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July 7, 1997

VIA FAX & FEDEX
Pension and Welfare Benefits Administration
Office of Exemption Determinations
U.S. Department of Labor
200 Constitution Avenue, N.W. Room N-5649
Washington, D.C. 20210

Re: Proposed Amendment to PTEs 90-30, 90-32, et al.

Dear Sir or Madam:

PSA The Bond Market Trade Association ("PSA")¹ is pleased to comment on proposed amendments published by the U.S. Department of Labor ("Department of Labor") relating to Prohibited Transactions Exemptions 90-30, 90-32 et al. ("underwriter exemptions" or "exemptions")². The underwriter exemptions are individual exemptions granted by the Department of Labor to provide limited relief from the prohibited transaction rules of the Employee Retirement Income Security Act of 1974 ("ERISA") with respect to the sale of certain types of mortgage-backed and asset-backed securities ("MBS" and "ABS", respectively) to ERISA plans.

In response to the Department of Labor's announcement in January 1996 that the existing underwriter exemptions would not apply in the case of MBS and ABS transactions involving "pre-funding accounts," PSA actively organized its members to submit a request for additional exemptive relief under those exemptions. This request was submitted by two named applicants (Bear, Stearns & Co. Inc. and Prudential Securities Incorporated) on March 25, 1996, and was subsequently restated in a submission dated February 26, 1997, on behalf of all similarly situated PSA members. For the reasons discussed below, PSA supports the Department of Labor's proposed expansion of the underwriter exemptions to include transactions involving pre-funding accounts, and the other changes described in the proposed amendments.

SUMMARY OF PROPOSED AMENDMENTS

The proposed amendments, if granted, would: (1) modify the definition of "Trust" to include a pre-funding account and a capitalized interest account as part of the corpus of the Trust; (2) provide retroactive relief for transactions involving asset pool investment trusts containing pre-funding accounts which have occurred on or after January 1, 1992; (3) include in the definition of "Certificate" a debt instrument that represents an interest in a Financial Asset Securitization Investment Trust ("FASIT"); and (4) make certain other changes that would reflect the Department's current interpretation of the underwriter exemptions.

DISCUSSION

As stated in the application, the primary purpose of the proposed amendments is to modify the definition of Trust contained in the underwriter exemptions to include a pre-funding account and a related capitalized interest account, both consisting of cash or temporary investments. When the underwriter exemptions were originally granted, ABS and MBS trusts were established in the following manner. A sponsor, servicer and trustee would enter into a pooling and servicing agreement or an equivalent agreement ("the agreement"). Prior to the closing date established by the agreement, the sponsor and/or the servicer would select receivables from the class of assets defined in the underwriter exemption to be included in a Trust, establish the Trust and designate an independent entity as trustee for the Trust. Typically, on or prior to the closing date, the sponsor would acquire legal title to all assets selected for the Trust. On the closing date, the sponsor would convey to the Trust legal title to the assets and the trustee would issue certificates representing fractional undivided interests in the Trust assets.

Since the receivables to be held in the Trust were all transferred as of the closing date, exemptive relief was not required nor requested under the original exemptions to enable the Trust to hold any cash or temporary investments, other than cash representing undistributed proceeds from payments of principal and interest by obligors under the receivables. However, in the last several years it has become common for transactions to be structured using a pre-funding account. Pre-funding accounts allow the Trust to acquire a portion of its assets during an interim period ("pre-funding period") following the closing date, instead of requiring that the entire pool of receivables held in the Trust be identified as of the closing date.

PSA believes that the inclusion of pre-funding accounts in the corpus of a Trust that qualifies under the terms and conditions set forth in the underwriter exemptions is desirable from a number of perspectives. From an economic perspective, the use of pre-funding accounts make ABS and MBS transactions more efficient, reduces their costs and provides better execution for sponsors and/or originators and plan investors. Pre-funding accounts allow the sponsor additional time after the closing date to assemble the files for receivables, complete quality control or other due diligence procedures and deliver the necessary documents to the trustee. The sale of receivables prior to their origination also allows the originator and/or sponsor and plans to protect against fluctuations in interest rates. Moreover, since many transactions costs are fixed regardless of the size of the receivables pool, the sale of additional receivables lowers the unit costs of the transaction, both for the originators/sponsor as well as plan investors (who otherwise might not be able to purchase the same volume of receivables on their own at a comparable unit price). Pre-funding accounts also allow originators/sponsors to reduce costs by permitting the sale of the existing receivables and delivery of additional receivables, without the need to warehouse the existing receivables during the period that the additional receivables are being acquired. Finally, the use of a pre-funding account allows originators/sponsors to sell, and plans to purchase, more securities at current market rates than in the absence of the pre-funding account. This may increase liquidity for the certificates and make them a more attractive investment for plans.

PSA also believes that the additional exemptive relief requested in the proposed amendment is consistent with the Department of Labor's interests in protecting ERISA plan beneficiaries, in that it provides for effective controls on the type and quality of prefunded receivables that may be contributed to ABS and MBS trusts. Each agreement sets forth the terms and conditions pursuant to which a Trust may purchase additional receivables from the originator or sponsor. Among these conditions are the requirements that, among other things, 1) all such receivables will meet the same terms and conditions for eligibility as those of the original receivables contributed to the Trust; 2) the transfer to the Trust of the receivables acquired during the pre-funding period will not result in the certificates receiving a lower credit rating than the rating that was obtained at the time of the initial issuance of the certificates of the Trust; 3) the weighted average annual percentage interest rate for all of the obligations in the Trust at the end of the pre-funding period will not be more than 100 basis points lower than the weighted average annual percentage interest rate for the obligations which were transferred to the Trust on the closing date; and 4) the characteristics of the additional obligations subsequently acquired will either be monitored by a credit support provider or other insurance provider which is independent of the sponsor, or an independent accountant will confirm that the characteristics of such obligations conform with prescribed eligibility criteria. Finally, each prospectus, private placement memorandum and/or pooling and servicing agreement will also set forth the terms and conditions, which will have been agreed to by the rating agency rating the certificates, for eligibility of the receivables to be included in the Trust as of the closing date and the eligibility of those to be acquired during the pre-funding period. These and other requirements set forth in the proposed amendment will ensure that adverse selection procedures are avoided in selecting receivables during the pre-funding period.

As described in the application, the transactions associated with the use of pre-funding accounts in the formation of ABS and MBS Trusts have been customary in the financial market place for the past several years and are taken into consideration by the national rating agencies when they rate the securities issued by such Trusts. PSA has consulted with four nationally recognized rating agencies and has found no evidence of any failure of a sponsor to meet its representations as to the characteristics of the subsequently acquired receivables or of any downgrading of a certificate rating at the end of a pre-funding period solely as a consequence of the use of a pre-funding mechanism.

PSA supports retroactive relief of the proposed amendment to address situations in which underwriters may have relied upon the original underwriter exemptions to engage in transactions involving pre-funding accounts since January 1, 1992. Prospective relief for transactions involving Trusts utilizing pre-funding accounts would remove the effective moratorium from the Department of Labor's 1996 announcement on using the underwriters exemptions for pre-funded pass-through certificate transactions.

Finally, PSA supports the proposal to grant exemptive relief to FASITs, provided that each of the other applicable requirements of the underwriter exemption are met. As stated in the proposed amendment, FASITs are designed to facilitate the securitization of debt obligations such as credit card receivables, home equity loans, and auto loans. Since the

applicable tax regulations require that the Trust must be maintained as essentially a passive entity, only FASITs with assets comprised of secured debt and which do not have revolving pools of assets or hedging investments not specifically authorized by the underwriter exemption would be permissible under the proposed amendment. The inclusion of certain applicable FASITs in the amended underwriter exemption is consistent with the Department of Labor's interpretation of the use of REMICs under the existing underwriter exemptions.

CONCLUSION

For the reasons expressed above, PSA supports the proposed amendments to the underwriter exemptions, and we appreciate the opportunity to provide the views expressed herein. Should you have any questions, please contact the undersigned at (212) 440-9403.

Sincerely,

George P. Miller
Vice President and
Deputy General Counsel

cc: Select PSA Staff

¹ PSA represents approximately 220 securities firms and banks that underwrite, trade and sell debt securities, both domestically and internationally. Most of the entities that have obtained an underwriter exemption from the Department of Labor are PSA members. More information about PSA can be obtained from our website at <http://www.psa.com>.

² 62 Federal Register 28502 (May 23, 1997).

July 16, 1997

VIA FEDERAL EXPRESS
Internal Revenue Service
Couriers Desk
1111 Constitution Avenue, N.W.
Washington, D.C. 20224
Attn: CC:DOM:CORP:R (FASIT Solicitation)

Re: Additional Comments on FASIT Regulations

Ladies and Gentlemen:

In a letter dated January 10, 1997, PSA The Bond Market Trade Association ("PSA") submitted comments¹ on issues that PSA believes should be addressed in upcoming FASIT regulations. We are writing to you now to supplement our earlier comments concerning gain recognition upon formation of a FASIT and to request a meeting between representatives of PSA and those at the IRS and Treasury responsible for developing FASIT regulations. We believe such a face-to-face meeting would be helpful to you in that we would be able to answer any questions the IRS and Treasury attorneys may have concerning our comments.

FASIT GAIN RECOGNITION RULES

Section 860I (a)² provides that if property is transferred to a FASIT by the holder of the ownership interest in the FASIT, the holder of the ownership interest will recognize gain, but not loss, on the property transferred. This section further provides that if property were to be transferred to the FASIT by someone other than the holder of the ownership interest, the property would be viewed as first having been transferred to the holder of the ownership interest and then transferred to the FASIT.

In the case of debt instruments that are traded on an established securities market and all assets other than debt instruments (e.g., hedging instruments), the gain recognized would equal the difference between the fair market value of the debt instrument or other asset and the adjusted basis of that debt instrument or other asset. In the case of debt instruments that are not traded on an established securities market, the gain would equal the excess of a formula amount over the debt instrument's adjusted basis. The formula amount would be the present value of all cash flows due under the debt instrument (taking into account anticipated prepayments and losses) determined by discounting those cash flows back to the date of transfer using a discount rate equal to 120% of the appropriate applicable federal rate ("AFR"). Section 860I(d)(1)(A)(ii), however, expressly grants to the IRS and Treasury regulatory authority to specify a different discount rate.

In our earlier letter, we observed that the formula valuation methodology set out in section 860(I)(d) would require a sponsor to project prepayments and defaults on debt instruments in developing a stream of reasonably expected payments. We indicated a need for guidance setting out a clear and objective methodology for projecting such payments. Further, we pointed out that verifiable market based information concerning both prepayment speeds and default rates often does not exist, and therefore, the regulations to be developed should contain certain safe harbors upon which sponsors could rely in projecting reasonably expected payments for purposes of applying the formula.

Although we continue to believe that such guidance is needed, we believe the IRS and Treasury should also consider drafting regulations that would apply the formula valuation

rules to only those debt instruments for which reasonable, readily ascertainable evidence of market value does not exist. We make this recommendation for two reasons.

First, the formula valuation rules, which were apparently enacted to provide certainty concerning valuation, in fact fail to provide such certainty due to the speculative nature of projecting reasonable payments due on debt instruments. Even the adoption of regulations setting out methodologies to be employed and safe harbors for making such projections will not eliminate this uncertainty.

Second, and more importantly, the formula valuation approach is likely to distort the recognition of income attributable to debt instruments transferred to a FASIT, particularly those having relatively longer remaining terms to maturity. The formula, because it employs a discount rate of only 120% of the AFR, will likely overstate the value of the debt instruments resulting in gain recognition to a FASIT sponsor on formation of a FASIT that has nothing to do with the actual fair market value of the debt instruments. Furthermore, the gain so recognized would increase the tax basis in those debt instruments. If the sponsor retains the ownership interest in the FASIT, that basis increase would result in a stream of premium recoveries with respect to the debt instruments in future periods. In other words, the formula would produce phantom gain on formation followed by phantom deductions over the life of the securitization transaction.³ PSA members have increasingly raised concern that the application of this formula valuation rule could render a FASIT election uneconomical to the point of being unviable as a securitization device for some asset types. We believe that this outcome would be extremely undesirable, given the FASIT statute's underlying goal of facilitating the securitization of a broad range of financial assets.

The distortion attributable to the application of the formula valuation rule would be most pronounced in a situation where a sponsor transfers loans having relatively longer maturities to a FASIT, such as commercial and residential mortgage loans. For instance, suppose that a sponsor purchased at par a self amortizing commercial mortgage loan (or a pool of such loans) for \$8 million, having an anticipated term to maturity of exactly 10 years, and calling for level semiannual payments, net of servicing, of \$622,492.48. Thus, the rate on the loan, reflecting semiannual compounding, would be 9.28% for an annual effective rate of 9.5% (100 basis points over the prime rate). For June, 1997, 120% of the long-term AFR, based on semiannual compounding, is 8.39%. If this rate were applied to a semiannual stream of payments in the amount of \$622,492.48, it would produce a present value of \$8,315,656.77. Consequently, the sponsor would have a taxable gain of \$315,656.77 if the formula valuation approach applied, and this would be true even if the yield on the securities sold by the sponsor and backed by the commercial loan exceeded 8.39%. This cannot be the result envisioned by Congress.

Clearly, the purchase price paid by the sponsor in a purchase transaction from an unrelated third party contemporaneously with the formation of the FASIT is the best indicator of value. Moreover, even if the sponsor itself had originated loans over a period of time, evidence may exist in the market that would indicate the value of the loans. For instance, in the case of one-to-four family residential real estate loans, lenders will

typically quote rates and discount points for loans from which one can derive a market price at which loans would be originated.

We believe the IRS and Treasury have regulatory authority to depart from this formula valuation regime where evidence exists in the market that would allow one to derive a value for a debt instrument or pool of debt instruments. First, Section 860I (d) expressly excludes from the scope of the formula valuation rules any debt instrument that is "traded on an established securities market," but it does not define that term. We suggest that the regulations interpret the term to include any debt instrument for which price quotations were readily available from any person, such as a broker, trader, or dealer. This approach would somewhat parallel that taken in Treas. Reg. § 1.1273-2(f)(5) (without including the safe harbors), and that taken in Treas. Reg. § 1.7704-1(c)(2) in defining "secondary market or substantial equivalent thereof" for purposes of determining whether a partnership is a publicly traded partnership.

Second, the Section 860I(d)(1)(A)(ii) expressly authorizes the use of a discount rate other than 120% AFR to the extent authorized by regulations. Regulations could provide that, in the case where market quotations for a class of debt instruments, such as mortgage loans, are readily available, then the appropriate discount rate to be applied would be either the quoted yield, or if prices were quoted rather than yields, the discount rate that would cause the present value of the future payments on the debt instrument(s) to equal the quoted price.

We realize that in situations where a lender originates loans, the price quoted to borrowers will reflect the costs of origination and servicing the loan. In other words, a lender could originate a \$100 loan for \$98 where the \$2 of discount would be attributable to origination costs. The lender could subsequently sell the loan to an investor, who would not incur those costs, for \$100. If concern exists that the use of origination prices, and the resulting yields they would produce would not be reflective of fair market value, the regulations could provide that the appropriate discount rate would be the yield at which comparable loans are being originated, less a specified number of basis points (e.g., 125 basis points for one-to-four family residential real estate loans). We note that the IRS has, in Rev. Proc. 91-50, 1991-2 C.B. 778, provided such a bright line rule to taxpayers in determining what constitutes normal servicing.

REQUEST FOR A MEETING

We realize that you may have concerns regarding your authority to craft regulations along the lines outlined above. We further realize that expressing a concept in abstract form is not nearly as difficult as reducing that concept to workable regulatory language. In an effort to assist you in addressing the issue set out above, as well as other issues you may have, we would be pleased to have representatives of PSA and their attorneys meet with the IRS and Treasury attorneys working on the FASIT regulation project. We believe that only in such a meeting can we have the kind of dialogue needed to crystallize the issues and develop a workable solution. After you have had an opportunity to consider our comments, please call the undersigned at (212) 440-9403, or our special

outside counsel, Robert Kreitman, Esq. of Brown & Wood L.L.P. at (212) 839-8637, so that we can arrange such a meeting.

Sincerely yours,

George P. Miller
Vice President,
Deputy General Counsel

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Selected PSA Staff

¹ We have attached a copy of that earlier letter for your information.

² All section references are to the Internal Revenue Code of 1986 unless the context clearly requires a different reference.

³ We find it interesting to note that the gain created under the formula valuation rule on formation of a FASIT could be sheltered with allowable deductions and losses, while the resulting premium created in the debt instruments held by the FASIT would offset income inside the FASIT that would otherwise be passed through to the holder of the ownership interest and be subject to the special inclusionary rules of section 860J (i.e., the income could not be offset with otherwise allowable deductions or losses).