External Meeting for Proposed Rule 79 FR 59898

Presentation to Rule Writing Teams from the CFTC, FCA, FDIC, FHFA, FRB, and OCC

May 12, 2015

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***Mr. Harrington has conducted research on the obligations and risks of derivative contracts in the structured finance sector for 15 years, most recently on an independent basis and previously as a Senior Vice President in the Derivatives Group of Moody's Investors Services. He has filed twelve evaluations of the derivative contracts commonly used by ABS issuers and corresponding rating methodologies with US and EU regulators and credit rating agencies. Mr. Harrington has followed-up with briefings for teams at the Bank of England, the New York Federal Reserve, the CFTC, and on five separate occasions in 2013-2014, the SEC.**

An ABS issuer in any ABS sector is a “high-risk” end user of swap contracts.

Unlike a municipality or a corporation, an ABS issuer can’t readily tap new financing or adjust its capital structure to fund a termination payment or, alternatively, rebalance a swap contract.

ABS issuers do not have spare funds to pay termination amounts.

ABS issuers are capitalized to pay swap obligations only over time and not on an accelerated basis.

To fund a potentially large termination payment, an ABS issuer must sell illiquid assets into volatile markets.

In the aftermath of the financial crisis, interest rates rallied by more than 400 basis points. This rally left ABS issuers on the hook for termination payments of 10%, 15%, and in some instances 20% of the notional amount of swap contracts.

Bailouts stemmed losses in all ABS sectors and masked the inability of issuers to fund termination payments.

If a key provider of interest rate, basis rate, or currency swap contracts to ABS issuers (e.g., AIG) had entered bankruptcy, issuers in all ABS sectors would have been obligated to sell illiquid assets at fire-sale prices and ABS losses would have been larger and more widespread.[1]

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[1] Lehman provided few interest rate, basis rate, or currency swap contracts to ABS issuers in the U.S.

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

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

A swap contract with a flip clause between an ABS issuer and a financial counterparty is more akin to a huge banana split that has somewhere beneath the maraschino cherries, whipped cream, caramel sauce, melted chocolate, chopped nuts,[2] bananas, pineapples, jimmies, strawberry ice cream, and chocolate ice cream, a dollop of vanilla ice cream.

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

[2] Only for those who are not allergic to nuts.

The complexity of an ABS priority of payments and swap contract masks a convenient fiction – namely that an ABS issuer exposes investors to zero counterparty risk[3] when party to one or several swap contracts.

Credit rating agencies propagate this fiction in methodologies for swap contracts and ABS issuers exploit this fiction to the hilt in obtaining AAA ratings without reserving a single dollar against counterparty exposure.[4]

In aggregate and across all sectors, ABS issuers that are party to swap contracts have earmarked a total of zero dollars as reserves against the contingency of counterparty default or bankruptcy.

The governing documents of an ABS issuer, particularly its priority of payments and swap contract, are in large part dictated by the credit rating agency methodologies for swap contracts.[5] These governing documents and rating protocols are effectively conjoined and cannot be evaluated in isolation from each other.

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[3] See the CFTC Letter No. 15-21 of March 31, 2015 issued by the Division of Swap Dealer and Intermediary Oversight.

[4] Unlike other end users of swap contracts such as municipalities or corporations, an ABS issuer has limited ability to tap new financing or restructure its capital profile after closing.

[5] Fitch Ratings Inc. "Counterparty Criteria for Structured Finance and Covered Bonds" (May 2014) and "Derivative Addendum (May 2014). Moody's investor Services, "Approach to Assessing Swap Counterparties in Structured Finance Cash Flow Transactions" (November, 12, 2013). Standard and Poor's Rating Services, *"Counterparty Risk Framework Methodology and Assumptions"* (May 31, 2012).

Without another bailout, ABS numbers don't add up – Takeaway from the 2010 decision by Judge Peck that an ABS issuer could not enforce a flip clause against the estate of Lehman Brothers

"Response to EU Consultation Document: An EU framework for simple, transparent and standardised securitization," Harrington (May 13, 2015).

"Efficient, commonsense steps to foster rating accuracy," Nobert J. Gaillard & Harrington.
Forthcoming in the "*Capital Markets Law Journal*."

"Comment on US Treasury Effort to Revive Private-Label RMBS," Harrington (August 8, 2014).
Available at http://www.regulations.gov/#!docketBrowser;rpp=50;po=0;dct=PS;D=TREAS-DO-2014-0005.

"2nd Comment on SEC Proposed Rules for Nationally Recognized Statistical Rating Organizations," Harrington (May 29, 2014).
Available at http://www.sec.gov/comments/s7-18-11/s71811-84.pdf.

"Reg AB disclosures for Securitization Swaps and Other Derivative Contracts," Harrington (February 17, 2014).
Available at http://www.sec.gov/comments/s7-08-10/s70810-283.pdf.

"Securitization Swaps and CFTC Clearing Mandate for Interest Rate Swaps" Harrington (Feb 3, 2014). Available on request.

"Moody's 2012 DPC Update – WJH Comments," Harrington (April 1, 2013). Available on request.

"WJH Response to Moody's LINKAGE Comment Request," Harrington (August 31, 2012). Available on request.

"Questions Regarding Moody's Derivative Analysis for Bank Ratings," Harrington (June 11, 2012). Available on request.

"WJH Comment on Fitch Exposure Draft of 12 March 2012," Harrington (April 28, 2012). Available on request.

"1st Comment on SEC Rules Proposed Rules for Nationally Recognizes Statistical Rating Organizations," Harrington (August 8, 2011). Available at http://www.sec.gov/comments/s7-18-11/s71811-33.pdf.

"Update on the Lehman Brothers Derivative Product Companies' Bankruptcy," Alice Yu & Harrington. *Moody's Structured Credit Perspectives* (June 2010).

Without another bailout, ABS numbers don't add up – Rating methodologies for derivative contracts from the opposing vantages of both ABS issuers and counterparties

"Mitigating Voluntary Bankruptcy Risk of U.S.-Domiciled Termination Derivative Product Companies and Assessing the Effectiveness of Continuation Derivative Product Companies," Alice Yu, Claudia Green, & Harrington. *Moody's Investors Service Methodology* (July 16, 2009). Available on request.

"Framework for De-Linking Hedge Counterparty Risks from Global Structured Finance Cashflow Transactions," Edward Manchester, Harrington, and Nicholas Lindstrom. *Moody's Investors Service Methodology* (in effect from 15 December 2006 to 12 November 2013). Available on request.

"Capping Hedge Termination Payments in Moody's Rated Structured Notes Following Default of the Underlying Debt Instrument," Deboleena Dutta & Harrington. *Moody's Investors Service Special Report* (September 2004). Available on request.

"Guidelines for CDO Hedge Counterparties," Jerry Gluck & Harrington. *Moody's Investors Service Guidelines* (October 23, 2002). Available on request.

Is 13 the lucky number for comment requests? What stops the CFTC and each of the Prudential Regulators from requesting follow-up from one of the first 12?

Requiring ABS issuers in all sectors to post full margin against all swap contracts will defuse their flip clauses.

Defusing flip clauses will:

1. **facilitate the orderly resolution of a bank counterparty;**
2. **make bail-out costs more transparent (although not reduce them);**
3. **foster sustainable growth by ending the ability of ABS issuers to extend credit on artificially cheap terms;**
4. **level the playing field between ABS issuers and other end users such as municipalities and corporations[6] who cannot add analogous, "walkaway" provisions to swap contracts;**
5. **dampen pro-cyclicality by eliminating the obligation of ABS issuers to conduct fires sales of illiquid assets; and**
6. **obligate investors to take responsibility for investment decisions.**

All of the preceding will be reinforced geometrically when ABS is posted as margin under both cleared and uncleared swap contracts.

[6] No other end -users of swap contracts (e.g., municipalities or corporations) join ABS issuers in pretending that they can repudiate 100% of termination payments owed to an insolvent counterparty under swap contracts that are its assets.

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

1. **the sole province of the ABS sector and unavailable to other end-users of swap contracts such as municipalities and corporations;**
2. **not a disclosure requirement for ABS issuers under Reg AB II;**
3. **a lynchpin of most ABS worldwide;**
4. **a ticking time bomb;**
5. **an original sin of the ABS sector;**
6. **a traffic light that simultaneously signals red and green;**
7. **a prime example of rating agency conflict of interest;**
8. **a systemic problem that grows with each new ABS and doesn't dissipate over time;**
9. **a natural outcome when investors assume they'll be bailed out again;**
10. **a provision that can't withstand close scrutiny with respect to fiduciary responsibility, risk management, capital requirements, governance, sustainability, or commonsense;**
11. **catnip for legal counsel who can opine until the cows come home on the differences between US and UK bankruptcy law;**
12. **an embarrassment for legal counsel whose enforceability opinions carve-out flip clauses;**
13. **an indication that neither the US nor the EU knows how to revive growth and is trotting out securitization in desperation; and/or**
14. **something that will be dealt with after a bank counterparty fails.**[7]

[7] After all, no one could have seen it coming and sayin' anything different is just bein' a Monday-morning quarterback.

By placing a flip clause in a swap contract, an ABS issuer takes full credit for one outcome in the event of counterparty failure and the counterparty itself takes full credit for a second, mutually exclusive outcome.

Under a flip clause, an ABS issuer subordinates 100% of termination payments owed under a swap contract with a defaulted/insolvent counterparty[8] and holds zero reserves against making a termination payment.

Being subject to subordination exposes a bank counterparty to a second form of credit risk, in addition to that of an ABS. However, bank counterparties hold zero reserves against the contingency of not receiving 100% of termination payments from ABS issuers, in part because a flip clause was not upheld in 2010.

Whether it will be ABS investors who lose under a flip clause in the event of the failure of a bank counterparty, the bank counterparty who loses, or both ABS investors and the bank counterparty who lose won't be determined until the resolution is well underway.

At best one party will break even and the other will incur substantial losses. However, the likelihood of litigation to settle the enforceability of a flip clause subjects both ABS issuers and the resolution agent to uncertainty that will absorb time and money.

[8] In the aftermath of the US financial crisis, US interest rates rallied by more than 400 basis points. This rally left ABS issuers on the hook for termination payments of 10%, 15%, and in some instances 20% of the notional amount of swap contracts.

Outcomes from flip clause litigation:

1. **Issuers in all ABS sectors will be obligated to sell illiquid assets simultaneously to fund 100% of termination payments owed to a bank counterparty[9] (i.e., ABS issuers lose and the bank breaks even);**
2. **The resolution agent of a bank will write-off 100% of mark-to-market assets with ABS issuers (i.e., the bank counterparty loses big time and the ABS investors break even); or**
3. **Issuers in all ABS sectors and the resolution agent settle (i.e. the bank counterparty and ABS investors both incur significant losses).**

The other standard provisions in swap contracts between an ABS issuers and a bank counterparty that are stipulated by credit rating methodologies have also fallen short and make flip clause litigation more likely .[10]

Replacement generally cannot be obtained and guarantees expose ABS investors to making a termination payment to an insolvent counterparty.

Bank counterparties avoid posting collateral to ABS issuers by inducing trustees to obtain no-downgrade letters form credit rating agencies.

[9] Unlike other end users of swap contracts such as municipalities or corporations, an ABS issuer has limited ability to tap new financing or restructure its capital profile after closing.
[10] See the CFTC Letter No. 15-21 of March 31, 2015 issued by the Division of Swap Dealer and Intermediary Oversight.

In other words, a swap contract with a flip clause and replacement and guarantee provisions between an ABS issuer and a financial counterparty that references interest rates, basis rates, or currencies is <u>not simply a huge banana split</u> with maraschino cherries, whipped cream, caramel sauce, melted chocolate, chopped nuts,[11] bananas, pineapples, jimmies, strawberry ice cream, chocolate ice cream, and a dollop of vanilla ice cream.

A swap contract with a flip clause and replacement and guarantee provisions between an ABS issuer and a financial counterparty that references interest rates, basis rates, or currencies is a <u>huge banana split that has been sitting in the sun for a decade or two.</u>

<u>Credit rating agencies endorse these banana splits as AAA fresh, vegan, and gluten-free.</u>[12]

Is this a surprise? One of these same credit rating agencies tried to hide other of its ABS tracks by producing research that backdated the start of the Great Depression by 29 years to 1900.[13]

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[11] Only for those who are not allergic to nuts.
[12] While entirely healthful, this banana split is not recommended by the credit rating agencies for those with peanut allergies.
[13] The U.S. Securities and Exchange Commission, “Administrative Proceeding File No 3-16346 in the Matter Against Standard & Poor’s Ratings Services, Respondent’, Release No 33-9704 (January 21, 2015). In particular, see ‘S&P’s Great Depression Article’, p. 4. “S&P’s analysis of purported Great Depression losses and defaults included analysis of performance of commercial mortgages originated between 1900 and 1935, many of which were not affected by the extreme economic stress of the Great Depression…which is commonly understood to have begun in 1929.”

Debunking Specious Claims that the World Will End if ABS Issuers Post Full Margin.

The U.S. ABS sector will be disadvantaged in competing against the EU ABS sector.[14]

1. **ABS issuance in the EU has been moribund since 2008 and has continued to decline even though new EU regulations mean few ABS issuers will post margin.**
2. **The EU faces a crisis of confidence and is looking to ABS as a silver bullet out of desperation.**
3. **Little overlap exists between the U.S. and EU ABS markets owing to the substantial risks of the cross-currency swap contracts that are needed to securitize US dollar assets into EU liabilities and vice-versa.**

Reviving Private-Label RMBS is needed to reduce the government footprint in the US housing market.

1. **Private-label RMBS increases the government footprint in the US housing market.**
2. **Balance-guaranteed swap contracts with flip clauses are entered into by RMBS issuers to offset exposure to rising interest rates and prepayments.**
3. **These swap contracts are among the most complicated, esoteric, and idiosyncratic of all swap contracts with flip clauses. 2008 can repeat itself if these contracts unravel in the wake of a counterparty failure.**
4. **To avoid a 2008 replay, a provider of balance-guaranteed swap contracts will lobby for bailouts.**

End-users like ABS issuers that weren't responsible for the financial crisis shouldn't be penalized.

1. **Too easy, like shooting fish in a barrel.**

[14] EU requirements for margin posting by ABS issuers are so lax that few if any issuers will actually post margin.

SUMMARY

ABS issuers must post full margin against swap contracts if the ABS sector is to be a durable contributor to the US economy and not a serial beneficiary of taxpayer bailouts. Margin cannot consist of other ABS.

There's no free lunch. ABS issuers who enter into swap contracts that require full margin posting will add more assets to an ABS at closing to fund margin posting and accordingly charge more to extend credit.

ABS investors will be exposed to fewer losses from termination payments as issuers buy options or add more assets to a transaction instead of choosing the regulatory and rating agency "arb" of entering into swap contracts with flip clauses. The financial system will be exposed to fewer disruptions.

Isn't this how finance is supposed to work? ABS will no longer offer artificially cheap credit, investment will flow to more optimal uses, and bailout costs will be reduced.

(Assigning accurate ratings to ABS would also help, but seems a distant dream. AAA ratings do not distinguish between: the absence of a derivative contract; a fully-paid option with an FDIC-insured sub; a 3M/6M LIBOR swap contract with no flip clause; and a balance-guaranteed interest rate swap contract with a flip clause and a shell counterparty that is guaranteed by a BBB-rated affiliate.)

COMMONSENSE TAKEAWAYS

The economy has serious underlying problems that won't be fixed by ABS issuers continuing to extend credit on artificially cheap terms and pretending that swap contracts don't require termination payments.

We've already had one financial crisis that was attributable in part to a proliferation of undercapitalized ABS.

Discussion of another financial crisis has become standard even in mainstream financial circles.

Non-financiers accept that making useful decisions that will hold up over time will come at a cost. Doing nothing may also come at a cost in the form of another financial crisis and decimated communities.

Undercapitalized ABS don't sustain job creation. Swap contracts, when backstopped by the US taxpayer rather than full margin posting, aren't free enterprise.

Fewer, but fully capitalized ABS and stringent margin requirements for swap contracts both within and outside the ABS sector will help reorient the financial system on a more stable axis.

Appendix A—April 14, 2015 e-mail to the CFTC and Prudential Regulators: "Meeting to Discuss the Necessity of ABS Issuers Posting Full Margin Against Swap Contracts with Flip Clauses"

----- Forwarded Message -----
From: Bill Harrington <wjharrington@yahoo.com>
To: "stuart.feldstein@occ.treas.gov" <stuart.feldstein@occ.treas.gov>; "rfeldman@fdic.gov" <rfeldman@fdic.gov>; "mardockb@fca.gov" <mardockb@fca.gov>; "Robert.Frierson@frb.org" <Robert.Frierson@frb.org>; "Alfred.Pollard@fhfa.gov" <Alfred.Pollard@fhfa.gov>; "ckirkpatrick@cftc.gov" <ckirkpatrick@cftc.gov>; "tsmith@cftc.gov" <tsmith@cftc.gov>
Cc: "Richard.Johns@sfindustry.org" <Richard.Johns@sfindustry.org>; "michel.madelain@moodys.com" <michel.madelain@moodys.com>; Andy Haldane <andy.haldane@bankofengland.co.uk>; Allison Parent <allison.parent@bankofengland.co.uk>; Michael Hume <michael.hume@bankofengland.co.uk>; Felix Flinterman <felix.flinterman@esma.europa.eu>; Adam Ashcraft <adam.ashcraft@ny.frb.org>; "orolh@sec.gov" <orolh@sec.gov>; Norbert Gaillard <gaillard@alumni.princeton.edu>
Sent: Tuesday, April 14, 2015 11:28 AM
Subject: Meeting to Discuss the Necessity of ABS Issuers Posting Full Margin Against Swap Contracts with Flip Clauses

Dear All:

I am writing to follow-up on my email of December 4, 2014 to the CFTC and Prudential Regulators (see further below) to request a meeting to discuss margin posting by issuers of asset-backed securities (ABS). As my December 4, 2014 email stated, my work of the last 15 years on swap contracts with flip clauses, ABS issuers, and their counterparties drives my conviction that ABS issuers must post full margin against swap contracts if the ABS sector is to be a durable contributor to the US economy and not a serial beneficiary of taxpayer bailouts.

I have also attached "Efficient, commonsense steps to foster rating accuracy" by my Wikirating colleague Norbert Gaillard and me. This paper, which has been accepted for publication by the Capital Markets Law Journal, details the systemic problems that originate with the deficient swap contracts that are most commonly used by ABS issuers -- i.e., non-clearable swap contracts with flip clauses and no margin posting. This paper also discusses the conflict of interest that induces rating agencies to ignore the losses to investors that are masked by flip clauses and to make these losses larger still by issuing RAC letters (which are akin to no-action letters) that allow bank counterparties to unilaterally strip existing swap contracts of investor protections. A simple and effective corrective is to require ABS issuers to post full margin against all swap contracts.

Appendix A—April 14, 2015 e-mail to the CFTC and Prudential Regulators: "Meeting to Discuss the Necessity of ABS Issuers Posting Full Margin Against Swap Contracts with Flip Clauses" (continued)

I note that the Structured Finance Industry Group (SFIG) has arranged an April 21 meeting with the CFTC and Prudential Regulators to argue the opposite case, namely that the continuation of the fragile US recovery hinges on ABS issuers being exempted from posting margin. I also note that the SFIG continues to provide the CFTC and Prudential Regulators with inaccurate information regarding ABS issuers that are party to swap contracts and, in particular, that are party to swap contracts with flip clauses.

For multiple examples of this inaccurate information, please see the November 24, 2014 letter from the SFIG to the CFTC and Prudential Regulators. For instance, this SFIG letter warned the CFTC and Prudential Regulators that ABS issuers in the US will, if required to post margin, be at a competitive disadvantage viz-a-viz EU issuers (most of whom will not be required to post margin under new EU regulations.)

This warning does not hold up to even perfunctory scrutiny. Here are three reasons why not.
1. ABS issuance in the EU has been moribund since 2008 and has actually declined since the new EU regulations effectively absolved ABS issuers from posting margin. The EU faces a crisis of confidence that will not be improved by the issuance of under-capitalized ABS.
2. Very little overlap exists between the ABS markets in the US and EU owing to the substantial risks and expenses of the cross-currency derivative contracts that are needed to securitize US dollar assets into EU liabilities and vice-versa.
3. Profound differences in the bedrock components of UK and US bankruptcy collide with respect to flip clauses. This collision mandates diametrically different regulations with respect to margin posting by ABS issuers. In other words, the "passporting" of EU regulations into the US that is being recommended by the SFIG will substantially increase both wind-down complexity and bailout risk in the US.

No other end-users of swap contracts join ABS issuers in pretending that they can repudiate 100% of termination payments owed to an insolvent counterparty under swap contracts that are its assets. If flip clauses are as innocuous as the SFIG suggests, why limit flip clauses to only ABS issuers? Shouldn't other end-users of swap contracts such as municipal and corporate entities incorporate variants of flip clauses such as walk-away and tear-up provisions into swap contracts? How can an orderly liquidation of a financial institution be conducted if all swap counterparties that owe termination amounts balk at paying them?

Appendix A—April 14, 2015 e-mail to the CFTC and Prudential Regulators: "Meeting to Discuss the Necessity of ABS Issuers Posting Full Margin Against Swap Contracts with Flip Clauses" (continued)

In other of its misrepresentations with respect to margin posting by ABS issuers, the SFIG has provided the CFTC and Prudential Regulators with inaccurate estimates of the size of potential termination payments that may be owed. In the aftermath of the US financial crisis, US interest rates rallied by more than 400 basis points. This rally left ABS issuers on the hook for termination payments of 10%, 15%, and in some instances 20% of the notional amount of swap contracts, i.e. considerably greater than the 5% suggested by the SFIG. However, even termination payments of 5% would obligate many ABS issuers to liquidate assets simultaneously, i.e., set-off a new round of distressed sales and ABS downgrades.

SFIG has also provided the CFTC with inaccurate information on an intertwined topic -- namely, rating agency criteria for swap contracts with flip clauses. Unfortunately and embarrassingly, the CFTC cited the inaccurate information provided by the SFIG as rationales for the no-action relief in CFTC Letter No. 15-21 of March 31, 2015. I would like for the CFTC and Prudential Regulators to avoid making a similar mistake with respect to margin posting by ABS issuers.

The footnotes in "Efficient, commonsense steps to foster rating accuracy" identify multiple sources that substantiate each point raised in this email. I look forward to discussing these points in person.

Please advise when we may meet. I live in New York City but I will happily come to Washington, D.C. to facilitate a meeting.

Best regards,

Bill Harrington
917-680-1465

Appendix B—December 4, 2014 e-mail to the CFTC and Prudential Regulators "SFIG/Flip Clauses/Exempting ABS Issuers from Posting Margin"

From: Bill Harrington <wjharrington@yahoo.com>
To: StasnyM@sec.gov; OrolH@sec.gov; SprattM@sec.gov; stuart.feldstein@occ.treas.gov; rfeldman@fdic.gov; mardockb@fca.gov; Robert.Frierson@frb.org; Alfred.Pollard@fhfa.gov; ckirkpatrick@cftc.gov
Cc: Richard.Johns@sfindustry.org; Sairah.Burki@sfindustry.org; Bill Harrington <wjharrington@yahoo.com>
Sent: Thursday, December 4, 2014 2:58 PM
Subject: SFIG/Flip Clauses/Exempting ABS Issuers from Posting Margin

Dear All:

The structured finance industry continues to paint itself into a corner with respect to unenforceable, walkaway flip clauses. Flip clauses ratchet up systemic risk and make future bail-outs more likely. Flip clauses are indefensible from a legal standpoint, from a risk management standpoint, and from a corporate governance standpoint. A simple solution is to require structured finance issuers to post full margin against uncleared swap contracts.

As example of the industry clinging to flip clauses, please see the attached November 24, 2014 letter to the CFTC and Prudential Regulators from the Structured Finance Industry Group (SFIG). This letter lists a set of rationales to support the SFIG lobbying position that structured finance issuers should not post margin against uncleared swap contracts with unenforceable, walkaway flip clauses.

This SFIG letter may also be accessed from the following link.
<http://www.sfindustry.org/images/uploads/pdfs/SFIG_Comment_Letter_Margin_Requirements.pdf>

Please note footnote 11, p. 8 on unenforceable, walkaway flip clauses.
"We note that termination payments typically remain no lower in priority than the interest of the senior most class of debt interests so long as the swap provider is not the defaulting party. It is standard market practice to include contractual provisions that provide that should the swap provider be the defaulting party to a swap, such default causes the swap provider to "flip" to a more junior position in the priority of payments. The inclusion of such a flip clause is consistent with requirements imposed by investors and rating agencies, who mandate that a defaulting party should not be permitted to maintain its senior position in the waterfall. We believe that the inclusion of a flip clause should not preclude a financial end user from meeting the requirement set forth in criteria No. 2."

Appendix B—December 4, 2014 e-mail to the CFTC and Prudential Regulators "SFIG/Flip Clauses/Exempting ABS Issuers from Posting Margin" (continued)

The inaccuracies in this footnote are too many to list here. Instead, I suggest that the SEC Office of Structured Finance set up a meeting with SFIG, the CFTC, the Prudential Regulators, other interested parties, and me to dissect the systemic risks that accumulate under uncleared swap contracts with unenforceable, walkaway flip clauses and no margin posting.

Unenforceable, walkaway flip clauses were a prime focus of my December 2, 2014 discussion with Mike Spratt and Allison Lee (counsels to SEC Commissioner Kara Stein), Harriet Orol of the SEC Office of Credit Ratings, and Michelle Stasny of the SEC Office of Structured Finance. Details of this meeting available are at http://www.sec.gov/comments/s7-08-10/s70810-310.pdf.

Best regards,

Bill Harrington
[redacted]