

ABS/MBS Disclosure Update #5: Reaction to the Comment Letters

4 August 2004

I. Introduction

The comment period for the SEC's ABS/MBS disclosure proposal¹ officially ended on July 12, but letters continued to trickle in after that date. We reviewed a sampling of the letters and found that they cover a wide range of topics. In addition, although we found many specific comments that appear entirely reasonable, we also found many that appear unreasonable. This note expresses our reactions to selected comment items.

The SEC received more than forty comment letters in response to its proposal. In addition, the SEC included a number of older letters in the file. The letters are available on the SEC's website.² Listings of the new letters and the old ones appear in Appendix A and Appendix B, respectively.

Two of the oldest letters are arguably the most important ones in the comment file. Those two are the letters submitted by the Association for Investment Management and Research (AIMR) and by the Investment Company Institute (ICI). Those letters likely rank high among the factors that originally prompted the SEC to pursue ABS/MBS disclosure issues in the first place.

As a whole, the new letters offer a seemingly lopsided collection of comments. Of the new letters, only three come from the buy-side: two investors and the ICI submitted comment letters. We find the buy-side's reticence somewhat disappointing and we expect that the SEC's Staff will share our disappointment. The Staff asked for comments and most of the buy-side ignored the request. If investors are dissatisfied with the final rules, they arguably will have to place some of the blame on themselves.

In contrast, the sell-side was heavily represented in the new comment letters. The SEC received fourteen comment letters from issuers and underwriters, and roughly again as many from trade associations that represent primarily sell-side entities. The legal community and others account for the remainder of the new letters.

The *longest* comment letter (157 pages) came from the American Securitization Forum (ASF). The ASF billed itself as the spokesperson for the securitization industry and, in fact, a majority of the comment letters from issuers or underwriters explicitly endorsed the ASF letter (see Appendix A). However, none of the three buy-side letters did so. In addition, the ASF letter specifically does not address the issue of static pool data because it had not achieved a "true consensus" on the issue.³ Based on the overall content of the ASF letter, we feel that it primarily represents sell-side views.

¹ Securities and Exchange Commission, Asset-Backed Securities, Release Nos. 33-8419, 34-49644, 69 Fed. Reg. 26650 (13 May 2004). The release is available online from the SEC's website at <http://www.sec.gov/rules/proposed/33-8419.htm> or <http://www.sec.gov/rules/proposed/33-8419.pdf>.

² <http://www.sec.gov/rules/proposed/s72104.shtml>

³ ASF comment letter of 7/12/04 at 5.

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Subsequently, the ASF submitted a second comment letter specifically addressing static pool data.⁴ Even there, clear disagreement between the buy-side and the sell-side was evident. Although the second letter gave its main emphasis to sell-side views, the buy-side was not entirely shut-out.⁵

II. Specific Items

Some of the comments struck us as extremely important and some seemed incomplete. Following are our reactions to a dozen particular items:

A. Static Pool Data – Items 1100(b), 1104(e)

As a general matter, static pool or vintage data is absolutely material and relevant to investors. Investors crave static pool data and issuers routinely provide it on their websites and through third party data vendors such as Intex, BloombergSM, and ABSNet. Moreover, the rating agencies have long identified static pool data as one of the most important types of data for analyzing the credit quality of assets destined for securitization. Therefore, it is somewhat surprising that several letters from the sell-side argue that static pool data is not material.⁶

However, depending on the context, the degree of detail with which an issuer should be required to display static pool data is reasonably debatable. For example, federally guaranteed student loans arguably should not need the same degree of extensive static pool disclosure as asset classes that display greater credit performance variability. Likewise, for master trusts backed by revolving pools, "vintage performance data" is a superior substitute for static pool data. And, admittedly, in a few exceptional cases, such as some CMBS, historical performance data about loans not included in a deal may not be relevant at all.

Therefore, we feel that while still adhering to a principles-based paradigm, the SEC could alleviate much angst on the part of issuers and underwriters by providing "Industry Guides" for the major asset classes.⁷ Industry guides could harmonize practices among issuers and provide the greater comparability that investors seek.

B. Incorporation by Reference

The SEC should broadly encourage issuers to use "incorporation by reference" as the means of including quantitative data in their prospectuses. Issuers could then file and periodically update the data in the ordinary course of business. This could help streamline the hectic process of bringing new deals to market. Encouraging the use of incorporation by reference may help alleviate frustrations voiced by some issuers.

C. Data File Formats

Market participants are generally able to use computer data files in any standard format (cdi, xls, csv, pdf, etc.). Virtually all market participants would benefit from being able to find the files on EDGAR and to download them for analysis into their computers.⁸

⁴ ASF comment letter of 7/30/04.

⁵ *Id.* at 6, 7 & n.4.

⁶ *See, e.g.*, UBS comment letter at 3; MBNA comment letter at 4-10; Capital One comment letter at 5; ASF comment letter of 7/30/04 at 3; *compare* Toyota comment letter at 8-9; JP Morgan Chase comment letter at 3-7.

⁷ State Street Global Advisors comment letter at 6.

⁸ *Cf.* MetLife comment letter at 2; ASF comment letter of 7/12/04 at 86, 97.

D. Aggregated '34 Act Filings

Aggregated '34 Act filings may be more convenient for investors. If the SEC allows such filings, an investor would potentially be able to get complete performance data on all of an issuer's deals by downloading a single file from EDGAR.⁹

E. Transition Period

The market is facing significant changes to the registration, disclosure, and reporting framework for ABS and MBS. There should be a substantial transition period to allow market participants to adapt to the new regime. A transition period even as long as a year might be appropriate.

There should be only limited "grandfathering" of old deals with respect to '34 Act reporting.¹⁰ For old deals, the '34 Act reporting requirement should be limited to filing reports that already are sent to investors.

No market participant can legitimately claim to have been blind-sided by the SEC's proposal. The letters from 1996 prove this.

F. Ownership of Residual Interests – Item 1112(d)(1)

Ownership of residual interests is relevant to ABS/MBS investors.¹¹ Often the owner of a deal's residual interest has the option to excise a "clean-up call" after the balance of the underlying collateral has declined to a predetermined level (e.g., as a result of scheduled amortization, prepayments, or losses.). If a frequent issuer retains the residual interests in its deals, it may establish a routine practice of exercising clean-up calls in order to satisfy investors' desires for stability and consistency across all the issuer's deals. In return, the issuer may receive better pricing on its new issues.

On the other hand, when a deal's residual is owned by an independent third party (i.e., an entity not affiliated with the issuer), the third party's decision to exercise the clean-up call is likely to be based solely on whether the underlying assets are worth more than par. The clean-up call options customarily provide for a strike price of par. Accordingly, if a deal's underlying assets are worth less than par exercise of the clean-up call is unlikely. Conversely, if the assets are worth more than par, exercise is likely.

G. Changes in Servicing Policies – Item 1107(a)(3)

Information about past changes in a servicer's servicing policies is relevant to investors.¹² Such information helps to shed light on historical performance, especially when performance variations are evident.

H. Definition of ABS – Lease Residual Values – Item 1101(c)(2)(v)

To make calculations simpler, the calculation of the proportion of a deal backed by lease residuals should be simply the sum of the booked residual values of the underlying physical assets divided by the stated principal balance of the pool.¹³

⁹ Cf. ASF comment letter of 7/12/04 at 98.

¹⁰ 69 Fed. Reg. at 26707; *contra* American Bar Association comment letter at 3, 97.

¹¹ *Contra* ASF comment letter of 7/12/04 at 67; BMA comment letter at 21.

¹² *Contra* ASF comment letter of 7/12/04 at 61; JP Morgan Chase comment letter at 13.

¹³ Cf. ASF comment letter of 7/12/04 at 31.

I. Definition of ABS – Prefunding – Item 1101(c)(3)(ii)

Limits on prefunding are appropriate as a condition for an instrument to qualify as an asset-backed security and to qualify for the use of Form S-3.¹⁴ In the absence of any restrictions on prefunding, an offering potentially verges on becoming a "blind pool." While such offerings may be reasonable under appropriate conditions, they are not **asset**-backed securities and should not be treated as such.

J. Sponsor vs. Originator vs. Seller – Items 1101(j), 1101(l), 1104 and 1109

The definition of the term sponsor should be based on "organizing and initiating" an ABS/MBS transaction without regard to whether the sponsor sells or transfers assets to the issuing entity.¹⁵ Investors reasonably may want to understand a sponsor's motivations for effecting ABS/MBS transactions and whether the sponsor's past transactions have performed well.

As a separate matter, investors may also want to understand motivations and business practices of an originator of securitized assets and of a seller of the assets (if either or both of those entities is different from the sponsor). The SEC's proposal already includes a treatment of originators in Item 1109. The treatment could be expanded to encompass changes in origination practices over time. However, the SEC's proposal does not include a treatment of sellers.

K. Suspension of '34 Act Reporting – '34 Act § 15(d)

ABS investors need a continuous flow of information in order to analyze ABS/MBS deals. Moreover, ABS investors should be protected from information that is inaccurate or false. Accordingly, an ABS/MBS issuer should be required not only to supply information for the life of its deals but arguably should also be required to file such information with the SEC. Ongoing filing requirements provide a strong assurance of *reliability and accuracy* of information supplied to ABS/MBS investors.

One market participant expressed the need for information as follows:

A better definition of securitization is that it consists of the use of *superior knowledge* about the expected financial behavior of particular assets, as opposed to knowledge about the expected financial behavior of the originator of the chosen assets, with the help of structure to more efficiently finance the assets. This definition is superior because it better explains the need for the most essential aspects of any securitization any where [sic] in the world under any legal system, and it better defines the place of securitization within several of the broader financial trends that have occurred at the end of our century.

* * *

Securitization, in the correct circumstances, is one of the very most efficient forms of financing. This is because of two additional trends. The first is the increasing importance of the use of information to create wealth. The second is the increasing sophistication of computers and their uses. Securitization is made possible by the combination of these two trends. Computers enable one to store and retrieve extensive data about the historical behavior of pools of assets. *This historical data in turn enables one to predict, under the right circumstances, the behavior of pools of such assets subsequently originated by the applicable originator. Because our knowledge about such behavior may be so precise and reliable, when structured correctly, a securitization may entail less risk than a financing of the entity that originated the securitized assets.* Again in Lord Kelvin's terms, our knowledge about the likely behavior of pools of assets is "measurable" and we "express it in numbers." It is a superior sort of knowledge from the perspective of the world of finance.¹⁶

¹⁴ State Street Global Advisors comment letter at 5; *compare* Capital One comment letter at 9; *contra* ASF comment letter of 7/12/04 at 35; Toyota comment letter at 4.

¹⁵ *Cf.* ASF comment letter of 7/12/04 at 45, 56.

¹⁶ Jason Kravitt, *Introduction to Securitization* (1998) (emphasis added), available online at <http://www.securitization.net/knowledge/transactions/introduction.asp>. The cited work begins with an interesting quotation: "When you measure what you are speaking about, and express it in numbers, you know something about it; but when you cannot measure it, when you cannot express it in numbers, your knowledge is of a meager and unsatisfactory kind..." William Thomson, Lord Kelvin, *Popular Lectures and Addresses* (1891-1894). We

Major ABS/MBS issuers ordinarily provide a continuous flow of updated performance data to investors through their own websites and through BloombergSM, Intex, ABSNet, and other data vendors. For example, "CLP" screens on BloombergSM display a selection of performance data for many MBS deals and many deals from the major ABS asset classes. In addition, the "CLC" screens display updated collateral characteristics for many MBS and home equity ABS, though not for most auto ABS or credit card ABS. ABS/MBS issuers should be encouraged to continue supplying information to the market through all of these channels.

Additionally, a continuing flow of information is essential to the further development of synthetic CDOs that use ABS/MBS as their underlying reference assets. In order to use an ABS or MBS as a reference credit, CDO market participants must have confidence that they will have ongoing access to performance reports on the security.

L. Servicer Financials

Information about the financial condition of a master servicer or servicer can be very important to investors. Instances of fraud in ABS transactions have most often been associated with situations where a servicer experiences financial distress.¹⁷

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include the quoted material to demonstrate a fairly common point of view. However, we somewhat disagree with unrealistic capabilities that it ascribes to computers and mathematical models in predicting the future.

¹⁷ *Contra* ASF comment letter of 7/12/04 at 114-115.

Appendix A – New Comment Letters

New Comment Letters						
Organization	No. of Pages	Endorses "ASF" Letter	Issuer or Underwriter	Investor	Law Firm	Other
AIG Credit Corp.	6		✓			
Allen & Overy LLP	14				✓	
American Bankers Association	15					✓
American Bar Association	107					✓
American Financial Services Association	10	✓				✓
American Honda Finance Corporation	3		✓			
American Honda, Daimler Chrysler, Ford, General Motors, and Navistar (together)	22	✓	✓			
American Securitization Forum (7/12/04)	157	n.a.				✓
American Securitization Forum (7/30/04)	14	n.a.				✓
American Society of Corporate Secretaries	2					✓
Association of Financial Guaranty Insurers	9					✓
Association of the Bar of the City of New York	20					✓
Australian Securitization Forum	11					✓
Bank of America	14	✓	✓			
Bond Market Association (The)	41	✓				✓
Capital One Financial Corp	11	✓	✓			
CFA Institute	5					✓
Citigroup Global Markets, Inc.	6	✓	✓			
Citigroup Inc.	9	✓	✓			
Commercial Mortgage Securities Association	24	✓				✓
Dewey Ballantine LLP	7				✓	
Financial Services Roundtable (The)	6					✓
First Marblehead	4	✓	✓			
Foley & Lardner LLP	113				✓	
Investment Company Institute	6					✓
J.P. Morgan Chase & Co.	21	✓	✓			
Jones Day	6				✓	
Kutak Rock LLP	6				✓	
Lewtan Technologies	1					✓
MBNA Corporation	20	✓	✓			
Metropolitan Life Insurance Company	4			✓		
Mitchell Silberberg & Knupp LLP	4				✓	
Moody's Investors Service	5					✓
Mortgage Bankers Association (The)	30	✓				✓
Mortgage Insurance Companies of America	6					✓
PricewaterhouseCoopers LLP	9					✓
Sallie Mae and Nelnet, Inc. (jointly)	24	✓	✓			
State Street Global Advisors	9			✓		
Toyota Motor Credit Corporation	13		✓			
Trenam Kemker	11				✓	
UBS Securities	4	✓	✓			
U.S. Bank National Association	9					✓
Wells Fargo Bank, National Association	27		✓			

Appendix B – Old Comment Letters

Old Comment Letters		
Company	Pages	Date
Association for Investment Management and Research	14	10/03/96
Bond Market Association (The)	59	12/04/01
Bond Market Association (The)	149	04/23/02
Investment Company Institute	36	10/29/96
Mortgage Bankers Association of America	14	02/18/97
PSA The Bond Market Association	11	11/05/96

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- Report from Arizona 2004: Coverage of Selected Sessions of the Winter Securitization Conferences (10 February 2004)
- U.S. Fixed Income 2004 Outlook/2003 Review (18 December 2003)

ABS

- ABS/MBS Disclosure Update #4: Issues from ASF Sunset Seminar (13 May 2004)
- ABS/MBS Disclosure Update #3: Start Your Engines – Get Ready to Comment (10 May 2004)
- ABS/MBS Disclosure Update #2 (5 May 2004)
- ABS/MBS Disclosure Update (29 April 2004)

MBS

- Nomura GNMA Project Loan Prepayment Report - June 2004 Factors (10 June 2004)
- Monthly Update on FHA/VA Reperforming Mortgages: Historical Prepayment Speeds, Default Losses, and Total Returns (3 June 2004)
- Nomura GNMA Project Loan Prepayment Report – May 2004 Factors (14 May 2004)
- Monthly Update on FHA/VA Reperforming Mortgages: Historical Prepayment Speeds, Default Losses, and Total Returns (14 May 2004)
- GNMA Project Loan REMIC Factor Comparison (20 April 2004)

Strategy

- CMO VADM Bonds Offer Excellent Extension Protection (17 June 2004)
- Partial Duration: A Portfolio Strategy Tool (10 June 2004)
- Corporate Bonds - A 30,000 Foot View (7 June 2004)
- Inflation Linked Bonds - An Emerging Sector (2 June 2004)
- Update on Terrorism Insurance (1 June 2004)
- MBS Check-up: Update & Thoughts on Extension (25 May 2004)

Corporates

- Corporate Weekly - For the week ended 25 June 2004 (28 June 2004)
- Corporate Weekly - For the week ended 18 June 2004 (21 June 2004)
- Corporate Weekly - For the week ended 11 June 2004 (14 June 2004)
- Corporate Weekly - For the week ended 4 June 2004 (7 June 2004)
- US Corporate Sector Review - May (6 June 2004)

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