

# PSA THE BOND MARKET TRADE ASSOCIATION

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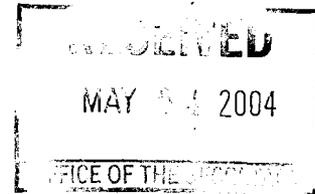
97-21-04

Doc. I. A. 5.

November 5, 1996

Mr. Brian Lane  
Director  
Division of Corporation Finance  
U.S. Securities and Exchange Commission  
450 Fifth Street, N.W.  
Washington, D.C. 20549

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RE: Response to Staff Request for Suggestions Concerning Possible Reforms of Disclosure and Reporting Rules for Mortgage and Asset-Backed Securities

Dear Mr. Lane:

In several previous meetings and discussions between Staff officials and representatives of PSA The Bond Market Trade Association (PSA)<sup>1</sup>, members of the Staff solicited suggestions concerning potential improvements to the existing system of disclosure and reporting for public offerings of mortgage-backed securities (MBS) and asset-backed securities (ABS). This letter constitutes PSA's initial response to this request and deals specifically with possible reforms of the disclosure and reporting system for MBS/ABS, addressed in the hypothetical context (as suggested by the Staff) of a complete overhaul of the system for dealing with MBS/ABS. Some of the matters addressed in this letter are also being addressed in a separate letter that is being sent by PSA in response to the Commission's Concept Release: Securities Act Concepts and Their Effect on Capital Formation (Release No. 33-7314 (July 25, 1996)).

## INTRODUCTION

PSA welcomes the initiative of the Staff in seeking suggestions on possible ways to improve the existing rules relating to disclosure and reporting<sup>2</sup> in connection with registered public offerings of MBS and ABS. PSA's members are extensively involved in the process of bringing new MBS and ABS issues to market, usually working in the role of capital markets intermediary between issuers and investors of mortgage-backed and asset-backed securities, as well as in the secondary market trading of those instruments. PSA's formal involvement in the MBS and ABS market is coordinated through a network of standing committees. This letter was prepared by an ad hoc "MBS/ABS Regulatory Task Force," comprised of senior business and legal professionals from a representative cross-section of PSA's membership that is particularly active in these markets.

<sup>1</sup> PSA The Bond Market Trade Association represents approximately 275 securities firms and banks that underwrite, trade and sell debt securities, both domestically and internationally. Among PSA's members are many of the underwriters that participate in the initial distribution and secondary market trading of mortgage-backed and asset-backed securities.

<sup>2</sup> Throughout this letter, the term "disclosure" shall refer generally to disclosure documents that are prepared in connection with the initial distribution of public offerings of MBS and ABS, while the term "reporting" shall refer generally to post-distribution disclosure with respect to such offerings.

The MBS and ABS markets are large and growing. PSA estimates that there are currently in excess of \$1.9 trillion MBS and over \$330 billion ABS outstanding. Collectively, this volume rivals or exceeds the outstanding volumes of other major categories of debt securities, including traditional corporate debt obligations. In short, and as the Staff is well aware, the MBS and ABS markets have become central vehicles for capital formation in the United States, and increasingly, abroad. Several recent statistical reports published by PSA that demonstrate the size, growth and increasing importance of these markets are attached.

Broad consultation among PSA's members who are involved in the issuance and trading of these types of securities reveals a consensus that the existing rules under the Securities Act of 1933 and the Securities Exchange Act of 1934, which were developed in the context of traditional corporate debt and equity securities offerings and which generally were adopted before securities such as MBS/ABS existed, are not well adapted to MBS/ABS. Primary differences between the MBS/ABS market and other financial markets include: (i) a principal focus in the MBS/ABS market on the structure of a class of securities and the nature of the underlying assets rather than on the financial prospects of an issuer with an ongoing business; (ii) the importance of evaluating the impact of alternative potential future cash flows in making a meaningful assessment of a security's yield; and (iii) the interaction between broker-dealers and investors in tailoring underlying pools of assets and offering structures to meet investor needs and changing market conditions.

The existing rules under the 1933 and 1934 Acts impose undue burdens on the parties involved in the structuring and issuance of such securities and lead to unnecessary costs and delays in consummating such issuance. Moreover, such costs and delays do not result in better disclosure for investors. Instead, it is widely felt that the disclosure documents typically associated with these categories of transactions are overly-long and opaque, and that existing legal rules at times actually stand in the way of disseminating useful information to investors, both at the time of initial issuance and in the secondary market.

PSA thus entirely supports the Staff's recognition that there are significant problems with the existing system and the Staff's willingness to consider substantial changes, possibly including an entirely new set of disclosure rules specifically adopted for MBS/ABS. This initiative is particularly timely, in that the Commission's new exemptive authority under the National Securities Markets Improvement Act of 1996 should facilitate the implementation of appropriate changes to the present rules. This letter sets forth, in preliminary form, PSA's views as to the inadequacies of the current regulatory framework and the broad outlines of a proposed approach to deal with the issues.

## I. SCOPE AND CONTENT OF REFORM

*A new regulation specifically designed to meet the unique requirements of the MBS/ABS market is needed.*

PSA has considered whether the existing disclosure system for MBS/ABS could adequately be improved simply by modifying the instructions to Forms S-3 and S-11 and the related provisions of Regulation S-K in a manner that would eliminate inapplicable provisions and

otherwise more appropriately adapt these forms and rules to the realities of the MBS/ABS market. PSA's view is that such incremental modifications would be difficult to implement, would be confusing to apply and would not sufficiently resolve existing problems. Instead, PSA would urge that the SEC consider promulgating a new regulation specifically designed to create a disclosure system that meets the unique requirements of the MBS/ABS market and better serves the needs of investors, issuers and underwriters. Approaching the matter de novo, with full participation of all market participants, is most likely to achieve a reform that will serve the interests of investors, while enabling the market to operate in a more efficient fashion. Should the Commission adopt the approach of creating de novo a disclosure system specifically adapted to MBS/ABS, PSA looks forward to participating in the rulemaking process with specific suggestions as to the content of such a system. In broad outline, PSA's preliminary views are that the disclosure documents under such a system should incorporate the following principles:

A. Improvement of clarity and elimination of repetition. The disclosure documents typically used today in registered public offerings of MBS/ABS are not "user-friendly". They tend to be extremely lengthy, highly repetitious and replete with formulaic disclosure that varies little, if at all, from transaction to transaction and from issuer to issuer. As a result, it is believed that few, if any investors, actually read the vast majority of these disclosure materials and that, if changes do occur in the portions that are largely invariable, investors are likely to overlook such changes entirely. Much of the bulk and complexity of the existing disclosure documentation is a product of several factors. One is the attempt to comply with the instructions to current Forms S-3 and S-11, neither of which was formulated with MBS/ABS in mind, and the cross-references to Regulation S-K, which also was not created to deal with MBS/ABS. The attempt to apply these instructions and provisions of Regulation S-K has led to the elaboration of descriptive material that is unlikely to be of substantial use to investors. A second factor is the SEC review process. Over the course of time different reviewers have imposed various disclosure requirements in their own attempt to fit MBS/ABS better into a framework created for traditional corporate debt and equity offerings. Each new requirement has tended not only to become incorporated into the disclosure documents for the issuer in question but, over the course of time, to spread to other issuances and eventually to have an industry-wide impact. Thus, MBS/ABS disclosure documents have grown longer and longer over the years.

In PSA's view, a disclosure system created de novo to deal with MBS/ABS would produce shorter and more readable documents that would be more useful to investors. Several specific ways in which this could be accomplished include:

- (i) *Eliminate duplicative summaries.*

The summary section of the prospectus (and prospectus supplement for shelf offerings) should be reduced to something along the lines of the typical terms sheet used in private placements -- i.e., a summary of the significant structural and economic terms of the transaction, with cross-references to the significant portions of the prospectus and/or supplement that investors should be cautioned to read with care, such as the "risk factors" section. Currently, it has become practice for the summary section to repeat a very large proportion of the substantive material found in the body. As a result, the summary tends to confuse investors and no longer serves the purpose of providing an accessible overview of the economic characteristics of the transaction. To encourage the use of more concise, readable summaries, the Commission should consider adopting a safe harbor provision similar to that found in current Rule 175. Such a safe

harbor provision would allow summaries to present the major features of an offering, without requiring a full discussion of all details concerning the transaction, which would appear elsewhere in the document.

In a shelf registration, it is difficult to see that there is any purpose served by the summary portion of the base prospectus. The transaction-specific summary presented in the prospectus supplement invariably overrides the summary that appears in the base. Consideration should therefore be given to eliminating the summary entirely in the base prospectus, and replacing it with a short description of the classes of assets and securities covered by the registration statement and a series of references to portions of the base prospectus that are especially important for investors.

(ii) *Provide guidance on generic MBS/ABS risk factor disclosure.*

Disclosure of risks is one of the most important aspects of a disclosure system. In typical issuances of corporate securities, risk factors tend to be specific to the issuer's business. MBS/ABS transactions relate primarily to pools of assets and not to business operations, and hence much of the disclosure of risk factors relating to MBS/ABS relates to issues that are common to all such transactions, such as the ways in which prepayments can affect yields or the ways in which geographic concentration may increase risks of loss. A great deal of the disclosure on these factors is virtually identical in all prospectuses, thus obscuring the deal-specific risks disclosed in the same section. Consideration could be given to developing a guide to required risk-related disclosure (or even a series of standard disclosure statements) that would set a minimum standard to be met in the base prospectus, leaving the issuer responsible in each prospectus supplement for identifying only such deal-specific or additional risk factors as are material to investors in that particular transaction. Among the risk factors of general application would be prepayment, yield and maturity risks; limited liquidity and lack of assurance of a secondary market; the limited effectiveness of credit support; limited obligations of depositor/trustee/servicer and others; ERISA; tax treatment of residuals; sensitivity of loss and default experience to general economic conditions; impact of concentration of geographic or other relevant factors in enhancing the risk of loss; and others.

(iii) *Eliminate inappropriate disclosure.*

Certain currently required disclosure that is not appropriate to MBS/ABS could be eliminated. For example, the "use of proceeds" adds little where the securities represent a pool of assets rather than interests in a going business concern.

(iv) *Focus on non-standard and non-customary terms in disclosure of operative documents.*

A substantial portion of the volume of current MBS/ABS disclosure documents consists of lengthy descriptions of the contents of the transactional documents, such as pooling and servicing agreements and trust indentures, and of the procedures that will be used in servicing the underlying pools of assets. These descriptions vary little, if at all, from transaction to transaction, because these transactional documents tend to become standardized (or at least highly similar) within the industry. It also is believed that few potential investors in MBS/ABS actually read these descriptions or add appreciably to their understanding of the proposed investment by

doing so. Disclosure could be improved and streamlined if it were not required to include discussion of customary or standard language, permitting a focus on non-standard provisions of indentures, pooling documents and the like. Such a distinction could foster development of a standard set of industry-developed guidelines for the typical contents of various MBS/ABS transactional documents insofar as they relate to such matters as the duties of the trustee and servicer, events of default and remedies on default, investor reporting and the like. An even more efficient approach would be to set this material forth in a separate document that could be incorporated by reference into the disclosure documents and made available to investors. However the standard, customary provisions are addressed, the objective should be to focus disclosure on the deal-specific payment terms and any deal-specific divergence from standard provisions.

(v) *Simplify generic disclosure on categories of assets.*

A significant portion of current MBS/ABS disclosure consists of information about specific asset classes (such as first or second-lien mortgages, automobile loans, credit card receivables and the like) which is general in nature, not transaction-specific and tends to be substantially identical across the entire industry. These descriptions are lengthy and complex and, in part because of their unvarying nature, are probably ignored by most investors, especially the institutional investors who make up the vast majority of all purchasers of publicly-offered MBS/ABS. A more efficient disclosure system would reduce the need to repeat in every disclosure document the well-known (and boilerplate) characteristics of established assets such as mortgages, auto loans, credit card receivables and others. Although at one time it may have been appropriate to describe how a car works in connection with an offering of debt by an auto maker, this is no longer the case, and we would submit that the market is not aided by reading repetitive summaries of standard mortgage foreclosure procedures, the procedures for perfecting a security interest in automobile or credit card receivables, general environmental law issues, drug proceeding forfeitures or the like.

In recognition of this maturing of the market and the need to focus disclosure on differences and the particular rather than the generic, the disclosure system could permit some categories of generic disclosure to be treated as unnecessary or permit incorporation by reference of standardized disclosures about such assets, their economic and legal characteristics and other general matters. Such disclosure could be included in a separate publication that would be incorporated by reference (in material part) in each prospectus and would be made available to investors. Issuers would, of course, still be responsible for disclosing in transaction-specific prospectuses or prospectus supplements any material characteristics of the assets relating to the specific transaction that differ from, or are not covered in, the material included in such publication. Development of such a standardized disclosure publication should permit the shelf process to deal more effectively with the use of a single shelf registration statement for multiple classes of assets.

B. Circulation of term sheet. *Permit early circulation of term sheets and other structuring information.*

The demands of the institutional investor market require that underwriters of MBS/ABS be able to circulate a brief description of the economic structure of a specific transaction to institutional investors before the final prospectus supplement is distributed. The

Commission (even if a more extensive reform of the MBS/ABS disclosure system is not undertaken) should consider promulgating a rule that makes circulation of such a term sheet possible without violating the prospectus rules, as long as a complete prospectus is delivered to the investor in connection with the consummation of any sale. In this regard, it should be recognized that preparation of a "red herring" preliminary prospectus addressing in detail all aspects of a possible transaction is not a feasible or desirable means in every case to provide important information to investors or to bring securities to market.

Indeed, as noted above, in the MBS/ABS market broker-dealers and issuers attempt to structure their offerings to meet particular investor needs and constantly changing market conditions. MBS/ABS offerings are typically divided into a number of separate classes of securities, with cash flows of principal and interest in the underlying assets allocated among the classes according to specified payment risks. Unlike a going concern that issues debt or equity, the key characteristics of each MBS/ABS transaction essentially are invented in response to investors and the market.

PSA believes that the market and the interests of all participants would best be served by adoption of a rule that replaced the current burdensome and untargetted system of filing certain computational materials and term sheets by a system that greatly liberalizes the ability to send to potential investors a wide range of information without a requirement that it be filed, so long as the prospectus (or prospectus supplement) includes indicative materials covering, with respect to the final structure of the transaction, the topics and types of data addressed in those preliminary materials. If only on the basis of practicality and cost, the formal disclosure document can not and should not include every item sent to every potential investor about every possible structure. Ready distribution of term sheets and other information would respond most directly to the expressed need of potential investors to obtain an early and meaningful understanding of proposed transactions. The market can do a better job of informing investors (and getting reactions from investors to possible structures) on a timely basis without the procedural burdens of the existing system - and the formal offering documents can be better focused on providing useful information.

C. Resecuritizations. *Eliminate barriers to inclusion of securitized assets in public offerings.*

The state of the law currently is unclear as to the ability of an issuer of MBS/ABS to include, as part of a pool of collateral, assets that are indirectly held through a securitization vehicle that has been the subject of a private placement or an earlier public offering. A variety of views expressed by members of the Staff to different issuers at different times has left market participants in a state of uncertainty. Any reform of the existing rules should address this issue and should eliminate artificial distinctions between securitized and unsecuritized assets. As long as there is full disclosure in the prospectus of relevant information about the assets underlying an issue of MBS/ABS (including any material disclosure about the effects that prior securitization may have on servicing, cash flows or other relevant matters), there seems no reason to raise obstacles to including assets that have already been securitized or to require registration or reregistration of the earlier transaction in which such assets were securitized.

D. Codification of SEC Staff positions. *Codify informal staff positions on disclosure requirements established during the review process.*

As discussed above, one reason for the bulk and complexity of current MBS/ABS disclosure documents is the cumulative effect of disclosure requirements that have been imposed over time through the SEC review process. Many of these requirements, established in connection with individual issuances of securities, have evolved into informal disclosure standards that are observed throughout the entire MBS/ABS industry.

As part of its overall disclosure reform efforts, PSA encourages the Commission to undertake a deliberative process to publish for comment and, where warranted, formally codify informal Staff views and positions in disclosure rules of specific applicability to MBS and ABS offerings. We believe that such a process will be helpful in limiting or eliminating unnecessary and inapplicable disclosure practices, and would result in clearer and more specific guidance to market participants concerning those disclosures that are required in particular circumstances.

## II. EXPANDING AVAILABILITY OF INFORMATION TO INVESTORS

*Reform the rules to permit greater access to information by investors and to facilitate the use of electronic communications.*

In many respects, existing rules relating to the offering of MBS/ABS have the effect of constricting the flow of relevant information to investors, especially to the sophisticated institutional investors who make up the vast bulk of the market for these securities. A number of pending problems in this area could be addressed as part of the Commission's broader consideration of reforms to the capital formation process. One of these is determining when a distribution has terminated for purposes of prospectus delivery and other requirements. In MBS/ABS transactions, PSA believes that such termination should be determined separately for each class of securities offered in the transaction structure. Other issues include general Section 5 prohibitions on the distribution of written non-prospectus communications, including research reports; the applicability of Rule 15c2-8 to the MBS/ABS markets; and similar issues that PSA expects to address in greater detail in its response to the Commission's above-cited Concept Release.

A. Information Relating to Underlying Assets. *Permit broader investor access to information relating to underlying assets without triggering filing requirements or Securities Act liability.*

A particular problem under the current disclosure system arises in connection with certain MBS/ABS transactions in which some (but not necessarily all) investors seek access to voluminous information about the underlying assets. This is particularly characteristic of securitized offerings of commercial mortgage loans, in which some institutional investors, even though the securities are being publicly offered, wish to perform their own due diligence on the underlying loans and real properties as if they were purchasing an interest in those assets directly. Such investors often seek access to third-party documentation held by the issuer and underwriters, such as appraisals, environmental reports, property managers' reports and engineering reports. Existing law makes unclear the ability of issuers and underwriters to furnish such materials or

their liability for doing so. It would seem appropriate, if individual investors wish to have access to underlying information that the issuer has not deemed requires disclosure in the prospectus (or has covered by summarizing in the prospectus), for such investors to have that option, so long as any prospective investor is given the same access upon request. However, there should be no requirement for the issuer to include such material in the prospectus or file it with the Commission, or for either the issuer or the underwriters to be required to assume liability under the Securities Act.

B. Electronic Access to Information. *Permit electronic posting of transaction information as soon as a prospectus is available.*

Another issue under current rules is the desire of investors to have electronic access to information about the pools of assets underlying a proposed issue of MBS/ABS at the earliest possible moment. For example, both investors and underwriters would like underwriters to be able to post information about the characteristics of underlying pools on electronic bulletin boards, such as Bloomberg, no later than when the prospectus is delivered to the underwriters, or in some cases even earlier. This information is contained in the prospectus (and currently is also furnished by some issuers to investors in an electronic medium together with the prospectus). It is generally not practicable to post the entire prospectus on such a bulletin board or to establish a hyper-text link to another site containing the prospectus. The current rules should be reformed to make clear that such a posting is permissible, as long as investors can obtain the entire prospectus upon request. It would also be desirable to make it possible for issuers to post on the same bulletin boards the computer models they have used to produce information in the prospectus, such as the effect of various interest rate and prepayment scenarios on yields. This would make it easier for prospective investors to model other scenarios that better fit the investor's own assumptions or needs.

### III. REFORM OF REPORTING REQUIREMENTS

*Replace exemptive orders, no-action letters and deregistration with a system under which servicer/trustee information is made readily available for the life of the deal.*

Closely related to the disclosure system are the reporting requirements under the Securities Exchange Act of 1934 as they apply to MBS/ABS. In connection with any reform of the MBS/ABS disclosure system, PSA suggests that the Commission also consider a parallel reform of the 1934 Act reporting system as applied to MBS/ABS. The inapplicability of many of the requirements of the 1934 Act reporting rules to MBS/ABS is evidenced by the fact that virtually every registrant seeks either an exemptive order or a no-action letter to relieve it of inappropriate reporting requirements. This process alone is a significant waste of time for both the Staff and registrants and should be replaced with a rule of general applicability.

A more fundamental issue with the reporting system is demonstrated by the fact that most registrants "deregister" at the earliest possible opportunity, not because they wish to stop supplying information to investors but because they wish to avoid liability for information over which they have no control. An issuance of MBS/ABS by its nature is a stand-alone structure. Once the securities have been sold, information about the registrant (which often is itself a special purpose entity that exists only to bring together pools of assets and securitize them) is immaterial

to investors. What investors and the secondary market need is information about the performance of the pool of assets. This typically is supplied by filing copies of the periodic reports that the trustee is required to send to investors. These reports in turn incorporate information provided by the servicer. All of the relevant information is internal to the pool of assets and is generated by entities, such as the trustee and servicer, whose function in the transaction is to provide services to the investors.

The current system does not adequately serve the interests of participants in the secondary market, who need as much current information as possible about the performance of the pools of assets underlying MBS/ABS. This concern is shared broadly by such participants, including investors and broker/dealers. Accordingly, PSA would propose that the Commission consider adopting rules to replace, for MBS/ABS, the reporting requirements currently applied under the 1934 Act with a requirement (a) that all transaction documents require the trustee or servicer to report to investors at least a prescribed minimum set of information no less often than or shortly following each payment date on the securities and (b) that all such information provided to investors be made available by the trustee or servicer on request to any requester (which requirement could be met by making such information generally available to the public, either directly or through third-party data providers). Compliance with these requirements should obviate the need for filing such information under the 1934 Act, although PSA would urge that registrants (including issuers whose securities are already outstanding) that satisfy these requirements should still be considered reporting companies for technical reasons (e.g., eligibility to use Form S-3.)

#### IV. REVISION OF SHELF REGISTRATION

*Eliminate or incorporate by reference generic and standard disclosure.*

Most MBS/ABS offerings are completed on shelf registrations under Rule 415. Under current rules and SEC policies, extensive disclosure is required in the base prospectus, even though the nature of the transactional structure and often even the characteristics of the assets that will underlie the transaction, are unknown until a specific take-down occurs. An improved disclosure system for MBS/ABS would recognize that these transactions are highly variable in transactional structure and would adapt the shelf registration process (which is indispensable to most issuances in the MBS/ABS market) accordingly. The application of Rule 415 to MBS/ABS should be reformed to provide for a significantly reduced body of material in the base prospectus.

Much of this could be accomplished by eliminating the need to include certain generic and standard matters or by the technique of allowing the industry, subject to the Commission's review, to develop standard disclosure about broad ranges of matters that do not vary significantly from prospectus to prospectus and to provide that such material may be incorporated by reference in base prospectuses, as well as transaction-specific prospectuses or prospectus supplements.

CONCLUSION

PSA welcomes the opportunity to provide its preliminary, conceptual views on appropriate disclosure and reporting reforms. We encourage the Commission to seek opportunities for joint discussion by all affected market participants of the most desirable and appropriate means by which to achieve these goals. In addition, we look forward to the opportunity to offer detailed comments in response to any specific, proposed rules that the Commission may issue in the future. Should you desire further information or any clarification of the matters discussed in this letter, please contact either of the undersigned, or Paul Saltzman, PSA General Counsel, at (212) 440-9459, or George Miller, PSA Associate General Counsel, at (212) 440-9403.

Sincerely,

*Lawrence E. Thomas*

Lawrence E. Thomas  
Vice-Chairman, PSA Mortgage and  
Asset-Backed Securities Division

*Thomas K. Guba*

Thomas K. Guba  
Chairman, PSA Mortgage and  
Asset-Backed Securities Division

*Attachment*

cc: Michael Mitchell, Esq.—SEC Division of Corporation Finance  
Selected PSA Committees and Staff

