

SEC Grants No-Action Relief Relating to Status of Certain Mortgage Servicing Rights and Cash Proceeds Under Section 3(c)(5)(C) of the Investment Company Act

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This article discusses a no-action letter issued by the U.S. Securities and Exchange Commission to a mortgage finance real estate investment trust, which may make it easier for certain entities to satisfy the asset composition test required by the Commission staff in its interpretation of Section 3(c)(5)(C) under the Investment Company Act of 1940 in respect of their holdings of certain mortgage servicing rights and cash proceeds.

The Division of Investment Management of the U.S. Securities and Exchange Commission (“SEC”) issued to Redwood Trust, Inc., a mortgage finance real estate investment trust (“REIT”), a no-action letter¹ (the “Redwood No-Action Letter”). The Redwood No-Action Letter may make it easier for certain entities to satisfy the asset composition test required by the SEC staff (the “Staff”) in its interpretation of Section 3(c)(5)(C) under the Investment Company Act of 1940 in respect of their holdings of certain mortgage servicing rights (“MSRs”) and cash proceeds. The Staff also continued its trend of granting principles-based relief in the

context of Section 3(c)(5)(C) and expanding the assets that satisfy the asset composition test by focusing on their indicia of engaging in a real estate finance business.

Background

Section 3(c)(5)(C) is an exception from registration for entities “primarily engaged in,” among other things, “purchasing or otherwise acquiring mortgages and other liens on and interests in real estate” (the “Real Estate Exception”). In order for an entity to be eligible for the Real Estate Exception, (1) at least 55

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percent of its assets must be comprised of assets that are closely connected to real estate such as whole mortgage loans, fee interests, leases and, depending on certain features, B-Notes and mezzanine loans (“Qualifying Real Estate Assets”), (2) an additional 25 percent of its assets must either be comprised of Qualifying Real Estate Assets or certain assets that are more loosely connected to real estate (“Real Estate-Related Assets”), and (3) the remaining 20 percent of its assets do not need to be real-estate-related (“Miscellaneous Assets”).

In reviewing an entity’s eligibility for the Real Estate Exception, the Staff historically conducted an asset-based analysis that focused solely on the characteristics of a particular asset to determine whether the asset should be considered a Qualifying Real Estate Asset, Real Estate-Related Asset or Miscellaneous Asset. In order for an asset to be considered a Qualifying Real Estate Asset, the Staff has generally required that the asset represent an actual interest in real estate or be fully secured by real estate.

In response to the evolution of financing techniques in the real estate finance business, the Staff offered an alternative to the asset-based analysis in certain circumstances. In a no-action letter² issued to Great Ajax Funding LLC (February 12, 2018) (“Great Ajax No-Action Letter”), the Staff stated that a real estate finance company that acquires assets in the normal course that are not Section 3(c)(5)(C) assets may still be able to rely on the Real Estate Exception if the company’s business activities (e.g., assets, income sources, historical development, public representations and the activities of its officers, directors and employees (and other relevant

factors)) “indicate that the issuer is primarily engaged in the real estate finance business.”

In the Great Ajax No-Action Letter, based on the business activities analysis, the Staff stated that securities of a securitization trust that a company received in exchange for mortgage loans (made or acquired by the parent company and transferred into the trust to obtain financing to acquire additional mortgage loans) should be treated as Qualifying Real Estate Assets because the “securities [were] acquired as a direct result of the . . . business of purchasing or otherwise acquiring whole mortgage loans.” Under the traditional asset-based analysis, a security of another entity engaged in the real estate business generally had not constituted a Qualifying Real Estate Asset because it would not have been considered an actual interest in real estate.

The Redwood No-Action Letter

In the Redwood No-Action Letter, the Staff indicated that under the 1940 Act:

a) An entity may treat cash proceeds from asset dispositions as Qualifying Real Estate Assets or Real Estate-Related Assets if, prior to such dispositions, such assets were themselves Qualifying Real Estate Assets or Real Estate-Related Assets, respectively. (Under the facts of the Redwood No-Action Letter, cash proceeds derived from principal amortizations, interest payments and payoffs or from the sale of whole mortgage loans generally would be treated as Qualifying Real Estate Assets, and cash proceeds derived from principal amortizations, interest payments and payoffs or from the sale of certain MBS generally would be treated as Real Estate-Related Assets.)

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b) An entity may treat MSRs as Qualifying Real Estate Assets if the MSRs relate to mortgages initially owned (whether originated or acquired) by the entity but retained upon the sale of the underlying mortgages.

With respect to the MSRs, the Staff noted that relief was being provided pursuant to the Great Ajax No-Action Letter business activities analysis and that its position was limited to MSRs retained upon the sale of mortgages, as opposed to MSRs that were otherwise acquired from an unaffiliated third party.

The Staff also qualified the relief granted with respect to cash proceeds. The relief applies only: (i) for a “temporary” period of up to 12 months from receipt, and (ii) if such proceeds are invested in “cash items” as defined by Section 3(a)(1)(C) of the 1940 Act and Rule 3a-1 under the 1940 Act. The SEC has interpreted “cash items” to include:

- Cash;
- Coins;
- Paper currency;
- Demand deposits with banks;
- Timely checks of others;
- Cashier checks;
- Certified checks;
- Bank drafts;
- Money orders;
- Travelers’ checks;
- Letters of credit; and also generally to include
- Money market funds.

NOTES:

¹ <https://www.sec.gov/investment/redwood-trust-081519-3c5>.

² <https://www.sec.gov/divisions/investment/noaction/2018/great-ajax-funding-021218-3c5.htm>.