

MEMORANDUM

TO: File No. S7-08-10
File No. S7-18-11

FROM: Paul A. Gumagay
Office of Commissioner Luis A. Aguilar

DATE: June 30, 2014

SUBJECT: Teleconference with William J. Harrington

On June 30, 2014, Paul A. Gumagay, Counsel to the Commissioner, had a teleconference with William J. Harrington. Mr. Harrington discussed, among other things, the Commission's Re-proposal of Shelf Eligibility Conditions for Asset-Backed Securities and Other Additional Requests for Comment (Release Nos. 33-9244; 34-71611; File No. S7-08-10); Proposed Rules for Nationally Recognized Statistical Rating Organizations (Release No. 34-64514; File No. S7-18-11); and his comment letter dated May 29, 2014. He also provided the attached document.

Outline of June 30, 2014 Phone Meeting Between William J. Harrington, Experts Board, Wikirating.org - Key Expert, Structured Finance Topics and Mr. Paul Gumagay, Counsel to Commissioner Luis A. Aguilar U.S. Securities and Exchange Commission

Subject: Proposed Rules for Nationally Recognized Statistical Rating Organizations (SEC Release No. 34-64514; File No. S7-18-11) and Derivative Disclosures by ABS Issuers under Regulation AB (Release Nos. 33-9244; 34-71611; File No. S7-08-10)

The points below flow from May 29, 2014 comment letter to the SEC on Proposed Rules for Nationally Recognized Statistical Rating Agencies, available at <<http://www.sec.gov/comments/s7-18-11/s71811-84.pdf>>.

1. Most ABS carry inflated ratings from all NRSROs; widespread downgrades should have already occurred

- Derivative contracts (i.e., real world risk and not ivory-tower, theoretical concerns) drive inflated ratings
- ABS dodged the bullet of counterparty risk thanks to the 2008 bailouts
- Derivatives contracts are contracts that impose new obligations on counterparties such as ABS issuers; derivative contracts are not outright assets that "transform" cashflows
- Cross-border capital flows occur via cross-currency swap contracts; these swap contracts are among the riskiest of derivative contracts

2. Alesco Preferred Funding Series I-XVI are cases in point for significant derivative risk that is ignored in ratings

- These TruPS CDOs have self-referencing, nested counterparty risk in which one Merrill Lynch/BoA entity (MLDP) assumes the guarantee of a second Merrill Lynch/BoA entity (ML & Co.) with respect to the payment, posting & replacement/guarantee obligations of a third Merrill Lynch/BoA entity (MLIB)
- Effectively, the guarantee is bogus and does not mitigate counterparty risk of Merrill Lynch/BoA, particularly with respect to swap termination payments & nullification of flip clauses
- Even so, Moody's upgraded Alesco Preferred Funding V, VI, VIII, IX, X, & XVI on June 26, 2014

3. Who vouches for accuracy of ABS ratings or flip clauses?

- Flip clause worst of all worlds; they undercut both NRSRO analysts and ABS investors who start from scratch in raking through an ABS priority of payments
- Has the SEC queried ABS issuers and underwriters on rationales for including flip clauses in priorities of payments post-January 2010 decision by Judge Peck of the Lehman bankruptcy case that struck down a flip clause as unenforceable under U.S. bankruptcy law?
- Has the SEC queried NRSROs on the conflict of interest between rating ABS as AAA and properly assessing risk from derivative contracts such as swap contracts with flip clauses?

4. Commissioner Piwowar's statements on Reg AB disclosures are flat out wrong

- Reg AB must address nascent revival of PLS RMBS as well as larger ABS sectors such as student loans, auto loans, CLOs and CMBS.
- Private-label RMBS has riskiest derivative contracts of all—balance-guaranteed swaps with flip clauses that offset both interest rate risk and prepayments
- U.S. Treasury request for comment of June 26, 2014 indicates administration support for revival of private-label RMBS? <<http://www.treasury.gov/press-center/press-releases/Pages/jl2446.aspx>>

5. Three years after I began apprising the SEC of rating inflation attributable to derivative contracts such as swap contracts with flip clauses, SEC still responds with equivalent of the "GM nod"

- Reminiscent of VA in not reducing wait time after staff spoke out; Ford Motor Credit Company No-Action letter the SEC equivalent of VA fabricating wait time data?
- Also reminiscent of flawed roll-out of Affordable Care Act; the SEC approves deficient derivative technology by ABS issuers and NRSROs
- Pure incompetence? On April 30, 2014, SEC Office of Structured Finance didn't seem to know that ABS routinely embed swap contracts with flip clauses <<http://www.sec.gov/comments/s7-08-10/s70810-301.pdf>>

6. My intertwined proposals for derivative disclosures by ABS issuers and new rules for NRSROs are both highly commonsense and costless

- Discuss pp. 18-19 of my May 29, 2014 comment letter to the SEC proposing new rules for NRSROs

7. Flawed derivative methodologies for all sectors, not simply ABS, are perfect illustration of NRSRO conflict of interest

- Flawed methodologies for derivative contracts imposed on rating groups
- Maybe 20 analysts across all NRSRO sectors are versed in their respective derivative methodologies although derivative proliferation permeates all sectors
- 4,000 SEC staffers compared with 4,000 NRSRO analysts across all sectors.
- NRSRO analysts don't operate in "eat what you kill" environment; they are rewarded by NRSRO management
- Misleading testimony by Moody's managers to the Senate Permanent Sub-committee on Investigations stating that managers protected analysts "abused" by bankers

8. Discuss pp. 1-2 of my May 29, 2014 comment letter to the SEC proposing new rules for NRSROs

- To date, the SEC has enabled NRSROs to assign inaccurate ratings with impunity
- Ford Motor Credit Company No-Action Letter nullifies Dodd-Frank penalties for inflating ABS ratings
- 2011 proposed rules for NRSROs would empower NRSROs to continue rating across all sectors—municipal, state, sovereign, supra-national, corporate, financial, as well as ABS

9. Discuss counter-proposals to proposed rules for NRSROs, per pp. 15-18 of my August 8, 2011 comment letter to the SEC <<http://www.sec.gov/comments/s7-18-11/s71811.shtml#comments>

- report the employment status of each analyst who has filed a complaint with the Compliance Department; has filed a complaint against the Compliance Department; or has commented on Moody's website with respect to a methodology on an annual basis for five ensuing year
- Annual Interview of Each Employee Who Has Been Disciplined by Compliance Department
- Managers Should Not Vote in Forming a Moody's Opinion
- Train Management in Committee Comportment
- Cite Total Number of Voting Members in Opinion Press Release
- Committee Assessment Function -- Analysts Police All Aspects of the "Credit Rating Process"

William J. Harrington Email of June 16, 2014 Requesting a Meeting with Staff of Each SEC Commissioner to Discuss May 29, 2014 Comment Letter on Proposed Rules NRSROs and Derivative Disclosures for ABS Issuers

(As of June 30, 2014, staff of Commissioner Luis A. Aguilar had responded. No acknowledgements have been received from staffs of Commissioners Mary Jo White, Kara Stein, Michael Piwowar or Daniel Gallagher.)

'Dear All:

Attached please find my May 29, 2014 comment letter on above topics (also available at <<http://www.sec.gov/comments/s7-18-11/s71811-84.pdf>>).

This comment letter (and my first comment letter of August 8, 2011) is also available on the SEC site at <<http://www.sec.gov/comments/s7-18-11/s71811.shtml#comments>>.

For 20 years, I have assessed derivative risk. For the last 15 years, I have focused on intertwined derivative risk between ABS issuers and bank counterparties. From 1999 to 2010, I was a senior vice president for derivatives at Moody's Investors Services. Since retiring in 2010, I have mapped festering derivative risk that is endorsed by the ABS methodology of each NRSRO, including Moody's.

I summarize my post-Moody's outreach on pp. 6-8 in the section entitled "Open Secret #2: The Commission sanctions inflated bank and ABS ratings."

My major concern is expressed on p. 18. "Already, a new cycle of rating inflation for ABS and other sectors with outsized derivative risk is, like the retreat of Antarctica glaciers, well under way. If not reversed, this cycle will usher in yet another derivative debacle, followed by mass downgrades and rating withdrawals."

I quote Commissioner Stein on p. 11 in the section entitled, "One Commissioner wants useful ABS and NRSROs rules. How about two more?"

I also offer a reminder. "However, enacting bad NRSRO and ABS rules that in tandem would permanently allow issuers to bring insufficiently capitalized ABS to market is not the answer. With the reopening of the ABS comment period, the Commission has the opportunity to overhaul its approach to NRSRO rules. It would be pulling its weight to redress a root cause of the financial crisis that falls squarely within its purview."

Please see the first paragraph on p1. for the solution. "I am writing to urge the Commission to re-propose and extensively revise rule changes relating to Nationally Recognized Statistical Rating Organizations (NRSROs). In addition, I also urge the Commission to enforce Section 939G of Dodd-Frank, which makes NRSROs subject to expert liability under Sections 7 and 11 of the Exchange Act for disclosures of ratings in securities registration statements."

I would like to discuss my insights with staff members for each commissioner.

Best regards,

Bill Harrington

██████████