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Sent: Thursday, May 10, 2018 4:27 PM
Subject: S&P Violations of SEC rules in Rating US CLOs with Waterfall Flip Clauses, US SLABS with Flip Clause Swaps, and Navient

Dear Mr. Risi and Mr. Carroll:

I am replying to your respective emails of April 19, 2018 and January 10, 2018. The emails, my three previous ones to you, and an SEC email to me of March 9 follow today's email in reverse chronological order.

Today's email copies SEC staff and offices that oversee NRSROs and violations of SEC rules. Several of the SEC staff, including my former Moody's colleague Abe Putney, have worked at an NRSRO. All are deeply knowledgeable about the capital, rating, and ethical deficiencies of flip clauses and of both parties to a flip clause swap.

The SEC violations that S&P continues to rack up in assigning ratings to US CLOs, to US student loan asset-backed securities (SLABS), and to the student loan company Navient pertain to waterfall flip clauses and flip clause swaps. The SEC violations that S&P continues to rack up with respect to US SLABS and Navient also pertain to maturity extensions of FFELP ABS.

1. In assigning ratings to notes of US CLO deals with waterfall flip clauses, *S&P does not*:
1.a. perform forward-looking analysis of the CLO deals;
1.b. review the respective CLO deals' legal opinions, including ones that carve out flip clause enforceability;
1.c. interview a CLO manager on its derivatives business plan, given that the manager can enter into a flip clause swap but cannot enter into a swap that complies with the swap margin rules because the deal lacks the necessary capital, operational, and legal capacities;
1.d. challenge a CLO manager on its competency, ethics, and compliance considering the manager's clear plan to skirt US swap margin regulations;
1.e. evaluate the trustworthiness of a CLO manager considering the above lapses in competency, ethics, and compliance;
1.f. apply rating criteria consistently to all notes of all US CLO deals, i.e., ones with and without waterfall flip clauses; or
1.g. fact check and update rating criteria, for instance with respect to the impact of LIBOR reform on CLOs, combination securities, and flip clause swaps.

In 11 very recent examples, S&P posted the pre-sale reports of 11 new US CLO deals between March 27, 2017 and April 25, 2017. Seven of the eleven CLO deals had waterfall flip clauses and four CLO deals did not. Despite this major distinction that should favor the ratings of notes of the latter four CLO deals relative to the former seven CLO deals, S&P rated the notes of all 11 CLO deals as if none had a waterfall flip clause.

The following seven CLOs are those that *have waterfall flip clauses*: RR 4; Bain Capital Credit CLO 2018-1; Antares CLO 2018-1; Greywolf CLO VI; Ivy Hill Middle Market Credit Fund XIV; Goldentree Loan Management US CLO 3; and Northwoods Capital XI-B.

The following four CLOs are those that *do not have waterfall flip clauses*: Chenango Park CLO; Woodmont 2018-4 Trust; Benefit Street Partners CLO V-B; and Neuberger Berman Loan Advisers CLO 28.

My email of February 28 and Mr. Risi's response of April 19 referenced a twelfth CLO deal, ZAIS CLO 8 Ltd. S&P posted a pre-sale report on ZAIS CLO 8 Ltd on February 13. As with the seven CLO deals above, ZAIS CLO 8 Ltd. has a waterfall flip clause but lacks the capital, operational, and legal capacities to comply with the swap margin rules.

(Like Abe Putney, ZAIS Group President and CEO Dan Curry is deeply knowledgeable about the capital, rating, and ethical deficiencies of waterfall flip clauses and of both parties to a flip clause swap. Dan and I examined flip clause swaps and flip clause swap providers at Moody's Investors Service from 1999 to 2007. For an itemization and evaluation of our flip clause collaboration, please see my Comment on SEC Roundtable for Asset-Backed Securities of June 3, 2013, HTML pages 18-37. Dan also directed the waterfall flip clause practice and the flip clause swap practice at the NRSRO DBRS, where he was President and then CEO from 2008 to 2016.)

Mr. Risi's response of April 19 -- "margin posting was not an analytical consideration when issuing our ratings" -- corroborates my point that S&P intentionally ignores US regulations so as to inflate the ratings of all notes from CLO deals that closed on or after March 1, 2017 with a waterfall flip clause.

A 2017 S&P criteria report that addresses the US swap margin rules provides still more corroboration. According to the criteria, the swap margin rules have voided waterfall flip clauses since March 1, 2017. See the S&P criteria "Special-Purpose Vehicle Margin Requirements for Swaps--Methodologies and Assumptions" (October 10, 2017), paragraph 35. "Under regulatory margin requirements, where applicable, we understand that these subordination provisions may no longer be available to the SPV."

In other words, S&P should not have rated any CLO or other ABS from a deal with a waterfall flip clause that closed on or after March 1, 2017.

Lastly, another of Mr. Risi's responses -- "If the ZAIS issuer were to enter into a [flip clause] swap, it would be at that time that we would apply our relevant criteria to assess any impact such a [flip clause] swap would have on our outstanding ratings" -- recalls pre-crisis rating practices, ones that:
-- assigned AAA ratings to RMBS, CDOs, and other ABS of deals with obviously faulty components; and
-- obligated S&P to settle with the US Department of Justice and state attorneys general for amounts in excess of USD 1.3 billion in early 2015.

Does the S&P policy that Mr. Risi advocates -- "rate CLOs today and examine them tomorrow or some other day" -- apply only to a US CLO deal with waterfall flip clauses? Or does S&P assign AAA ratings to senior notes of a CLO deal that can purchase any asset -- e.g., liar loan, inverse floater, or foreign currency equity -- provided that the purchase is deferred until after closing? Apparently, S&P employs the practice of "rate CLOs today and examine them tomorrow or some other day" in all instances, including major ones such as the transition from LIBOR.

Please see the following presentation by the Loan Syndications and Trading Association (LSTA) entitled "LIBOR and the Loan Market" of April 24, 2018. https://www.lsta.org/uploads/DocumentModel/3523/file/libor-in-the-loan-market_042418.pdf. The presentation is highly germane to the ratings of CLOs, combination securities, and flip clause swaps.

Ms. Meredith Coffey, LSTA EVP of Research and Regulation, described the LIBOR transition as a gargantuan one for which the CLO industry is not remotely prepared in a webinar entitled "End of the (Loan Regulatory) World As We Know It? of May 9.

https://www.lsta.org/events-and-education/calendar-of-events/event-details/2018-05-09-end-of-the-loan-regulatory-world-as-we-know-it

(Unfortunately, the webinar/CLE session prevented participants such as me from asking about the impact of the LIBOR transition on CLOs, combination securities, and flip clause swaps. As this impaired the learning content of the CLE session for all participants, I am petitioning the MCLE to withhold credit.)

2. In assigning ratings to notes of US SLABS deals with flip clause swaps, *S&P does not*:
2.a. perform forward looking analysis of "replacement" assumptions;
2.b. review legal opinions, including ones that address flip clause enforceability;
2.c. fact check rating criteria;
2.d. update rating criteria in a timely manner; for instance with respect to the impact of the LIBOR transition on US SLABS and flip clause swaps;
2.e. cross-check the respective rating models of SLABS deals with flip clause swaps, of flip clause swap counterparties, and of sovereigns that backstop counterparties;
2.f. independently examine regulatory developments regarding flip clause swaps such as the swap margin rules and the CFTC Letter No. 17-52 of October 27, 2017; or
2.g. apply criteria consistently to all US SLABS, i.e., ones of deals that have flip clause swaps and the remaining SLABS of deals that do not have flip clause swaps.
2. (cont). Additionally, in assigning ratings to FFELP SLABS with legal final maturities of 2045, 2065, or even 2085, *S&P does not:*
2.h. examine the impact on legacy FFELP SLABS from multi-decade maturity extensions;
2.i. cross-check and impose consistency on the multi-decade rating assumptions of both new and legacy FFELP SLABS with long-dated maturities, of the respective below-investment grade servicers, and of US government reimbursements of individual borrower defaults; or
2.j. apply criteria consistently to all US FFELP SLABS, i.e., ones with and without legal final maturities that extend as far as 2085.

Today's email again cites the S&P criteria "Special-Purpose Vehicle Margin Requirements for Swaps--Methodologies and Assumptions" (October 10, 2017) as a prime example of S&P failure to either fact check rating criteria or update them in a timely manner.

In the first and overarching instance of failure to update rating criteria in a timely way, S&P posted the criteria on October 10, 2017, which is almost two years after the prudential regulators adopted swap margin rules in October 2015 and 20 months after the CFTC adopted a complementary and nearly identical set of swap margin rules in December 2015.

Other observations on the criteria, as well as several corrections to errors contained therein, are noted below in order of appearance in the criteria (as indicated by paragraph number in parenthesis.)

WJH Correction to S&P Error 1 (Paragraph 3): Margin requirements apply to all SPVs in US structured finance transactions that entered into a swap contract on or after March 1, 2017. US regulators retained the *cut-off date* of March 1, 2017, which determines whether a swap is new or legacy, when extending the *compliance date* forward by six months to September 1, 2017.

WJH Correction to S&P Error 2 (Paragraph 3): SPVs that are subsidiaries of captive finance companies do NOT benefit from an exemption to the swap margin requirements.

S&P may verify this correction by reading the CFTC Letter No. 17-52 of October 27, 2017. https://www.cftc.gov/sites/default/files/idc/groups/public/@lrlettergeneral/documents/letter/17-52.pdf. Footnote 1 lists the subsidiary of a finance company in the auto sector as having requested no-action relief from the margin requirements. *"Orient Corporation, Request for No-Action Relief from CFTC Regulations 23.152-161 in Connection with OSCAR US Funding Trust, et al. (July 13, 2017)."* Footnote 3 provides additional information. "See Moody's places four auto loan ABS under review for downgrade after updating its approach to counterparty risks (July 27, 2017), available at: https://www.moodys.com/research/Moodys-places-four-autoloan-ABS-under-review-for-downgrade--PR_370302," Lastly, the CFTC letter mentions no exemptions to the swap margin rules for any type of SPV, including one that is a subsidiary of a captive finance company.

The CFTC Letter No. 17-52 makes no mention of exemptions to the swap margin rules for SPV entities because no such exemptions exist. I reported this information*, namely that the subsidiaries of captive finance companies did NOT benefit from an exemption to the swap margin requirements*, in several *Debtwire ABS* articles in 2016. I shared these articles with S&P staff on multiple occasions in 2016.

Following is an excerpt from my article "Margin posting: swaps increase ABS issuance costs by 1%, 3%, 7%...of deal size" of May 16, 2016. The Structured Finance Industry Group "was prescient in listing vehicles and equipment finance with other ABS sectors that might be subject to the swap margin rules. In fact, auto and equipment ABS are subject to the rules, as reported (see article ["Auto ABS still part of the margin-posting pack; road diverges ahead?"], 4 April). II There has been a widespread misconception that a parallel exemption in the swap margin rules that benefits 'captive finance companies' such as some auto and equipment finance companies also applies to their ABS vehicles. However, no such exemption exists, at least not yet. If the captive finance companies wish to clarify whether or not their ABS vehicles will be exempted from the swap margin rule, 'they can make a request' along those lines to the applicable regulator, according to a source familiar."

WJH Observation of S&P Failure to Update Criteria in a Timely Manner (Paragraph 6): Prior to October 10, 2017, S&P had last updated the SPV swap criteria four years earlier in 2013. The four-year interval in updating the criteria ignored the prudential regulators having adopted swap margin rules in October 2015 and the CFTC having adopted a complementary and nearly identical set of swap margin rules in December 2015.

WJH Correction to S&P Error 3 (Paragraphs 7-22): An SPV may also fund margin posting by securitizing additional assets or holding more cash. Either choice would allow the SPV to lessen reliance on a liquidity provider, or even dispense with one altogether.

WJH Correction to S&P Error 4 (Paragraphs 30-31 and 34-35): Flip clause swaps are zero sum contracts that enable both the originator of an ABS deal and counterparty to under-capitalize the respective exposures. Flip clause swaps are an original and uncured sin of the ABS industry. As evidence, flip clause swaps were integral components of the ABS that ushered in the financial crisis and either failed during it or would have done so but for huge amounts of taxpayer support. S&P should already have downgraded all ABS of deals with flip clause swaps, including SLABS deals with flip clause swaps, to reflect the respective under-capitalization of each such ABS.

WJH Observation of S&P Failure to Update Criteria in a Timely Manner (Paragraph 33): ABS of deals that comply with the swap margin rules should have higher ratings than ABS of legacy deals that are party to flip clause swaps, because the former ABS have much less counterparty exposure than the latter. A counterparty to a swap that complies with the swap margin rules exchanges daily margin with a deal from the outset. In contrast, counterparties to flip clause swaps often avoid posting margin to deals.

WJH Correction to S&P Error 5 (Paragraph 35): The "replacement" assumption is another original sin of the ABS industry. S&P has first-hand knowledge of the limited instances in which a downgraded counterparty has replaced itself and the much larger number of instances in which a downgraded counterparty has not replaced itself. Moreover, the combination of a waterfall flip clause and replacement assumption negatively reinforces both provisions in a downward spiral. For instance, the higher the likelihood that a flip clause will be upheld, the lower the likelihood that a new counterparty will agree to replace a downgraded one. In the US, a recent ruling in a Lehman appeal -- Lehman Brothers Special Financing Inc. vs. Bank of America National Association, et al. (In re: Lehman Brothers Holding Inc), 2018 -- may produce just this outcome. S&P should already have downgraded all ABS of deals with flip clause swaps that have replacement provisions, including all SLABS of deals with flip clause swaps that have replacement provisions, to reflect the respective under-capitalization of each such ABS.

WJH Correction to S&P Error 6 (Paragraph 36): The US swap margin rules apply to any swap with an SPV that was either entered into or amended on or after March 1, 2017. I first reported that legacy swaps that were amended on or after March 1 2017 became immediately subject to the swap margin rules in a *Debtwire ABS* article of August 12, 2016. The article "Existing ABS swaps also caught in swap margin net" is one of the several that I shared with S&P analysts on multiple occasions in 2016.

WJH Observation of S&P Failure to Apply Criteria Consistently to all US SLABS, i.e., Ones of Deals With and Without Flip Clause Swaps. The above corrections corroborate the point that US SLABS of deals that are not party to a flip clause swap, such as many Navient private and FFELP SLABS deals, should have uniformly higher ratings than otherwise similar US SLABS of deals that are party to a flip clause swap, such as 28 Navient private SLABS deals and 11 Navient FFELP SLABS deals. My submission to the CFTC [31 Misrepresentations in CFTC Letter No 17-52] of February 2 lists 43 SLABS deals with a flip clause swap on pages 2-4.

WJH Observation of S&P Failure to Apply Criteria Consistently to all US FFELP SLABS, i.e., Ones With and Without Legal Final Maturities of 2045, 2065, or Even 2085. My CFTC submission of February 2 also lists 50 FFELP SLABS of 31 deals for which Navient effectuated extensions of final maturities by 30, 40 or even 60 years. See pages 30-33. Moreover, all new FFELP SLABS deals that closed after January 1, 2016 have similarly long legal final maturities. All SLABS, both new and legacy, with legal final maturities of 2045 or later should have lower ratings, given the unreliability of multi-decade assumptions such as the ongoing viability of Navient and other below-investment grade servicers, and the transition from LIBOR.

WJH Observation of S&P Failure to Cross-Check Rating Models for Navient-Sponsored SLABS. Navient has reported erroneous counterparty information in the monthly remittance reports of some SLABS deals since the respective closings 15 years ago in 2003. Has S&P used the same erroneous information that Moody's described in the following rating announcements of March 28 and April 10, respectively?

[Rating Action: Moody's reviews for downgrade three classes of notes from two SLM student loan ABS securitizations 28 Mar 2018] "Today's rating actions are prompted by Moody's identification of a potential error in the analysis used in prior rating actions. Previous analyses had used the Aa2 rating of CDC Ixis's guaranteed senior unsecured debt when assessing the currency swap counterparty of the transactions. CDC Ixis Capital Markets was the original swap counterparty for these transactions. Servicer reports for the transactions, including the most recent reports, indicate that CDC Ixis Capital Markets has remained as the swap counterparty for the transactions. However, through a series of mergers and acquisitions starting in 2004, CDC Ixis and its successors are now known as Natixis, A1(cr), and the servicer has confirmed that Natixis is the current swap counterparty for the transactions. II Moody's has been advised by Navient that there may be guarantees associated with the swaps or the swap counterparty that would decrease the probability of default by the counterparty, and therefore decrease the risk of the transactions becoming unhedged. During the review period, Moody's will investigate this issue and consider any relevant information provided by Navient."

[Rating Action: Moody's downgrades 4 classes of notes from two FFELP student loan ABS securitizations 10 Apr 2018] "Moody's could downgrade the ratings if Moody's could not obtain the proof of guarantee on the affected swaps or the swap counterparty [Barclays, which Moody's recently downgraded]."

3. In assigning ratings to Navient, *S&P does not:*
3.a. perform forward-looking analysis of "replacement" assumptions on the Navient residual valuations of SLABS deals with flip clause swaps;
3.b. review legal opinions, including ones that address flip clause enforceability, in Navient-sponsored SLABS deals with flip clause swaps;
3.c. evaluate Navient residual valuations of SLABS deals under the two possible outcomes that an activated flip clause is and is not upheld;
3.d. haircut Navient residual valuations of SLABS deals to incorporate flip clause data from the Lehman bankruptcy case, namely that litigation, which costs time and money, can extend for ten or more years;
3.e. fact check rating criteria;
3.f. update rating criteria in a timely manner; for instance with respect to the impact of the LIBOR transition on flip clause swaps, US SLABS, and the valuations of residual interests in all SLABS deals, particularly ones with flip clauses swaps and ones with maturities after 2045;
3.g. apply criteria consistently to the Navient residual valuations of all Navient-sponsored SLABS deals, i.e., ones with and without flip clause swaps;

3.h. impose consistency on the respective rating models of Navient and of Navient-sponsored SLABS so that all input the same assumptions and data. In some instances, output from one model should be input to another. For example, output of residual valuations from models of Navient-sponsored SLABS deals that properly assess poor replacement prospects should be input to the S&P model of Navient assets and earnings;
3.i. challenge Navient valuations of SLABS residual interests for the years 2015 (when the US swap margin rules were adopted), 2016 (when the US swap margin rules had no exemptions), and 2017 to the present date (after the CFTC exempted ***some*** amended legacy swaps from ***some*** provisions pertaining to the variation margin rules);
3.j. challenge Navient earnings and earnings projections for 2015 (when the newly adopted US swap margin rules specified that entities such as Navient must post initial margin against all exposures, i.e., the sum of both corporate positions and flip clause swaps in SLABS deals, by 2020) and for 2016 to the present date (the swap margin rules still specify that Navient must post initial margin against all corporate and SLABS deal exposures by 2020).
3.k. challenge Navient valuations of SLABS residuals in deals that are projected to incur maturity defaults and in deals that have extended legal final maturities to avoid maturity defaults, e.g., with respect to the LIBOR transition; or
3.l. consider whether Navient might have violated securities laws or other laws in valuing residual interests in SLABS deals with flip clause swaps or in SLABS deals with maturity concerns for 2015, 2016, 2017, and to the present date.

An excerpt from Mr. Carroll's email response of January 10 corroborated the points that S&P does not fact check rating criteria, apply them consistently to all Navient-sponsored SLABS, or impose consistency on the respective rating models of the SLABS deals with flip clause swaps and of Navient. "As part of our analysis of Navient, we consider its counterparty credit exposures to swaps counterparties, which we believe are largely mitigated by credit support annexes."

In fact, credit support annexes *do not* largely mitigate the exposure of Navient-sponsored SLABS or of Navient as owner of the respective residual interests to the credit exposures to the respective counterparties such as Barclays, Deutsche Bank, and AIG. Most obviously, a credit support annex **CANNOT** mitigate the credit exposure that a flip clause presents to Navient-sponsored SLABS and to Navient because a credit support annex and a flip clause each operate in one of two, entirely separate instances that are mutually exclusive. A counterparty posts margin under a credit support annex only when a flip clause swap is in-the-money to a Navient-sponsored SLABS deal, whereas the flip clause is activated only when the swap is out-of-the-money to the SLABS deal. In essence, the Navient-sponsored SLABS and Navient have **DOUBLE** counterparty exposure under each flip clause swap.

Moreover, a credit support annex *does not* ensure that a counterparty will post margin to a Navient-sponsored SLABS deal even when its swap is in-the-money. A counterparty has several, rating agency endorsed ways to avoid ever posting margin. For a start, a credit support annex generally specifies that a counterparty ***does not post margin*** until downgraded to a comparatively weak level such as low investment grade. The specification of a counterparty assessment or other measure as the margin posting trigger, rather than an issuer rating, lowers the effective rating still further to below investment grade. (S&P also fails to tie the impact of counterparty assessments, which rest on the assumption of government support, to the ratings of the respective sovereign.) Lastly, a credit support annex often allows even a below investment grade counterparty to avoid posting margin indefinitely by obtaining rating agency approval.

Similarly, the very dubious S&P assumption of "replacement" does not mitigate the exposure of Navient-sponsored SLABS or of Navient to the credit exposures of the respective counterparties. S&P has firsthand experience that downgraded counterparties have replaced themselves in too few instances since 2005 to justify replacement as a dependable mitigation against counterparty exposure. In recognition, S&P should have eliminated the rating benefit that criteria assign to the replacement assumption, applied multi-notch downgrades to SLABS of Navient-sponsored deals that are parties to flip clause swaps, and cut up to USD 5 billion from the valuations of the respective Navient residual interests in the deals. Instead, S&P has preserved replacement as a central prong of criteria, downgraded no Navient-sponsored SLABS (whether for exposure to flip clause swaps, maturities after 2045, or any other reason), and blindly accepted Navient valuations of residual interests at face value rather than evaluate them independently.

Another part of Mr. Carroll's response of January 10 suggests that S&P analysts are unaware of flip clauses, are unaware of walkaway provisions, are unaware of the poor replacement prospects for SLABS deals with flip clause swaps, and are unaware that S&P leniency in enabling downgraded counterparties to avoid posting margin against flip clause swaps increases the Navient derivatives exposure. "In addition, we apply a risk-weighting to Navient's derivative assets in our risk-adjusted capital framework (RACF), which we use to assess the capital adequacy of banks and certain nonbank financial institutions. Based on our RACF, we believe that Navient has adequate capital." My review of the RACF framework shows it to be fatally deficient, with no mention of the capital deficiency that Navient maintains with respect to its residual interests in each SLABS deal with a flip clause swap.

Mr. Carroll's response also cites and included three S&P swap criteria. The citations and criteria demonstrate singly and collectively that S&P does not fact check, update, or impose consistency on rating criteria. For a start, Mr. Carroll's citations and misrepresentations are as erroneous as those that Mr. Risi made on April 19 and which are enumerated above in today's email. From Mr. Carroll's reply: "For your reference, please find attached our Structured Finance criteria, 'Special-Purpose Vehicle Margin Requirements For Swaps—Methodology And Assumptions', published on Oct. 10, 2017 and two related articles. The new U.S. margin rules are not retroactive, and therefore don't affect swap transactions that SPVs entered into before Sept. 1, 2017."

The "two related articles," like the criteria, corroborate many points in today's email. For instance, S&P acknowledged that it has downgraded no SLABS with exposure to flip clause swaps in the following except from one of the articles -- "CFTC No-Action Letter Reduces Concerns on Legacy Swap Replacements in US Structured Finance Transactions" of November 16, 2017. "As a result, we no longer consider that the CFTC margin rules potentially affect our view regarding the replaceability of legacy swaps in U.S. structured finance transactions. Accordingly, we are not proceeding with a review of the approximately 50 U.S. structured finance transactions, previously described in our Oct. 20 publication referenced above."

Looking forward, S&P states that it will balk at downgrading US SLABS with exposure to flip clause swaps even upon concluding (correctly) that the criteria assumption of "replacement" is untenable. Following is an excerpt from the second S&P article that Mr. Carroll included in his response -- "Effect of Regulatory Margin Requirements on Legacy Swaps Replacement in US Structured Finance Transactions" of October 20, 2017. "If we assess that, for a specific U.S. structured finance transaction, it is unlikely that the counterparty's replacement commitment could be implemented, the rating on the supported security may no longer exceed the rating on the counterparty solely on the basis of the swap replacement framework. ***It is possible, however, that we may conclude that the rating on a security in a U.S. structured finance transaction can still continue to exceed the rating on a swap counterparty if we assess that counterparty default risk is sufficiently covered by credit enhancement in the transaction*** [bold italics added]."

Mr. Carroll's response also reveals other deficiencies in the S&P analysis of Navient, namely that the CFTC Letter No. 17-52 of October 27, 2017 does *not* apply to replacement that occurs after a counterparty has defaulted. "If a swap was entered into prior to Sept. 1, 2017, based on a "no action" letter issued by the Commodities and Futures Trading Commission (CFTC) on Oct. 27, 2017, we now understand that an SPE would not be required to post a margin, following the transfer of a swap to a new counterparty, if the transfer was a result of the original counterparty's contractual commitment to replace itself following a lowering of its rating below a certain level, and the new swap was on substantially similar economic terms to the original swap."

To educate themselves better, I suggest that Mr. Carroll and all S&P analysts review the Moody's Sector Comment by Edward Manchester "CFTC relief from margining from SPV swaps is credit positive bu narrow in scope" of December 12, 2017. "The CFTC's no-action position is credit positive as it improves the effectiveness of transfer triggers in structured finance transactions that are affected by variation (but not initial) margin requirement…However, the CFTC's no-action position is expressed to be narrow in scope. In particular, by reference to condition 1 above, *relief will not apply when an SPV enters into a swap with a replacement counterparty following the default of the original counterparty* [italics added]."

Edward Manchester and I worked closely together on flip clause swaps from 2006 until 2010. Like Abe Putney and Dan Curry, Edward has extensive firsthand knowledge about the capital, rating, and ethical deficiencies of flip clauses and of both parties to a flip clause swap. Like S&P analysts, Edward and his Moody's colleagues do their best to ignore the implications of their first hand knowledge. The following is from my submission to the CFTC on the proper capitalization of flip clause swaps "Capital Requirements for Swap Dealers and Major Swap Participants" of May 4, 2017, which is available at https://comments.cftc.gov/PublicComments/ViewComment.aspx?id=61196&SearchText. The following excerpt is on pages 44-45. For other analysis of failed replacement, see pages 98-109 and 115-122.

"Edward and I had worked closely on Moody’s global methodology for uncleared swaps with RAC provisions and flip clauses (Moody’s Hedge Framework) from 2006 until my resignation from Moody’s in 2010. From 2006 to the present date, Edward has led Moody’s global efforts in formulating adjustments to the methodology for uncleared swaps with RAC provisions and flip clauses and in approving contract templates that providers of these swaps propose. II I apprised Edward and other Moody’s colleagues in a 2010 teleconference that one of the major swap counterparties for issuers of US cashflow RMBS — Bear Stearns Financial Products Inc. (BSFP) — had concluded in 2006 that the replacement assumption was not valid for uncleared, balance-guaranteed swaps with RAC provisions and flip clauses…Edward’s responded along the lines of 'Well, I wish I had known that in 2006.' This point was valid in 2010 but is a little stale seven years later in 2017."

Best regards,

Bill Harrington
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Sent: Thursday, April 19, 2018 2:46 PM
Subject: Re: NRSRO Ratings of US CLOs with Flip Clauses but No Margin Posting Provisions

Dear Mr. Risi,

I appreciate your reply, which proves my point. S&P does not abide by its methodologies when assigning ratings to US CLOs with flip clauses in the priorities of payment.

Most obviously, S&P represents that it conducts a forward-looking analysis on all features of a new deal such as ZAIS CLO 8 Ltd./ZAIS CLO 8 LLC. If so, what forward-looking analysis did S&P conduct with respect to the legal opinion on flip clause enforcement, the business plan to enter into a flip clause swap but not a margin posting swap, and manager quality?

S&P also represents that it applies applicable rating methodologies consistently across a given asset class. If so, what forward-looking comparisons did S&P conduct between US CLOs that do and do not have flip clauses in the priorities of payment?

I'll reply at greater length with more examples next week.

Best regards,

Bill Harrington

From: OWB Correspondence <owbcorrespondence@sec.gov>
To: "wjharrington@yahoo.com" <wjharrington@yahoo.com>
Sent: Friday, March 9, 2018 4:39 PM
Subject: Acknowledgement Letter

Good afternoon:

Attached is an acknowledgement letter from your recent submission to our office. Please contact us at 202-551-4790 should you have difficulty opening the document. Thank you.

C. Briscoe

From: Bill Harrington [mailto:wjharrington@yahoo.com]
Sent: Friday, February 16, 2018 5:44 PM
To: putneya@sec.gov; orolh@sec.gov; audinod@sec.gov; Ombudsman@sec.gov; weinstockj@sec.gov; norbergj@sec.gov
Cc: oig@cftc.gov; Chris Kirkpatrick; mkulkin@cftc.gov; Frank Fisanich; Thomas J. Smith; rthoele@nfa.futures.org; jpiracci@nfa.futures.org; Verena Ross; Felix Flinterman; gwenael.pover@esma.europa.eu; Elisabeth Van Laere; Valentina Mejdahl; Direct-supervision; evert.vanwalsum@esma.europa.eu; AndyHaldane; richard.johns@sfig.org; alyssa.acevedo@sfindustry.org; Sairah Burki; Kevin Duignan; marjan.weijden@fitchratings.com; Tuuli Krane; raymond.mcdaniel@moodys.com; michel.madelain@moodys.com; robert.fauber@moodys.com; richard.cantor@moodys.com; nicolas.weill@moodys.com; edward.manchester@moodys.com; Ghetti, Belinda (Analytical); Herrera, Felix (Analytical); O'Neill, Andrew (Analytical); Polizu, Cristina (Analytical)
Subject: NRSRO Ratings of US CLOs with Flip Clauses but No Margin Posting Provisions

Dear Abe,

Please consider this a formal complaint to the SEC Office of Credit Ratings, the SEC Office of Investor Advocate and the SEC Office of the Whistleblower regarding NRSROs that assign ratings to US CLOs that have closed or refinanced since 1 March 2017 with a flip clause but no provision for margin posting against an uncleared swap.

Margin posting for uncleared swaps has been the law of the land since 1 March 2017. Moreover, the margin rules were in place by 16 December 2015. A US CLO with a flip clause but no provision for margin posting cannot comply with US law. An NRSRO that assigns ratings to a new or refinanced US CLO that cannot comply with US law has failed to abide by the respective methodologies for both CLOs and derivative contracts.

ZAIS CLO 8 Ltd./ZAIS CLO 8 LLC is a recent example of one such new CLO. See the S&P Global presale report, which can be accessed with this link.
https://www.spratings.com/documents/20184/769219/ZAISCLO8LTD/2a638e5e-dc9b-469a-a255-6c8ea5ac2653

I filed a report with the Moody's Integrity Hotline regarding the erroneous Moody's ratings of US CLOs that closed or refinanced after 1 March 2017 with a flip clause but no provision for margin posting today, 16 February at 4:45.

Best regards,

Bill Harrington
917-680-1465