Client Alert

February 2018

SEC Staff Issues Significant No-Action Letter Regarding Mortgage Exemption

On February 12, 2018, the SEC staff issued a no-action letter favorable to mortgage industry participants who originate or acquire whole mortgage loans and then securitize them. The letter interprets Section 3(c)(5)(C), the statutory provision exempting many mortgage companies from registering under the Investment Company Act of 1940. The new interpretation marks a stark departure from the decades-old analysis of whether a company is "primarily engaged" in the mortgage business based upon a snapshot of the company's assets, into a more principles-based approach that considers additional factors to determine whether a company, based on its business as a whole, should be considered "primarily engaged" in the mortgage business.

By its terms, Section 3(c)(5)(C) applies to companies primarily engaged in "purchasing or otherwise acquiring mortgages and other liens on and interests in real estate." The statute does not define "primarily engaged," so through the years the SEC staff has indicated that in order to satisfy the "primarily engaged" requirement of Section 3(c)(5)(C), a company:

> must invest at least fifty-five percent of its assets in mortgages and other liens on and interests in real estate ("qualifying interests"). An additional twenty-five percent of the [company]'s assets must be in real estate related assets, although this percentage may be reduced to the extent that more than fifty-five percent of the [company]'s assets are to be invested in qualifying interests.[1]

"Qualifying interests" under the 55 percent test include whole mortgage loans and "whole pool" agency certificates, but it has been less clear whether the securities retained in mortgage securitizations are "qualifying interests." Informal conversations with the SEC staff over the years have suggested that the treatment of the retained securities might depend on which classes are retained; whether the entire class is retained; whether "contiguous" classes are retained; and whether the company services the loans, has the right to replace the servicer or has the "unilateral right to foreclose."

In the new letter, none of these elements are required. Instead, the SEC staff concludes that "an issuer, such as the Depositor, that acquires whole mortgage loans, which it then transfers into a securitization trust which it sponsors for the purpose of obtaining financing to acquire additional whole mortgage loans, may treat as qualifying interests for purposes of Section 3(c)(5)(C) any securities issued by that trust that it retains because such securities are acquired as a direct result of the issuer being engaged in the business of purchasing or otherwise acquiring whole mortgage loans."

In other words, an issuer's retained securities from a securitization are qualifying interests, good for the 55 percent test, if the issuer (1) originated or acquired the whole mortgage loans and (2) securitizes the loans in order to obtain financing to acquire additional mortgage loans. This is true even if an issuer does not, as previous informal guidance required, (1) retain any particular classes or percentages of those

[1] Div. of Inv. Mgmt., Sec. & Exch. Comm'n, Protecting Investors: A Half Century of Investment Company Regulation 72 (footnote omitted) (1992) ("Protecting Investors Study").

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classes or (2) act as servicer, have the ability to replace the servicer or have the "unilateral right to foreclose."

The letter is not helpful, however, to an issuer that acquires mortgage-backed securities in the marketplace—an issuer must own the loans prior to the securitization—as highlighted by the SEC staff: "We note, however, that our position focuses on the business activities of the issuer and not on the assets themselves; thus, our position does not encompass securities issued by a securitization trust that are acquired in a different manner (e.g., from an unaffiliated third party) because acquiring such assets in this manner could be more consistent with the issuer being engaged in an investment activity rather than a financing activity."

In the letter, the SEC staff takes a holistic view when determining whether an issuer qualifies for the mortgage exemption, focusing on the issuer's business activities, sources of income and other factors in addition to the assets it holds directly. In this light, the SEC staff signals that it would like to provide further guidance on the following matters noted in the letter, if someone will submit a request:

- We would be willing to entertain other no-action requests to treat as qualifying interests certain other mortgage-related assets if they are acquired by an issuer as a direct result of the issuer being engaged in the business of purchasing or otherwise acquiring whole mortgage loans (e.g., certain "A-Notes" and servicing rights).

- Similarly, rather than focusing solely on an issuer's assets when determining whether the issuer is primarily engaged in the real estate finance business and thus can rely on Section 3(c)(5)(C), we would be willing to entertain no-action requests that would broaden the "primarily engagement" test to include other factors that would indicate whether the issuer is primarily engaged in the real estate finance business.

Hunton and Williams LLP welcomes the opportunity to assist a client in submitting a request asking for guidance on one of these matters, or similar matters.

A link to the full no-action letter is here: https://www.sec.gov/divisions/investment/noaction/2018/great-ajax-funding-021218-3c5.htm

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