

**From:** Bill Harrington <[wjharrington@yahoo.com](mailto:wjharrington@yahoo.com)>  
**To:** "[ombudsman@sec.gov](mailto:ombudsman@sec.gov)" <[ombudsman@sec.gov](mailto:ombudsman@sec.gov)>  
**Cc:** "[orolh@sec.gov](mailto:orolh@sec.gov)" <[orolh@sec.gov](mailto:orolh@sec.gov)>; "[norbergj@sec.gov](mailto:norbergj@sec.gov)" <[norbergj@sec.gov](mailto:norbergj@sec.gov)>; "[saloni\\_sharma@warren.senate.gov](mailto:saloni_sharma@warren.senate.gov)" <[saloni\\_sharma@warren.senate.gov](mailto:saloni_sharma@warren.senate.gov)>; "[stephanie\\_akpa@warren.senate.gov](mailto:stephanie_akpa@warren.senate.gov)" <[stephanie\\_akpa@warren.senate.gov](mailto:stephanie_akpa@warren.senate.gov)>; "[christopher\\_huntley@warren.senate.gov](mailto:christopher_huntley@warren.senate.gov)" <[christopher\\_huntley@warren.senate.gov](mailto:christopher_huntley@warren.senate.gov)>; "[ariel\\_oxman@warren.senate.gov](mailto:ariel_oxman@warren.senate.gov)" <[ariel\\_oxman@warren.senate.gov](mailto:ariel_oxman@warren.senate.gov)>; "[susannah\\_savage@warren.senate.gov](mailto:susannah_savage@warren.senate.gov)" <[susannah\\_savage@warren.senate.gov](mailto:susannah_savage@warren.senate.gov)>; "[macchiarolim@sec.gov](mailto:macchiarolim@sec.gov)" <[macchiarolim@sec.gov](mailto:macchiarolim@sec.gov)>; "[mcgowant@sec.gov](mailto:mcgowant@sec.gov)" <[mcgowant@sec.gov](mailto:mcgowant@sec.gov)>; "[royr@sec.gov](mailto:royr@sec.gov)" <[royr@sec.gov](mailto:royr@sec.gov)>; "[SwartzS@sec.gov](mailto:SwartzS@sec.gov)" <[swartzs@sec.gov](mailto:swartzs@sec.gov)>; "[foxt@sec.gov](mailto:foxt@sec.gov)" <[foxt@sec.gov](mailto:foxt@sec.gov)>; "[dengv@sec.gov](mailto:dengv@sec.gov)" <[dengv@sec.gov](mailto:dengv@sec.gov)>; "[kostyukovskyn@sec.gov](mailto:kostyukovskyn@sec.gov)" <[kostyukovskyn@sec.gov](mailto:kostyukovskyn@sec.gov)>; Cezary Podkul <[cezary.podkul@wsj.com](mailto:cezary.podkul@wsj.com)>  
**Sent:** Tuesday, December 4, 2018 5:54 PM  
**Subject:** Senator Elizabeth Warren Questions Re: Leveraged Loans / CLOs / Volcker Rule / NRSRO Credit Ratings

Dear Ombudsman,

My name is Bill Harrington. I am a private US citizen who has provided assessments of the inflated NRSRO ratings of structured finance debt such as collateralized loan obligations (CLOs) and student loan asset-backed securities (SLABS) to your office, the Office of Credit Ratings, and the Office of the Whistleblower.

[Wikirating.org](http://Wikirating.org) has posted some of my communications with your colleagues and you, as well as other of my communications on related topics with Commodities Futures Trading Commission (CFTC) staff and with NRSRO rating analysts. I have served as a Key Expert -- Structured Finance Topics on the Wikirating Experts Board since 2013.

I am also a senior fellow at Croatan Institute, an independent, nonprofit research institute whose mission is to harness the power of investment for social good and ecological resilience by working at the critical nexus where sustainability, finance, and economic development intersect. My Croatan Institute Working Paper "[Can Green Bonds Flourish in a Complex-Finance Brownfield?](#)" synthesizes and memorializes my 20-year research on the inflated NRSRO ratings and under-capitalization of structured debt such as CLOs and SLABS and of all parties to a derivative contract.

**I am writing to you regarding three interconnected items:**

- (1) the letter pertaining to leveraged corporate lending and CLOs that US Senator Elizabeth Warren addressed to five regulators, including Chairman Clayton, on November 14, 2018;
- (2) my comment response "[Full Margin Posting + 100% Capital Charge for a Security-Based Swap with a Flip Clause or Walkaway Provision](#)" of November 19, 2018; and
- (3) information that I have provided to the Office of the Whistleblower, including "[S&P Violations of SEC Rules in Rating US CLOs with Waterfall Flip Clauses, US SLABS with Flip Clause Swaps, and Navient.](#)"

(As a note, I opt **not** to be considered for a whistleblower award in conjunction with the information and analyses that I provide to the Office of the Whistleblower. As corroboration, I quote from the acknowledgement letter that Chief of the Office of the Whistleblower Jane Norberg sent on February 21, 2018. "Thank you for the information that you submitted under the SEC's Whistleblower Program." II "It is now required that you submit a signed Form-TCR (including the declarations page) in order to be considered for a whistleblower award. You are encouraged to submit the form using our-online questionnaire, which you can access

at [www.sec.whistleblower.com](http://www.sec.whistleblower.com). That website also has a link to a pdf of the Form-TCR that you may also complete and sign and send to us via hard copy at Office of the Whistleblower, 100 F Street, NE, Mail Stop 5971, Washington, DC 20549 or fax it to (703) 813-9322." Similarly, I opt **not** to be considered for a whistleblower award in conjunction with the information and analyses that I provide to the CFTC and other regulators.)

This email copies: the SEC Office of Credit Ratings; the SEC Office of the Whistleblower; five staff members of Senator Warren; the seven staff members whom the SEC listed as contacts regarding the proposed rule "Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers" [Release No. 34-84409; File No. S7-08-12]; and Cezary Podkul, Senior Reporter at The Wall Street Journal.

**Senator Warren posed the following questions to Chairman Clayton in her letter of November 14.**

"[Question] 6. Do you have concerns about the CLO market for leveraged loans?"

"[Question] 7. As you know, the Dodd-Frank Act established an Office of Credit Ratings within the SEC that is responsible for promoting the accuracy of credit ratings issued by Nationally Recognized Statistical Ratings Organizations (NRSROs) and ensuring that such ratings are not unduly influenced by conflicts of interest or sales considerations."

--- "a. In your supervision of NRSROs, do you find any evidence that ratings of leveraged loans and CLOs are lacking in accuracy or are unduly influenced by conflicts of interest or sales considerations?"

--- "b. How is the increasing prevalence of 'covenant-light' loans incorporated into the formal NRSRO ratings of such loans? For example, are the 'covenant score' metrics generated by certain NRSROs incorporated or taken into account in their methodologies for producing ratings of securitized products, bonds, or notes related to those leveraged loans?"

My comment response of November 19 and my Croatan Institute Working Paper both identify inflated NRSRO ratings of CLOs with flip clauses and of CLO marketing structures such as re-packaged notes with flip clauses and CLO combination securities. As an historical note, flip clauses, re-packaged notes, and combination securities were integral to the collateralized debt obligations that ignited, fueled, and prolonged the financial crisis.

Regarding my comment response of November 19, please enable all hyperlinks for the respective primary sources. My comment response is the only one of [the 16 comment responses dated on or after November 19, 2018](#) in which the SEC has disabled most hyperlinks. As example, please enable the hyperlink for the US Department of Justice announcement of the settlement with Moody's Corporation and affiliates of January 13, 2017 on page 2. As part of the settlement, Moody's agreed to compliance commitments regarding the uniform application of rating methodologies for the ensuing five years. Moody's may well have breached the commitments with respect to the ratings and methodologies for CLOs with flip clauses in the priorities of payments viz-a-viz CLOs without flip clauses in the priorities of payments. Similarly, Moody's may well have breached the commitments with respect to the ratings and methodologies of CLO marketing structures such as repackaged notes with flip clauses and CLO combination securities.

Regarding my Croatan Institute Working Paper, please see Section 10 "Green around the gills: US CLOs and student loan ABS drip with flip clauses (-10)." Please note the following from pages 24-25.

*"For instance, dealmakers have sold many new, AAA-rated CLO tranches directly into a second security denominated in Japanese yen, added a flip clause swap but no additional resources, and still obtained a pass-through of the AAA-rating. Technically, the repackaged foreign securities and not the underlying CLO debt are party to the respective flip clause swaps, which are cross-currency, balance guaranteed, and medium-to-long term. The two layers of CLO ownership, along with the flip clause swap, increase the extent of capital shortfall relative to the AAA-rating."*

Please also see Section 11 "Grading the US push to reverse Dodd-Frank and revive crisis-causing mortgage deals (US RMBS and CLO sectors both pushing to revive flip clause swaps)." Please note the following two paragraphs from pages 25-26.

*"A sizable number of CLO dealmakers have also been betting on a revival of flip clause swaps, as evidenced by their placing flip clauses in the priorities of payments of new deals. The deals are not yet party to flip clause swaps owing to the US swap margin rules. However, the flip clauses, which are presumably placeholders should the US bank regulators and the CFTC exempt CLO deals from the swap margin rules at a later date, represent a clear-cut choice and not happenstance. Many new CLOs have flip clauses and the remainder do not. **Moreover, no CLO deal with a flip clause can enter into a swap that complies with the swap margin rules because none of the CLO deals have the capital, legal, and operation capacities to exchange daily margin** [bold added]."*

||

*"Rating agencies also seem to be betting on a policy revival of flip clause swaps, as evidenced by the companies assigning top ratings to CLO notes irrespective of whether a deal has flip clauses in the priorities of payments. **The widespread rating practice may well violate SEC rules, but the SEC generally overlooks rating violations** [bold added]. With respect to Moody's, the practice may also violate the company's settlement with the US Department of Justice and the attorneys general of 21 states and the District of Columbia of January 13, 2017."*

Also, regarding my Croatan Institute Working Paper, please see Section 4 "Code red! Rating agencies claim 'free speech' protects designed-to-fail deal specifications." The section describes the ongoing SEC policy of incentivizing NRSROs to inflate ratings and to preserve demonstrably deficient rating methodologies for all structured debt, including CLOs and related marketing structures. In particular, please note the following two paragraphs on pages 10-11.

*"The SEC backs the unsubstantiated "free speech" of Moody's, S&P, and the other rating agencies that have registered as nationally recognized statistical rating organizations (NRSROs) to the hilt. Most notably, the SEC continues to shield NRSROs from a Dodd-Frank provision that subjects them to expert liability in certain instances of assigning ABS ratings. Had the provision — Dodd-Frank Section 939G — taken automatic effect on 22 July 2010 as plainly specified, NRSROs would almost certainly have retired the respective methodologies for flip clause swaps, many ABS, and other crisis-causing products."*

||

*"This author's research unearthed the disquieting information that the SEC acted preemptively to prevent Dodd-Frank Section 939G from taking effect. The preemption sequence — an incoming letter from two Ford Motor Company entities that requested suspension of the provision, followed by the SEC no-action letter that effectuated the suspension — appeared to be market generated but in fact was orchestrated by the SEC."*

With respect to "covenant-lite" leveraged loans and CLO ratings, NRSROs play both sides of the fence. As example, Moody's Investors Service lowered the forecasts for leveraged loan recoveries in market commentaries while retaining out-dated, higher leveraged loan recoveries as key inputs for assigning and monitoring CLO ratings. See "[Announcement: Moody's: Convergence of loan and high-yield bond markets sets stage for lower recoveries in next downturn](#)" of August 16, 2018.

**Senator Warren posed the following question to Chairman Powell, Comptroller Otting, Chairman McWilliams, and Chairman Clayton in her letter of November 14.**

"[Question] 2. "The Volcker Rule is intended to restrict bank involvement with external funds, including securitizations. Securitizations like CLOs are central to the leveraged lending market. Trade associations have asked you to significantly loosen Volcker Rule controls on bank involvement with CLOs, and questions in your latest Volcker Rule proposal suggest you are considering greatly broadening permissible external funds activities by banks. Expanding securitization exemptions as requested by industry trade groups could significantly increase such holdings and produce bank involvement in more complex CLO re-securitizations and synthetic securitizations. Have you investigated how such liberalization in Volcker Rule standards could affect underwriting in the leveraged lending market, and whether it could lead to a proliferation of complex leveraged lending securitizations that would be more difficult for ratings agencies and investors to assess?"

The flip clause in the priorities of payment of many US CLOs is one mechanism by which the respective CLOs can leverage any changes to the Volcker Rule that allow CLOs to securitize, among other assets, ones that are: denominated in a second currency; fixed-rate; re-securitizations; or synthetic securities. Investors will certainly have a much more difficult time assessing CLOs that securitize the above-mentioned types of assets. In contrast, each NRSRO could easily make accurate assessments, but instead will continue to inflate the associated CLO ratings in order to preserve CLO rating franchises.

I will ask Wikirating.org to post this email.

Best regards,

Bill Harrington  
917-680-1465