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VIA E-MAIL: rule-comments@sec.gov

Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090
Attn: Elizabeth M. Murphy

File No. S7-34-11

Re: Concept Release: Companies Engaged in the Business of Acquiring Mortgages and Mortgage-Related Instruments

Ladies and Gentlemen:

Redwood Trust, Inc. ("Redwood")[1] appreciates the opportunity to share our views in response to the concept release and request for comment (the "Concept Release")[2] on interpretive issues under the Investment Company Act of 1940 (the "Act") relating to the status under the Act of companies that are engaged in the business of acquiring mortgages and mortgage-related instruments and that rely on the exclusion from the definition of "investment company" set forth in Section 3(c)(5)(C) of the Act.

Section 3(c)(5)(C) of the Act provides that a person satisfying the following criteria is not an "investment company" within the meaning of the Act:

> "Any person who is not engaged in the business of issuing redeemable securities, face-amount certificates of the installment type or periodic payment plan certificates, and who is primarily engaged in one or more of the following businesses: ... (C) purchasing or otherwise acquiring mortgages and other liens on and interests in real estate." (emphasis added)

As discussed below, the legislative history regarding the Section 3(c)(5)(C) exclusion clearly shows that Congress did not intend to regulate under the Act companies like Redwood that are engaged in the mortgage banking business and that do not have the characteristics of investment companies intended to be regulated by the Act.

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1 References herein to "Redwood" refer to Redwood Trust, Inc. together with its direct and indirect wholly-owned subsidiaries, unless the context requires otherwise.

2 Release No. IC-29778; File No. S7-34-11, dated August 31, 2011.

We provide our views below on the following:

- The relevant legislative history of the Section 3(c)(5)(C) exclusion;
- The qualitative indicia of being "primarily engaged in . . . purchasing or otherwise acquiring mortgages and other liens on and interests in real estate";
- The quantitative test described in SEC staff no-action letters to determine the availability of the Section 3(c)(5)(C) exclusion, including our specific proposals regarding the following:
    - Use of a rolling average balance sheet test to take into account a more complete picture of a company's business over time and enable better compliance planning;
    - Use of an alternative revenue/cash flow quantitative test, which for some companies may better capture that they are "primarily engaged" in the mortgage banking business;
    - Treatment of wholly-owned subsidiaries as a group for purposes of the quantitative test; and
    - Treatment of mortgage-backed securities created and retained by a securitization sponsor as "Qualifying Interests" under the quantitative test (including mortgage-backed securities required to be retained under any applicable risk retention rules or regulations).

Legislative History of Section 3(c)(5)(C) of the Act

In reviewing and considering an appropriate standard for the applicability of the Section 3(c)(5)(C) exclusion, it is important to understand the original intent behind the exclusion. Although, as noted in the Concept Release, mortgage markets have evolved and expanded since Section 3(c)(5)(C) was enacted in 1940, the legislative history, scarce as it may be, should serve to guide the current discussion.

A review of the Congressional Record and the hearings held in Congress at the time Section 3(c)(5)(C) was enacted clearly shows that Congress had no intention of regulating what were then referred to as "companies dealing in mortgages," which may now be referred to as companies in the "mortgage banking business." The 1940 report by the House Committee on Interstate and Foreign Commerce relating to the enactment of the Act states that:

> "Subsection (c) specifically excludes brokers, underwriters, banks, insurance companies, common or commingled trust funds administered by a bank, bank-holding-company affiliates subject to the supervision of the Board of Governors of the Federal Reserve System, companies subject to the Interstate Commerce Act, and those of their wholly owned subsidiaries substantially all of whose assets consist of securities of companies which themselves are subject to the Interstate Commerce Act, small-loan companies, factoring companies, companies dealing in mortgages or discount papers, holding companies subject to the Public Utility Holding Company Act of 1935, and certain other special types of companies."[3] (emphasis added)

Similarly, the 1940 report by the Senate Committee on Banking and Currency relating to the enactment of the Act states that:

> "the bill specifically excludes brokers, underwriters, banks, insurance companies, common or commingled trust funds administered by a bank, bank holding company affiliates subject to the supervision of the Board of Governors of the Federal Reserve System, companies subject to the Interstate Commerce Act, and those of their wholly owned subsidiaries substantially all of whose assets consist of securities of companies which themselves are subject to the Interstate Commerce Act, small loan companies, factoring companies, companies dealing in mortgages or discount papers, holding companies subject to the Public Utility Holding Company Act of 1935, and certain other special types of companies."[4] (emphasis added)

Another way to discern Congressional intent is through the statements made by Federal agencies and in Congress in the years following enactment. For example, a 1966 SEC report on the public policy implications of investment company growth (the "PPI Report")[5] states that "Section 3(c)(6) [redesignated section 3(c)(5)] provides an exclusion from the definition of an investment company for companies primarily engaged in the factoring, discounting, or real estate business." (emphasis added)

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3 H.R. Rep. No. 2639, 76th Cong., 3d Sess. 12 (1940).

4 Senate Rep. No. 1775, 76th Cong., 3d Sess. (1940).

5 SEC, Report on the Public Policy Implications of Investment Company Growth, H.R. Rep. No. 2337, 89th Cong. 2d Sess. 328 (1966).

Statements by Congress and Federal agencies have also differentiated between companies dealing in mortgages and companies which should be regulated as investment companies. The PPI Report states, with respect to companies primarily engaged in the real estate business:

> "Although these companies are engaged in … acquiring mortgages and other interests in real estate—thus acquiring investment securities, such activities are generally understood not to be within the concept of a conventional investment company which invests in stocks and bonds of corporate issuers." (emphasis added)

Similarly, a 1970 report by the House Committee on Interstate and Foreign Commerce[6] on amendments to the Act states that:

> "Although the companies enumerated in section 3(c)(6), redesignated section 3(c)(5), have portfolios of securities in the form of notes, commercial paper, or mortgages and other liens on and interests in real estate, they are excluded from the act's coverage because they do not come within the generally understood concept of a conventional investment company investing in stocks and bonds of corporate issuers." (emphasis added)

The Concept Release itself notes that "Section 3(c)(5)(C) of the Act was enacted in 1940 to exclude from regulation under the Investment Company Act companies that were engaged in the mortgage banking business and that did not resemble, or were not considered to be, issuers that were in the investment company business." (emphasis added)

The above review confirms that companies engaged in activities that fit within the below characterizations were intended to be excluded from regulation under the Act:

- Companies dealing in mortgages;
- Companies that have portfolios of investment securities that are in the form of mortgages and other liens on and interests in real estate;
- Companies primarily engaged in the real estate business; and
- Companies primarily engaged in the mortgage banking business.

[6] H.R. Rep. No. 1382, 91st Cong., 2d Sess. 17 (1970).

Qualitative Indicia of Being Primarily Engaged in the Mortgage Banking Business

Although the SEC staff currently uses a balance sheet-focused quantitative test to determine the availability of the Section 3(c)(5)(C) exclusion, in considering the interpretive issues raised in the Concept Release it is important to analyze the qualitative indicia of what it means to be a company engaged in the mortgage banking business in a manner consistent with the exclusion intended by Congress. Such an analysis is essential to understanding the meaning of the Section 3(c)(5)(C) exclusion and to ensuring that any reformulation of this exclusion would continue to permit a company to rely on the exclusion to the extent that the company is engaged in the mortgage banking business in a manner that is consistent with Congressional intent.

The SEC staff described "mortgage banking" activities in a 1973 no-action letter:

> "As a mortgage banker, the Company's principal activities include: (1) originating and otherwise acquiring real estate mortgages for its own account; (2) selling the acquired mortgages; (3) servicing mortgages which it has sold; (4) making construction and development loans to builders and real estate developers; (5) writing health and accident mortgage cancellation insurance; and (6) writing mortgage payment disability insurance."[7]

The IRS described the mortgage banking business in a 2000 Technical Advice Memorandum:

> "X is engaged in the mortgage banking business. As a mortgage banker, X originates mortgages for sale in the secondary mortgage market and sells and services mortgages. Mortgages are originated in two ways, either directly by X, or alternatively by a third party mortgage originator and then acquired by X. Mortgages originated under both methods are pooled by X and sold into the secondary mortgage market. X typically retains the right to service the mortgages sold."[8]

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[7] 73 CCH Dec., FSLR ¶79,540, Georgia Company., (Sep. 06, 1973), Securities and Exchange Commission, (Sep. 6, 1973).

[8] IRS, National Office Technical Advice Memorandum, June 9, 2000, Number 200043010, Release Date 10/27/2000, Index (UIL) No. 446.04-01, 1286.00-00.

A U.S. District Court specifically included securitizations within the definition of "mortgage banking" in an opinion in which it stated that "[m]ortgage banking institutions issue mortgage-backed securities and sell them to investors who receive the income stream from the underlying pool of mortgage loans."[9]

We view the following activities as among the characteristics of companies engaged in the mortgage banking business:

(i) Originating mortgage loans;

(ii) Acquiring whole loans secured by residential real estate, and thereby providing financing to originators and borrowers;

(iii) Engaging in underwriting, appraisal, and regulatory compliance reviews in connection with whole loan originations and acquisitions;

(iv) Selling or financing mortgage loans originated or acquired, including through securitization transactions;

(v) Engaging in ongoing credit analysis of whole loans;

(vi) Servicing mortgage loans, directly or indirectly; and

(vii) Tracking performance and monitoring servicing of whole loans.

Certain of these activities are within the plain language of Section 3(c)(5)(C), while the others are also necessarily at the core of what it means to be in the mortgage banking business in the manner contemplated by the Section 3(c)(5)(C) exclusion. Certain other activities that are the functional equivalent of engaging in these activities are also appropriately considered to be core mortgage banking business activities.

Any reformulation of the Section 3(c)(5)(C) exclusion should recognize that markets have evolved since the Act was enacted in 1940 and few individual companies are engaged in all of these activities. If the SEC is to engage in any reformulation of the Section 3(c)(5)(C) exclusion, a company that is primarily engaged in the mortgage banking business activities listed above, with a particular emphasis on the core mortgage banking activities of originating, acquiring, and financing their originations and acquisitions of mortgage loans, should continue to be eligible to rely on the exclusion.

9 Luminent Mortgage Capital, Inc., et al, v. Merrill Lynch & Co., et al, 652 F.Supp.2d 576 (E.D. Pa. Aug. 20, 2009).

Quantitative Test Used to Determine the Availability of the Section 3(c)(5)(C) Exclusion

SEC staff no-action letters relating to the question of whether a company is "primarily engaged" in "purchasing or otherwise acquiring mortgages and other liens on and interests in real estate" focus on the proportion of the company's assets that are: (i) an actual interest in real estate, loans or liens fully secured by real estate, and, in certain cases, their functional equivalents (collectively, "Qualifying Interests") or (ii) certain other types of real estate and mortgage-related assets (collectively, "Real Estate-Type Interests"). We identify below several proposals for improving the guidance that has emerged from the SEC staff no-action letters.

Rolling Average Balance Sheet Test

A company's balance sheet alone may not always be determinative of whether a company is "primarily engaged" in "purchasing or otherwise acquiring mortgages and other liens on and interests in real estate." During a mortgage banking company's normal operations, it may buy and sell assets in such a way that, at a specific moment in time, it does not hold a sufficient number of Qualifying Interests and/or Real Estate-Type Interests to meet the quantitative tests outlined in the staff no-action letters. However, it may be clear that the company is "primarily engaged" in "purchasing or otherwise acquiring mortgages and other liens on and interests in real estate" by observing its activities over a period of time rather than at a specific point in time. Accordingly, we propose that consideration be given in any reformulation of the Section 3(c)(5)(C) exclusion to the use of a rolling average balance sheet test over a period of time (*e.g.*, two years). A rolling average approach would also give a company the ability to manage its business and compliance planning with greater certainty.

Revenue/Cash Flow Test as an Alternative

In addition to a rolling average balance sheet test, we propose that consideration be given to an alternative test that recognizes that a mortgage banking company's revenue or cash flow over a period of time may also provide clearer evidence that it is "primarily engaged" in "purchasing or otherwise acquiring mortgages and other liens on and interests in real estate." What is reflected on a company's balance sheet from time to time may not always be indicative of the company's activities. A mortgage banking company may originate, purchase, and sell mortgages during the course of a year in large volumes but most of the mortgages originated or purchased may not show up on the company's balance sheet at quarter end or year end. The revenues or cash flows associated with the company's mortgage origination, purchase, and sale activities may, however, be better evidence of the nature of the business in which the company is "primarily engaged."

We propose this as an alternative test, rather than an additional test, as the structure of different mortgage banking businesses may, in some cases, result in mortgage banking activity being consistently reflected through the balance sheet, while in others, mortgage banking activities may be more consistently reflected in revenues or cash flows.

Wholly-Owned Subsidiaries

The protections under the Act are, in large part, focused on the conflicts that arise when two groups of equity stakeholders are unequally exposed to the financial performance of the same entity (*e.g.*, a mutual fund and its external advisor). If two or more entities in a corporate family rely on the Section 3(c)(5)(C) exclusion and they are all wholly-owned by the same set of equity stakeholders, we propose that they should be subjected to the 3(c)(5)(C) test as a group and not separately – and we do not believe that to do so would undermine any investor protection policy. This approach would also recognize that, for a variety of reasons, mortgage banking businesses often have to conduct their activities through various wholly-owned subsidiaries, including, for example, in order to comply with Federal and state tax regulations.

Retained Securitization Interests

We propose that if a securitization sponsor retains a partial pool mortgage-backed security issued in a securitization transaction it sponsored, whether as a result of the application of the proposed risk retention rule[10] or in connection with the use of securitization to obtain financing for its whole loan investments, then the retained asset should be treated as a "Qualifying Interest" for purposes of the Section 3(c)(5)(C) exclusion. These partial pool mortgage-backed securities are assets that securitization sponsors will hold precisely because they have engaged in carrying out key mortgage banking business functions. Any quantitative test for the Section 3(c)(5)(C) exclusion should treat such assets accordingly regardless, as discussed further below, of whether those assets are retained in order to comply with regulatory requirements or voluntarily retained.

Regulatory Risk Retention Requirements

We believe that the SEC's review of the Section 3(c)(5)(C) exclusion should take into account other regulatory measures being implemented relating to mortgage finance. Absent a coordinated approach, securitization sponsors that rely on the Section 3(c)(5)(C) exclusion may be unnecessarily inhibited from continuing to carry out key mortgage banking functions, including the formation of capital to finance mortgage loan originations.

One key feature of the current regulatory reform efforts is the credit risk retention requirement for securitizations sponsors. Pursuant to Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), the Securities Exchange Act of 1934 was amended by adding Section 15G, which generally requires securitization sponsors to retain an economic interest in a portion of the credit risk of assets sold into a securitization in accordance with regulations to be prescribed by the Federal agencies. The Federal agencies

[10] Release No. 34-64148; File No. S7-14-11, dated March 30, 2011.

issued a notice of proposed rulemaking on March 30, 2011 in connection with this risk retention requirement (the "Risk Retention NPR").[11]

The risk retention requirements of the Dodd-Frank Act and the Risk Retention NPR are, in many respects, a response to the historical evolution of the mortgage banking business away from an integrated model (*i.e.*, the origination of a mortgage by a bank or other firm which would then service and hold that mortgage until maturity) and towards the prevailing model of more recent times, in which key functions of the mortgage banking business are carried out as distinct business lines, with some firms engaging in one or more of these functions, and others specializing in just one.

The Risk Retention NPR reviews problems in the mortgage market and notes that "some lenders using an 'originate-to-distribute' business model loosened their underwriting standards knowing that the loans could be sold through a securitization and retained little or no continuing exposure to the quality of those assets." In an effort to address this "loosening" in the origination function of the mortgage banking business, Congress, the SEC, and the other Federal agencies have proposed requiring (or, in the case of the FDIC, have already in effect required) a securitization sponsor to retain credit risk with respect to assets sold into a securitization – a recognition by each of these policy-making bodies that securitization sponsors are integral participants in the mortgage banking business.

The Risk Retention NPR states that:

> "By requiring that the securitizer retain a portion of the credit risk of the assets being securitized, section 15G provides securitizers an incentive to monitor and ensure the quality of the assets underlying a securitization transaction, and thereby helps align the interests of the securitizer with the interests of investors."

Also, with respect to risk retention, the September 27, 2010 final rule on the treatment by the FDIC as conservator or receiver of financial assets transferred by an insured depository institution in connection with a securitization[12] states that:

> "The FDIC believes that requiring the sponsor to retain an economic interest in the credit risk relating to each credit tranche or in a representative sample of financial assets will help ensure quality origination practices. … The recent economic crisis made clear that, if quality underwriting is to be assured, it will require true risk retention by sponsors, and that the existence of representations and warranties or regulatory standards for underwriting will not alone be sufficient."

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11 Release No. 34-64148; File No. S7-14-11, dated March 30, 2011.

12 12 CFR 360.6.

Section 3(c)(5)(C) of the Act, in relevant part, refers to being "primarily engaged" in "purchasing or otherwise acquiring mortgages and other liens on and interests in real estate." Sponsoring a securitization of mortgage loans involves exactly this – *i.e.*, purchasing whole mortgage loans and subsequently financing or selling those whole loans through securitization transactions. In any reformulation of the Section 3(c)(5)(C) exclusion, the SEC should recognize that the securitization interests required to be retained by a sponsor are the result of the sponsor's mortgage banking activities, and these retained interests should, therefore, be treated as Qualifying Interests. The same is true for securitization interests created by a sponsor that the sponsor chooses to retain, as discussed below.

Voluntarily Retained Securitization Interests

Companies that are in the business of originating or acquiring mortgages may choose to obtain financing for their acquisition activity through sponsoring securitization transactions or through other secured borrowing transactions. When these companies finance their business through pledging mortgage assets to a lender in a secured debt transaction, the pledged mortgage assets continue to be treated as Qualifying Interests. Financing those same mortgage loans through securitization should not result in a different outcome for the purposes of the Section 3(c)(5)(C) exclusion. To have a different result under the SEC staff's quantitative test is to elevate form over substance, and we do not believe that the Section 3(c)(5)(C) analysis should be dictated by the method a company chooses to use in obtaining financing for its mortgage banking business.

To further elaborate, following the execution of a securitization, a mortgage banking company that is using securitization to obtain financing for its mortgage assets would typically retain a portion of the securities issued, which securities would represent its continuing interest in the mortgage loans securitized. Just as those mortgage loans assets would be characterized as Qualifying Interests for purposes of the quantitative test used to determine whether a company is "primarily engaged" in "purchasing or otherwise acquiring mortgages," the retained securities that result from securitizing those same mortgage loans should also be characterized as Qualifying Interests for so long as those securities continue to be held by the securitization sponsor that created them.

We note, as well, that retention of a mortgage-backed security by a securitization sponsor is materially different than the acquisition of a security by an investment company that is in the business of buying and selling bonds. In the securitization context, the sponsor creates the retained interest in connection with engaging in the very activities that are covered by the Section 3(c)(5)(C) exclusion (*i.e.*, the mortgage banking activities of acquiring, financing and selling mortgage loans).

Based on all of the foregoing, and notwithstanding that retained interests would be partial pool securities, we believe that these retained interests should be treated as Qualifying Interests while they continue to be held by the securitization sponsor that created them.

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Companies like Redwood play an important role in the mortgage banking business, particularly at a time when there is widespread, bipartisan support for eventually reducing the role of the Federal government in the mortgage markets and increasing the private sector's role in financing residential mortgages. Since the inception of the financial crisis, Redwood has sponsored the only securitizations of newly originated residential mortgages – three transactions backed in the aggregate by over $900 million of mortgages acquired by Redwood.

In order for this financial market to re-establish itself and eventually reduce the current level of government support needed for mortgage finance, additional securitization sponsors need to participate alongside Redwood. Mortgage-focused real estate investment trusts, such as Redwood, are well-suited to carry out this key mortgage banking business function. However, these companies need to continue to be able to rely on the Section 3(c)(5)(C) exclusion in order to efficiently and effectively carry out their business. Accordingly, as it considers the interpretive issues under the Act that are described in the Concept Release, the SEC should continue to recognize that companies engaged in the securitization business fit squarely within the statutory language of Section 3(c)(5)(C) and its legislative and interpretative history. Just as importantly, the SEC should also consider the proposals we have made in this letter, including to assure that the SEC's and other Federal agencies' various mortgage-finance reforms are effectively coordinated and integrated.

We appreciate the opportunity to provide our views in response to the Concept Release. Should you have any questions or desire clarification concerning the matters discussed in this letter, please do not hesitate to contact the undersigned by telephone at 415-384-7373 or via e-mail at andy.stone@redwoodtrust.com.

Sincerely,

Andrew R. Stone
General Counsel,
Redwood Trust, Inc.