UNITED STATE COURT OF APPEALS FOR THE SECOND CIRCUIT

LEHMAN BROTHERS SPECIAL FINANCING INC.,

Plaintiff-Appellant,

—against—

Case No. 18-1079

BRANCH BANKING AND TRUST COMPANY, et al.

Defendants-Appellees

MOTION BY WILLIAM J. HARRINGTON FOR LEAVE TO FILE AMICUS BRIEF

William J. Harrington
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Private US Citizen

CORPORATE DISCLOSURE STATEMENT

I, William J. Harrington, am a private US citizen. I self-finance research advocacy to eliminate the type of priority payment provisions at issue in this litigation (the ***flip clause***), to fix Nationally Recognized Statistical Rating Organization (***NRSRO***) credit ratings, and to improve the capitalization and regulation of asset-backed securities and other structured finance products (***ABS***) and of derivative contracts.

I have no commercial relationship with any party to the above-captioned case or any affiliate of any such party.

I have no financial or commercial interest in the above-captioned case, its outcome, or any implication thereof.

I am not employed by, or consult on a paid basis for, any entity.

I ***am*** a Key Expert on Structured Finance Topics for the Experts Board of Wikirating.org — a worldwide, independent, transparent, and collaborative organization for credit ratings. The Swiss nonprofit Wikirating Association operates the Wikirating platform.

I ***am*** affiliated as senior fellow with Croatan Institute — an independent, nonprofit, tax exempt **501(c)**(3), research institute.

I have no other professional affiliation.

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MOTION FOR LEAVE TO FILE AMICUS BRIEF

Pursuant to Federal Rule of Appellate Procedure 29(b), I, William J. Harrington respectfully move this Court for leave to file the brief attached hereto as Exhibit A (***Proposed Brief***) as amicus curiae in the above-captioned case (***Case***.)

In support of this motion, I state the following:

1. I am a private US citizen.

2. I am not an attorney.[1]

3. I self-finance investigation into the capitalization and regulation of complex finance, publicly report findings, and disseminate them widely.[2]

4. I work to boost the sustainability of our financial system by improving price-making, reducing the likelihood of bailouts, and eliminating the flip clause.

5. Pursuant to Second Circuit Local Rule 27.1(f)(1), I aver that the collective experience of teaching myself to write and submit an amicus brief is an "extraordinary circumstance."

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[1] I worked fulltime to submit a brief after fruitlessly seeking help from professors at seven law schools and four law clinics, two attorney friends, and several others (who collectively contacted 170-plus attorneys on my behalf) in October-November 2018.

[2] Harrington, William J., "Submission to the US Commodity Futures Trading Commission Re: RIN 3038-AE85 'Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants' (In the Event of No Deal Brexit)," May 31, 2019. (https://comments.cftc.gov/PublicComments/CommentList.aspx?id=2960.)

6. Pursuant to Second Circuit Local Rule 27.1(f)(3), I am filing Exhibit A "as soon as practicable" i.e., ***on the day*** that I completed an amicus brief that is clear, concise, ***and complete***.[3]

7. My lodestar has been that the which United States District Court for the Southern District of New York (the ***District Court***) cited in affirming the decision of the United States Bankruptcy Court for the Southern District of New York (the ***Bankruptcy Court***): To present analysis and "facts of which the court may take judicial notice" (Opinion And Order, Page 7).[4]

8. I have a singular ability to help the Court deliberate the Case because I am among the few to have continually scrutinized global use of the flip clause since June 1999, when I joined the derivatives group of Moody's Investors Service (***Moody's***).

9. I support my claim with the othe following personal observations.

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[3] US Securities and Exchange Commission (***SEC***), "Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital and Segregation Requirements for Broker-Dealers," *FR Pending*, **June 21, 2019**, (***SEC-Swap-Margin-Rule***.) Footnotes 327, 377, 463, 519, 569, 730, 738, 796, 1052, and 1058. (https://www.sec.gov/rules/final/2019/34-86175.pdf.)

[4] (https://dlbjbjzgnk95t.cloudfront.net/1022000/1022435/https-ecf-nysd-uscourts-gov-doc1-127122046923.pdf.)

10. I have scrutinized the flip clause from the following **18** vantages: **1)** academic literature of the financial crisis; **2)** bankruptcy law of the US and other jurisdictions; **3)** byline journalism; **4)** competing exposures of the two parties to a swap contract, including the zero-sum exposure that a flip clause creates; **5)** global market practice since 1999; **6)** investigation by the US Department of Justice and attorneys general of 21 states and District of Columbia that resulted in them obtaining an $864 million settlement, including a Statement of Facts, from Moody's Corporation, Moody's Analytics, and Moody's in 2017;[5] **7)** lead NRSRO credit analyst and team leader who proposed credit ratings, voted in 1500 ABS, banking, derivative, insurance, municipal, and sovereign committees, and co-developed global methodologies for derivative contracts, including both standard swap contracts and ones in which an ABS issuer referred to a flip clause in paying a swap dealer (***flip-clause-swap-contract***); **8)** lead NRSRO analyst for 50 ABS, collateralized loan obligations (***CLOs***), and collateralized debt obligations (***CDOs***), including three that defendants-appellees issued or insured; **9)** lead NRSRO analyst for ten derivative dealers, including two Lehman Brothers affiliates, that provided swap contracts both with and without a flip clause; **10)** lead NRSRO liaison with the

[5] US Department of Justice, "Justice Department and State Partners Secure Nearly $864 Million Settlement with Moody's Arising from Conduct in the Lead up to the Financial Crisis," *Announcement*, January 13, 2017. (https://www.**justice**.gov/opa/pr/**justice-department-and-state-partners-secure-nearly-864-million-settlement-moody-s-arising**.)

swap trading desks at 15 financial institutions, including both the plaintiff-appellant and five defendants-appellees, regarding development and implementation of a global NRSRO methodology for flip-clause-swap-contracts; **11)** legal enforceability opinions with carve-outs; **12)** longitudinal tracking of core components of the flip-clause-swap-contract, including but not limited to the flip clause; **13)** review of NRSRO methodologies for the flip-clause-swap-contract; **14)** self-financed, public-citizen advocate for responsible US finance whose advocacy against the flip-clause-swap-contract US financial regulators both cited and adopted in Dodd-Frank Wall Street Reform and Consumer Protection Act (***Dodd-Frank Act***) rulemaking;[6] **15)** Structured Finance Industry Group (***SFIG***) member from May 13, 2013 to December 31, 2013 and participant on the "Derivatives in Securitization Committee," which champions the flip-clause-swap-contract, from May 15, 2013 to December 31, 2013;[7] **16)** the student loan crisis; **17)** pro-bono "whistleblower" who regularly provides analysis to the SEC and the US Commodity Futures Trading Commission (***CFTC***) while explicitly opting **not** to be considered for a financial award; and **18)** the respective regulations and proposals of 14 financial regulators — Australian Prudential Regulation Authority, Bank of England, European Banking Authority, European Central Bank, European Commission, European Securities and

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6 (https://www.congress.gov/111/plaws/publ203/PLAW-111publ203.pdf)

7 On January 17, 2014, the SFIG Treasurer informed me that the Membership Committee had decided I would no longer be a member.

Markets Authority, Japanese Financial Services Agency, Board of Governors of the US Federal Reserve Board System (***Federal Reserve***), US Farm Credit Administration, US Federal Deposit Insurance Corporation (***FDIC***), US Federal Housing Finance Agency, Office of the Comptroller of the Currency (collectively, the preceding five US regulators, the ***prudential regulators***), the CFTC, and the SEC.

11. I am a dispassionate friend of the Court because I am agnostic regarding the correctness of both the Bankruptcy Court decision and its affirmation by the District Court.

12. I ***do*** have a well-founded view that no decision by the Court can fix the flip clause. It cannot be fixed.

13. ***The flip clause is quicksand. No financial sector or market that uses the flip clause can be stabilized because quicksand cannot be stabilized.***

14. Whatever the Court's decision, it will confirm US market and regulatory assessments that the flip clause is inherently and irredeemably defective. Upholding the flip clause will render it unacceptable to swap dealers. Striking down the flip clause will render it unacceptable to investors. Splitting the difference will exposure future parties to a decade of litigation.

15. Accordingly, the Court must contort neither law nor logic in a futile effort to prop up the flip clause. In particular, the Court must carefully review three distinctions that the Bankruptcy Court made.

Firstly, the Type 1 / Type 2 designation is a distinction without a difference.

Secondly, the inclusion of transaction documents in a swap agreement has unintended consequences because such documents are, along with the rest of a swap contract, subject to US regulations for swap margin.

Thirdly, three prudential regulators enacted rules in 2017 that explicitly make failure of a major financial institution a "singular" event.

16. My 20 years of scrutiny have produced a disquieting finding. ***Every party that agreed to or endorsed a flip clause generated the financial crisis. None was a blindsided casualty.***

17. From 2000 to 2007, US ABS issuers that entered into a swap contract almost uniformly entered into a flip-clause-swap-contract.

18. Few post-crisis issuers have entered into a flip-clause-swap-contract and none have done so since January 2016.[8]

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[8] "The good news is that embedded swaps are less prevalent in U.S. deals..." Adelson, Mark and Robbin Conner, "SFIG Vegas 2017 Conference Notes,"

19. ***US ABS are thriving without the flip-clause-swap contract*!**[9]

20. In July 2010, Congress enacted its clear intent to eliminate the flip-clause-swap-contract in multiple sections of the Dodd-Frank Act. It explicitly instructs US financial regulators to establish rules that impose variation margin requirements on a swap dealer for each uncleared swap contract with an end user.

21. ***A variation margin requirement supersedes both the operation and the purpose of a flip clause, thereby rendering it doubly superfluous***.

22. In 2015, the prudential regulators and the CFTC complied with the Dodd-Frank mandate by adopting swap margin rules that intentionally kill the flip-clause-swap-contract by preventing a swap dealer from providing a new contract or amending an existing one.[10] On June 21, 2019, the SEC followed suit.

23. In 2017, three prudential regulators cited the Lehman bankruptcy in adopting additional Dodd-Frank rules to prevent the mass termination of derivative contracts in the event that an entity within a systemically important

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March 11, 2017, page 20. (http://www.**markadelson.**com/pubs/**SFIG-Vegas-2017-Conference-Notes**.pdf.)

9 "Global Securitization on Pace for $1 Trillion in 2018," *S&P Global Ratings RatingsDirect*, July 24, 2018. (https://www.**spratings**.com/documents/20184/0/**Global+Securitization+On+Pace+For+$1+Trillion+In+2018**/8f1dd609-c3e8-469f-8b81-1175a7fe1bdb.)

10 Harrington, Bill, "Existing ABS swaps also caught in swap margin net," *Debtwire ABS*, August 12, 2016. (https://www.**debtwire**.com/info/**existing-abs-swaps-also-caught-swap-margin-net**-%E2%80%94-**analysis**.)

banking organization enters bankruptcy or resolution. ***Notably, the derivative contracts of such entities must "prohibit a counterparty… from exercising cross-default rights."***[11]

24. Issuers have always had better alternatives to a flip-clause-swap-contract. As examples, issuers can accept lower ABS ratings, align the payment characteristics of assets and ABS, buy options, enter into a swap contract with two-way margin posting, increase deal resources, or let non-US investors mitigate exposures outside of a deal.[12] Unsurprisingly, each alternative costs more than a flip-clause-swap-contract, verifying that it is an artificial contrivance and not a product of free market forces.

25. I resigned from Moody's in July 2010 largely because the company thwarted an honest post-mortem of its role in the financial crisis, e.g., with

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[11] Memo from Federal Reserve Chair Jerome Powell, August 24, 2017. (https://www.**federalreserve**.gov/aboutthefed/**boardmeetings**/files/**qfc-board-memo-20170901**.pdf.)

[12] Tempkin, Adam, "Here's Why the Japanese Bid for CLOs Isn't Likely to Slow Soon," *Bloomberg Markets*, April 2, 2019. (https://www.**bloomberg**.com/news/articles/2019-04-02/**here-s-why-the-japanese-bid-for-clos-isn-t-likely-to-slow-soon**) Also, Rodriguez, Mayra Valladres, "Non-Banks Are The Largest Holders of Collateralized Loan Obligations," *Forbes*, June 11, 2019. "Japanese banks hold about $108 billion in US CLOs." (https://www.**forbes**.com/sites/**mayrarodriguezvalladares**/2019/06/11/**non-banks-are-the-largest-holders-of-collateralized-loan-obligations-**globally/#1160a9c6e95e.)

respect to ***the failure of all flip-clause-swap-contract components***.[13] In addition to the flip clause, the other failed components include rating agency confirmation (***RAC***), replacement/guarantee, and one-way collateralization.[14]

26. In January 2011, I began a fulltime, self-financed advocacy to eliminate the flip-clause-swap-contract as a financing tool for the US economy, particularly the housing sector.[15] My ongoing advocacy, which has largely succeeded, centers on the 40-plus technical comments that I have submitted to US and EU financial regulators, US and UK legislative inquiries, and NRSROs.[16]

27. From October 2015 - November 2016, I worked as a journalist at *Debtwire ABS*, analyzing and reporting on the regulation and use of flip-clause-

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13 Harrington, William J., "Electronic Letter to Moody's President and Chief Operating Officer Mr. Michel Madelain," June 11, 2012, final page. (HTML page 152 of Harrington, William J., "Electronic Letter to the US SEC Re: Rule Comment Number 4-661," June 3, 2013 (***WJH-SEC-Comment-06-03-2013***.) (https://www.sec.gov/comments/4-661/4661-28.pdf.))

14 Gaillard, Norbert J. and William J. Harrington, "Efficient, commonsense actions to foster accurate credit ratings," *Capital Markets Law Journal* 11, No.1 (2016): 38-59. https://doi: 10.1093/cmlj/kmv064. Regarding the respective provisions' failures, see pages 42-44, including footnotes 37, 40, 41, 42, 44, and 45, 46, and 47.

15 Both Wikirating and Croatan Institute post my work. (https://wikirating.org/ and http://www.croataninstitute.org/william-j-harrington, respectively.)

16 Most recently, SEC-Swap-Margin-Rule, pages 175-6 and 204-5.

swap-contracts. Anticipating renewed lobbying to revive the contract after the 2016 elections, I resigned to resume fulltime, self-financed advocacy in December 2016.[17]

28. Mine is the only rigorous analysis of the flip-clause-swap-contract worldwide.[18] Disappointingly, even academics and policy makers who study the financial crisis have not evaluated the contract.[19]

29. When I joined Moody's in 1999, NRSROs routinely predicated the ratings of ABS such as CDOs, CLOs, residential mortgage-backed securities (***RMBS***) on reference to a flip clause when an issuer was party to a swap contract.

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[17] For lobbying and NRSRO materials to preserve flip-clause-swap-contracts, see Harrington, William J. "Electronic Letter to the CFTC 'Re: CFTC Letter No. 17-52, No-Action,'" February 2, 2018, in toto. (https://www.wikirating.org/data/other/20180203_**Harrington_J_William_31_Misrepresentations_in_CFTC**%20_**Letter_No_17-52**.pdf.)

[18] As example, I was the first to publicly correct legal and NRSRO misinformation regarding legacy flip-clause-swap-contracts and the new swap margin rules. Harrington, *Debtwire ABS*, August 12, 2016.

[19] For ***vacuous*** work, see Miguel Segoviano et al. "Securitization: Lessons Learned and the Road Ahead," *International Monetary Fund Working Paper WP/15/2355*, November 2013, pages 38-39. (https://www.**imf.**org/external/pubs/ft/wp/2013/**wp13255**.pdf.) Also, Harrington, William J. "Submission to the CFTC Re: RIN 3038-AD54 'Capital Requirements for Swap Dealers and Major Swap Participants,'" May 4, 2017 (***WJH-CFTC-Comment-05-04-2017***), footnote 5. "I apprised Dr. Segoviano and his co-authors of the risk characteristics of an uncleared swap with a flip clause in a teleconference on 16 January 2014." They had been unaware of the flip clause. (https://comments.**cftc.gov**/**PublicComments**/ViewComment.aspx?id=61196&SearchText=.)

In doing so, the NRSROs asserted a brazen proposition — namely, a swap contract injected **zero** counterparty exposure into either a deal or a swap dealer.

30. NRSRO endorsement made the flip-clause-swap-contract artificially cheap and pre-crisis ABS issuers used it heavily to offset the potential depreciation of securitized assets viz-a-viz ABS and to create assets.[20] Spectacularly reckless issuers accrued exponential exposure to-flip-clause-swap-contracts by buying ABS from issuers that themselves were parties to a contract.[21]

31. A flip-clause-swap-contract can reference a basis rate, a commodity, a currency, one or more entities, an interest rate, or the payment characteristics of an asset pool. The contract ***always*** exposes both a deal and a swap dealer to outsized losses regardless of which party is in-the-money. The ABS sector intentionally concocted the contract so that it could only fail its patently fantastic

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20 WJH-CFTC-Comment-05-04-2017, page 102. Under a flip-clause-swap-contract, an issuer "posted no collateral to a swap dealer and held *no* capital against its insolvency."

21 Pauley, Justin and Dave Preston, "Wachovia CDO Research presents our summary of CDO Default Statistics," *Wachovia Structured Product Research*, (December 31, 2008.) We "track 283 ABS CDOs with a total aggregate issuance amount of $295 billion that have tripped their EOD triggers between October 2007 and Dec. 31, 2008." Also, Moody's Announcement, September 11, 2008. Moody's withdrew "the ratings of 261 classes of notes issued by 34 CDOs backed primarily by portfolios of RMBS securities" and CDO-squared deals that "completed [post-EOD] liquidation." (https://www.moodys.com/research/**Moodys-withdraws-ratings-of-Notes-issued-by-34-ABS-CDOs**--PR_162573.)

purpose — namely, ensuring that neither a deal nor a swap dealer incurred ***any*** loss following the latter's bankruptcy.

32. The Bankruptcy Court detailed the 100% loss of contract values that the plaintiff-appellant (***LBSF***) incurred under 100% of a "multitude" of in-the-money, flip-clause-swap-contracts in the decision.

> **"*The amount of the proceeds of the liquidation of the Collateral was insufficient to make any payment to LBSF under the Waterfall after proceeds were paid pursuant to Noteholder Priority.*"**[22]

(Memorandum Decision, Page 11. Emphasis added.)

Under a separate, very large in-the-money contract, LBSF may have lost 67%.[23] Partly owing to the outsized losses that the LBSF flip-clause-swap-contract portfolio incurred, LBSF creditors received lower recoveries than other Lehman creditors.[24]

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22 http://www.nysb.uscourts.gov/sites/default/files/opinions/202553_1360_opinion.pdf.)

23 Moody's Announcement on Ballyrock ABS CDO 2007-1, March 4, 2010. "…the Issuer has just over $137MM in cash while the credit default swap termination payments due to LBSF is approximately $405MM." (https://www.moodys.com/research/**Moodys-downgrades-the-ratings-of-two-classes-of-Notes-issued**--PR_195797.)

24 Denison, Erin, Michael Fleming, and Asani Sarkar, "Creditor Recovery in Lehman's Recovery," *Federal Reserve Bank of New York*, January 14, 2019. (https://**libertystreeteconomics.newyorkfed**.org/**2019/01/creditor-recovery-in-lehmans-bankruptcy**.html.)

Conversely, one European deal lost 34% under an *in-the-money* flip-clause-swap-contract, i.e., one that was *out-of-the-money* to a Lehman entity.[25] Collectively, European flip-clause-swap-contracts with a variety of swap dealers undermined national economies, most notably Greece.[26]

33. Pre-crisis issuers of CDOs, CLOs, RMBS, and other ABS that entered into a flip-clause-swap-contract knowingly under-capitalized their deals, i.e., intentionally adulterated them. Likewise, the corresponding swap dealers undermined themselves by under-capitalizing the offsetting exposures to the same contracts. Many *deals* failed, including most CDOs that the defendants-appellees issued or insured. Several *dealers* failed, including the plaintiff-appellant. Surviving deals and dealers, including several other defendants-appellees, might otherwise have failed but for direct and indirect government intervention.

Without the flip-clause-swap-contract, pre-crisis issuers would have either better capitalized deals or not issued them in the first place. Lehman and other

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25 Fitch Ratings Announcement on Eurosail-UK 2007-4BL: December 17, 2014. "[P]roceeds of USD116m received by the issuer represent approximately 66% of the stipulated claim amount." (https://www.businesswire.com/news/home/20141217005430/en/**Fitch-Takes-Rating-Actions-Eurosail-UK-2007-4BL-PLC**.)

26 Story, Louise, Landon Thomas Jr. and Nelson D. Schwartz, "Wall St. Helped to Mask Debt Fueling Europe's Crisis," *New York Times*, February 13, 2010. (https://www.nytimes.com/2010/02/14/business/global/14debt.html?partner=MOREOVERNEWS&ei=5040.)

swap dealers would have been better capitalized. The financial crisis might never have occurred.

34. Moody's Derivatives Group assigned and monitored ratings of the respective CDOs and ABS of 16 deals that defendants-appellees issued. The group also provided financial institution colleagues with the underlying "shadow" ratings on CDO and ABS that monoline insurers, including at least one defendant-appellee, "wrapped."

I was lead analyst in assigning the initial ratings to three CDOs that defendants-appellees issued or wrapped.[27] In total, I was lead analyst in assigning initial ratings to the respective CDOs, CLOs, and other ABS of 50 deals from June 1999 until assuming new responsibilities in Spring 2006.[28] Moreover, I was a voting member of the rating committees for many more ABS because I was the derivatives go-to person for North American analysts in all sectors.

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27 Moody's Announcements: December 20, 2002; and June 30, 2005 (two). (https://www.moodys.com/research/**MOODYS-RATES-THE-MULBERRY-STREET-CDO-LTD-OFFERING-FROM-UBS--**PR_62979) (https://www.moodys.com/research/**MOODYS-RATES-THE-CROWN-CITY-CDO-2005-1-LIMITED-OFFERING**--PR_98907) (https://www.moodys.com/research/**MOODYS-RATES-THE-CROWN-CITY-CDO-2005-2-LIMITED-OFFERING**--PR_98908)

28 Harrington, William J., "Submission to the US SEC Re: File Number S7-18-11, 'Proposed Rules for Nationally Recognized Statistical Rating Organization,'" August 8, 2011 (***WJH-SEC-Comment-08-08-2011***), pages 3 and 57-58. (https://www.sec.gov/comments/s7-18-11/s71811-33.pdf.)

The overwhelming majority of pre-crisis CDO, CLO, RMBS, and other ABS issuers that entered into a swap contract laden it with a flip clause refence to avoid adding resources to the deal. However, a CDO that I rated (and a defendant-appellee wrapped) entered into swaps but paid certain termination amounts from a ringfenced cash reserve.[29] Many CLO issuers bought an option; some but not all also entered into a flip-clause-swap-contract. Issuers in all ABS sectors simply aligned the payment characteristics of assets and liabilities and forewent a derivative contract altogether.

35. Moody's Derivatives Group assigned and monitored ratings for structured finance operating companies that dealt derivative contracts (***SFOCs***). SFOCs included: dealers of uncollateralized credit derivative contracts, although not flip-clause-swap-contracts (credit derivative product companies or ***CDPCs***); dealers of generally uncollateralized currency and interest rate derivative contracts, including flip-clause-swap-contracts (derivative product companies or ***DPCs***); and collateralized swap and repo programs. Upon joining Moody's, I became lead analyst for several DPCs, including Lehman Brothers Derivative Products (***LBDP***), Lehman Brothers Financial Products (***LBFP***), and Merrill Lynch Derivative

[29] Moody's Announcement: March 21, 2001. (https://www.moodys.com/research/**MOODYS-ASSIGNS-RATING-TO-PHOENIX-FUNDING-LIMITED-CDO**--PR_44224.)

Products (***MLDP***). I also assumed the lead in assigning the initial rating to a new DPC (Nomura Derivative Products Inc, or ***NDPI***) in 2000 and to a new collateralized swap program (Enhanced-Rating ISDA Program of JPMorgan Chase Bank) in 2005. I monitored each SFOC until resigning from Moody's in July 2010.

At various times, LBDP, LBFP, MLDP, or NDPI proposed to provide a flip-clause-swap-contract. In each instance, I responded that, in order to do so, the DPC must hold significantly more resources than would be the case for an otherwise identical, and much more standard, swap contract that did not refer to a flip clause. ***After all, almost all of a swap dealer's counterparties, i.e., those that do not reference a flip clause when paying the dealer, face outsized and potentially cascading losses in the event that the dealer fails while exposed to a flip clause.*** To limit the losses from a flip clause, DPCs were to dynamically increase or decrease the additional resources in line with the mark-to-market, i.e., the outsized exposure that the flip clause creates.[30] Largely owing to the projected costs, each DPC provided few-to-no flip-clause-swap-contracts.

36. My monitoring contributed to LBDP and LBFP ***eventually*** paying unsecured creditors in full.[31] In addition to insisting that the Lehman DPCs

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30 WJH-CFTC-Comment-05-04-2017, pages 98-107.

31 Harrington, Bill et al, "Update on the Lehman Brothers Derivative Product Companies' Bankruptcy (Plan of reorganization by the Lehman bankrupt

fully capitalize the respective exposures under new flip-clause-swap-contracts, I also obligated the DPCS to hold "capital and collateral resources in cash and highly liquid U.S. government securities…[and]…refused a request by the DPCs to credit a new monoline guarantee to capital resources upon expiry of a prior guarantee that had been in place since formation."[32]

37. More generally, all DPCs under my purview had more capital and collateral resources than otherwise because I ***did not enact*** Moody's global practice of diluting relevant benchmarks for Aaa-ratings.[33]

38. I was Team Co-Leader of SFOCs beginning in 2005, which enabled me to monitor additional SFOCs.[34] One legacy DPC that I began monitoring — Bear Stearns Financial Products (***BSFP***) — was an established provider of flip-

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estate proposes to pay 100% of allowed claims against two Lehman DPCs)," *Moody's Structured Credit Perspectives*, June 2010, pages 29-31.

32 Harrington, William J., "Electronic Letter to Moody's President and Chief Operating Officer Mr. Michel Madelain," April 1, 2013 (***WJH-Letter-Moody's-Madelain-04-01-2013***), pages 9-10 (HTML pages 24-25 in WJH-SEC-Comment-06-03-2013)

33 US Department of Justice. *Announcement*, January 13, 2017. (https://www.**justice**.gov/opa/pr/**justice-department-and-state-partners-secure-nearly-864-million-settlement-moody-s-arising**.) "Starting in 2004, Moody's did not follow its published idealized expected loss standards in rating certain Aaa CDO securities…In 2005, Moody's authorized the expanded use of this practice to all Aaa CDO securities."

34 WJH-Letter-Moody's-Madelain-04-01-2013, pages 15-18, 23-30, and 33-54 (HTML pages 30-33, 38-45, and 48-69 in WJH-SEC-Comment-06-03-2013).

clause-swap-contracts to RMBS issuers.[35] I also led colleagues in stemming CDPC trading with CDOs, RMBS, and other ABS sectors.

39. As the financial crisis unfolded, I led colleagues in directing four global financial institutions to add tangible resources to the respective portfolios of flip-clause-swap-contracts.

BSFP added capital to track ***in-the-money*** flip-clause-swap-contracts.

In March 2008, JPMorgan Chase amended a guarantee of selected obligations of multiple Bear Stearns entities to add performance obligations that Moody's Derivative Group had identified as critical to protecting BSFP counterparties.[36]

In Summer 2008, the then independent Merrill Lynch agreed to fully implement my colleagues' proposals in a credit support annex with the PARCS / PYXIS programs that secured the latter's swap claims of USD 8 billion.[37]

In 2009-2010, Bank of America agreed to finance a proposal by its new subsidiary MLDP to guarantee the performance of third-party AIG under flip-

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35 Ibid., pages 10-14 (HTML pages 25-29.)

36 Moody's Announcements: March 25, 2008 and June 4, 2008. (https://www.moodys.com/research/**Moodys-continues-Bear-Stearns-review-assigns-JPM-backed-issuer-ratings**--PR_151714.) (https://www.**moodys.com/research/Moodys-issues-rating-confirmation-for-Bear-Stearns-affiliate**--PR_156804.)

37 WJH-SEC-Comment-08-08-2011, pages 4, 21-24, 68, and 76.

clause-swap-contracts with 50 CDO and ABS issuers. The contracts were deeply in-the-money to AIG (i.e., the flip clauses exposed the tottering insurance company to significant exposure to its own credit deterioration) in part because many deals were repaying loans that AIG had made upfront when entering the respective contracts.[38]

Finally, I led SFOC colleagues in overhauling a DPC methodology and in downgrading DPCs to address deficiencies that BSFP and the Lehman DPCs revealed in 2008. The update produced a key insight: A DPC effectively holds a "walkaway" provision, which is akin to a flip clause, in the master swap with the parent institution.[39]

40. I enjoyed evaluating the exposure of a DPC under a flip-clause-swap-contract because the work informed my other major responsibility from the outset of joining Moody's — namely, evaluating the exactly opposite exposure of an ABS issuer. My interest in articulating the zero-sum nature of the flip clause flowed from two pre-Moody's jobs. I structured derivative contracts that referenced interest rates, currencies, and sovereign entities at Merrill Lynch (1992-1998) and was an international economist for the interest rate and currency service of The WEFA Group (1987-1990.)

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38 Ibid., pages 4, 27-29 (including footnote 7), 36, 40, 62-68, 70-71, and 73-74.

39 Ibid. pages 68-70. Also, WJH-CFTC-Comment-05-04-2017, footnote 87, page 99.

41. At Moody's, I co-developed three guides for an issuer that entered into a derivative contract. The guides were published in 2002, 2004, and 2006, respectively. Each specified certain parameters of a derivative contract to align it with the same aggressive numerical input that Moody's had long used to support its ABS franchise; namely that a derivative contract injected **zero** counterparty exposure into a deal.

42. The 2002 guide applied to US issuers of cashflow CDOs and described one half of the flip clause, i.e., waterfall seniority (***Moody's-2002-CDO-Framework***.)[40] "The guidelines are being published as senior noteholders and hedge counterparties in the banking industry compete increasingly for seniority." II "Hedge Counterparties Are Climbing the Waterfall."[41] Other ABS teams piggybacked on the guide to address the (with hindsight) impossible-to-reconcile clash between ABS and swap dealer.

43. The 2004 guide capped the rating for a structured note in line with certain senior termination amounts payable to a swap dealer. As example, a structured note would be rated Aa1 — i.e., only one notch below Aaa — when an

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40 "Moody's Approach for Rating Thresholds of Hedge Counterparties in CDO Transactions," *Moody's Investors Service Special Report,* October 23, 2002 (with Gus Harris, Isaac Efrat, Jerry Gluck, and Bill May).

41 Moody's Announcement: November 4, 2002. (https://www.moodys.com/research/**MOODYS-PUBLISHES-GUIDELINES-FOR-CDO-HEDGE-COUNTERPARTIES--**PR_61233.)

issuer capped certain senior termination amounts at **45% of contract notional** (**NB**, not the much smaller 45% of mark-to-market.)[42] Even so, both issuers and Moody's shunned the approach.

44. The 2006 publication applied to issuers of cashflow (as opposed to synthetic) ABS worldwide and was operational until November 11, 2013 (***Moody's-2006-Hedge-Framework***).[43] The methodology, which ostensibly supplanted existing ones, improved on them by comprehensively articulating and standardizing many flip-clause-swap-contract provisions.[44] The 2006 framework also provided a pro-forma template for incorporation boilerplate ISDA documents.[45]

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42 Dutta, Deboleena and Bill Harrington, "Capping Hedge Termination Payments in Moody's Rated Structured Notes Following Default of the Underlying Debt Instrument," *Moody's Investors Service Special Report*, September 17, 2004.

43 Manchester, Edward, Bill Harrington, and Nicholas Lindstrom, "Framework for De-Linking Hedge Counterparty Risks from Global Structured Finance Cashflow Transactions," *Moody's Investors Service Rating Methodology,* May 25, 2006.

44 Securities Industry and Financial Markets Association (***SIFMA***) and International Swaps and Derivatives Association (***ISDA***), "Proposed Brief of Amicus Curiae in Support of Defendants-Appellees and Affirmance in Lehman Brothers Special Financing, Inc. versus Bank of America National Association et al. (Case No. 17-cv-1224-LGS (Document 87)," June 16, 2017. Appendix A contains Moody's-2006-Hedge-Framework. (https://www.**sifma**.org/wp-content/uploads/2017/06/**LehmanBrothers**061617.pdf.*)*

45 Moody's Announcement: May 25, 2006. (https://www.moodys.com/research/**MOODYS-UNIFIES-HEDGE-FRAMEWORK-FOR-HIGHLY-RATED-STRUCTURED-FINANCE-CASH**--PR_114003.)

45. One Moody's legal colleague in London crafted the flip clause provisions. A second legal colleague in London drafted the ISDA template. No US legal analyst developed or drafted even a small part of Moody's-2006-Hedge-Framework. The absence is notable because Moody's Derivatives managers assigned a legal analyst to virtually every CDO, CLO, and SFOC.

46. ***To repeat, Moody's assigned NO US legal analyst who was well-versed in the flip-clause-swap-contract to develop Moodys-2006-Hedge-Framework***.

47. My London colleague cited first in the preceding paragraph kicked-off the project by proposing the flip clause articulation. I, not knowing that the flip clause had a stronger grounding under UK law than US law, endorsed the articulation wholeheartedly. In our shared view, we were to develop an airtight framework so that Moody's nonnegotiable rating assumption — namely, that a flip-clause-swap-contract injected ***zero*** counterparty exposure into a deal — became a reality in each contract.[46]

We spoke to teams that provided flip-clause-swap-contracts at US and EU financial institutions. Furthermore, we published two detailed comment requests that featured the flip clause articulation in 2005.[47]

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[46] WJH-SEC-Comment-08-08-2011, page 58.

[47] Moody's Announcement: December 7, 2005. (**https://www.moodys.com/research/MOODYS-REQUESTS-**

I discussed the framework with New York-based swaps teams at: Bank of America; Bank of New York; Bear Stearns; BSFP; CIBC, Credit Suisse; Deutsche Bank; Goldman Sachs; JPMorgan Chase; Lehman Brothers; Merrill Lynch (the corporation); MLDP; Swiss Re; UBS; and Wachovia. I also discussed the framework with deal counsel for US RMBS deals and with then Bank of England Deputy Governor Mr. Paul Tucker.[48]

48. The swap teams challenged many obligations such as posting collateral, replacement/guarantee, and the respective rating triggers. ***However, no swap team disputed the flip clause, let alone challenged its enforceability.***

49. Similarly, no issuer, investor, trustee, or vendor to an ABS deal or SFOC had disputed the flip clause or challenged its enforcement with me.[49] Nor, with one exception, did a US Moody's legal colleague.[50]

COMMENTS-ON-PROPOSAL-FOR-SWAPS-IN-HIGHLY-RATED--PR_106039.)

48 Moody's Announcement: August 28, 2006. (https://www.moodys.com/research/**Moodys-framework-for-de-linking-hedge-counterparty-risks-from-global**--PR_118610.)

49 William J. Harrington, Letter to Moody's President and COO Mr. Michel Madelain, October 26, 2012 (***WJH-Letter-Moody's-Madelain-10-26-2012***), pages 1-5.

50 In 2014, a former Moody's legal colleague stated that no counsel for a US deal had ever delivered a clean opinion with respect to the enforceability of the flip clause.

50. From early 2004 to December 2006, my London colleagues and I regularly updated a global team of senior Moody's management, who approved each stage of the framework-in-progress.[51]

51. Citations, and even wholesale inclusion, of Moody's-2006-Hedge-Framework in amicus briefs that SIFMA and ISDA proposed for a slew of cases corroborate that ABS practitioners — e.g., auditors, bankers, counsel, credit analysts, industry groups, insurers, issuers, swap providers, trustees, underwriters, and warehousers — contemporaneously examined the flip clause treatment therein. Additionally, a Moody's colleague who had previously worked at S&P offered that its analysts had also used Moody's-2006-Hedge-Framework.

52. The widespread reliance on the flip clause nagged at me out of simple common sense. Wouldn't the FDIC simply repudiate the flip clauses of a bank in receivership to preserve both it and taxpayer money? After all, a failed bank that had agreed to a flip clause knowingly hastened its own insolvency — i.e., was "willfully negligent." I shared the concern with Moody's Executive Vice President

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[51] Moody's Investors Service, "Structured Finance Responds to Issues of Counterparty Risk and Basel II in Calls for Comment," *Inside Credit Policy*, January 2006, pages 4-5. (https://www.moodys.com/sites/products/AboutMoodysRatingsAttachments/2005200000425263.pdf.)

and Co-Chief Operating Office Mr. Brian Clarkson. He hesitated before replying that the regulators were "aware of the issue."[52]

Mr. Clarkson's evasion was standard Moody's practice. The ABS and banking franchises maximized revenues by minimizing the respective capital implications for both deal and dealer that were party to a flip-clause-swap-contract. No Moody's financial analyst pro-actively measured issuers' derivative exposures, let alone tracked the walk-away provisions in master swaps with DPCs or the flip clause exposure to ABS deals.[53]

53. My managers in the US Derivatives Group set the example.[54] ***Firstly***, the Derivatives Group did *not* abide by Moody's-2006-Hedge-Framework in ratings *cashflow* CDOs and *cashflow* CLOs from 2006 to 2013. Instead, managers allowed issuers to cherry pick the most lenient parameters from Moody's-2002-

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52 WJH-Letter-Moody's-Madelain-10-26-2012, page 5.

53 As example, "Moody's Announcement: March 29, 2007." "The rating does not address any payments that may be due to the Class Al Swap Counterparty upon the early termination of the Class Al Swap." (https://www.moodys.com/research/**Moodys-rates-the-Class-V-Funding-III-Ltd-offering-from**--PR_126229.)

54 Moody's Derivatives managers regularly helped Goldman Sachs Mitsui Marine Derivative Products misrepresent the outsize exposures being accumulated under flip-clause-swap-contracts. WJH-Letter-Moody's-Madelain-04-01-2013, pages 10-11 (HTML pages 25-26 in WJH-SEC-Comment-06-03-2013.) "Managers provided letters upon request from GSMMDP as a 'business accommodation' stating that the senior-most debt of CDO issuers that were counterparty to GSMMDP was rated Aaa."

CDO-Framework and Moody's-2006-Hedge-Framework. Accordingly, issuers such as Lancer Funding II, Ltd jerry rigged flip-clause-swap-contracts that required less capitalization than a contract that fully adhered to either the 2002 or the 2006 framework.[55]

Secondly, Moody's managers allowed issuers of *synthetic* ABS to use Moody's-2006-Hedge-Framework in the first place. The 2006 framework excluded "synthetic transactions, such as credit default swaps and synthetic CDOs."[56]

54. Moody's still ignores issuer exposure to derivative contracts, including from flip clauses and walkway provisions, in maintaining ***ALL*** ratings (e.g., ABS, corporate, financial, municipal, and sovereign.) Ditto DBRS, Fitch Ratings and S&P Global.[57]

55. Accordingly, I respectfully request permission to file the Proposed Brief.

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55 Emails of Moody's analysts, manager Yvonne Fu, and UBS banker, May 22-23, 2007, US Senate Permanent Subcommittee on Investigations, *"Wall Street and the Financial Crisis: Anatomy of A Financial Crisis,"* footnote 1084 and pages 0626-0629. (https://archive.org/stream/283228-sandp0112/283228-sandp0112_djvu.txt.)

56 Moody's-2006-Hedge-Framework, footnote 2.

57 Harrington, Bill, "Moody's bets Germany will support Deutsche Bank derivatives above all else," *Debtwire ABS*, 12 October 2016. (https://www.debtwire.com/info/**moody**%E2%80%99s-**bets-germany-will-support-deutsche-bank-derivatives-above-all-else**-%E2%80%94-analysis.)

Dated: New York, New York

June 25, 2019

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