LESS FORM, MORE SUBSTANCE: THE SEC STAFF'S RECENT FUNCTIONAL APPROACH TO SECTION 3(C)(5)(C)

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U.S. Investment Management Alert

The staff of the Securities and Exchange Commission ("SEC"), in recognition of the evolution of the real estate business over the past 70 years, has been incrementally expanding the scope of a "qualifying asset" for purposes of reliance on Section 3(c)(5)(C) of the Investment Company Act of 1940 ("1940 Act"). Recently, the staff further moved down this path by issuing a no-action position in *Great Ajax Funding LLC*. [1] There, the staff permitted an issuer (Great Ajax Funding LLC ("GAF")) to rely on Section 3(c)(5)(C) to the extent that GAF acquired assets integral to a vertically integrated real-estate finance business, even though GAF itself did not purchase "mortgages and other liens on and interests in real estate," as expressly provided in Section 3(c)(5)(C) of the 1940 Act.

Section 3(c)(5)(C) of the 1940 Act excludes, among others, real estate companies from the definition of investment company to the extent that the company does not issue redeemable securities, face-amount certificates of the installment type, or periodic payment plan certificates and is "primarily engaged in … purchasing or otherwise acquiring mortgages and other liens on and interests in real estate." Over time, the SEC staff has interpreted Section 3(c)(5)(C) pursuant to a test that permits reliance by an issuer that holds at least 55% of its total assets in "qualifying assets" and no more than 45% of its total assets in real estate-related assets (of which no more than 20% may be in any type of investment). Real estate investment trusts, mortgage banking organizations, mortgage-backed securities issuers, and other real-estate-related organizations apply this 55/45% test to rely on Section 3(c)(5)(C) in not registering with the SEC as investment companies.

Qualifying assets, for these purposes, are not limited solely to "bricks and mortar" (i.e., fee interests in real estate). Rather, the SEC staff has historically viewed a "qualifying asset" for the 55% bucket to include a loan/lien or second mortgage backed by real estate where the holder of the loan or lien has rights of repossession, in the case of a default, or rights to control any foreclosure process. Qualifying assets also include mortgage-backed securities backed by whole-pool mortgages, deeds of trust on real estate, installment land contracts and leasehold interests secured by real estate, and whole-pool agency certificates. [2] Until *Great Ajax Funding LLC*, the staff traditionally had taken the position that a "qualifying asset" would not include holdings of securities of a company that, itself, engaged in a real estate business contemplated by Section 3(c)(5)(C). [3]

The *Great Ajax Funding LLC* no-action letter modifies this traditional position where organizationally and functionally a company's operations show that its holdings are not investments but instead are necessary to facilitate an excepted real estate business. Factually, GAF is part of a real estate investment trust ("REIT") structure in which a REIT is engaged in the business of acquiring, investing in, and managing a portfolio of whole mortgage loans and real property in reliance on Section 3(c)(5)(C). GAF, a wholly owned subsidiary of the REIT, facilitates the securitization of pools of whole mortgage loans acquired from the REIT. That is, GAF acquires

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mortgage loans from the REIT, transfers the loans to a series of trusts sponsored by GAF, and exercises significant control over the operation and management of each of the trusts in exchange for subordinated notes and equity interests in each of the trusts. The subordinated notes and equity interests are the only assets of GAF, and GAF's income is derived entirely from the asset holdings. In addition to the subordinated notes, and as part of the securitization of the mortgage loans, each of the trusts issues senior notes that are offered to institutional investors in private offerings. The REIT uses the proceeds of these offerings to acquire additional mortgage loans to finance its real estate business.

The staff avoided applying an overly formalistic analysis in *Great Ajax Funding LLC* and advocated a look at GAF's historical development, public presentations of policies, activities of its officers and directors, nature of assets, and present source of income (factors the staff derived from the seminal case of *Tonopah Mining Company of Nevada*) to conclude that GAF was engaged primarily in the real estate business subject to Section 3(c)(5)(C). This analysis is notable because the staff applied a holistic approach to a real estate company structure where each part is co-dependent on the other parts, as a complete enterprise engaged in a real estate business. It avoided an approach that looked solely at GAF's assets as dispositive of the company's primary business at the expense of other factors relevant to the business of the enterprise as a whole. The facts of *Great Ajax Funding LLC*, by the same token, are limiting in that GAF's acquisition of interests, transfers of assets, and administration of services are by affiliates in a vertically integrated enterprise and not the result of acquiring interests from nonaffiliates. Notably, the staff expressly noted that its position does not encompass a similar position if an issuer's assets were acquired from a third party in a transaction more closely having an investment purpose, rather than a purpose integral to the operation of a vertically integrated real estate business outside of the scope of the 1940 Act.

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[1] SEC No-Action Letter (pub. avail. Feb. 12, 2018).

[2] *See, e.g., Premier Mortgage Corp.,* SEC No-Action Letter (pub. avail. March 14, 1983) (mortgage-backed securities); Investment Company Act Release No. 29778 (Aug. 31, 2011) (deeds of trust on real estate, installment land contracts, and leasehold interests); and *Salomon Brothers Mortgage*, SEC No-Action Letter (pub. avail. Nov. 8, 1983); *The Federal Home Loan Mortgage Corporation*, SEC No-Action Letter (pub. avail. June 14, 1985); and Equibank, SEC No-Action Letter (pub. avail. Aug. 29, 1983) (whole-pool agency certificates).

[3] The staff recognized that its position deviated from earlier staff precedent, such as its position in *Urban Land Investments Inc.*, SEC No-Action Letter (pub. avail. Nov. 4, 1971).

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