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Comment on the IOSCO Consultation Report on the Disclosure Principles for Public Offerings and Listings of Asset-Backed Securities

Securitization Forum of Japan

I. Introduction

A. The Securitization industry in Japan welcomes this IOSCO initiative and appreciates the opportunity being provided for comment in the consultation process as to the Disclosure Principles for Public Offerings and Listings of Asset-Backed Securities ("the ABS Disclosure Principles").

B. Our comments on the IOSCO Consultation Report on the ABS Disclosure Principles ("the Report") are based on the existing disclosure practices in Japan's ABS market. Since we basically agree with the observations, purposes, and disclosure topics stated in the Report, we would like to present our comments mainly on the applicability and adaptability of the disclosure topics in Japan.

C. In Japan, there are already several practices with regard to ABS disclosure principles, some of which are summarized in the IOSCO Subprime Report[1]. These practices include: (a) the Financial Instruments and Exchange Act (Act No. 25 of 1948, "FIEA"); its lower-level regulations such as (b) the Cabinet Office Ordinance for Disclosure of Specific Securities (Regulation No. 22 of 1993); and (c) the FSA's (The Financial Services Agency) Guidelines for Financial Instruments Business Supervision.

D. In addition, there is voluntary self-regulation of disclosure ("SIRP")[2] in Japan, which was arranged by the JSDA (Japan Securities Dealers Association), and it has been effective since June 2009. The SIRP was originally intended to ensure the traceability of securitized products, by which investors could evaluate the

[1] The *Final Report of the Task Force on the Subprime Crisis*, dated May 2008 ("the Subprime Report"), Appendix A, p. vii.

[2] In 2008, major market participants in Japan discussed the data integrity in Japan's securitization market and established the Standardized Information Reporting Package ("SIRP") to be used for industry-level self-regulation. In the discussion of the SIRP, the Investor Reporting Package rolled out by the CMSA (Commercial Mortgage Securities Association) was referred to.

credit risk of the products using sufficient and up-to-date information of the underlying asset in a timely manner.

E. Now that most Japanese securitized products are regulated under these practices in terms of disclosure, we would like to comment on the ABS Disclosure Principles from the viewpoint of these existing practices.

II. General Comments

A. Since the subprime crisis, each jurisdiction has made an effort to establish a new supervisory framework to avoid such crisis. These efforts usually relate to disclosure procedures in some way. In fact, we already have several types of disclosure practices for various purposes; not only does the FIEA provide disclosure procedures from the viewpoint of investor protection, but also banking regulations provide rating-related disclosure requirements under Basel II local regulations. In addition, as mentioned before, JSDA has recently set out further self-regulation regarding disclosure of securitized products. Therefore, upon adapting the Principles to the Japanese market, it may be necessary to re-organize all the disclosure-related rules in order not to place the ABS Disclosure Principles in a crowded field of similar rules, thereby avoiding duplicate disclosure obligations and establishing best practice.

B. We believe the ABS Disclosure Principles will be effectively utilized as a guideline for public offering disclosure practices in each jurisdiction. We need to keep in mind, however, that we should always consider who should be liable for the cost associated with the disclosure. If we always place the burden of considerable cost on the sponsor, the sponsor will eventually adopt a fund-raising tool on a private placement basis rather than on a public offering basis to avoid such costs. This situation tends to become more obvious where alternative fund-raising tools such as ABLs, which are a kind of securitized product in the form of Asset Backed Loans (ABL) that are often used in Japanese securitization on a private placement basis, are available. The FIEA judiciously requires a less strict disclosure level in a private placement with limited investors. As such, jurisdictions should well consider the cost allocation issue prior to applying and adapting the ABS Disclosure Principles to the Japanese market.

C. In order to avoid spoiling the convenience and efficiency of securitized products as fund-raising tools, we should consider how we could reduce the clerical burden of disclosure under the ABS Disclosure Principles. If we disregard this aspect and fail to reduce the burden, sponsors will tend to seek alternatives other than securitization so that they could easily raise money with less of a disclosure burden. In this context, there may be room for allowing “boilerplate language,” as the Report mentions on page 5, as long as such language is appropriately accompanied by a supplemental explanation. It is also worth considering placing the disclosure at the discretion of the sponsor, with data references by which investors can easily contact relevant parties for more detailed information or supplementary materials, depending on their needs. Saving both excessive paper

work and documentation involved in disclosure will help develop the convenience of securitized products as fund-raising tools on a public offering basis.

D. With regard to the benefit of disclosure, we have concerns about the inconsistent relationship between the positive stance in disclosure and price mechanism efficacy in the market. Sponsors with well disclosed information naturally expect that they can raise money at a lower cost (i.e., low interest or spread) than they would with less disclosure. However, the reality of the market often shows that investors and other market participants pay attention only to the negative factors of the disclosed information (e.g., high default rate of the underlying asset), and disregard the existence of credit enhancements appropriately addressed in the securitized transaction according to such negative factors. We therefore think that it is important that, in the course of developing disclosure best practice, we should promote among market participants how to best interpret and utilize the disclosed information in their investment decisions.

III. Comments on INTRODUCTION (pp. 3-4)

A. We agree with the observation stated in this section. When we apply the ABS Disclosure principles in Japan, we will consider the practical side of applying and adapting them to the Japanese market so that we can avoid overly rigid, uniform, and unnecessary rules. In addition, it is essential that applying and adapting the ABS Disclosure principles to the Japanese market should be considered not only according to the manner in which the ABS is issued (i.e., on a public offering basis or on a private placement basis), but also according to the characteristics of individual products and the degree of investors' sophistication.

B. The Report appropriately discusses the applicable scope of the Principles (p. 4). We wish to comment on some points here to add some flexibility to the scope. There may be some areas, other than private-placement, where such Disclosure Principles need not apply. Specifically, in cases where the securitized products are substantially backed by the creditworthiness of some good-standing entity rather than by the pooled assets, or in other cases where the securitized products have already been regulated by other legislation, we would not need to consider including such cases within the scope.

C. The Report clearly recognizes that there is a wide range of application and adaptation with regard to the principles (p. 4). We totally agree with this idea from the viewpoint of best practice in each jurisdiction. We believe that the ABS Disclosure Principles would be realized in mainly three ways: (a) regulation by authorities; (b) flexible self-regulation by industry organizations; and (c) exemption or no regulation at all (leaving regulation to market practices). We should consider what form of regulation should apply, and to what extent, based on the characteristics of products, on the current regulation and flexible business practices in respective jurisdictions and, as the case may be, on the viewpoint of global policy coordination among authorities and industry organizations. For example, where investors to the transaction are all sophisticated institutional

professionals, disclosure regulation by authorities would seem to be too rigid; self-regulation at most would be more suitable. This is partly because it is reasonable to require such investors to take responsibility for acquiring information relevant to investment decisions. Mere rigid and standardized regulation by authorities, and its uniform application to all types of securitized products, would lack the necessary case-by-case flexibility, and could serve individual cases inadequately, leading to market stagnation. From this point, we believe that, when we refine our existing framework within our market, the ABS Disclosure Principles will be recognized not as a mandatory requirement but as an informative guideline, as the Report suggests.

D. Above all, we should not regard disclosure with insufficient information as inadequate if the parties responsible for the disclosure provide alternative information or appropriate explanations for the limited information or, as the case may be, obtain prior consent from investors.

E. We believe it could also be recommended that the ABS Disclosure Principles be used as a reference list of disclosure items and topics, a list which enables investors to compare the specific items and judge the degree of disclosure among similar transactions. Such comparison by investors will stimulate further disclosure by sponsors in future transactions. This "reference list" method is also desirable based on the fact that the needs and the depth of information required for investors varies depending upon the degree of sophistication in investment decision-making by investors. In this regard, one of the primary purposes of the ABS Disclosure Principle may be to facilitate investment decisions and investor due diligence[3]. Considering this, there may be an area where it is more reasonable to disclose the minimum items on the reference list while having further information available according to respective investors' individual needs and provided at their request. As a result, such comparison may subsequently stimulate further disclosure on the part of the arranger.

IV. Comments on GLOSSARY OF DEFINED TERMS –Asset-backed Securities– (p. 6)

A. The definition of "Asset-backed Securities" seems to need more clarification. Some transaction lawyers have expressed concerns that this definition makes it difficult to distinguish typical ABS from other securitized products. For example, CMBS could be regarded as "[s]ecurities that are primarily serviced by the cash flows of a discrete pool of receivables or other financial assets," since the funds to redeem the CMBS usually come from the collection of non-recourse loans backed by commercial mortgages. To rule out such CMBS from the scope of the definition, we should clarify the intended ABS as those backed by a pool of granular receivables or other financial assets, ruling out deals backed by idiosyncratic assets like typical CMBS.

[3] The Subprime Report, p. 1.

B. Even in the course of market stagnation, JHF (Japan Housing Finance Agency, a government-affiliated but independent-administrative agency) MBS has been solid in Japan. JHF regularly issues its MBS on a public offering basis, pursuant to the JHF Act (Act No. 82 of 2005), with prospectus and details of asset pool characteristics offered to investors in a timely manner. Investors can also access the information about cash flow projections and asset pool payment rates through Bloomberg L.P. and other data vendors. In summary, the JHF MBS is supposed to be a kind of "mortgage bond" which is, as the Report points out on page 6, regulated by different laws and regulations in Japan. Therefore, we understand that the current disclosure level of JHF MBS is sufficient for investors and their investment decision-making, and needs no further requirements under the ABS Disclosure Principles.

V. Comments on III.B.2. Sponsor's Securitization Experience (p. 9)

A. Even though the sponsor's securitization experience is relevant information concerning securitized products, there may be cases where it is not always informative in investment decisions; in other words, mere past experience does not have determinant power for the individual when they review a transaction for investment. Rather than using past experience when evaluating the securitization transaction, investors often place more importance on relevant transaction agreements and results from due diligence meetings with the sponsor. This way, investors could better understand the present substantive capability of doing business, and the degree of individual commitment to the transaction. From this point, as the Report states, the sponsor's securitization experience is a requisite item of disclosure only when it is material. This idea may also be true with the topics discussed in "E.2. Identifying information and experience" (p. 12); "F.1. Trustee's Background and Responsibilities" (p. 14); "G. Originators" (p. 14); and "H. Other Transaction Participants" (p. 15).

VI. Comments on item III.D.4. Transfer of Assets (p. 11)

A. This section suggests that the amount of "[e]xpenses incurred in connection with the selection and acquisition of the pool assets" should be specifically disclosed if such expenses will be paid out of the offering proceeds, while there are many other types of expenses in structuring transactions. It is advisable that we should clarify the specific items to be disclosed in this context as well as the purpose of the disclosure. We should also re-consider whether disclosing such expenses is indispensable to investment decisions.

VII. Comments on III.D.5. Security Interest and Bankruptcy (p. 11)

A. This section suggests that "[d]isclosure should be provided if there is a possibility that the securitized assets could become part of the bankruptcy estate of the Sponsor, Depositor, or another entity." In a sense, every securitized product

inherently faces the potential risk of being attacked by bankruptcy trustees of the Sponsor, Depositor, or another entity. If a court were to judge the transaction not to be a true sale structure, the securitized assets could become part of the bankruptcy estate. Even though securitized transactions are usually equipped with a "bullet-proof" structure against such trustee attacks, it does not mean that we can make the transaction an absolute bankruptcy-proof structure. From this point, no detailed information about the risk should be required; only a general explanation about the risk is enough.

VIII. Comments on III.E.2. Identifying information and experience (p. 12)

A. This section claims that "[t]he Document should provide general background information about the Servicer" and that "[a] general discussion of the Servicer's experience in servicing assets of any type, as well as a more detailed discussion of the Servicer's experience in, and procedures for, servicing assets of the type included in the securitization transaction, should be provided." As is mentioned above, there may be cases where this kind of general background information is not informative in investment decisions. Rather, the information tends to be less objective and lacks accuracy so that it could lead investors to misjudgment. In addition, it does not seem realistic to make the issuer liable for the disclosure of this information. Anyway, there are several means by which investors could get information about the servicer and its servicing capabilities. Instead of disclosing the information, we believe it more desirable that relevant agreements about servicer termination and replacement by a backup servicer should be disclosed.

IX. Comments on III.G. Originators (pp. 14-15)

A. As is pointed out in the Subprime Report, the importance of disclosure information about asset pool characteristics, in particular, credit-granting or underwriting criteria (p. 15) has been increasing along with the recent subprime crisis, where a dramatic weakening of underwriting standards triggered the turmoil[4]. We totally agree with the opinions and recommendations stated in this section. In this respect, however, it is essential to discuss further not only how to ensure the timeliness of the disclosure, but also how to warrant the accuracy of the disclosure. Representations and warranties regarding the accuracy of underwriting criteria are also essential[5], and basically worth disclosing. This issue may also apply to the concern about the Loan Modification as the Report states on p. 13.

B. On the other hand, there is another concern about credit-granting or underwriting criteria disclosure. Some market participants point out negative aspects of such disclosure. Their claims include: (a) in some cases, information about credit-

[4] The Subprime Report, p. 3.

[5] Just for reference, some regulators are planning to introduce a new rule which provides that a certain portion of every securitized product should be held by the sponsor of the product.

granting or underwriting criteria may not be indispensable to investment decisions; and (b) there may be a case where investors would excessively rely on the information, resulting in a distortion of their investment decision. In addition, based on the competitive situation among originators in the same industry, they would tend to strategically avoid disclosing such information. Due to these aspects, it is advisable to further consider in what way and to what degree the information should be disclosed.

X. Comments on IV. STATIC POOL INFORMATION (p. 15)

A. With regard to static pool information, it is worth considering placing the disclosure at the discretion of the sponsor, with data references by which investors could easily contact relevant parties for more detailed information or supplementary materials depending on their needs. In addition, with regard to data in terms of asset pool characteristics and historical performance, it may be an idea to stylize the disclosure. In order for investors to maintain easy glancing and data comparison among transactions, it is adequate to lay out a recommended data format in each jurisdiction, showing the items to be listed and their sequence.

B. In some cases, static pool information of the underlying asset is not available at closing. For example, local municipalities in Japan, in order to facilitate fund-raising for small and medium-sized enterprises (SMEs), sometimes arrange publicly-offered CLO/CBOs[6] backed by local government loans to SMEs or privately-placed corporate bonds that the SMEs issue. In this case, static pool information of the underlying asset is not usually available at closing. To make up for the lack of relevant information, local municipalities make public the eligibility criteria of CLO/CBOs, and rating agencies publish pre-sales reports. In this context, we think the Report adequately discusses alternative disclosure on page 16. We basically agree with this idea. Considering the actual restrictions arrangers face when structuring transactions using newly originated assets with limited information, it is necessary to have an alternative in providing static pool information.

C. We understand that such alternatives are also essential with regard to IV. A. (Amortizing Asset Pools).

XI. Comments on VIII.C. Fees and expenses (p. 23)

A. The Report suggests on p. 23 the idea that fees and expenses of ABS transactions be disclosed. But we have some concerns based on the actual situation of structuring frontlines. It appears to be a reality that relevant parties to the transaction often offer discounts to their important customers to maintain good business relations; they sometimes offer discount rates in accordance with the amount of securitization deals concluded so far with the customer. For another

[6] CLO: Collateralized Loan Obligation, CBO: Collateralized Bond Obligation

example, compensation for the servicing operation, which is one of the critical fees of the securitized products, would usually be determined by the collection ability and experience of the servicer appointed. It is natural that relevant parties to the transaction usually tend to keep such price benefits quiet. In other words, there may be cases where it is not appropriate to reveal the price benefit publicly. Therefore, it may be a desirable option to allow such disclosure to indicate only the items of fees and expenses with no specific numbers applied, or to indicate only computational expressions, on condition that investors could individually obtain information about the details, if they are required for their investment decision. Cash flow projection using aggregate amounts of fees and expenses may also be acceptable.

XII. Comments on VIII.D. Excess cash flow (p. 23)

A. The Report suggests the idea that "[a]ny arrangements to facilitate a securitization of the excess cash flow or retained interest from the transaction, including whether any material changes to the transaction structure may be made without the consent of ABS holders in connection with this securitization" should be disclosed. We believe that this disclosure may be unnecessary. Moreover, we believe this is not so much an issue of disclosure as a problem with structuring. It is rather appropriate to restrict transactions in which publicly-offered ABS holders' interests would be infringed without their clear consent. We recognize the necessity of securitizing the excess cash flow of, or retained interest from, the precedent publicly-offered ABS. But such securitization should be acceptable only on the condition that the ABS holders' interest is firmly protected.

XIII. Comments on VIII.G. Prepayment, maturity, and yield considerations (p. 24)

A. The Report proposes that "[s]tatistical information such as the effect of prepayments on yield and weighted average life" should be disclosed. While such statistical information is essential to evaluate the credit risk associated with securitized products with longer horizons, such as MBS, there are cases where detailed disclosure of statistical information is not possible due to data limitations, or even unnecessary due to the relatively short horizon of the transaction. It is worth considering a case-by-case treatment for the disclosure of statistical information according to the characteristics of the transaction.

XIV. Comments on XVII.C. Relationships Related to the Securitization Transaction or Pool Assets (p. 30)

A. In this section, the Report states that disclosure about the relationships among the participants in the securitization transaction, outside the ordinary course of business among the participants, and relationships related to the securitization transaction or pool assets would help investors understand the structure of the securitization transaction. We basically agree with the idea. Investors, however,

often place more importance on the relevant agreements of the transaction and results from due diligence meetings with the transaction participants rather than these current and past relationships. From this point, as the Report adequately states, disclosure about such relationships should be a requisite item of disclosure only when it is material.

XV. Comments on XVIII. INTERESTS OF EXPERTS AND COUNSEL (p. 30)

A. The Report recommends that disclosure about the interests of experts and counsel would be highly relevant to investors. We basically agree with the idea. We believe, on the other hand, that each jurisdiction already has specific legislation regarding the duty of secrecy and other professional conduct of these experts and counsel. From this point, each jurisdiction should be allowed a discretion whether to disclose information about the interests of experts and counsel; in cases where the specific legislation works well, such disclosure may be unnecessary.

XVI. Concluding Remarks

A. With regard to disclosure requirements, we would like to stress again that adequate rule-making based on the individual features of the securitized products and investors is essential. Mere rigid and standardized disclosure regulations by the authorities would lack the necessary case-by-case flexibility, and might place unnecessary burdens on transaction participants, leading to market stagnation.

B. In summary, overly strict, broad, and open-ended disclosure regulations and their uniform application to every publicly-offered ABS has substantive adverse side-effects which may lead to:

1. sponsors adopting fund-raising tools other than securitization on a public offering basis to avoid excessive disclosure requirements;
2. arrangers decreasing the volume of arrangements for securitized products on a public offering basis due to the heavy burden of disclosure; and
3. investors making their investment decisions poorly and performing their due diligence procedures ineffectively due to the considerable amount of uniformly disclosed information, but missing the point of the investors' individual concerns.

All these side-effects could lead to a freeze in the public offering ABS market.

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