian RMBS issuance with a fixed-for-floating floating flip-clause-swap-contract provided by Bank of Montreal.

Moody's should, but demonstrably does not, assign lower recovery rates to Bank of Montreal that recognize the outsized credit exposures occasioned by the 100% correlation of flip-clause activation by *ALL* RMBS, ABS, and other structured debt issuer counterparties around the world

that would have out-of-the-money flip-clause-swap-contracts should Bank of Montreal default, enter bankruptcy, or become insolvent.

Moody's should, but demonstrably does not, assign lower governance scores to Bank of Montreal that recognize the bank's disastrous governance in providing flip-clause-swap-contracts.

The announcement does not disclose the priority of payments but the flip clause can be imputed from Aaa rating of the Class A notes.

The announcement *does* mischaracterize the flip-clause-swap-contract as providing "credit enhancement".

> "*Excess spread provides the first source of credit enhancement to all of the classes of notes through an interest rate swap with BMO as the counterparty. The swap arrangement provides the Trust with 1.35% in annual excess spread, payable monthly.*"

Fortified Trust 2023-1 *assets*, not the flip-clause-swap-contract, provide "*credit enhancement*" in the form of "*excess spread*." At initiation, the flip-clause-swap-contract is *on-the-money* — i.e., market neutral — and *cannot* generate excess spread or indeed any credit enhancement. What the contract *does do* from initiation straight though to maturity is exchange and re-exchange the asset-generated-excess-spread by simultaneously receiving the spread from the issuer and paying it right back. Moreover, as with every flip-clause-swap-contract, the contract exposes Fortified Trust RMBS to significant *credit exposure* to the swap dealer.

Moody's Investors Service Pre-Sale Report "Fortified Trust, Series 2023-1", 26 January 2023, may provide more information on the flip-clause-swap-contract, but was "locked", i.e., available only to paid subscribers, at time of writing.

S&P Global Ratings New Issue: "Finance Ireland RMBS No. 4 DAC", February 3, 2022

The S&P New Issue report informs the below comment on the three Fitch Ratings Active Rating Criteria "CLOs and Corporate CDOs Rating Criteria", "Corporate Hybrids Treatment and Notching Criteria", and "Non-Bank Financial Institutions Rating Criteria", the two Moody's Investors Service In-Use Rating Methodologies "Moody's Global Approach to Rating Collateralized Loan Obligations", and "Repackaged Securities Methodology", and S&P Global Ratings Criteria "CDOs: Global Methodology and Assumptions For CLOs and Corporate CDOs".

Fitch, Moody's, and S&P must update the respective credit rating methodologies / criteria to accurately assign lower recoveries and lower governance scores to a bank or swap contract dealer with self-credit-exposure of 100% loss of value under a flip-clause-swap-contract when either of the following conditions apply.

(1) A dealer exposes itself to a "*balance-guaranteed*" flip-clause-swap contract, which has higher expected losses than an otherwise similar contract with known amortization.
(2) A credit rating company cannot ascertain the likelihood that a dealer may retain permanent self-exposure to 100% loss of flip-clause-swap-contract value owing to novation provisions that are unknown, ambiguous, or weak.

Furthermore, and crucially, Fitch, Moody's, and S&P must update the respective credit rating methodologies / criteria for financial institutions to do the following with utmost rigor to accurately assign lower recoveries to a bank or swap contract dealer.

(3) Track each flip-clause-swap-contract that a dealer has with an RMBS, ABS, or other structured debt issuer anywhere in the world, regardless of whether Fitch, or Moody's, or S&P, or another credit rating company, or no credit rating company assigns credit ratings to the respective RMBS, ABS, or other structured debt.
(4) Assess all contract terms.
(5) ***Assign plausible likelihood of NO NOVATION*** to each flip-clause-swap-contract, based on *realistic* evaluation of novation provisions.
(6) Assume 100% correlation of flip clause activation against a dealer for *ALL* in-the-money flip-clause-swap-contracts with RMBS, ABS, and other structured debt issuers everywhere in the world.

S&P Global Ratings New Issue: "Finance Ireland RMBS No. 4 DAC", February 3, 2022, details an Irish RMBS issuance with a fixed-for-floating, balance-guaranteed flip-clause-swap-contract provided by BNP Paribas, London Branch.

S&P should, but demonstrably does not, assign lower recoveries credit ratings to BNP Paribas, London Branch, that recognize outsized default probabilities occasioned by the 100% correlation of flip-clause activation by *ALL* RMBS, ABS, and other structured debt issuer

counterparties around the world that would have out-of-the-money flip-clause-swap-contracts should BNP Paribas default, enter bankruptcy, or become insolvent.

S&P should, but demonstrably does not, assign lower governance scores to BNP Paribas, London Branch, that recognize the bank's disastrous governance in providing flip-clause-swap-contracts.

"*Table 4—Priority of Payments—Revenue priority of payments (simplified)*", p17, omits the subordinated portion of the flip clause but it can be imputed from both the Class A AAA rating and other information such as the following on page 19. "*The collateral posting and replacement triggers in the draft swap documents are in line with our counterparty criteria.*"

The flip-clause-swap-contract is "*balance-guaranteed*", which means that the contract has an unknown, variable notional schedule rather than a predetermined, known notional schedule that exposes both Finance Ireland RMBS No. 4 DAC RMBS and BNP Paribas, London Branch to larger expected losses relative to an otherwise similar contract that is not "balance-guaranteed.". See page 19. **"***This is a balance-guaranteed swap."*

"Counterparty Risk / Table 10 / Supporting Ratings" lists the respective credit rating triggers at which a downgraded BNP Paribas, London Branch is obligated to post collateral and then to novate (the latter, "*find a replacement*"). However, there is no mention of whether the standard to novate is the toothless "commercially reasonable efforts", a similarly weak standard, or one that is more robust. See page 22.

> "*The documented replacement mechanisms adequately mitigate the transaction's exposure to counterparty risk in line with our counterparty criteria.*
> II
> "*BNP Paribas, London Branch . . . A-1+ (post collateral) A+ 90 to find a replacement*"

S&P Global Ratings Presale "Bluestone NZ Prime 2022-2 Trust", December 12, 2022

The S&P Presale informs the below comment on the three Fitch Ratings Active Rating Criteria "CLOs and Corporate CDOs Rating Criteria", "Corporate Hybrids Treatment and Notching Criteria", and "Non-Bank Financial Institutions Rating Criteria", the two Moody's Investors Service In-Use Rating Methodologies "Moody's Global Approach to Rating Collateralized Loan Obligations", and "Repackaged Securities Methodology", and S&P Global Ratings Criteria "CDOs: Global Methodology and Assumptions For CLOs and Corporate CDOs".

Fitch, Moody's, and S&P must update the respective credit rating methodologies / criteria to accurately assign lower recoveries and lower governance scores to a bank or swap contract dealer with self-credit-exposure of 100% loss of value under a flip-clause-swap-contract when any of the following conditions apply.

(1) A swap dealer is party to a very large flip-clause-swap-contract.
(2) A swap dealer may choose, or be obligated, to increase flip-clause-swap-contract notional or provide additional contracts post-close.
(3) A credit rating company cannot ascertain the likelihood that a dealer may retain permanent self-exposure to 100% loss of flip-clause-swap-contract value owing to novation provisions that are unknown, ambiguous, or weak.

Furthermore, and crucially, Fitch, Moody's, and S&P must update the respective credit rating methodologies / criteria for financial institutions to do the following with utmost rigor to accurately assign lower recoveries to a bank or swap contract dealer.

(4) Track each flip-clause-swap-contract that a dealer has with an RMBS, ABS, or other structured debt issuer anywhere in the world, regardless of whether Fitch, or Moody's, or S&P, or another credit rating company, or no credit rating company assigns credit ratings to the respective RMBS, ABS, or other structured debt.
(5) Assess all contract terms such as possible increase of contract maturity or notional.
(6) ***Assign plausible likelihood of NO NOVATION*** to each flip-clause-swap-contract, based on *realistic* evaluation of novation provisions.
(7) Assume 100% correlation of flip clause activation against a dealer for *ALL* in-the-money flip-clause-swap-contracts with RMBS, ABS, and other structured debt issuers everywhere in the world.

S&P Global Ratings Presale "Bluestone NZ Prime 2022-2 Trust", December 12, 2022, details a New Zealand RMBS issuance with a large, and potentially growing, fixed-for-floating, flip-clause-swap-contract provided by Bank of New Zealand.

S&P should, but demonstrably does not, assign lower recovery rates to Bank of New Zealand that recognize the outsized default probabilities of all to BNZ under the large and potentially growing flip-clause-swap-contract with dubious novation and guarantee provisions.

S&P should, but demonstrably does not, assign lower recovery rates to Bank of New Zealand that recognize the outsized default probabilities occasioned by the 100% correlation of flip-clause activation by *ALL* RMBS, ABS, and other structured debt issuer counterparties around the world that would have out-of-the-money flip-clause-swap-contracts should BNZ default, enter bankruptcy, or become insolvent.

S&P should, but demonstrably does not, assign lower governance scores to Bank of New Zealand that recognize the bank's disastrous governance in providing flip-clause-swap-contracts.

The report omits the priority of payments but the flip clause can be imputed from the AAA ratings for the three Class A tranches (Class A1-S, Class A1-L, and Class A2). The swap notional is large owing to the mismatch between 70% fixed-rate assets and at least 90% floating-rate liabilities, and will not step down for at least five years. See page 15.

> "*The portfolio consists of 69.6% fixed-rate loans with a maximum fixed-rate period of up to five years.*"

Moreover, the large swap notional may grow larger after close. See pages 15 and 16, respectively.

> "*The transaction documents allow for variable-rate loans to convert to a fixed rate of interest and for existing fixed-rate loans to refix for another fixed-rate period, subject to the fixed interest rate being hedged under an interest-rate swap and that the net receipt to the trust from the fixed-rate loans (after the interest-rate swap) meets a documented minimum margin.*"
> II
> "*Fixed- to floating-rate swaps have been entered into to hedge the fixed-rate loans included in the portfolio at closing and any loans that convert to fixed rate after transaction close.*"

The S&P Presale offers little useful information on flip-clause-swap-contract parameters, but raises alarms by indicating potentially massive governance failures by both issuer and Bank of New Zealand. To wit, should S&P Global Ratings downgrade BNZ, the latter may evade posting collateral, novating, obtaining a guarantee, or taking any action to limit issuer losses. See page 15.

> "*The swap agreements include downgrade language that requires the posting of collateral or the replacement of the swap counterparties **or other remedy** [emphasis added], consistent with our 'Counterparty Risk Framework: Methodology And*

Assumptions' criteria, published on March 8, 2019, should the rating of the counterparties fall below the applicable ratings."

Post-2008, a slew of downgraded swap dealers, often with credit rating companies and issuers approvals, defined "other remedy" as "no action" so as to ignore obligations to post collateral, to novate, to obtain a guarantee, or to otherwise mitigate increased risk of non-performance.

"*Given the difficulty of replacing counterparties and expense of posting collateral for cashflow securitisations, high volumes of swap-related rating agency confirmations [RACs] look set to continue, potentially eroding investor protections in their wake.*
II
"*For at least 78 of the RACs, the swap counterparty successfully petitioned Moody's to be allowed to amend an existing derivative contract with an ABS transaction so as to avoid posting collateral and/or finding a replacement counterparty.*

"The RACs were issued to 25 swap counterparties: 20 to Barclays; 12 to RBS; seven RACs each to BNP Paribas, UBS and Morgan Stanley; five RACs each to Banco Santander and Natixis; four RACs each to Deutsche Bank and Bank of America Merrill Lynch; three RACs each to JPMorgan and UniCredit; two RACs each to Banca IMI, SG, Credit Agricole, Goldman Sachs and DZ Bank; and one RAC each to Banca Intesa, Standard Bank of South Africa, Banque AIG, Merrill Lynch Derivative Products, National Bank of Greece, Erste Abwicklungsanstalt, Capital Home Loans, Bankia and Intesa Sanpaolo.

"Harrington suggests that such actions by Moody's are essentially 'giving swap providers a free pass to unilaterally write-off long-standing contractual obligations without obtaining consent of ABS noteholders or providing consideration in the form of alternative protections or compensation.' He points to 20 near-identical RACs covering 38 ABS transactions that were obtained by Barclays so as to avoid posting collateral, despite having been downgraded to A2 in June 2012.
II
"The seven RACs provided to Morgan Stanley, meanwhile, were related to seven ABS transactions. Harrington notes that in each case Baa1-rated Morgan Stanley was obliged to find a replacement counterparty for a deep-in-the-money swap but instead retained the swap on its own book, leaving the ABS exposed to making a termination payment in the event of a Morgan Stanley insolvency. A RAC in respect of Broadgate Financing is one example here."[85]

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[85] Structured Credit Investors (SCI), "Counterparty Conundrums", 2 August 2013 in Harrington, William J., "Electronic Letter to the U.S. Securities and Exchange Commission and the European Securities and Markets Authority Re Inflated Credit Ratings of ABS and Derivative Product Companies", September 11, 2013 , Appendix B, pp17-19. **(https://www.wikirating.com/data/other/20130911_Harrington_J_William_ABS_Losses_Attributable_to_Securitization_Swaps.pdf).**

The S&P Presale misstates RMBS credit exposure to the Bluestone NZ Prime 2022-2 Trust issuer's governance as "*below average, in line with sector benchmark".* That is flat-out wrong because the "sector" however defined — say, New Zealand and other non-U.S. RMBS, ABS, and other structured debt issuers — routinely uses flip-clause-swap-contracts. See page 3.

> "*The transaction's exposure to governance credit factors is below average, in line with the sector benchmark. Given the nature of structured finance transactions, most have relatively strong governance frameworks that typically restrict what activities the special-purpose entity can undertake. We consider the risk-management and governance practices in place to be consistent with industry standards and our benchmark expectations.*"

S&P Global Ratings fails its own self-governance by setting governance benchmarks that *willfully ignore* the outsized expected losses incurred by each New Zealand and other non-U.S. RMBS, ABS, and other structured debt issuer that is party to a flip-swap-contract. The following re-work of the Presale is more accurate.

> "*The transaction's exposure to governance credit factors is abysmal, in line with the sector benchmark of routinely incurring outsized expected losses by entering flip-clause-swap-contracts. Moreover, the issuer doubled-down on abysmal governance to incur still more outsized expected losses by agreeing that a downgraded Bank of New Zealand may take "other remedy" such as "no action" to avoid collateralizing, or novating, or obtaining a guarantee."*

Moody's Investors Service Pre-Sale Report "Elstree Funding No. 3 PLC", 9 March 2023

The Moody's pre-sale report informs the below comment on the three Fitch Ratings Active Rating Criteria "CLOs and Corporate CDOs Rating Criteria", "Corporate Hybrids Treatment and Notching Criteria", and "Non-Bank Financial Institutions Rating Criteria", the two Moody's Investors Service In-Use Rating Methodologies "Moody's Global Approach to Rating Collateralized Loan Obligations", and "Repackaged Securities Methodology", and S&P Global Ratings Criteria "CDOs: Global Methodology and Assumptions For CLOs and Corporate CDOs".

Fitch, Moody's, and S&P must update the respective credit rating methodologies / criteria to accurately assign lower recoveries and lower governance scores to a bank or swap contract dealer with self-credit-exposure of 100% loss of value under a flip-clause-swap-contract when either of the following conditions apply.

(1) A dealer is party to a huge flip-clause-swap-contract.
(2) A dealer may retain permanent self-exposure to 100% loss of contract value because it is not obligated to novate a flip-clause-swap-contract.

Furthermore, and crucially, Fitch, Moody's, and S&P must update the respective credit rating methodologies / criteria for financial institutions to do the following with utmost rigor, to accurately assign lower recoveries to a bank or swap contract dealer.

(3) Track each flip-clause-swap-contract that a dealer has with an RMBS, ABS, or other structured debt issuer anywhere in the world, regardless of whether Fitch, or Moody's, or S&P, or another credit rating company, or no credit rating company assigns credit ratings to the respective RMBS, ABS, or other structured debt.
(4) Assess all contract terms.
(5) ***Assign plausible likelihood of NO NOVATION*** to each flip-clause-swap-contract, based on *realistic* evaluation of novation provisions.
(6) Assume 100% correlation of flip clause activation against a dealer for *ALL* in-the-money flip-clause-swap-contracts with RMBS, ABS, and other structured debt issuers everywhere in the world.

Moody's Investors Service Pre-Sale Report "Elstree Funding No. 3 PLC", 9 March 2023 and "WJH and Bank of England Staff -- Flip Clause Meeting and Correspondence -- 31 May 2014 to 26 June 2019" inform the following comments on U.K. regulation and capitalization of swap dealers.[86]

Bank of England perpetuation of the flip-clause-swap-contact is a major headache for U.S. people! BoE disregard of the well-being of U.K. people and the U.K. economy supplies U.S. regulators with a seemingly benign rationale — namely, amplifying "*international comity*" — to

[86] "WJH and Bank of England Staff -- Flip Clause Meeting and Correspondence -- 31 May 2014 to 26 June 2019" available at: **(https://www.sec.gov/comments/4-790/4790-195119-387602.pdf).**

harm U.S. people and the U.S. economy by proposing to reinstate the flip-clause-swap-contract for U.S. swap dealers and for U.S. RMBS, ABS, and other structured debt issuers.[87]

By 2016 at the latest, U.K. regulators should have already prohibited swap dealers from both entering new flip-clause-swap-contracts anywhere in the world and extending maturities of existing contracts anywhere in the world.

By 2016 at the latest, U.K. regulators should have already obligated swap dealers to immediately post capital equal to 100% of value against every legacy flip-clause-swap-contract anywhere in the world.

Since at least May 31, 2014, I have spoon fed Bank of England staff and other U.K. financial regulators with clear-sighted evidence of economic damage that the flip-clause-swap-contract wreaks. For example, I have happily provided evidence directly to Ms. Sarah Breeden. Her colleague Ms. Allison Parent also relayed my evidence to Ms. Breeden and other BoE staff several times after I met Ms. Parent and Michalis Vasios in-person at the BoE on March 18, 2015. In preparing for our meeting, Ms. Parent requested that I send "Efficient, commonsense actions to foster accurate credit ratings" by Norbert J. Gaillard and me.[88]

> "*From: Parent, Allison*
> *To: wjharrington@yahoo.com*
> *Cc: "Nicola.Anderson@bankofengland.co.uk";*
> *"Andy.Haldane@bankofengland.co.uk";*
> *"Sarah.Breeden@bankofengland.co.uk";*
> *"Lewis.Webber@bankofengland.co.uk";*
> *"Michael.Hume@bankofengland.co.uk";*
> *Alexandra.Ellis@bankofengland.co.uk*
> *Sent: Friday, March 13, 2015 at 12:03:05 PM EDT*
> *Subject: RE: Non-Clearable Swap Contracts with Flip Clauses and No Margin Posting*
>
> "*Afternoon Bill,*
>
> "*Thank you for your offer to meet next week. Does next Wednesday, 18th at 4pm still work for you?*

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87 CFTC Chair Rostin Behnam, "Testimony Before the Subcommittee on Agriculture, Rural Development, Food and Drug Administration and Related Agencies Committee on Appropriations, U.S. House of Representative", March 28, 2023. *"[O]ver the next two years, the Commission will consider and vote on matters for consideration that . . . amplify **international comity** [emphasis added]."* **(https://www.cftc.gov/PressRoom/SpeechesTestimony/opabehnam35).**

88 Gaillard, Norbert J. and William J. Harrington, "Efficient, commonsense actions to foster accurate credit ratings", *Capital Markets Law Journal* 11, no. 1 (2016): 38-59. See "flip clause" throughout. **(https://doi.org/10.1093/cmlj/kmv064)**.

"*Prior to joining the Bank, I worked in the US Congress as General Counsel of Senate Budget Committee focusing on both fiscal and financial services issues. I am familiar with the OTCDs reform having negotiated the text of Title VII of DFA and working with CFTC in the development of their rules. Glad to hear you will be participating at their upcoming roundtable and will be able to share your points with them directly at the event.*

"*The Bank looks forward to learning more about the issues you reference below.* ***Please send along your paper in advance for us to review to help facilitate the dialogue and to share with others who regrettably will be out of the office next week*** *[emphasis added].*"[89]

Why has Ms. Breeden not convinced the Bank of England to regulate the flip-clause-swap-contract out of existence? The flip-clause-swap-contract poses immense dangers to U.K. bank swap dealers, to the U.K. financial system, to the wider U.K. economy, to BoE prudential regulation, and, most importantly, to the U.K. people. Ms. Breeden's experience indicates that eliminating the flip-clause-swap-contract should be Priority Number 1.

"*Sarah is the Executive Director for Financial Stability Strategy and Risk and a member of the Financial Policy Committee . . . the United Kingdom's 'macroprudential' authority. It is tasked by Parliament with guarding against the financial system damaging the wider economy. Sarah is responsible for the Bank of England's work to deliver that objective*.
II
"*Prior to her current role, Sarah was the Executive Director for UK Deposit Takers Supervision, responsible for the supervision of the UK's banks, building societies and credit unions. Before that, she was Executive Director for International Banks Supervision, where having joined the directorate in 2015, she was responsible for supervision of the UK operations of international banks.*

"*Before moving into supervision, Sarah was a Director in the Bank's Financial Stability Strategy and Risk Directorate, where she focused on developing the UK's macroprudential policy making framework and supporting the Financial Policy Committee. Previously she was head of the division that assessed risks to financial stability from financial markets, the non-bank financial sector, and the real economy.*

"*Sarah led the Bank's work to support the transition of prudential regulation of banks and insurers from the Financial Services Authority to the Bank.*

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[89] Allison Parent email to Bill Harrington "Re Non-Clearable Swap Contracts with Flip Clauses and No Margin Posting", March 13, 2015, in "WJH and Bank of England Staff -- Flip Clause Meeting and Correspondence -- 31 May 2014 to 26 June 2019", p5. **(https://www.sec.gov/comments/4-790/4790-195119-387602.pdf).**

"*Prior to that she was head of the Bank's Risk Management Division and head of Special Projects in the Markets Directorate, leading the design and risk management of financial market operations undertaken by the Bank including those launched during the financial crisis*."[90]

On June 1, 2014, then Bank of England Chief Economist Andy Haldane introduced me to Sarah Breeden and Niki Anderson in replying to my email of the previous day.

"*Thanks Bill. I am copying in colleagues here at the Bank leading on this work, Sarah [Breeden] and Niki [Anderson], who I am sure will be interested in your thoughts*."[91]

My thoughts have held firm since well before cold-emailing Andy Haldane on May 31, 2014.

"*The fatal flaw in the swap contracts most commonly used by ABS issuers is a 'flip clause.' Flip clause risk should be a major concern of the Bank of England, for instance with respect to the bad bank portfolios of swap providers such as RBS and Barclays.*"[92]

Flip-clause-swap-contracts rendered RBS and Barclays "*bad bank portfolios*" much, much badder than commonly understood by even the Bank of England. As damning evidence, my email of May 31, 2014, cited my "*May 29 comment letter to the U.S. SEC that proposes derivative disclosures with respect to securitisations. [**https://www.sec.gov/comments/s7-18-11/s71811-84.pdf**]*."[93]

> **"*Flip side of a flip clause: A derivative provider's rating should be debited twice***
> *"With respect to the rating of a derivative provider, an NRSRO should apply two (non-zero) debits to the swap contract: a first debit that reflects the credit profile of an ABS issuer and a second, much larger debit that reflects the punitive losses that a derivative provider inflicts upon itself in the event of insolvency. As an alternative to incurring the second derivative debit, a derivative provider can set aside significant reserves that must be augmented upon being downgraded.*
>
> *"However, counterparties are unlikely to continue providing swap contracts with flip clauses if required to account for their potential losses in a meaningful way. For example, derivative providers under my supervision while at Moody's (DPCs such as Nomura Derivative Products Inc., Merrill Lynch Derivative Products AG, Lehman Brother Financial*

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90 "Sarah Breeden", Bank of England website, accessed April 17, 2023. **(https://www.bankofengland.co.uk/about/people/sarah-breeden/biography)**.

91 Andy Haldane email to Bill Harrington "Re Improving Securitisation Quality - WJH Comment Letter to U.S. SEC on ABS Ratings", June 1, 2014, in "WJH and Bank of England Staff -- Flip Clause Meeting and Correspondence -- 31 May 2014 to 26 June 2019", p2. **(https://www.sec.gov/comments/4-790/4790-195119-387602.pdf).**

92 Bill Harrington email to Andy Haldane "Re Improving Securitisation Quality - WJH Comment Letter to U.S. SEC on ABS Ratings", May 31, 2014, in "WJH and Bank of England Staff -- Flip Clause Meeting and Correspondence -- 31 May 2014 to 26 June 2019", p1. **(https://www.sec.gov/comments/4-790/4790-195119-387602.pdf).**

93 "Ibid."

Products Inc., and Lehman Brothers Derivative Products Inc.) generally abstained from providing swap contracts with flip clauses after being apprised of their rating implications.

"Without flip clauses that make swap contracts look airtight against a major component of counterparty risk, ABS issuers would be forced to buy options or set aside reserves when bringing new ABS to market, i.e., the ABS industry could no longer offer artificially cheap credit to borrowers across ABS sectors. Some ABS sectors, such as student loan ABS, would grind to a complete halt and other sectors, such as residential mortgage ABS, would not be revived in their earlier form."[94]

I copied Sarah Breeden and other Bank of England staff in six additional emails pertaining to the flip-clause-swap-contract between June 14, 2014, to June 26, 2019.[95] My email of May 12, 2015, provided a link to an extremely amusing, extremely effective presentation that a former Moody's colleague and I made that day to staff of six U.S. financial regulators — the CFTC and the five prudential regulators the FCA, FDIC, FHFA, FRB, and OCC. The presentation and meeting helped convince the six regulators to adopt best-in-world swap margin rules that regulate the flip-clause-swap-contract out of existence for U.S. swap dealers and for U.S. RMBS, ABS, and other structured debt issuers.**[96]**

"*Attached please find the presentation that I gave today to the teams from the CFTC, FCA, FDIC, FHFA, FRB, and OCC with respect to margin posting by ABS issuers, flip clauses, and clearinghouses.*
[https://www.cftc.gov/node/157371
and
dfsubmission_051215_2376_0.pdf (cftc.gov)]."

My email of May 12, 2015, also raised the "*UK referendum on remaining in the EU*."

"A point that came up in the call is the UK referendum on remaining in the EU. This uncertainty argues that there is no reason to be harmonizing EU and US financial regulations until after the UK status is settled."[97]

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94 Harrington, William J., "Response to U.S. Securities and Exchange Commission Re: 'File Number S7-18-11 Request for Re-proposal Relating to Nationally Recognized Statistical Rating Organizations'", May 29, 2014, pp3-4. **(https://www.sec.gov/comments/s7-18-11/s71811-84.pdf).**

95 Bill Harrington emails of June 23, 2014, March 8, 2015, March 13, 2015, March 24, 2015, May 12, 2015, and June 10, 2019, respectively, in "WJH and Bank of England Staff -- Flip Clause Meeting and Correspondence -- 31 May 2014 to 26 June 2019", pp3, 4, 6, 7, 9, and 11, respectively. **(https://www.sec.gov/comments/4-790/4790-195119-387602.pdf).**

96 For summary of the joint prudential regulators' rule, see Harrington, Bill, "US margin rule for swaps obliges securitization issuers to overhaul structures, add resources, and rethink capital structures", *Debtwire ABS*, 5 Nov 2015. **(https://www.sec.gov/rules/petitions/2022/petn4-790-ex2.pdf).**

97 Bill Harrington email to Allison Parent "Re: Non-Clearable Swap Contracts with Flip Clauses and No Margin Posting", May 12, 2015, in "WJH and Bank of England Staff -- Flip Clause Meeting and

The Bank of England in the person of Allison Parent summarily dismissed BREXIT referendum concerns and entirely ignored flip-clause-swap-contract concerns. Clearly, The Old Lady of Threadneedle Street always knows what's best for the U.K. financial system, the wider U.K. economy, and, most importantly, the U.K. people. Witness the extremely happy circumstances that a few or even several U.K. people enjoy today, owing to the stellar U.K. economy.

> "*Thank you, Bill for forwarding along to us the presentation you shared with US regulators. We appreciate you keeping us in the loop.*
>
> "*The debate around cross-border regulation for all areas (tax, financial reform, accounting, etc.) will always be a complicated topic for many reasons, including political uncertainty. Thank you for flagging the uncertainty the US regulators see related to the referendum question in regards to cross border derivatives reform.*"[98]

I emailed Ms. Breeden directly regarding the flip-clause-swap-contract on June 10, 2019.

> "*I hope that you will discuss the damage that financial catastrophes have on public appetite for climate mitigation at tomorrow's CFTC Market Risk Advisory Committee Meeting.*
> II
> "*As an update, I affiliated as a senior fellow with Croatan Institute in November 2017. The Institute, which actively assesses climate sustainability and finance, posted my Working Paper 'Can Green Bonds Flourish in a Complex-Finance Brownfield?' in July 2018. The Working Paper proposes a financial sustainability score to measure the impact of a financial instrument on the sustainability of the financial system.* ***Unsurprisingly, flip clause swap contracts, including ones in prominent EU 'green' RMBS deals, score among the worst with respect to both a given deal and the swap dealer that assumes walk-away risk to its own credit profile*** *[emphasis added].* ***[https://croataninstitute.org/2018/07/01/can-green-bonds-flourish-in-a-complex-finance-brownfield/]***
>
> "*Following is a link to the comment 'Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants (In the Event of No-Deal Brexit)' that I submitted to the CFTC on May 31, 2019.*
> ***https://comments.cftc.gov/PublicComments/CommentList.aspx?id=2960.***

Correspondence -- 31 May 2014 to 26 June 2019", p9. **(https://www.sec.gov/comments/4-790/4790-195119-387602.pdf).**

98 Allison Parent email to Bill Harrington "Re: Non-Clearable Swap Contracts with Flip Clauses and No Margin Posting", May 13, 2015, in "WJH and Bank of England Staff -- Flip Clause Meeting and Correspondence -- 31 May 2014 to 26 June 2019", p10. **(https://www.sec.gov/comments/4-790/4790-195119-387602.pdf).**

"*The comment take-away: 'The CFTC must amend the CFTC No-Deal Brexit Rule to exclude a swap contract with a flip clause, other walkaway provision, or rating agency condition/ confirmation (RAC) that is transferred to an affiliate, branch, or other entity domiciled in the US.'*"[99]

Moody's Investors Service Pre-Sale Report "Elstree Funding No. 3 PLC", 9 March 2023 details a U.K. RMBS issuance with fixed-for-floating, predetermined-schedule flip-clause-swap-contract provided by NatWest Markets.

Moody's should, but demonstrably does not, assign lower credit ratings to NatWest Markets that recognize the outsized credit exposures of all to NatWest under the huge flip-clause-swap-contract that does not obligate a downgraded NatWest to novate or obtain a guarantee.

Moody's should, but demonstrably does not, assign lower recovery rates to NatWest Markets that recognize the outsized credit exposures occasioned by the 100% correlation of flip-clause activation by *ALL* RMBS, ABS, and other structured debt issuer counterparties around the world that would have out-of-the-money flip-clause-swap-contracts should NatWest default, enter bankruptcy, or become insolvent.

Moody's should, but demonstrably does not, assign lower governance scores to NatWest Markets that recognize the bank's disastrous governance in providing flip-clause-swap-contracts.

"Flow of funds, Allocation of payments/pre-accelerated revenue waterfall", Steps 2 and 16, page 17 constitute the flip clause.

The Elstree Funding No. 3 PLC flip-clause-swap-contract is HUGE because 95% of residential mortgage loans are initially fixed-rate. The contract is "**not balance guaranteed**." See page 20.

"*[A]bout 95.3% of the loans in the pool are fixed-rate mortgages, which will revert to West One's SVR or BBR plus a margin between December 2023 and October 2029*.
II
"*The swap notional follows a predetermined schedule and does not reference the actual outstanding amount of loans being hedged during each period. This feature has in recent years become more common in other UK RMBS transactions . . .*"

[99] Bill Harrington email to Sarah Breeden "Re: CFTC MRAC June 12 2019 + 'Improving Securitisation Quality - WJH Comment Letter to U.S. SEC on ABS Ratings'", June 10, 2019, in "WJH and Bank of England Staff -- Flip Clause Meeting and Correspondence -- 31 May 2014 to 26 June 2019", pp11-12. **(https://www.sec.gov/comments/4-790/4790-195119-387602.pdf).**

The issuer moderately mitigated poor governance in entering the flip-clause-swap-contract by eliminating a balance-guaranteed component sometime after soliciting credit ratings from S&P Global Ratings. From the S&P Presale "Elstree Funding No. 3 PLC", 9 March 2023.[100]

> "*The transaction no longer features a balance-guaranteed swap and instead the notional for the swap follows a schedule.*"

Unfortunately, the issuer and NatWest Markets each enacted a massive governance failure by omitting a hard transfer obligation ("replacement") from the flip-clause-swap-contract. See Moody's Pre-Sale, page 20.

> "*However, there is no transfer trigger in the swap definition and swap counterparty must post collateral or transfer rights.*"

NatWest ability to avoid either transferring the flip-clause-swap-contract or obtaining a guarantee by instead merely posting collateral even if approaching default, bankruptcy, or insolvency increases the expected losses of Elstree Funding No. 3 PLC RMBS today. The lack of hard transfer obligation all but ensures that a defaulted, bankrupt, or insolvent NatWest will remain counterparty to the contract and expose the issuer to outsize losses 100% of the time, i.e., both when the contract is in-the-money to the issuer and when the contract is out-of-the-money.

Likewise, NatWest ability to avoid transferring the flip-clause-swap-contract by instead merely posting collateral even if approaching default, bankruptcy, or insolvency increases NatWest expected losses today. The lack of hard transfer obligation all but ensures that a defaulted, bankrupt, or insolvent NatWest will remain counterparty to the contract and, if in-the-money, lose 100% of contract value.

The Elstree Funding No. 3 PLC issuer exposes its RMBS to an extreme level of governance risk, i.e., well beyond the already high governance risk that is the baseline for U.K. RMBS! Most U.K. RMBS are exposed to high governance risk because most issuers are party to flip-clause-swap-contracts. Moody's Pre-Sale describes eight "*other transactions by the same originator and comparable transactions*." Each has a "*hedge in place*" that is a "*fixed-floating swap*" and all such swaps are, with 100% certainty, flip-clause-swap-contracts. See page 20.

Moody's Investors Service fails its own self-governance by setting governance benchmarks that *willfully ignore* the outsized expected losses incurred by each U.K. and other non-U.S. RMBS, ABS, and other structured debt issuer that is party to a flip-swap-contract. The following re-work of Moody's Pre-Sale, page 3, is more accurate.

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[100] **(https://www.spglobal.com/ratings/en/research/pdf-articles/230309-presale-elstree-funding-no-3-plc-12584847).**

"*UK RMBS sector governance risk is high, based on issuers' pervasive use of flip-clause-swap-contracts, many of which are disproportionately huge.*
II
"*Governance: Governance risks for this transaction are high based on the presence of a huge flip-clause-swap-contract with no hard obligation for a downgraded NatWest Markets to transfer or obtain a guarantee."*

Likewise, the following re-work of Moody's Pre-Sale, pages 21-22, is more accurate.

"***ESG - Governance considerations***

"Strong RMBS governance relates to transaction features that promote the integrity of the operations of the transaction for the benefit of investors, as well as the data provided to investors. The following are some of the governance considerations related to the transaction:

*"**» Absence of flip-clause-swap-contract.***

*" **… "***

Best regards,

Bill Harrington