

MEMORANDUM

To: File No. S7-08-10

From: Michael J. Spratt
Counsel to Commissioner Kara Stein
U.S. Securities and Exchange Commission

Date: December 2, 2014

Re: Teleconference with William J. Harrington

On December 2, 2014, Michael Spratt, Allison Lee, Michelle Stasny, and Harriet Orol had a teleconference with William J. Harrington. The parties discussed, among other things, rules concerning Asset-Backed Securities Disclosure and Registration, and Nationally Recognized Statistical Rating Organizations.

1. Introduction for briefing for staff of SEC Commissioner Kara Stein on unenforceable, walkaway flip clauses in asset-backed security (ABS) waterfalls by William J. Harrington, former Senior Vice President, Derivatives Group of Moody's Investors Services

- a. My credentials available at: <http://www.linkedin.com/in/williamjharringtonmoodysvp>
- b. SEC unlikely to find a more knowledgeable analyst of "uncleared swap contracts with unenforceable, walkaway flip clauses and no margin posting." These swap contracts, which may reference currencies, interest rates, or basis rates underpin most ABS sectors worldwide
 - (i) Big picture take-away: walkaway flip clause cannot be risk managed by either ABS issuers or their counterparties
- c. From outset in 2002, my Moody's publications with respect to derivative contracts, ABS, and derivative counterparties made top ratings for ABS and derivative counterparties harder to obtain
- d. Work of last four years--correct bogus post-mortem of rating failure, ABS failure, and systemic failure
- e. SEC work on ABS/NRSROs equivalent to "GM Nod," VA wait times, & flawed 2013 roll-out of Affordable Care Act
 - (i) Exhibit Number 1 = No-Action Letter to Ford Motor Credit Company LLC
 - (ii) My May 29, 2014 comment letter on derivative disclosures by ABS issuers and proposed rules for NRSROs details my 2011-2014 outreach to SEC staff in all divisions.

2. I disseminate my work broadly

- a. All work in the public domain since August 8, 2011 comment letter to the SEC on proposed rules for NRSROs
- b. I cc: senior management of NRSROs on all correspondence; remove plausible deniability
- c. No secret meetings, nor whistleblower protection, nor personal gain
- d. Deposed under plaintiff subpoena in only case that Moody's (and co-defendants S&P and Morgan Stanley) settled
- e. Traction with consumer groups (NCRC & David Berenbaum; Barbara Roper and Micah Hauptman at Consumer Federation of America; Marcus Stanley at Americans for Financial Security)

3. Who else is undertaking similar work?

- a. Who has established credibility in assessing the smoke and mirrors of derivative contracts?
- b. Y2K exercise needed for derivative contracts generally; dot.com comparison apt
 - (i) Industry-wide failure by ABS issuer to reserve against counterparty losses a particularly egregious example, not an isolated example
- c. Most in Congress, SEC, and other regulators afraid to admit how little is understood with respect to derivative contracts?
 - (i) 10,000 House staffers? (ii) 4,000 SEC staffers (iii) 10 flip clause analysts at all NRSROs combined?
 - (ii) Big Picture Takeaway: a derivative contract is first and foremost a contract that imposes obligations on both parties. A derivative contract is not an asset akin to a stock or a bond.

4. Most ABS rated too high despite enactment of NRSRO Rules on August 27, 2014
 - a. Perfect expression of NRSRO conflict of interest; franchise-wide conflict, not one of individual analysts
 - b. Another series of downgrades should have already occurred, management says no
 - c. No NRSRO (i.e., accredited rating agency) warrants that any ratings, including ABS, are accurate
 - d. SEC has given free pass for inaccurate ratings by nullifying expert liability for NRSROs since enactment of D-F via two No-Action letters

5. One enabler of rating inflation of ABS and other sectors is deficient assessment of derivative contracts. All NRSROs uniformly assume that derivative contracts deliver benefits to issuers without exposing them to any counterparty risk
 - a. i.e., misrating is real-world concern that conceals real world losses, not ivory tower musings
 - b. Rating inflation most egregious for ABS
 - c. Again, derivative contract is a contract, not an asset
 - d. No empirical data to show that derivative contracts make life better; like evolution, just a theory
 - e. Cross-border capital flows = cross-currency swap = riskiest of contract

6. ABS is bad acronym; better description is asset-and-derivative-contract-backed security
 - a. RMBS is particularly bad acronym: securities are backed by both residential mortgages and highly complex, completely idiosyncratic derivative contracts known as "uncleared, balance-guaranteed, interest rate swap contracts with unenforceable, walkaway flip clauses and no margin posting"
 - b. Other asset-and-derivative-backed sectors include student loans, credit cards, equipment leases, CLOs (collateralized loan obligations), TruPS CDOs, auto loans, and sub-prime auto loans. These sectors all depend on "unenforceable, walkaway flip clauses" to protect against counterparty insolvency
 - c. ABS sectors that don't routinely depend on derivative contracts, e.g., commercial mortgages, retain the ability to enter into derivative contracts and preserve unenforceable, walkaway flip clauses in their waterfalls, just in case
 - d. What other ABS risks are ignored by NRSROs when inflating ratings?

7. ABS rating inflation extends credit too cheaply
 - a. Financing by ABS should cost more
 - b. No free lunch; too cheap financing today = bailouts tomorrow
 - c. D-F preamble: "To promote the financial stability of the United States by improving accountability and transparency in the financial system, to end "too big to fail", **to protect the American taxpayer by ending bailouts**, to protect consumers from abusive financial services practices, and for other purposes."

8. "Unenforceable, walkaway flip clauses" let ABS issuer pretend that they may write-off 100% of derivative amounts owed an insolvent bank
- a. No other sector--sovereign, regional, municipal, financial, corporate, supra-national--claims the same privilege
 - (i) Big Picture Question: Why can't every party to a swap contract in all sectors get a walk-away flip clause? What makes ABS issuers so special?
 - b. Wind-down agent of insolvent entity, i.e., FDIC, will show deference to ABS issuers and not contest walkaway flip clauses?
 - c. In 2010, Lehman bankruptcy judge has ruled differently, i.e., struck down a walkaway flip clause
 - (i) Lehman prevailed again in contesting a flip clause November 2014
 - d. ENORMOUS stain on U.S. counsel, as they still advise that ABS issuers include unenforceable, walkaway, flip clauses in interest rate swap contracts
 - (i) I forwarded May 29, 2014 comment letter to the SEC on derivative disclosures for ABS issuers/proposed rules for NRSROs to every member of the ABS Structured Finance Committee

9. Who in ABS industry (defined at its widest?) will speak on record regarding unenforceable, walkaway flip clauses, let alone defend them?
- (i) Mr. Abe Losice, Assistant Director of the SEC? After discussing these issues, and other limitation of swap contracts used by ABS issuers, Mr. Losice replied these insights weren't news to the SEC.

10. RMBS is highly topical, given comment request by Treasury Secretary Lew on reviving "safe" private-label RMBS
- a. See June 26, 2014 announcement: "U.S. Treasury Department Seeks Public Comment On The Development Of A Responsible Private Label Securities Market" <http://www.treasury.gov/press-center/press-releases/Pages/jl2446.aspx>
 - b. The comment request asks the impossible, i.e.: structure "safe" RMBS that takes mortgage credit risk outside of government-supported channels.
 - (i) Treasury views the development of a healthy and responsible PLS market as an important component of a reformed, safe, and sustainable housing finance system that will complement the enactment of comprehensive housing finance reform legislation consistent with the President's core principles released last August.
 - (ii) Treasury would like to...encourage private capital to play a larger role in taking mortgage credit risk outside of government-supported channels
 - c. RMBS with "uncleared, balance-guaranteed, interest rate swap contracts with unenforceable, walkaway flip clauses and no margin posting" are the opposite of safe; these derivative contracts directly add to bail-out risk

11. Reviving RMBS with "uncleared, balance-guaranteed, interest rate swap contracts with unenforceable, walkaway flip clauses and no margin posting" will be a systemic disaster.
 - a. I undertook my self-appointed, self-funded work four years ago in part to be ready to counter RMBS lobbying when it materialized
 - b. Moody's would not have paid me to critique the basic guts of most ABS, particularly the highly tainted sector of RMBS
 - c. Fortunately, Treasury efforts to revive RMBS seem to be going nowhere for many reasons

12. Ask experts in housing finance, securitization, credit risk management, investing, or regulation about RMBS and "uncleared, balance-guaranteed interest rate swap contracts with unenforceable, walkaway flip clauses and no margin posting"
 - a. None will defend these swap contract, though they underpin securitizations of all pre-payable, fixed rate mortgages of all tenors, including 30-years
 - b. Effectively, "uncleared, balance-guaranteed interest rate swap contracts with unenforceable, walkaway flip clauses and no margin posting" are a jerry-rigged construct of the ABS industry that would have failed spectacularly in 2008 but for the bail-outs
 - (i) WJH experience in evaluating major providers of these contracts that were saved only by 2008 financial consolidation & bail-outs

13. Risk of "uncleared, interest rate swaps with unenforceable, walkaway flip clauses and no margin posting" and "uncleared, balance-guaranteed, interest rate swap contracts with unenforceable, walkaway flip clauses and no margin posting" is not well known, particularly by regulators
 - a. SEC, including Office of Structured Finance, demonstrated no understanding of derivative contracts that are embedded in ABS
 - b. Teams at the Fed, FDIC, CFTC have listened with varying degrees of interest
 - c. For the most part, these regulators were not well versed in ABS derivative risks
 - d. I continually cold-call US and EU regulators; in only one instance have they reached out to me
 - e. SEC seems victim of "Stockholm Syndrome", i.e. "regulatory capture"
 - (i) Moody's misreporting on "revolving door analysts", and many, many other instances

14. Nightmare template for one-world financial regulation
 - a. EU regulators don't understand flip clauses either
 - b. In UK, a flip clauses has been upheld against Lehman Brothers, i.e., UK banks at grace risk of write-offs
 - c. Flip clauses a problem of poor risk management both by ABS issuers and their counterparties; harmonization of international law with respect to flip clauses a side show