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

January 31, 2016

VIA ELECTRONIC MAIL

Mr. Bobby R. Bean
Associate Director, Capital Markets Branch
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429.

Re: Margin and Capital Requirements for Covered Swap Entities; Interim Final Rule to Exempt Commercial End Users and Small Banks (Federal Register Vol. 80, No. 229, Pages 74916-74924)
- **Department of the Treasury, Office of the Comptroller of the Currency, 12 CFR Part 45 [Docket No. OCC–2015–0023] RIN 1557–AD00**
- **Federal Reserve System, 12 CFR Part 237 [Docket No. R–1415] RIN 7100–AD74**
- **Federal Deposit Insurance Corporation, 12 CFR Part 349 RIN 3064–AE21**
- **Farm Credit Administration,12 CFR Part 624 RIN 3052–AC69**
- **Federal Housing Finance Agency, 12 CFR Part 1221 RIN 2590–AA45**

Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants; Interim Final Rule (Federal Register Vol 81, No. 3, Pages 636-638)
- **Commodity Futures Trading Commission (§ 23.150(b))**

Dear All,

I am a private US citizen. The comments contained herein with respect to the Interim Final Rule of the prudential regulators are mine alone and do not represent the views of any other person, my employer, or other entities.

I will also submit a comment to the CFTC regarding its analogous Interim Final Rule. The CFTC deadline for submission is 6 February 2016.

After submitting these comments, I will contact the CFTC to arrange a joint call with its rule-writing team and the rule-writing team of each prudential regulator to discuss my comments.

On 12 May 2015, I led a joint conference call with Mr. Rick Michalek and the rule writing teams from the CFTC and prudential regulators regarding the proposed rule 79 FR 59898 (i.e., the rule proposal that preceded the respective final rules for margin posting of uncleared swaps: "Margin

and Capital Requirements for Covered Swap Entities"; and "Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants.")

The following link accesses the CFTC notice of the joint conference call, the materials that I used to lead the call, and the overarching point conveyed by Mr. Michalek and me, which is quoted below. http://comments.cftc.gov/PublicComments/ViewExParte.aspx?id=1016

> "Commenters argue against an exemption from margin requirements for issuers of asset backed securities. Commenters believe ABS issuers' current practice for dealing with counterparty credit risk is inadequate by construction and presents a systemic risk."

"Flip clauses" and "RAC" provisions mask capital inadequacies of ABS and covered swap entities

"Flip clauses" and "RAC" provisions are commonly placed into swaps by ABS issuers to address counterparty credit but are inadequate for this purpose.

For a start, few if any ABS issuers have ever obtained a U.S. legal opinion with respect to the enforceability of a flip clause in a priority of payments. The inability to obtain an opinion regarding the enforceability of a flip clause is attributable in large part to the similarity of a flip clause to a walk-away provision.

The ratcheting up of ABS risk and systemic risk that accumulates from flip clauses and RAC provisions can by gauged both by examining the respective mechanics of flip clauses and RAC provisions and by tracking outcomes for ABS issuers that were pre-crisis counterparties to Lehman Brothers Holdings Inc. and affiliates under swaps.

Swaps with flip clauses and RAC provisions have long underpinned the ABS sector and, in common with other practices by ABS issuers, contributed to the inadequate capitalization of ABS that was a central contributor to the financial crisis. Neither the swaps with flip clauses and RAC provisions nor the ABS that are structured with these swaps can be viewed in isolation from each other.

But for the bailouts that prevented other counterparties from following Lehman Brothers Holdings Inc. into bankruptcy and the extraordinary measures by the U.S. government to buy ABS and other structured products, the inadequate capitalization of ABS that is attributable to a swap with a flip clause and RAC provisions would be more generally appreciated.

Equally, but for the bailouts and other government programs, the systemic risks that accrue from covered swap entities being party to swaps with flip clauses would also be more generally appreciated. Being party to these swaps represents extremely reckless behavior on the part of covered swap entities, as well as a failure of corporate and regulatory governance, given the many attributes that a flip clause has in common with a "walk-away" provision.

Appendix A and B to this letter contain my assessment of the deficiencies of flip clauses and RAC provisions in conjunction with my examination of the CFTC Letter No. 15-21 of March 31, 2015: "No-Action Position: Certain Commission Regulations Applicable to Swaps with Legacy Special Purpose Vehicles", which was issued by the Division of Swap Dealer and Intermediary

Oversight. On 28 May 2015. Mr. Rick Michalek and I discussed these deficiencies with the CFTC staff that issued the CFTC Letter No. 15-21.

Title III of TRIPRA does not exempt a swap with a flip clauses or RAC provision
I have read and re-read Title III of the Terrorist Risk Insurance Program Reauthorization Act TRIPRA). I have also read and re-read the Bill Summary & Status, 114th Congress (2015-2016), H.R.26, CRS Summary.

Neither Title III of TRIPRA nor the CRS Summary states that, to quote from the latter, the exemption "from the rules of the prudential regulators for swap dealers and major swap participants with respect to initial and variation margin requirements for swaps not cleared by a registered derivatives clearing organization, those swaps in which one of the counterparties: (1) is eligible for an exception from clearing requirements because it is not a financial entity, uses swaps to hedge or mitigate commercial risk, and notifies the Commodity Futures Trading Commission how it meets financial obligations associated with entering into non-cleared swaps" applies to a swap with a flip clause or a RAC provision.

Moreover, the Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants; Final Rule notes that "One commentator, however, argued that requiring SPVs and other asset-backed security issuers to post full margin against all swap contracts would defuse commonly used "flip clauses" and decrease the loss exposure of investors in asset-backed securities."

1. Accordingly, given that a swap with a flip clause or RAC provision does not qualify for an exemption under Title III of TRIPRA, the final rule that will become effective on 1 April 2016 and which will have followed consideration of comments received with respect to the Interim Final Rule should contain the following language: "For the avoidance of doubt, a swap with either a flip clause or a RAC provision does not qualify for an exemption from either the Margin and Capital Requirements for Covered Swap Entities; Final Rule or the Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants; Final Rule."

2. In notifying "the Commodity Futures Trading Commission how it meets financial obligations associated with entering into non-cleared swaps", a company seeking an exception must file with the CFTC an affidavit signed by a senior officer that states that all swaps that are included in the exemption do not have: (1) a flip clause; (2) any other clause that can be reasonably classified as a walk-away provision; or (3) a RAC provision.

3. The prudential regulators and the CFTC should obligate any covered swap entity, swap dealer, or major swap participant to post both initial margin and variation margin to its guarantor or hedging affiliate against a swap that contains a (1) a flip clause; or (2) any other clause that can be reasonably classified as a walk-away provision. In this way, the losses that arise under the entry into a flip clause or walk-away provision will be fully absorbed by the covered swap entity, swap dealer, or major swap participant that recklessly agreed to the flip clause or walk-away provision and will not be transmitted to its affiliates such as an FDIC-insured subsidiary.

Credentials
On 18 October 2015, I joined 'Debtwire ABS' as a senior ABS analyst. Debtwire ABS is a subscription-based, online provider of news and commentary on the US, EU, and other markets for ABS and structured products.

In my role, I write articles on the capitalization, regulation, and ratings of ABS and structured products. On 21 October 2015, the prudential regulators began the process of adopting the joint swap margin rule. The timing was fortuitous for me, as I was new to both Debtwire ABS and journalism, but interested and well-versed in the application of the swap margin rule to ABS and structured product issuers.

My first articles at Debtwire ABS covered the swap margin rule. These articles addressed the implications for the standard swap contacts with flip clauses and RAC provisions that have long been used by ABS and structured product issuers, the need for credit rating agencies to overhaul methodologies for rating ABS and structured debt when an issuer enters into a swap contract with margin posting, and pushback to margin posting that was being organized by the Structured Finance Industry Group.

After giving subscribers significant time to review these articles, Debtwire ABS posted this article of mine on its public site. http://www.debtwire.com/info/2015/11/04/analysis-us-margin-rule-swaps-obliges-securitization-issuers-overhaul-structures-add-resources-rethink-capital-structures/

From 2011 until joining Debtwire ABS in 2015, I had engaged in a fulltime, self-financed effort to alert regulators, market participants, credit rating agencies, and the media to the deficient processes for assigning credit ratings to debt issued by entities that are party to derivative contracts such as uncleared swaps. These rating deficiencies enable an entity such as an ABS or structured product issuer to misrepresent its credit profile to providers of derivative contracts and, in tandem with this misrepresentation, issue debt that is under-capitalized relative to its credit rating.

In January 2016, Capital Markets Law Journal published the following article by my co-author Norbert Gaillard and me. This article traces relates the problems with flip clauses and RAC provisions to the major deficiencies that continue to exist with respect to the methodologies and rating practices of credit rating agencies.

Efficient, commonsense actions to foster accurate credit ratings
Norbert J. Gaillard; William J. Harrington
Capital Markets Law Journal 2016 11 (1): 38-59
doi: 10.1093/cmlj/kmv064

An extract can be accessed from this link. http://cmlj.oxfordjournals.org/content/11/1/38.extract and the full article can be accessed from my LinkedIn profile (William J. Harrington).

From 1999 to 2010, I worked as an analyst in the derivatives group of Moody's Investors Service where I evaluated the impact of flip clauses and RAC provisions to both parties to a swap, i.e., an ABS issuer and a derivative counterparty. In July 2010, I resigned as a senior vice president.

Prior to Moody's, I worked as derivative structurer at Merrill Lynch and a currency analyst at Wharton Econometrics.

Sincerely yours,

William J. Harrington

cc: The Honorable Thomas J. Curry, Comptroller of the Currency
The Honorable Janet Yellen, Chair, Board of Governors of the Federal Reserve System
The Honorable Martin J. Gruenberg, Chairman, Federal Deposit Insurance Corporation
The Honorable Kenneth A. Spearman, Board Chair and Chief Executive Officer, Farm Credit Administration
The Honorable Melvin Watt, Director, Federal Housing Finance Agency
The Honorable Timothy G. Massad, Chairman, Commodity Futures Trading Commission

Appendix A—15 May 2015 Letter to Mr. Thomas Smith of the U.S. Commodity and Futures Trading Commission, Ms. Harriet Orol of the U.S. Securities and Exchange Commission, and Mr. Felix Flinterman of the European Securities and Market Authority: "Letter No. 15-21 & Rating Agency Overrides of Published Methodologies for Swap Contracts"

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

May 15, 2015

VIA ELECTRONIC MAIL

Mr. Thomas Smith
Acting Director
Division of Swap Dealer and Intermediary Oversight
U.S. Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

Ms. Harriet Orol
Office of Credit Ratings
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20002-4224

Mr. Felix Flinterman
Head of Unit CRA Supervision
European Securities and Markets Authority
103 Rue de Grenelle CS 60747 Paris
75345 CEDEX 07 France

Re: CFTC Letter No. 15-21 of March 31, 2015
Division of Swap Dealer and Intermediary Oversight
"No-Action Position: Certain Commission Regulations Applicable to Swaps with Legacy Special Purpose Vehicles"

Dear Mr. Smith, Ms. Orol, and Mr. Flinterman:

I am writing with respect to the CFTC Letter No. 15-21 that was issued on March 31, 2015.

For several days in May 2015, the CFTC Letter No. 15-21 could not be accessed on the CFTC website. Accordingly, my letter today quotes the entirety of key passages from the CFTC Letter No. 15-21 in the event that it again becomes inaccessible or is withdrawn. My letter also uses several terms that were defined in the CFTC Letter No. 15-21, such as Legacy SPV Swap, Remedial Action, and Delinking Criteria.

Today's letter follows up on my April 7, 2015 e-mail "CFTC Letter No. 15-21 & Inaccurate Representations of De-Linking Criteria," which is contained herein as an Appendix.

As my April 7 e-mail stated, the CFTC Letter No. 15-21 provides the SEC and the U.S. Department of Justice with grounds to bring enforcement actions against Fitch, Moody's, and S&P. From 2006 onward, each of these credit rating agencies ignored its respective Delinking Criteria in assigning ratings to debt issued by SPVs that were party to swap contracts. These swap contracts are the same Legacy SPV Swap contracts that are the subject of the CFTC Letter No. 15-21.

The CFTC Letter No. 15-21 also provides ESMA with grounds to bring enforcement actions against Fitch, Moody's, and S&P. From 2006 onward, each of these credit rating agencies ignored its respective Delinking Criteria in assigning and subsequently monitoring ratings to debt issued by SPVs in the EU that were party to swap contracts.[1]

Ignoring published criteria to assign and monitor the ratings of SPV debt is a violation of the respective procedures of each credit rating agency and the regulatory rules of both the SEC and ESMA. Investors in SPV debt (e.g., residential mortgage-backed securitizations, collateralized debt obligation transactions, credit-linked note transactions, and other financial asset repackage transactions) that were originated or restructured in as late as 2009 suffered losses, as did U.S. and EU taxpayers. Accordingly, a U.S. action under the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 may be commenced as late as 2019.

Furthermore, each credit rating agency compounded its violations of internal policies and external rules by greenlighting amendments to the Legacy SPV Swap contracts and similar SPV swap contracts in the EU that stripped them of existing protections for investors in SPV debt. As of this writing, the credit rating agencies were continuing to greenlight these amendments. As a result, a U.S. action under the Financial Institutions Reform, Recovery, and Enforcement Act of

[1] See Norbert J. Gaillard and William J. Harrington, "Efficient, Commonsense Steps to Foster Rating Accuracy," *Capital Markets Law Journal* (in press 2015), footnote 109. Moody's applied its Delinking Criteria to assign ratings to debt issued by an SPV established by Greece so that it could mask borrowings of Euro 5 billion under swap contracts with Goldman Sachs.

1989 may be commenced on any date up to and including the earlier of either May 15, 2025 or 10 years after the last date on which a credit rating agency greenlighted an amendment to a Legacy SPV Swap contract. In the EU, both ESMA and investors have multiple grounds for bringing actions.[2]

The CFTC Letter No. 15-21 cites as rationales a series of representations that were made by the SFIG with respect to the operations of SPVs and the content of Delinking Criteria. Many of these representations are inaccurate and, as a consequence, the CFTC Letter No. 15-21 provides a safe harbor for the Legacy SPV Swap contracts to be amended in ways that will strip them of still more investor protections.

To preserve what investor protections still remain in the Legacy SPV Swap contracts, the CFTC should revise the definition of a Remedial Action[3] as follows:

"The taking of any Remedial Action will not affect the material economic terms of the Legacy SPV Swap, ***nor increase the exposures of investors in SPV debt to the credit quality of SDs that may be attributable to the non-enforcement, nullification, or vitiation of a flip clause.***

"*A 'Remedial Action' means* ***either*** *of the following:*

1. *Posting of collateral; or*
2. *Replacing the downgraded SD with an entity who satisfies the* ***currently*** *applicable credit rating requirements of the Legacy SPV Swap,* ***with the rating or ratings of such entity classified by the respective credit rating agencies as "fundamental" and provided that such entity is not an SPV, a structured finance operating company, or an entity with a structured finance rating.***

"For the avoidance of doubt, no other actions are Remedial Actions."

Attached to the e-mail delivering today's letter is "Efficient, Commonsense Steps to Foster Rating Accuracy," written by my Wikirating colleague Norbert J. Gaillard and me (GH2015). This paper has been accepted for publication by the *Capital Markets Law Journal* and is being presented at several conferences this year.

Today's letter cites passages, footnotes, and sources from GH2015. Sources are identified using the abbreviations established in GH2015 (e.g., Harrington (2014), p. #.) Collectively, these passages, footnotes, and sources (most of which have been posted on sec.gov for at least two years) memorialize the development and content of the two Moody's Delinking Criteria that are,

[2] Ibid., pp. 8-10.
[3] Remedial Actions are defined on p. 5 of the CFTC Letter No. 15-21.

whether in whole, in part, or in tandem, present in most Legacy SPV Swap contracts and similar SPV swap contracts in the EU.

I was a co-author of both of Moody's Delinking Criteria (as well as a third, analogous criteria for application in assigning and monitoring ratings of credit-linked note transactions and other financial asset repackage transactions and a fourth, separate methodology for application in assigning and monitoring the ratings of counterparties to SPVs under swap contracts).[4]

In developing the second of the two Delinking Criteria for Moody's, my U.S. and EU colleagues and I actively solicited the input of SDs by meeting with individual SDs[5] and their regulators[6] and by issuing several comment requests.[7] We also announced the key provisions of the Delinking Criteria in succinct press releases[8] and worked closely with SDs, SPVs, and their respective counsels in incorporating the Delinking Criteria into what have become the Legacy SPV Swap contracts.[9]

Our team had a big-picture goal of approving a standard swap contract with each SD[10] as an efficient means to codifying several best practices for the benefit of investors, SDs, and Moody's. Investors in all types of SPV debt would benefit from the same protections. Rating teams could focus most of their analysis on the assets being securitized. SDs could accurately price the costs of Remedial Actions. And all SDs would face a level playing field.[11]

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[4] See Harrington (2014), pp. 1-2 and footnote 9.

[5] Moody's U.S. and EU teams met with the following SDs: Bank of America, Bank of New York, Barclays Bank, Bear Stearns and Bear Stearns Financial Products, CSFB, Deutsche Bank, Lehman Brothers and the two Lehman Brothers Derivative Product Companies, Merrill Lynch Derivative Products, Nomura Derivative Products Inc., Royal Bank of Scotland, SwissRe, Wachovia, and UBS. From 2004 to 2006, Moody's teams were rebuffed in their repeated offers to meet with Goldman Sachs. Three years later, in 2009, as SD downgrades loomed and Remedial Actions were being activated, Goldman Sachs offered to discuss the Delinking Criteria.

[6] In 2006, I discussed Moody's new Delinking Criteria with Paul Tucker of the Bank of England during his visit to Moody's offices in New York. Afterwards, I forwarded a copy of the framework to Mr. Tucker with a cc: to my London colleagues, as they were best suited to provide further updates.

[7] See PDF-numbered pages 35-36 of the document cited in footnote 9 of Harrington (2014). See also "Moody's Requests Comments on Proposals for Swaps in Highly-Rated Structured Finance Cash-flow Transactions" (December 7, 2005).

[8] Ibid., PDF-numbered pages 34 and 37.

[9] Ibid., PDF-numbered pages 25-29.

[10] Ibid. See PDF-numbered pages 24-29 with respect to the standard swap contract approved for Bear Stearns Financial Products and SPVs that issued debt backed by residential mortgage-backed securities. Similarly, my Moody's colleagues Nicolas Weill (Chief Credit Officer, Global Structured Finance) and Michael Kanef (Chief Regulatory Affairs and Compliance Officer) and I approved a standard form for UBS to use when entering into swap contracts with SPVs that issued debt backed by student loans.

[11] Ibid., PDF-numbered pages 35-37.

The second of the two Moody's Delinking Criteria, "Framework for De-Linking Hedge Counterparty Risks from Global Structured Finance Cashflow Transactions" (Moody's Hedge Framework), was in worldwide effect from December 15, 2006 until November 12, 2013. Moody's Hedge Framework was in development from 2003 until its publication on May 25, 2006.

The forerunner to Moody's Hedge Framework, "Guidelines for CDO Hedge Counterparties," was in effect in North America from November 2, 2002 until its ostensible withdrawal on December 15, 2006.[12] However, in violation of both its published guidelines and SEC regulations, Moody's accommodated requests by SDs to apply this Delinking Criteria on a piecemeal basis in assigning ratings to new collateralized debt obligations,[13] credit-linked note transactions,[14] and residential mortgage-backed securities.[15] Moreover, Moody's continued its practice of applying the criteria on a piecemeal basis for at least three years after December 15, 2006.[16]

Based on my 15-year experience in developing and evaluating Moody's Delinking Criteria, as well as on the analogous criteria of Fitch and S&P with respect to both SPV investors and SDs,[17] I offer the following observations regarding the SFIG representations cited in the CFTC Letter No. 15-21.

SFIG Representation #1. *"SFIG states that an SD would not be able to comply with the Specified Regulations because restrictions in SPVs' governing documentation may prevent an SPV from taking certain actions required by the SD to comply with the Specified Regulations."* (CFTC Letter No. 15-21, pp. 1-2.)

The *"restrictions in SPVs' governing documentation"* <u>do not</u> *"prevent an SPV from taking certain actions required by the SD to comply with the Specified Regulations."* The trustee of an SPV can amend governing documentation either by obtaining the consents of SPV noteholders

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[12] See Moody's Hedge Framework, p. 1.

[13] See "Guidelines for CDO Hedge Counterparties," pp. 1 and 3, and Harrington (2011), pp. 25-29 and 63-64. Moody's Delinking Criteria for CDOs stipulated higher rating triggers for an SD that provided a hedge "*whose market risk is potentially greater than that of a single-currency, interest rate swap that is on market at initiation*." In direct violation of this criteria, Moody's assigned ratings to more than 50 CDOs issued by SPVs that had entered into swap contracts that were off-market at initiation but that did not contain the higher ratings triggers. AIG was, and remains, the SD for most of these off-market swap contracts. See also PDF-numbered pages 27 and 57-59 of the document cited in footnote 9 of Harrington (2014).

[14] See Harrington (2011), pp. 21-24.

[15] See PDF-numbered pages 25-29 of the document cited in footnote 9 of Harrington (2014). I led a series of Moody's committees that exempted Bear Stearns Financial Products Inc. from complying with a key provision of Moody's Hedge Framework. These exemptions violated both Moody's internal guidelines and SEC regulations.

[16] Ibid. See also Harrington (2011), Item 4a on p.62 and PDF-numbered page 27 of the document cited in footnote 9 of Harrington (2014).

[17] See also PDF-numbered pages 1-6 and 89-152 of the document cited in footnote 9 of Harrington (2014).

or by paying a modest fee to a credit rating agency to induce it to issue a RAC.[18] However, the trustees of an SPV should not need to obtain a RAC in order for an SD to perform a Remedial Action; these contractual obligations should have been undertaken by SDs when they began being downgraded in 2009.[19]

To find examples of trustees having amended SPVs' governing documentation by obtaining RACs that relate directly to the CFTC Letter No. 15-21, one needs only to examine the amendments to the governing documentation of 100 SPVs that unilaterally stripped investor protections from Legacy SPV Swap contracts and similar SPV swap contracts in the EU for the benefit of SDs.[20] The RACS issued by Moody's increased the expected losses of SPV debt and thus violated a key provision in Moody's Hedge Framework.[21]

In contrast, amending governing documentation to allow SPVs to take "*certain actions required by the SD to comply with the Specified Regulations"* that would not reduce protections for investors in SPV debt would be noncontroversial. Trustees could effectuate these amendments either by obtaining the consents of SPV noteholders or by obtaining RACs from credit rating agencies.

SFIG Representation #2. *"Of note in relation to this letter, a number of the Commission's rules under the External BCS require SDs and MSPs to provide or obtain specific information from their counterparties and to perform certain due diligence inquiries with respect to their counterparties prior to entering into (or in some cases, offering to enter into) a swap with such counterparties."* (CFTC Letter No. 15-21, p. 2.)

In relation to the CFTC Letter No. 15-21, the Commission's rules do not, but should, *"require SDs and MSPs to provide or obtain specific information from their counterparties"* that are SPVs in regard to investor protections and the enforceability of flip clauses in their swap contracts and priorities of payments. Similarly, the Commission's rules do not, but should, require SDs and MSPs *"to perform certain due diligence inquiries with respect to their counterparties prior to entering into (or in some cases, offering to enter into) a swap with such counterparties"* that are SPVs in regard to investor protections and the enforceability of flip clauses in their swap contracts and priorities of payments.

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[18] See GH2015, p. 7.

[19] See Moody's Hedge Framework, p. 6: *"None of these obligations may be contingent upon issuance of Rating Agency Confirmation by Moody's prior to being activated."*

[20] See GH2015, footnote 38.

[21] See Moody's Hedge Framework, footnote 5: *"Governing documents of most cashflow transactions enable an existing hedge to be adjusted, or a new one entered into, if modeling shows the expected losses of rated liabilities to be unimpaired by the proposed hedge."*

The flip clause, which subordinates swap payments owed by an SPV to an SD or MSP that has defaulted or is bankrupt, was an integral part of Moody's Hedge Framework.[22] However, the well-publicized nullification of a flip clause in 2010[23] has left SPVs that are parties to out-of-the-money swap contracts fully exposed to the credit quality of SDs.[24] Owing to very low interest rates, the vast majority of Legacy SPV Swap contracts are in fact out-of-the-money and expose investors in SPV debt to the credit quality of SDs and MSPs.

The Delinking Criteria of Moody's, S&P, and Fitch either glossed over or entirely ignored the loss of investor protections and the increase in exposures of SPV debt to the credit quality of SDs and MSPs that occurred with nullification of a flip clause in 2010.[25] As a result, most SPVs continue to insert flip clauses into both their priorities of payments and their swap contracts more than five years after a flip clause was nullified in 2010.

SFIG Representation #3. *"Regarding the content of swap trading relationship documentation, each SD must establish policies and procedures reasonably designed to ensure that the parties have agreed in writing to all terms governing their trading relationship, including, among other things, terms related to credit support arrangements, such as initial and variation margin requirements and custodial arrangements, and terms addressing payment obligations, netting of payments, events of default or other termination events, calculation and netting of obligations upon termination, transfer of rights and obligations, governing law, valuation, and dispute resolution. With respect to valuation of swaps, SDs must include agreement on the process for determining the value of each swap at any time from execution to the termination, maturity, or expiration of the swap, for the purposes of complying with: (1) the margin requirements under section 4s(e) of the CEA and Commission regulations; and (2) the risk management requirements under section 4s(j) of the CEA and Commission regulations. The documentation also must include either: (1) alternative methods for determining the value of the swap, in the event of the unavailability or other failure of any input required to value the swap; or (2) a valuation dispute resolution process."* (CFTC Letter No. 15-21, pp. 3-4.)

The attributes of a Legacy SPV Swap contract that are laid out in SFIG Representation #3 were all present in Moody's Hedge Framework in 2006. Each of the following three paragraphs contains a portion of SFIG Representation #3 and ends with a footnote that identifies the analogous provisions in Moody's Hedge Framework.

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[22] Ibid., p. 16, *"Priority of Termination Payments to Counterparty."*

[23] See GH2015, footnote 40.

[24] See Harrington (2011), pp.24-34 and PDF-numbered pages 57-59 of the document cited in footnote 9 of Harrington (2014).

[25] See Harrington (2011), pp. 30-34, S&P's "Counterparty and Supporting Obligations Methodology and Assumptions" (December 6, 2010), and Fitch's "Lehman Court Settlement Leaves Legal Conflict for Structured Finance Derivatives: Criteria Amended (March 14, 2011). Additionally, see PDF-numbered pages 25-29 and 89-152 of the document cited in footnote 9 of Harrington (2014).

An SPV and an SD or MSP were to agree at the outset *"in writing to all terms governing their trading relationship, including, among other things, terms related to credit support arrangements, such as initial and variation margin requirements and custodial arrangements, and terms addressing payment obligations, netting of payments, events of default or other termination events, calculation and netting of obligations upon termination, transfer of rights and obligations, governing law, valuation, and dispute resolution."*[26]

When entering into a swap contract, SPVs and *"SDs must include agreement on the process for determining the value of each swap at any time from execution to the termination, maturity, or expiration of the swap…."*[27]

For a swap contract between an SPV and an SD, initial *"documentation also must include either: (1) alternative methods for determining the value of the swap, in the event of the unavailability or other failure of any input required to value the swap; or (2) a valuation dispute resolution process."*[28]

In sum, with respect to *"the content of swap trading relationship documentation"* and the "*valuation of"* any Legacy SPV Swap contract associated with debt that was rated by Moody's, an SD should already be in compliance and thus not require the relief of the CFTC Letter No. 15-21.

With respect to an SD that is not in compliance and thus requires the relief of CFTC Letter No. 15-21, the credit quality of the SD is <u>linked</u> to the SPV debt rated by Moody's and moreover <u>has been linked</u> from the time of initial rating. In other words, Moody's violated—and continues to violate—its published methodology and assigned an inaccurate rating to the SPV debt by modeling it as being delinked from the credit risk of an SD.[29]

SFIG Representation #4. *"SPVs commonly enter into swaps with SDs to:…(ii) transfer the credit and/or market risk on certain underlying obligations to or from the SPV."* (CFTC Letter No. 15-21, p. 4.)

[26] For analogous provisions in Moody's Hedge Framework, see pp. 4-6 and 15-16.
[27] Ibid., pp. 7-13 and 31-45.
[28] Ibid., pp. 40-41.
[29] See Moody's "Approach to Assessing Linkage to Swap Counterparties in Structured Finance Cash Flow Transactions" (November, 12, 2013). See also PDF-numbered page 16 of the document cited in footnote 9 of Harrington (2014). "Moody's warns that even full 'compliance with the de-linkage framework at closing does not ensure that de-linkage will persist throughout the life of a transaction,' although Moody's will assume persistent de-linkage in assigning new ratings of Aaa(sf)." Using different assumptions to assign new ratings and monitor existing ones (e.g., the delinkage assumption for new ratings and the linkage assumption for existing ratings) is a violation of the regulatory rules of both the SEC and ESMA.

Moody's Hedge Framework was applicable to interest rate swap contracts, basis rate swap contracts, and currency swap contracts only. The framework explicitly excluded credit default swap contracts.[30]

"Moody's Approach for Rating Thresholds of Hedge Counterparties in CDO Transactions" stipulated that a credit default swap contract would contain higher rating triggers than those for an "on-market, interest rate swap."[31] To the extent that Moody's assigned ratings to debt issued by an SPV that entered into a credit default swap contract that did not incorporate the higher rating triggers, Moody's violated its own internal guidelines as well as SEC regulations.

SFIG Representation #5. *"SFIG represents that, in order to minimize the impact of SD credit risk on the risk profile of the obligations issued by the SPV, the rating agencies have developed criteria designed to isolate the credit risk of the SD (the "Delinking Criteria") so that the rating agencies may assign a credit rating to the obligations issued by the SPV based solely on the quality of the underlying assets of the SPV and the structural features of the SPV, without taking into account the credit quality of the SD."* (CFTC Letter No. 15-21, p. 4.)

The flip clause, which remains a structural feature in the priorities of payments of most SPVs, was an integral part of Moody's Hedge Framework.[32] However, the nullification of a flip clause in 2010[33] has fully exposed SPVs with out-of-the-money swap contracts to the credit risk of SDs.[34] The vast majority of Legacy SPV Swap contracts are out-of-the-money and thus expose investors in SPV debt to *"the credit quality of the SDs."*

The updated Delinking Criteria do not state that the respective credit rating agencies can "*assign a credit rating to the obligations issued by the SPV based solely on the quality of the underlying assets of the SPV and the structural features of the SPV, without taking into account the credit quality of the SD."* Nor do the credit rating agencies represent that they, in assigning *"credit ratings to the obligations issued by the SPV,"* establish whether an SPV and SD have incorporated the provisions of Delinking Criteria into a swap contract.[35]

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[30] See Moody's Hedge Framework, footnote 2.
[31] See "Moody's Approach for Rating Thresholds of Hedge Counterparties in CDO Transactions" (October 23, 2002), p. 1.
[32] See Moody's Hedge Framework, p. 16, "*Priority of Termination Payments to Counterparties.*"
[33] See GH2015, footnote 40.
[34] See Harrington (2011), pp. 24-34, and Harrington (2014), pp. 2-8.
[35] See Fitch's "Counterparty Criteria for Structured Finance and Covered Bonds" (May 13, 2013), Moody's "Approach to Assessing Linkage to Swap Counterparties in Structured Finance Cash Flow Transactions" (November, 12, 2013), and S&P's "Counterparty Risk Framework Methodology and Assumptions" (May 31, 2012).

SFIG Representation #6. *"The Delinking Criteria are prescriptive rules that aim to ensure performance by the SD."* (CFTC Letter No. 15-21, p. 4.)

Delinking Criteria are no longer "*prescriptive rules that aim to ensure performance by the SD."*[36]

With respect to the Delinking Criteria that are applicable to the Legacy SPV Swap contracts, Moody's Hedge Framework contained pro-forma language that was to be included in the formation of what are now Legacy SPV Swap contracts.[37] This pro-forma language articulated all aspects of the framework and was intended to be incorporated into a swap contract at the outset and to be binding. Otherwise, if the provisions were not present in the swap contract at the outset or were not binding, the SPV debt was not delinked from the credit profile of an SD.[38]

Rather than abide by the binding provisions of the Legacy SPV Swap contracts, SDs directed trustees to have the provisions nullified by obtaining RACs from credit rating agencies that amended the provisions without offering compensation, consideration, or other forms of protection to SPV noteholders.[39] With respect to the RACs that were issued by Moody's, the agency violated an explicit tenet of Moody's Hedge Framework and, in so doing, violated both its internal guidelines and U.S. and EU regulations.[40]

In other words, credit rating agencies proactively undermined their Delinking Criteria by assisting SDs in <u>not</u> performing their obligations under Legacy SPV Swap contracts.

SFIG Representation #7. *"SFIG explains that under the Delinking Criteria, certain provisions of the documents governing the Legacy SPV Swap (the "Legacy SPV Swap Documentation") require the SD to take one or more Remedial Actions (as defined below) within designated time periods (in many cases, 30 days or less) following the withdrawal, qualification, and/or downgrade of the SD's credit ratings below certain specified thresholds."* (CFTC Letter No. 15-21, pp. 4-5.)

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[36] Ibid. The current Delinking Criteria of Fitch, Moody's, and S&P explicitly acknowledge that key provisions are absent from new swap contracts between ABS issuers and SDs. See PDF-numbered pages 110-115 of the document cited in footnote 9 of Harrington (2014) for Moody's comments on the partial incorporation of its criteria into swap contracts between ABS issuers and SDs.

[37] See Moody's Hedge Framework, pp. 6 and 14-45.

[38] Ibid., pp. 1 and 4.

[39] See GH2015, footnote 38.

[40] See Moody's Hedge Framework, footnote 5: *"Governing documents of most cashflow transactions enable an existing hedge to be adjusted, or a new one entered into, if modeling shows the expected losses of rated liabilities to be unimpaired by the proposed hedge."* See also p. 6: *"None of these obligations may be contingent upon issuance of Rating Agency Confirmation by Moody's prior to being activated."*

Moody's Hedge Framework was developed in close consultation with the SDs.[41]

In part based on these consultations, Moody's Hedge Framework explicitly stated that, alone of the Remedial Actions to be undertaken by an SD, only the posting of collateral was to occur within 30 days or less.[42] Posting of collateral is a key protection for holders of SPV debt when a Legacy SPV Swap contract is in-the-money to an issuer. The collateral amounts and valuation percentages set out in Moody's Hedge Framework were calibrated to offset the maximum number of days of market risk that could elapse before initial margin was posted and between the subsequent postings of variation margin.[43]

Moody's Hedge Framework also contained several provisions to facilitate timely posting of collateral by an SD, which, when present in a swap contract from the outset as stipulated by the framework,[44] would enable an SD to easily post collateral under a Legacy SPV Swap contract within 30 days.[45] Moreover, other than in a single circumstance, failure of an SD to post collateral gave rise only to a termination event rather than an SD event of default.[46]

With respect to the other Remedial Actions—effecting replacement or obtaining a guaranty—Moody's Hedge Framework explicitly acknowledged that market realities might prevent an SD from ever complying let alone doing so within 30 days.[47] Accordingly, the framework introduced measures to maximize the likelihood of replacement occurring,[48] but provided no sanctions or penalties for an SPV to apply against an SD that had failed to either replace itself or obtain a guaranty.[49]

SFIG Representation #8. *"The purpose of any Remedial Action is to insulate the investors in obligations issued by the SPV from the credit risk of the SD. The taking of any Remedial Action will not affect the material economic terms (as represented by SFIG, for the purposes hereof, "material economic terms" means the pricing and other economic terms typically documented in*

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[41] See PDF-numbered page 36 of the document cited in footnote 9 of Harrington (2014): *"These obligations and sanctions incorporate the practical concerns aired by swap counterparties and participants in structured finance transactions, including the length of time typically required to post collateral under automatic notification, the time needed to effect replacement, and the potentially limited universe of replacement counterparties."* See also footnotes 5 and 10 in today's letter.

[42] See Moody's Hedge Framework, pp. 15-16.

[43] Ibid., pp. 11-13 and 19-28.

[44] Ibid., p. 4 and also p. 6: *"None of these obligations may be contingent upon issuance of Rating Agency Confirmation by Moody's prior to being activated."*

[45] Ibid., pp. 6-8 and 15-16.

[46] Ibid., pp. 17-18.

[47] Ibid., pp. 5-6.

[48] Ibid., pp. 9-10.

[49] Ibid., pp. 16-18.

a transaction confirmation that establish the amount and timing of the SPV's obligations) of the Legacy SPV Swap.

SFIG represents that "Remedial Action" means any of the following:

1. Posting of collateral by the SD, which may require the SD and the SPV to enter into a collateral agreement and amend the Legacy SPV Swap Documentation in order to give effect thereto;" (CFTC Letter No. 15-21, p. 5.)

Moody's Hedge Framework explicitly and intentionally stipulated that an SD and an SPV were to enter into a collateral agreement at closing.[50] In other words, *"posting of collateral by the SD"* should not *"require the SD and the SPV to enter into a collateral agreement and amend the Legacy SPV Swap Documentation in order to give effect thereto"* at this late date.

To the extent that Moody's assigned ratings to debt issued by SPVs that had not entered into collateral agreements under the assumption that the debt was delinked from the credit risk of an SD, the debt ratings were both inaccurate and inconsistent with Moody's published methodology.

SFIG Representation #9. (Remedial Actions, continued)

"2. Replacing the downgraded SD with an entity who satisfies (or whose guarantor satisfies) the applicable credit rating requirements of the Legacy SPV Swap;

3. Obtaining a guaranty of the SD's obligations under the Legacy SPV Swap from a guarantor that satisfies the requisite credit ratings;" (CFTC Letter No. 15-21, p. 5.)

Moody's Hedge Framework included the flip clause as an investor protection of last resort for instances when an SD defaulted or entered bankruptcy[51] without having effected either Remedial Action #2 or #3 with respect to a swap contact that was out-of-the-money to an SPV.[52] Without a flip clause, an SPV with a swap contract that was out-of-the-money would be obligated to divert funds earmarked solely to pay SPV debt and use them to pay an accelerated termination amount to a SD counterparty that had defaulted or was in bankruptcy.

However, the nullification of a flip clause in 2010 also nullified Remedial Action #3, "*Obtaining a guaranty of the SD's obligations under the Legacy SPV Swap from a guarantor that satisfies the requisite credit ratings"* as a means of delinking SPV debt from the credit quality of an SD.

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[50] See Moody's Hedge Framework, pp. 4, 6-8, and 15-16. Also note on p. 6: *"None of these obligations may be contingent upon issuance of Rating Agency Confirmation by Moody's prior to being activated."*

[51] Ibid., p. 16, "*Priority of Termination Payments to Counterparty."*

[52] Ibid., pp. 5-6, "*Replacement Drives the Framework, but Cannot be Guaranteed."*

Simply put, a guaranty leaves the contractual relationship between an original SD and an SPV intact and does not relieve the SPV of its obligation to divert funds earmarked solely to pay SPV debt and use them to pay an accelerated termination amount to the SD in the event it defaults or enters bankruptcy.

A large-scale instance of ongoing linkage to the credit quality of an SD exists with respect to the 50+ guarantees that were provided by Merrill Lynch Derivative Products AG in respect of AIG obligations under Legacy SPV Swap contracts that were and remain deeply out-of-the-money to the respective CDO issuers.[53] These issuers remain fully exposed to the credit quality of AIG and will be obligated to divert funds earmarked solely to pay SPV debt and use them to pay accelerated termination amounts to AIG in the event of its default or bankruptcy.

To protect investors in SPV debt from its own credit quality, an SD must replace itself "*with an entity who satisfies the applicable credit rating requirements of the Legacy SPV Swap.*" However, the new Delinking Criteria of Moody's, S&P, and Fitch continue to include *obtaining a guaranty* as a Remedial Action that is equivalent to replacement in fully protecting investors in SPV debt.[54]

SFIG Representation #10. (Remedial Actions, continued)
"*4. Taking any other action as agreed with each relevant rating agency through procedures that are specified in the Legacy SPV Swap Documentation.*" (CFTC Letter No. 15-21, p. 5.)

Moody's Hedge Framework intentionally and explicitly ruled out Remedial Actions such as "(*T)aking any other action as agreed with each relevant rating agency through procedures that are specified in the Legacy SPV Swap Documentation.*"[55]

As I stated in my e-mail of April 7, 2015: "*I wrote this provision to mitigate the gaming of structured finance methodologies and criteria which was widespread and which has since been identified as a major source of investor losses and a key catalyst of the financial crisis. With respect to this provision, you may verify my account with Moody's Chief Credit Officer for Structured Finance Nicolas Weill.*" You may also verify my account with Moody's Chief Regulatory Affairs and Compliance Officer Michael Kanef.

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[53] See Harrington (2011), pp. 25-29 and 63-64. See also PDF-numbered pages 57-59 of the document cited in footnote 9 of Harrington (2014).

[54] See Fitch's "Counterparty Criteria for Structured Finance and Covered Bonds" (May 13, 2013), Moody's "Approach to Assessing Linkage to Swap Counterparties in Structured Finance Cash Flow Transactions" (November, 12, 2013), and S&P's "Counterparty Risk Framework Methodology and Assumptions" (May 31, 2012).

[55] See Moody's Hedge Framework, p.4: *"To eliminate these distortions, the framework specifies Counterparty obligations upfront and does not contemplate their being supplanted in the future by 'other such remedies as may be agreed at a later date.' Alternatives to this framework will be considered at closing where the relevant provisions are already in place, rather than being left open-ended for future specification."*

All Moody's RACs that enabled an SD to forgo either posting collateral under a Legacy SPV Swap contract and similar SPV swap contracts in the EU or installing a replacement counterparty for a Legacy SPV Swap contract and similar SPV swap contracts in the EU have violated Moody's Delinking Criteria and either SEC or ESMA regulations. These Moody's RACs affected "*the material economic terms"* of the Legacy SPV Swap contracts in a way that diminished previously existing protections for SPV debt and increased the extent of their linkage to the credit quality of SDs.[56]

As I wrote in my e-mail of April 7, 2015: "*Moody's RACs have often cited Remedial Action #4 as rationale in direct violation of the Moody's delinking criteria. Under these RACs, swap dealers avoided posting collateral, avoided replacing themselves, avoided obtaining guarantees, and ratcheted up investor exposure to unenforceable flip clauses.*

"Simply put, swap dealers have obtained the blessing of Moody's and all credit rating agencies to define Remedial Action #4 as taking no action at all (i.e., to renege on existing contractual responsibilities that, if honored, would have protected investors). Contrary to the SFIG representation, the delinking criteria have NOT "proven to be prescriptive rules that aim to ensure performance by the swap dealer" (CFTC Letter No. 15-21, p. 4), but rather a very, very fluid set of protocols that swap dealers can unilaterally change simply by paying credit rating agencies to issue RAC."

Similarly, all S&P RACs with respect to Legacy SPV Swap contracts and similar SPV swap contracts in the EU issued after December 6, 2011 violated S&P's Delinking Criteria.[57] As with the Moody's RACs, the S&P RACs affected "*the material economic terms"* of the Legacy SPV Swap contracts and similar SPV swap contracts in the EU in a way that diminished previously existing protections for SPV debt and increased the extent of their linkage to the credit quality of SDs.

Additionally, RACs issued by S&P in 2015 may also violate the terms of various settlements between S&P and the SEC and the U.S. Department of Justice.[58]

SFIG Representation #11. *"The Remedial Actions required to be taken by SDs and SPVs may include amending a Legacy SPV Swap or amending and transferring the obligations of the SD under a Legacy SPV Swap to a third party or an affiliate of the SD. Although any such action will not change the material economic terms of a Legacy SPV Swap, it may cause a Legacy SPV*

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[56] See GH2015, footnote 38.

[57] See S&P's "Counterparty and Supporting Obligations Methodology and Assumptions" (December 6, 2011), "*Evidence of binding obligation," p. 8.*

[58] See GH2015, footnotes 82, 83, 84, and 96.

Swap to be considered a 'new swap' or a 'swap transaction' for the purposes of the Specified Regulation." (CFTC Letter No. 15-21, p. 5.)

SDs have created this problem for themselves by not having undertaken their contractual obligations to post collateral or to transfer "*the obligations of the SD under a Legacy SPV Swap to a third party or an affiliate of the SD"* as soon as these obligations were activated by the first of a series of downgrades of the credit ratings of SDs, beginning in 2009. The credit rating agencies signaled each series of SD downgrades well in advance. In response, SDs could have easily started posting collateral or transferring obligations under a Legacy SPV Swap contract to *"an affiliate."*

Prior to the enactment of the Specified Regulations, neither the posting of collateral nor *"transferring the obligations of the SD under a Legacy SPV Swap to a third party or an affiliate of the SD"* would have been contingent upon *"amending a Legacy SPV Swap."*[59]

Instead, the SDs have responded to their downgrades from 2009 onward by inducing SPV trustees to obtain RACs to dilute the Legacy SPV Swap contracts and similar SPV swap contracts in the EU of the obligations pertaining to the posting of collateral or "*transferring the obligations of the SD under a Legacy SPV Swap to a third party or an affiliate of the SD*." These RACs <u>did</u> change "*the material economic terms of a Legacy SPV Swap"* contract and similar SPV swap contracts in the EU in ways that impaired investor protections. With respect to the RACs it issued, Moody's issued them even though the associated amendments increased the expected losses to investors,[60] which violated an explicit provision of Moody's Hedge Framework.[61]

Similarly, staff at Fitch, Moody's, S&P, several of the prudential regulators, and the SEC were alerted as early as 2011 to the deficiencies in the Delinking Criteria that were eroding protections for investors in SPV debt and increasing the extent of linkage to the credit quality of SDs.[62] In 2012, these credit rating agencies and the SEC were also alerted to the likelihood that the Legacy SPV Swap contracts would run afoul of clearing requirements.[63]

SFIG Representation #12. *"This is significant because, as discussed above, the Legacy SPV Swap may not previously have been subject to or affected by some or all of the Specified*

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[59] See Moody's Hedge Framework, p. 6: *"None of the obligations may be contingent upon issuance of a Rating Agency Confirmation by Moody's prior to being activated."*

[60] See GH2015, footnote 38.

[61] See Moody's Hedge Framework, footnote 5: *"Governing documents of most cashflow transactions enable an existing hedge to be adjusted, or a new one entered into, if modeling shows the expected losses of rated liabilities to be unimpaired by the proposed hedge."*

[62] See Harrington (2011), pp. 24-25. See also PDF-numbered pages 1-6 of the document cited in footnote 9 of Harrington (2014).

[63] See PDF-numbered page 103 of the document cited in footnote 9 of Harrington (2014).

Regulations because it was entered into prior to the compliance date of such regulations. Thus, a Legacy SPV Swap may be subject to one or more Specified Regulations solely as a result of Remedial Actions taken by the SD and the SPV to remediate a credit ratings downgrade." (CFTC Letter No. 15-21, p. 5.)

As with the SFIG Representation #11, the SDs have brought this problem on themselves by not posting collateral or obtaining replacement counterparties as the contractual obligations began being activated in 2009.[64] Moody's Hedge Framework specified provisions that, when implemented in a swap contract, would have prevented surprises such as a Legacy SPV Swap contract being *"subject to one or more Specified Regulations solely as a result of Remedial Actions taken by the SD and the SPV to remediate a credit ratings downgrade."*[65]

SFIG Representation #13. *"Consequently, SFIG represents that it is highly likely that service providers will take the position that it is, at best, unclear whether they have the authority or discretion to take the steps on behalf of SPVs that may be necessary to enable the SD to comply with its regulatory obligations under the Specified Regulations."* (CFTC Letter No. 15-21, p. 6.)

Service providers such as trustees and rating agencies have already demonstrated with more than 100 RACs that they don't lack *"the authority or discretion to take the steps on SPVs that may be necessary to enable the SD to comply with its regulatory obligations under the Specified Regulations."*[66]

In particular, credit rating agencies, by having issued the RACs and weakened the investor protections in their updated Delinking Criteria,[67] have demonstrated that they have both the authority and discretion to take all steps requested by SDs even when these steps harm the interests of investors in SPV debt.

SFIG Representation # 14. *"Due to the legal and practical impediments described above, SFIG represents that SDs have a reasonable basis to believe that SPVs will not be able to agree to: (i) provide information necessary to satisfy an SD's onboarding procedures required to comply with the Specified Regulations; (ii) further amend their Legacy SPV Swaps, either via an industry-wide protocol or on a bilateral basis, to incorporate contractual provisions; or (iii) enter into new agreements (e.g., agreements related to portfolio reconciliation) that may be required to enable the SD to comply with its regulatory obligations under the Specified Regulations*. (CFTC Letter No. 15-21, p. 6.)

[64] Ibid.
[65] See Moody's Hedge Framework, p. 4.
[66] See GH2015, footnote 38.
[67] See Harrington (2014), pp. 4-5.

For the reasons already stated in today's letter, there is no *"reasonable basis"* for the SD's beliefs.

By obtaining noteholder consents or RACs,[68] the trustees of SPVs can easily and costlessly "*agree to: (i) provide information necessary to satisfy an SD's onboarding procedures required to comply with the Specified Regulations; (ii) further amend their Legacy SPV Swaps, either via an industry-wide protocol or on a bilateral basis, to incorporate contractual provisions; or (iii) enter into new agreements (e.g., agreements related to portfolio reconciliation) that may be required to enable the SD to comply with its regulatory obligations under the Specified Regulations*."

Sincerely yours,

William J. Harrington
Experts Board, Wikirating.org – Key Expert, Structured Finance Topics

cc: Ms. Regina Thoele, Compliance, National Futures Association, Chicago
Ms. Jamila A. Piracci, OTC Derivatives, National Futures Association, New York
Mr. Frank Fisanich, Division of Swap Dealer and Intermediary Oversight, CFTC, Washington, D.C.
Mr. Christopher Kirkpatrick, Secretary, CFTC, Washington, D.C.
Mr. Brian O'Keefe, Division of Clearing and Risk, CFTC, Washington, D.C.
Ms. Verena Ross, Executive Director, European Securities and Markets Authority, Paris, France
Mr. Adam Ashcraft, Credit Risk Management, Federal Reserve Bank of New York, New York
Mr. Andy Haldane, Bank of England, London, UK
Ms. Allison Parent, Bank of England, London, UK
Mr. Michael Hume, Bank of England, London, UK
Mr. Richard Johns, Executive Director, Structured Finance Industry Group, Washington, D.C.
Mr. Michel Madelain, President, Moody's Investors Services, New York
Mr. Michael Kanef, Chief Regulatory Affairs and Compliance Officer, Moody's Investors Services, New York
Mr. Nicolas Weill, Chief Credit Officer – Global Structured Finance, Moody's Investors Services, New York

[68] See GH2015, p. 7.

Appendix B—April 7, 2015 e-mail to Mr. Thomas Smith, Acting Director, Division of Swap Dealer and Intermediary Oversight: "CFTC Letter No. 15-21 & Inaccurate Representations of Delinking Criteria"

From: Bill Harrington <wjharrington@yahoo.com>

To: "tsmith@cftc.gov" <tsmith@cftc.gov>; "ffisanich@cftc.gov" <ffisanich@cftc.gov>

Cc: Brian EO'Keefe <bokeefe@cftc.gov>; "ckirkpatrick@cftc.gov" <ckirkpatrick@cftc.gov>; "michel.madelain@moodys.com" <michel.madelain@moodys.com>; "richard.johns@sfig.org" <richard.johns@sfindustry.org>; "orolh@sec.gov" <orolh@sec.gov>; "rthoele@nfa.futures.org" <rthoele@nfa.futures.org>; "jpiracci@nfa.futures.org" <jpiracci@nfa.futures.org>; "nicolas.weill@moodys.com" <nicolas.weill@moodys.com>

Sent: *Tuesday, April 7, 2015 12:58 PM*

Subject: *CFTC Letter No. 15-21 & Inaccurate Representations of Delinking Criteria*

Dear Mr. Smith:

I am writing in regard to CFTC Letter No. 15-21 dated March 31, 2015. This no-action letter cites several representations by the Structured Finance Industry Group (SFIG) which, if correct, provide the US Securities and Exchange Commission (SEC) with grounds to bring an action against at least one of the credit rating agencies. As a result, amendments to existing swap contracts that rely on CFTC Letter No. 15-21 may become evidence in an SEC enforcement against one or more credit rating agencies.

In preparing CFTC Letter No. 15-21, did the CFTC consult with the credit rating agencies or simply rely upon representations by SFIG?

For the entirety of the period covered by CFTC Letter No. 15-21, the delinking criteria of Moody's Investors Service ("Framework for De-Linking Hedge Counterparty Risks from Global Structured Finance Cashflow Transactions") contained an explicit provision that ruled out Remedial Action #4 (CFTC Letter No. 15-21, p.5). I wrote this provision to mitigate the gaming of structured finance methodologies and criteria which was widespread and which has since been identified as a major source of investor losses and a key catalyst of the financial crisis. With respect to this provision, you may verify my account with Moody's Chief Credit Officer for Structured Finance Nicolas Weill.

Next week, I will submit a letter that lays out my points more fully. In the interim, attached please find "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 rating agency processes that are cited in CFTC Letter No. 15-21 -- most notably, the issuance of rating agency condition or confirmation (RAC) to dealer proposals to strip investor protections from existing swap contracts. Moody's RACs have often cited Remedial Action #4 as rationale in direct violation of the Moody's delinking criteria. Under

these RACs, swap dealers avoided posting collateral, avoided replacing themselves, avoided obtaining guarantees, and ratcheted up investor exposure to unenforceable flip clauses.

Simply put, swap dealers have obtained the blessing of Moody's and all credit rating agencies to define Remedial Action #4 as taking no action at all (i.e., to renege on existing contractual responsibilities that, if honored, would have protected investors). Contrary to the SFIG representation, the delinking criteria have NOT "proven to be prescriptive rules that aim to ensure performance by the swap dealer" (CFTC Letter No. 15-21, p. 4), but rather a very, very fluid set of protocols that swap dealers can unilaterally change simply by paying credit rating agencies to issue RAC.

Best regards,

William J. Harrington
917-680-1465