William J. Harrington
[redacted]

July 21, 2022

Ms. Vanessa Countryman
Secretary, Office of the Secretary
U.S. Securities and Exchange Commission
100 F St. NE
Washington, DC 20549-1090

Ms. Kruti Muni
Managing Director – Structured Finance
Moody's Investors Service
7 World Trade Center at 250 Greenwich Street
New York, NY 10007

Copy: Office of Credit Ratings, U.S. Securities and Exchange Commission; Supervision of Credit Rating Agencies, European Securities and Markets Authority; and Credit Rating Supervision, UK Financial Conduct Authority

Via Electronic Mail

Re: **Petition for Rulemaking Submitted to the SEC** ***("I seek a rulemaking by the Commission that prohibits a security-based swap dealer or other entity subject to Commission regulation from predicating a security-based swap or other financial instrument subject to Commission regulation on a flip clause, walk-away, or variable subordination.")***
AND
Moody's Investors Service Request for Comment "General Principles for Assessing ESG -- Structured Finance" (June 6, 2022)

Dear Ms. Countryman and Ms. Muni,

My name is Bill Harrington. I am senior fellow at the non-profit research and action entity Croatan Institute.
Bill Harrington - Croatan Institute

The entirety of this letter and of the five other documents that the delivering email attached is a joint submission to the SEC and to the NRSRO credit rating company Moody's Investors Service, respectively.

I petition the SEC to permanently ban the flip clause in the United States of America and exhort Moody's Investors Service to neutralize the flip clause globally by amending its proposed ESG methodology for structured finance.

Here's why the flip clause must be eradicated.

> "*The flip-clause-swap-contract was a root cause of the 2008 global financial catastrophe. The flip-clause-swap-contract was an integral component of the under-capitalized structured debt that started, fueled, and pro-longed the 2008 financial catastrophe. The flip-clause-swap-contract was a tool that financial institutions such as AIG, Bear Stearns, Lehman Brothers, and many others used to under-capitalize themselves. The flip-clause-swap-contract was a tool that Greece, with the active assistance of Goldman Sachs, used to crash its own economy.*"
> 20201228_Harrington_J_William_Flip_Clause_Questions_to_CFTC-SEC-LSTA-SFA-DBRS-Fitch-Moodys-SP.pdf (croataninstitute.org)
> — Page 3

Here's why the SEC and Moody's must act to eradicate the flip clause.

> *The flip clause is a spectacularly egregious market failure that financial practitioners refuse to fix. "**Every party that agreed to, guaranteed, or endorsed a flip clause generated the financial crisis. None was a blindsided casualty.**"*
> — Ibid, Page 3

Here's why joint action by both the SEC and Moody's is necessary.

> *The SEC regulates certain **providers** of a swap with a flip clause, whereas Moody's assigns structured finance ratings to most structured finance transactions globally that are or can **be end-users** of a swap with a flip clause.*

For a compendium of representative swaps with a flip clause, of representative structured finance transactions party to a swap with a flip clause, and of representative providers of a swap with a flip clause, please see my Croatan Institute *Working Paper* "Can Green Bonds Flourish in a Complex-Finance Brownfield?" (July 2018), pages 32-38.
Can Green Bonds Flourish in a Complex-Finance Brownfield? - Croatan Institute

By operation of law and of policy, the SEC must either make the joint submission publicly available on the "Petitions for Rulemaking Submitted to the SEC" tab or immediately inform me as to why not. I have re-submitted the petition several times since January 17, 2022, to perfect it to SEC requirements.

Once the SEC posts the joint submission, I will publicize the posting so that others may submit comments to the SEC pertaining to the petition and to the flip clause. Furthermore, I will use the same SEC comment feature to post additional materials and analyses that support the petition and to rebut comments to preserve the flip clause.

The entirety of the joint submission, i.e., this letter and the five other documents that the delivering email attached, is my response to Moody's Request for Comment "General Principles for Assessing ESG Risks: Proposed Methodology Update – Structured Finance Appendix," June 6, 2022. Moody's ESG comment request is the second attachment to the delivering email.

I provided Moody's with the joint submission via its "Request for Comment" tab on July 21, 2022 at 8.20 am EDST. I insist that Moody's make the joint submission publicly available via an operational link on the same tab. In the past, Moody's has blocked access to my critiques of its ESG methodologies by assigning them inoperative links.

Croatan Institute posts the joint submission on my bio page.

The joint submission copies the respective supervisory offices for credit rating companies at the SEC, the European Securities and Markets Authority, and the UK Financial Conduct Authority. Individually and collectively, the regulators knowingly greenlight credit rating companies to undermine economies, destabilize financial systems, and deceive the public by relentlessly purveying flip clause misinformation. As a result, credit rating companies continually adulterate credit rating methodologies, inflate credit ratings, and vitiate credit rating announcements by infesting them with flip clause falsehoods.

Financial practitioners worldwide join credit rating companies in perpet rating flip clause damage.

> ***The flip clause is a collective governance failure by academicians, accountants, auditors, bankers, bond analysts, consultants, counsel, credit analysts, ESG evaluators, equity analysts, financial regulators, investors, issuers, journalists, market analysts, pricing evaluators, risk managers, swap providers, traders, trustees, and underwriters.***

I have produced far and away the most comprehensive public domain work on the flip clause of any person worldwide. I began examining the capitalization, credit ratings, law, market practices, and regulation of each of the two parties to a swap with a flip clause upon joining Moody's Derivatives Group as vice president / senior analyst in 1999. I co-authored several Moody's global

credit rating methodologies for a structured finance issuer that is *an end-user* of a swap with a flip clause, as well as several corresponding global credit rating methodologies *for a provider* of a swap with a flip clause.

In July 2010, I resigned as senior vice president in Moody's Derivatives Group because Moody's refused to rigorously assess glaringly obvious flip clause failures that were root causes of 2008 financial calamities. For the same reason, I refused an unsolicited offer to join Moody's Credit Policy Group as senior vice president with responsibilities for overseeing development and content of credit rating methodologies, including ones for a party to a swap with a flip clause.

Since 2011, I have pursued full-time and almost entirely uncompensated private-citizen advocacy to permanently eradicate the flip clause. My work boosts the sustainability of the world financial system with the dual aims of rationalizing economic decision-making and avoiding bailouts. I focus on governance decisions in the financial sector that establish the capitalization and regulation of complex finance, particularly derivative contracts and structured finance products.
Injecting Accountability into the U.S. and Global Financial Systems - Croatan Institute

In 2019, I, a non-attorney, successfully submitted a motion to file an amicus curiae brief with the U.S. Court of Appeals for the Second Circuit in respect of a massive Lehman Brothers bankruptcy case regarding the zero-sum essence of the flip clause that imposed 100% losses on the Lehman estate. The entirety of my motion to file details my flip clause work both at Moody's and after resigning.
WJH Motion to File Amicus Brief in 2nd Circuit Case 18-1079 bk Lehman Brothers vs the World.pdf (croataninstitute.org)

Pages 1-6 of my proposed amicus curiae brief show that the entire financial sector lost sizeable amounts under swaps with a flip clause. In other words, the entire financial sector knows first-hand that flip clause deficiencies were root causes of 2008 financial calamities.
WJH Proposed Brief in 2nd Circuit Case 18-1079-bk Lehman-Brothers vs the World.pdf (croataninstitute.org)

> "*The flip clause is the global ABS sector's: 1. best practice; 2. black hole; 3. Escher-staircase-to-nowhere; 4. foundation; 5. nifty lawyering; 6. original sin; and 7. quicksand.*"
>
> II
>
> *"Parties that refer to a flip clause in making payments under a swap contract knowingly drafted it to fail. The plaintiff-appellant, defendants-appellees, and other crisis-causing entities routinely embedded ABS deals with flip-clause-swap-contracts, thereby wrecking our economy and undermining our Country."*
>
> — Page 20

My proposed amicus curiae brief articulates what the SEC, Moody's, other NRSROs, and financial practitioners globally know. The flip clause cannot work in law, cannot work in practice, and cannot work in theory. My brief also documents the role of the swap with a flip clause in imploding the U.S. and European economies and financial systems in 2008 and delaying recovery thereafter.

> "*Indeed, dealers such as AIG, Bank of America, Barclays Bank, Bear Stearns Financial Products, Deutsche Bank, Goldman Sachs, JPMorgan, and Merrill Lynch preserved assets under most flip-clause-swap-contracts with zombie CDO and RMBS deals. Each dealer maximized the value of a given flip-clause-swap-contract by allowing the deal to continue paying according to schedule rather than by terminating the contract and risking a fire-sale shortfall.*"
> — Page 45

> "*The flip-clause-swap-contract was central to the EU financial crisis. Even so, EU issuers of RMBS and other ABS use the flip-clause-swap-contact under policy that the US has prudently rejected.*"
> — Page 38

In 2015-2016, I examined the use and regulation of swaps with a flip clause as a byline reporter for *Debtwire ABS*, a provider of daily information on structured finance deals. The joint submission contains four of my *Debtwire ABS* articles that pertain to the flip clause, one linked immediately below and the third, fourth, and fifth documents that the delivering email attaches.
Existing ABS swaps also caught in swap margin net — ANALYSIS - Debtwire

> "*Lastly, margin posting may well consign flip clauses to where they belong — the dustbin of discredited schema that issuers used to construct deals that failed during the financial crisis. Litigation will continue for as long as flip clauses are included in ABS because a flip clause can't possibly work for both an issuer and a swap provider. One or the other will take a significant loss even before the legal fees kick in." II "Even so, many CLO issuers are holding on and still inserting flip clauses in priorities of payments, as reported on 4 August. Additional review shows 13 of 25 CLOs that have closed since 24 May contain flip clauses, according to the respective rating reports.*"

My 2018 Croatan Institute *Working Paper* "Can Green Bonds Flourish in a Complex-Finance Brownfield?" documents that Dutch issuers of residential mortgage-backed securities routinely use the swap contract with a flip clause, and that a majority of U.S. CLO issuers place flip clauses in priorities of payments despite lacking resources to comply with U.S. swap margin rules.
Can Green Bonds Flourish in a Complex-Finance Brownfield? - Croatan Institute

"*A sizeable 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.*"

II

"*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. 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 14, 2017.*"

— Pages 25-26

In 2020, I submitted a petition to the U.S. Commodity Futures Trading Commission seeking a rulemaking "*to prohibit a swap dealer, major swap participant, or other regulated entity from predicating a swap obligation on a flip clause, walk-away, or variable subordination.*"
CFTC-WJH-2020-6-26-Sec-13.1-Rulemaking-Petition-Acknowledgment_WJHarrington_06-26-2020.pdf (croataninstitute.org)

In 2021, I obtained information from the CFTC in response to a Freedom of Information Act request that undermined the regulator's rationale for dismissing flip clause deficiencies in a major cross-border rule-making. The FOIA information showed that CFTC had developed no in-house information on the flip clause but instead relied on my submissions and communications. See the sixth attachment to the delivering email.

"*Dear Mr. Harrington, This is in response to your request dated December 17, 2020, under the Freedom of Information Act seeking access to [all information pertaining to 'swap transactions involving flip clauses' that the Commission either used or uses in establishing that it 'believes' that the 'standardized market risk capital charges' in Commodity Futures Trading Commission 'Capital Requirements of Swap Dealers and Major Swap Participants' (September 15, 2020) 85 FR 57465 are 'effective and appropriately calibrated'. …]*"

— Page 2

In 2022, I self-nominated myself to, and provided topics for, two CFTC advisory committees. WJH-to-CFTC-Re-Global-Markets-Advisory-Committee-Market-Risk-Advisory-Committee-June-17-2022.pdf (croataninstitute.org)

Here is the first topic that I proposed.

> "*The non-margined and non-cleared swap contract with a flip clause, walk-away, or other variable subordination provision: Harm to the public interest, to economic efficiency, competition, and capital formation in the debt and derivative sectors, and to financial stability*"
> — Page 2

Today, I submit the following petition to the Commission.

> "***I petition the Commission to issue a rule-making that prohibits a security-based swap dealer or other entity subject to Commission regulation from predicating a security-based swap or other financial instrument subject to Commission regulation on a flip clause, walk-away, or variable subordination.***"

The entirety of the joint submission, including all references herein, state my interest in the petition and my reason for requesting Commission action.

Today, I propose that Moody's neutralize the flip clause globally by amending its proposed ESG methodology for structured finance.
N.B. Quotes are excerpts from Moody's proposed ESG methodology.

Moody's must amend its ESG methodology for structured finance to specify that an issuer or other controlling party anywhere in the world that is or can be exposed to a flip clause—namely any structured finance transaction with a flip clause in the priorities of payments or whose issuer can otherwise enter a swap with a flip clause or is a party to a swap with a flip clause—exercises negligently deficient governance by knowingly and intentionally exposing structured finance debt to outsized expected losses.

As consequence, *"[i]f this cross-sector methodology is updated as [this joint submission] proposed, there will be*" **massive** "*changes to outstanding ratings for structured finance transactions*" globally. Massive changes to structured finance credit ratings around the world—**specifically, steep downgrades to structured finance credit ratings around the world**—are long overdue. To enact the steep downgrades, Moody's must amend the proposed ESG methodology to specify that structured finance debt that is or can be exposed to a flip clause has a credit rating at least three sub-notches below that of otherwise similar debt that is not and cannot be exposed to a flip clause.

To scale the outsized expected losses that a flip clause imposes on different types of structured debt viz-a-viz the debt of issuers that cannot use the flip clause, or to scale the outsized losses that different types of swap with a flip clause impose on a swap provider viz-a-viz otherwise similar swaps without a flip clause, please see my Croatan Institute *Working Paper* "Can Green Bonds Flourish in a Complex-Finance Brownfield?" (July 2018), pages 32-38.
Can Green Bonds Flourish in a Complex-Finance Brownfield? - Croatan Institute

Moody's should have long ago publicly posted a rigorous flip clause study—i.e., should have long ago produced the scale that my Croatan Institute Working Paper proposes. Since 1993, Moody's has tracked the performance of most structured finance issuers worldwide that place a flip clause in the priorities of payments, or can otherwise enter a swap with a flip clause, or are party to a swap with a flip clause. Similarly, since 1993, Moody's has tracked the performance of structured finance operating companies that provided swaps with a flip clause. Finally, Moody's has assigned a variety of assessments to many swaps with a flip clause.

For my part, I have repeatedly urged Moody's to enact basic self-governance by posting a rigorous flip clause study both during and after my Moody's tenure. As recent example, please see my letter to the SEC, Moody's, et al "Deficient Accounting, Capitalization, Credit Ratings, and Regulation of EVERY Party to a Swap Contract with a Flip Clause or Other Walk-Away Provision" (December 28, 2020), "Questions for DBRS, Fitch, Moody's and S&P," pages 19-23.
20201228_Harrington_J_William_Flip_Clause_Questions_to_CFTC-SEC-LSTA-SFA-DBRS-Fitch-Moodys-SP.pdf (croataninstitute.org)

With the changes to Moody's ESG methodology that this joint submission proposes, and backed by exacting, 30-year empirical evaluation of the flip clause around the world that Moody's can easily produce, Moody's "*assessment of a transaction's exposure to ESG risks and benefits would be primarily*" **quantitative.** Moody's will first meticulously measure and then accurately "*describe considerations that are generally applicable across structured finance transactions.*" Moreover, Moody's "*qualitative assessment*" will "*be informed by quantitative metrics*" that Moody's develops "*for all rated transactions*" using Moody's own comprehensive data that the entire world can examine. The result? Moody's credit ratings for structured finance transactions globally **will be** more accurate and informative, **will** "*consistently present E, S and G IPSs and CISs across structured finance asset classes*," and **will not** "*vary among structured finance asset classes*."

To neutralize the flip clause, Moody's must also amend its ESG methodology to increase "*specific governance risk categories for structured finance*" to include at least one category for an issuer that has exposed structured debt to a flip clause or can expose structured debt to a flip clause. The "*specific governance risk*" category would be among the worst, and the most punitive with respect to expected losses.

Accordingly, Moody's must assign an exceptionally high "*G[overnance] IPS to all structured finance transactions*" with a flip clause in the priorities of payments or whose issuer can enter a swap with a flip clause or is party to a swap with a flip clause "*since they are by design*" greatly "*exposed to governance risks*." Commensurate with the exceptionally high "*G[overnance] IPS*," Moody's will assign an exceptionally high expected loss and an exceptionally low credit rating to all structured finance debt with a flip clause in the priorities of payments or whose issuer can enter a swap with a flip clause or is party to a swap with a flip clause.

In contrast, Moody's will only "*assign a Neutral-to-Low G[overnance] IPS to most structured finance transactions*" that **cannot** be exposed to a flip clause, namely any structured finance transaction with **no** flip clause in the priorities of payments whose issuer **cannot** otherwise enter a swap with a flip clause and is **not** party to a swap with a flip clause. A structured finance transaction that cannot be exposed to a flip clause is *by design less exposed to governance risks*" than a structured finance transaction that is or can be exposed to a flip clause. Commensurate with the "*Neutral-to-Low G[overnance] IPS to most structured finance transactions*" that cannot be exposed to a flip clause, Moody's will assign the corresponding structured finance debt lower expected losses and higher credit ratings viz-a-viz otherwise similar structured finance debt that is or can be exposed to a flip clause.

Sincerely yours,

Bill Harrington