APRIL 29, 2021

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MORTGAGE REIT SUMMIT

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January 21
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A New Day Dawns at the CFPB

Authors Ori Lev Stephanie C. Robinson Tori K. Shinohara

With President Joe Biden's inauguration as the 46th President of the United States, change is coming to Washington. And that change will be felt quickly and acutely at the Consumer Financial Protection Bureau (CFPB). At President Biden's request, CFPB Director Kathy Kraninger submitted her resignation on Wednesday, clearing the way for the President to appoint current FTC Commissioner and former CFPB official Rohit Chopra as the next Director of the agency. Given the CFPB's single director structure, the new Director will have significant opportunities to shape the direction of the CFPB over the next four years. Below we address what we can expect to see from CFPB under the new administration.

Who is Rohit Chopra? Mr. Chopra is a graduate of Harvard University and the Wharton business school at the University of Pennsylvania. After working briefly at McKinsey & Company, he joined Elizabeth Warren at the then-nascent CFPB as its first Student Loan Ombudsman. In that role, Mr. Chopra was an effective advocate for student borrowers and brought attention to the increasing student loan burden in the country. Most recently, Mr. Chopra has served as one of five Commissioners, and one of two Democrats, at the FTC. In that role, Mr. Chopra has been outspoken in dissenting from various agency actions that in his view did not impose sufficiently severe penalties or ensure sufficient consumer redress. As the sole Director of the CFPB, Mr. Chopra will no longer have to dissent; his will be the sole deciding vote on matters of enforcement, regulation and policy.

What change is coming? The CFPB's jurisdiction is broad and its authorities many, so Mr. Chopra could choose to go in many different directions. However, his history, the administration's priorities and the current economic crisis all offer clues as to what are likely to be the CFPB's key priorities.

Fair Lending. Congress established the CFPB with a statutorily mandated Office of Fair Lending and Equal Opportunity (OFLEO). Among other things, that office was to have the power to "provid[e] oversight and enforcement of Federal laws intended to ensure the fair, equitable, and nondiscriminatory access to credit," including the Equal Credit Opportunity Act (ECOA) and the Home Mortgage Disclosure Act (HMDA). When the CFPB was first established, OFLEO was part of the Division of Supervision, Enforcement and Fair Lending

(SEFL). As SEFL's name suggests, OFLEO had an important role in setting and executing the agency's fair lending priorities in both the supervision and enforcement arenas. All that changed with the arrival of Acting Director Mick Mulvaney, who moved OFLEO out of SEFL to the Director's office, thereby cutting it off from its integral role in the supervisory and enforcement process. And, indeed, in the three-plus years since Mulvaney first arrived at the CFPB, the agency has brought only three fair lending enforcement actions (one under ECOA and two under HMDA) and has substantially decreased the number of referrals it makes to the Department of Justice.

Against this background, and the new administration's focus on racial equity issues, we expect Director Chopra to restore OFLEO to its prior role as a critical voice in the agency's fair lending supervision and enforcement efforts. That is likely to mean greater focus on fair lending examinations, a greater number of fair lending enforcement investigations and actions, and an increased number of referrals to the Department of Justice. It also is likely to mean a revival of the disparate impact theory of liability, which fell out of favor under the Trump administration. During his tenure at the FTC, Mr. Chopra took an expansive view of disparate impact and suggested that practices that have a disparate impact on protected classes could also constitute violations of prohibitions against unfair practices in the non-credit context when ECOA does not apply.

<u>Student lending</u>. As noted above, Mr. Chopra served as the agency's first Student Loan Ombudsman. As his official FTC biography describes his role, "he led efforts to spur competition in the student loan financing market, develop new tools for students and student loan borrowers to make smarter decisions, and secure hundreds of millions of dollars in refunds for borrowers victimized by unlawful conduct by loan servicers, debt collectors, and for-profit college chains." Between his positions at the CFPB and the FTC, Mr. Chopra also served as a Special Adviser to the Secretary of Education "to advance the Department's efforts to improve student loan servicing, reduce unnecessary defaults, and bolster enforcement." Given Mr. Chopra's background, the enormous size of the student loan marketplace and the policy focus on student loan issues, it is fair to expect that student lending will be an area of priority for the new CFPB. This will likely include attention to private student loan origination (particularly involving for-profit schools), all student loan servicing and student loan debt relief companies (which the CFPB has been aggressively pursuing under Director Kraninger as well). As with fair lending, this will likely entail additional focus on student loan examinations for those institutions under the CFPB's supervisory jurisdiction and increased enforcement scrutiny on the full life cycle of student debt.

<u>Mortgage servicing</u>. The CFPB was born from the financial crisis and the mortgage market—the largest consumer finance market in the country—has long been a CFPB priority. In the midst of a pandemic, with its attendant impact on the economy, and in light of the various federal government relief efforts (in the CARES Act and otherwise), it is clear that the CFPB

will continue to focus on mortgage borrowers, likely with a focus on those borrowers impacted by the current economic downturn and on how banks, mortgage servicers and others are implementing CARES Act requirements and otherwise treating such borrowers. We expect Mr. Chopra to push for aggressive supervision and enforcement in this area, as well as to serve as an advocate for congressional and executive actions to help consumers.

Aggressive enforcement. Given Mr. Chopra's dissents at the FTC, it seems likely that he will push for greater monetary remedies in enforcement actions—both in terms of consumer redress and civil money penalties. We expect the CFPB to continue to focus on unfair, deceptive and abusive acts and practices (UDAAP) in its enforcement actions.

Other issues. The list of other possible priorities is long. It includes rulemakings concerning payday lending, debt collection, consumer access to information and small business data collection. It includes rescinding or revising the CFPB's policy statement on abusiveness and developing a coherent approach to that unique CFPB authority. And it includes developing strategies to protect consumers in areas as disparate as credit reporting and fintech lending.

Continuity? One of Director Kraninger's achievements in her tenure as CFPB Director was invigorating the agency's innovation initiatives, including its No Action Letter policy and its Compliance Assistance Sandbox. Both programs allow companies to seek authorization from the CFPB to offer particular consumer financial products or services under specified terms without fear of enforcement action. The CFPB also launched an Advisory Opinion program and has issued several advisory opinions regarding the agency's interpretation of provisions of federal consumer financial law. These programs are not inherently conservative or liberal, and it will be interesting to see the extent to which Mr. Chopra continues the CFPB's work in these areas.

As with all change, only time will tell what the new administration will bring. Currently unforeseen events, resource limitations and personnel will all play a role in determining the CFPB's actions in the coming years. But it seems fairly certain that the agency will be even more active than it has been as it enters its second decade of existence.

Co-author Ori Lev served as a Deputy Enforcement Director at the CFPB.

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Key Insights From First US Public Redlining Action Against a Non-Bank Lender

Authors Tori K. Shinohara James K. Williams

On July 15, 2020, the Consumer Financial Protection Bureau ("CFPB" or "Bureau") filed a lawsuit against Townstone Financial, Inc. ("Townstone" or the "Company"), a Chicago-based mortgage lender and mortgage broker, alleging that Townstone "redlined" African-American neighborhoods in the Chicago Metropolitan Statistical Area ("MSA") and discouraged prospective applicants from applying to Townstone for mortgage loans on the basis of race.[1] This marks the first time that a federal regulator has taken a public redlining action against a non-bank mortgage lender.

In its complaint, the CFPB departs from the historic practice of leveraging banks' obligations under the Community Reinvestment Act ("CRA") to support redlining allegations and instead argues that the "totality of the circumstances" evidences unlawful redlining. This complaint underscores what the Bureau has stated publicly—redlining is a key area of focus under the CFPB's current leadership.[2] Moreover, it is a warning shot for non-bank mortgage companies, which increasingly originate more mortgages by volume annually than depository institutions.

The CFPB's Allegations

The Equal Credit Opportunity Act ("ECOA") and its implementing regulation, Regulation B, prohibit creditors from discriminating against an applicant in any aspect of a credit transaction on a prohibited basis, including on the basis of race.[3] This prohibition includes statements, acts, or practices that would discourage a reasonable applicant *or prospective applicant*, on a prohibited basis, from applying for credit.[4] According to the Department of Justice ("DOJ"), "redlining" is a term used to describe "an illegal practice in which lenders intentionally avoid providing services to individuals living in predominantly minority neighborhoods because of the race of the residents in those neighborhoods."[5]

In its complaint, the CFPB raises three primary types of allegations to support its claim that, from 2014 to 2017, Townstone acted to meet the credit needs of non-minority neighborhoods within the Chicago MSA while avoiding the credit needs of predominantly African-American neighborhoods. First, the CFPB alleges that the Company's owners and other senior management made disparaging remarks about African-Americans, predominantly African-

American neighborhoods and women, on "The Townstone Financial Show," an AM radio show and podcast. The CFPB's complaint cites to five instances from 2014 to 2017 in which a member of the Company's senior management made comments on The Townstone Financial Show that the CFPB believes would discourage prospective applicants from applying to Townstone for mortgage loans on the basis of race or the racial composition of the neighborhood. For instance, on one episode, Townstone's CEO and owner allegedly stated that the South Side of Chicago between Friday and Monday is "hoodlum weekend" and that the police are "the only ones between that turning into a real war zone and keeping it where it's kind of at."[6] The CFPB alleges that statements such as these would discourage prospective applicants living on Chicago's South Side from applying to Townstone for mortgage loans and would discourage prospective applicants living in other areas from applying to Townstone for mortgage loans for properties on the South Side.[7] In response to the allegations, Townstone has asserted that it is being punished for voicing conservative political speech.[8]

The CFPB's second category of allegations focused on Townstone's failure to affirmatively market to African-Americans and its failure to employ any African-American loan officers. Specifically, the CFPB alleged that Townstone "made no effort to market directly to African-Americans" even though African-Americans make up 17 percent of the population of the Chicago MSA.[9] By the CFPB's own admission, however, Townstone broadcast its radio show throughout the entire Chicago MSA, made it available online as a podcast and shared it widely on social media through Townstone's Facebook, Twitter and LinkedIn accounts. Marketing-related allegations in past redlining actions generally have focused on claims that the target bank either excluded majority-minority areas from its marketing strategies or selectively included predominantly white areas (for example, for pre-screened offers of credit). Here, the CFPB only alleges that Townstone did not affirmatively conduct targeted marketing to African-American consumers, not that it selectively included or excluded certain geographies from its marketing strategy.

The CFPB also noted that Townstone employed 17 loan officers during the applicable period, but none of them were African-American.[10] Although the CFPB implies that the demographics of Townstone's salesforce evidences a failure to serve African-American communities, the Bureau's complaint does not allege that the Company discriminated against any actual mortgage loan applicants on the basis of race or ethnicity. For example, in a previous redlining action, the Bureau used testers to bolster its claims of redlining by alleging that African-American testers were treated less favorably than similarly situated white testers when attempting to apply for mortgage loans at bank branches.[11]

The third category of CFPB allegations focused on statistical analysis of Townstone's mortgage loan application volume. Townstone is a relatively small mortgage company,

receiving an average of 740 mortgage loan applications each year during the applicable time period. The complaint asserts that, during the relevant period, Townstone received between 1.3 percent and 2.3 percent of its applications for properties in majority-African-American neighborhoods compared to between 7.6 percent and 8.2 percent by "peer" lenders.[12] In other words, Townstone's peer lenders allegedly received between 3.6 and 6.2 times more mortgage loan applications from majority-African-American areas in the Chicago MSA than did Townstone.[13] One of the most challenging aspects of conducting a market penetration analysis is properly defining peer lenders. For example, is it fair to compare the performance of a regional non-bank lender to a national bank with greater brand recognition and marketing resources? Also, mortgage loans in specific census tracts are finite, not infinite. Depository institutions may offer Special Purpose Credit Programs designed to help meet their CRA obligations and it can be difficult for smaller, non-bank lenders to compete for loans in certain areas. It is also notable that the complaint does not include the results of the proportional distribution analysis of Townstone's mortgage loan originations during the applicable time period, as compared to its peers. Origination data is arguably more indicative of whether an institution is "redlining" than application data because mortgage loan originations demonstrate that an institution is actually serving the credit needs of majority-minority communities.

Based on the above, the CFPB alleges that "the totality of Townstone's statements, acts, and practices," demonstrate that Townstone redlined African-American neighborhoods in the Chicago MSA and discouraged prospective mortgage applicants on the basis of race.[14]

A New Redlining Framework

This is the first public redlining action against a non-bank mortgage lender by any federal regulator.[15] Although depository institutions have historically originated the vast majority of mortgage loans by volume, in the past decade, non-bank mortgage companies have been increasingly gaining market share.

Because redlining claims have traditionally been brought against depository institutions, regulators have clearly articulated theories of liability they use to bring redlining claims. In the past, regulators have alleged redlining based on (i) statistical allegations and (ii) other factual allegations. The crux of the other factual allegations to support claims of redlining historically have centered on banks' delineation of their CRA assessment areas. Under the CRA, every depository institution must designate an assessment area or assessment areas.[16] Once a depository institution designates its assessment area(s), it must act to serve the credit needs of the entire area – including low- and moderate-income ("LMI") areas. These areas often overlap with predominantly minority areas.

In the past, redlining cases have included allegations that depository institutions intentionally drew their assessment areas to avoid majority-minority areas and failed to establish or maintain physical branch locations in majority-minority areas. (Notably, this appears to be the first redlining action brought by a federal regulator that does not include allegations related to the locations of physical branches. This could signify the Bureau's recognition that brick-and-mortar locations are no longer significant drivers of mortgage volume in the digital age.) In bringing redlining cases, the CFPB and DOJ also have looked at larger geographic areas outside of target banks' designated assessment areas and implied that these areas were the "Proper Assessment Areas."[17] In the CRA context, this concept is referred to as an institution's Reasonably Expected Market Area ("REMA"). Generally, this refers to situations in which a banking regulator believes that a depository institution's CRA assessment area is too geographically limited because it arbitrarily excludes LMI areas or does not consist of whole geographies.[18] Banking regulators use REMA to demonstrate areas where an institution actually marketed and provided credit as compared to the area where it could reasonably be expected to have marketed and provided credit.[19] Because redlining actions against depository institutions have focused on the delineation of an institution's assessment area, redlining settlements often require depository institutions to expand their assessment areas to include certain majority-minority areas that regulators viewed as improperly excluded.

Unlike banks, non-banks do not have CRA obligations and they have no affirmative legal obligation to lend in any specific geography. As a result, regulators have struggled to develop an appropriate legal framework for bringing redlining claims against non-bank lenders. In its complaint, the CFPB appears to leverage the concepts of a REMA or a "Proper Assessment Area" to suggest that Townstone was required to serve the entire Chicago MSA to the same extent as if it were a designated CRA assessment area. By unmooring itself from the traditional legal framework for redlining allegations against depository institutions, the CFPB endorses a more flexible "totality of the circumstances" framework for redlining allegations against non-banks.

Specifically, in bringing its redlining case against Townstone, the CFPB focused on factual allegations related to marketing and employment practices to support its statistical analysis of Townstone's mortgage application activity. Although the complaint outlines certain factual allegations related to the potential discouragement of prospective applicants in connection with certain marketing statements, redlining is fundamentally about the refusal to do business in majority-minority geographies. Because most redlining cases ultimately settle, there is very little case law precedent. As a result, it is unclear whether the CFPB's allegations about the Company's marketing and employment practices, coupled with its statistical allegations, will be sufficient to prove a redlining claim in a court of law.

Conclusion

Although every redlining action is based on unique facts and circumstances, this case should be followed closely for several reasons. First and foremost, this is the first public redlining case to be brought against a non-bank lender and provides insight into the CFPB's framework for analyzing redlining claims against non-banks. This case also demonstrates that small lenders are not immune from redlining claims. Based on this unprecedented action, mortgage lenders should consider risk mitigation strategies to minimize potential redlining risk. Lenders can help mitigate redlining risk by evaluating their market penetration performance and marketing strategies. In the digital age, all forms of marketing may be considered fair game for regulatory scrutiny, including social media activity. Ensuring that advertising and marketing efforts are inclusive and reach residents in majority-minority areas can help mitigate the risk that a lender could be viewed as avoiding the credit needs of such areas. Finally, implementing a strong fair lending compliance management system, including a written fair lending policy, effective fair lending training, and appropriate senior management oversight, can help demonstrate a lender's commitment to fair lending.

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[1] Compl., *CFPB v. Townstone*, Case No. 1:20-cv-04176 (July 15, 2020), available at: https://files.consumerfinance.gov/f/documents/cfpb_townstone-financial_complaint_2020-07.pdf (hereafter, "Complaint").

[2] *2019 Fair Lending Report of the Bureau of Consumer Financial Protection*, CFPB (April 2020), *available at* https://files.consumerfinance.gov/f/documents/cfpb_2019-fair-lending_report.pdf.

[3] *See* 15 U.S.C. § 1691(a); 12 C.F.R. 1002.1 et. seq.

[4] 12 C.F.R. pt. 1002, Supp. I, 1002.4(b)(1) ("In keeping with the purpose of the Act—to promote the availability of credit on a nondiscriminatory basis—§ 1002.4(b) covers acts or practices directed at prospective applicants that could discourage a reasonable person, on a prohibited basis, from applying for credit.").

[5] *See Justice Department Settles Suit Against Indiana Bank to Resolve Lending Discrimination Claims*, DOJ (June 13, 2019), *available at* https://www.justice.gov/opa/pr/justice-department-settles-suit-against-indiana-bank-resolve-lending-discrimination-claims

[6] *Complaint* ¶¶ 33 – 34.

[7] *Complaint* ¶¶ 23 – 40.

[8] *See Townstone Financial Fires Back at CFPB Discrimination Lawsuit*, Housing Wire (July 17, 2020), *available at* https://www.housingwire.com/articles/townstone-financial-fires-back-at-cfpb-discrimination-lawsuit.

[9] *Complaint* ¶¶ 41 – 42.

[10] *Complaint* ¶ 43.

[11] *CFPB v. BancorpSouth Bank*, Complaint, Case No. 1:16-cv-118-GHD-DAS (N. D. Miss. June 29, 2016).

[12] *Complaint* ¶ 49.

[13] *Complaint* ¶ 49.

[14] *Complaint* ¶ 51.

[15] It is also the CFPB's first redlining case under the Trump administration, although the CFPB has only brought two other public redlining case in its history, and those cases were joint efforts that involved the Department of Justice. *CFPB v. Hudson City Savings Bank, F.S.B.*, Case No. 2:15-cv-07056 (D. N.J. Sept. 24, 2015); *CFPB v. BancorpSouth Bank*, Complaint, Case No. 1:16-cv-118-GHD-DAS (N. D. Miss. June 29, 2016).

[16] *See* 12 C.F.R. § 25.41.

[17] *See, e.g.*, *United States of America v. Kleinbank*, Complaint, Case No. 17-cv-136 (D. Minn. Jan. 1, 2017).

[18] *See Consumer Compliance Examination Manual*, FDIC (Sept. 2015); FFIEC, *Interagency Fair Lending Examination Procedures*, FFIEC (Aug. 2009).

[19] *See* https://www.fdic.gov/news/events/sf-region/2018-03-14-rema-cra-presentation.pdf.

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New Rule Allows US Mortgage Servicers to Provide Faster Relief to Borrowers Impacted by Pandemic

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The impacts of the COVID-19 pandemic are putting the Consumer Financial Protection Bureau's (the "CFPB" or "Bureau") Regulation X default servicing rules to the test. According to the Mortgage Bankers Association, as of June 28, 2020, nearly 4.2 million homeowners in the United States were in forbearance plans, representing approximately 8.4% of servicers' portfolio volume and demonstrating the significant impacts of the COVID-19 pandemic on the housing market.[1] As servicers and investors work to develop additional loss mitigation options to assist borrowers when they exit forbearance plans, it has become increasingly clear that the servicing rules do not adequately address emergency situations such as the COVID-19 pandemic. An interim rule promulgated by the CFPB, which became effective on July 1, loosens restrictions and gives servicers the flexibility to offer additional loss mitigation options to assist borrowers impacted by the pandemic.[2]

In this Legal Update, we describe the servicing rules' so-called "anti-evasion" requirement that restricts the loss mitigation servicers can offer in certain situations, discuss the new exception created by the CFPB's interim final rule, and consider whether additional flexibility is warranted.

Regulation X's Anti-Evasion Requirement

The loss mitigation provisions of Regulation X provide that if a borrower submits a complete loss mitigation application,[3] the servicer must evaluate the borrower for all available options offered by the owner of the loan and must satisfy certain deadlines and notice requirements.[4] Regulation X further provides that servicers may not evade this obligation by offering loss mitigation based on an evaluation of an incomplete loss mitigation application.[5] This is known as the "anti-evasion" requirement.

It is worth noting that the servicing rules do not prohibit servicers from offering loss mitigation to borrowers when that offer is not based on any loss mitigation application.[6] However, the

CFPB broadly conceives of what qualifies as a loss mitigation application. Even a phone call with a borrower in which the borrower speaks about their financial concerns can qualify as a loss mitigation application, triggering the anti-evasion requirement.[7]

According to the Bureau, the purpose of the anti-evasion requirement is to ensure that the loss mitigation evaluation process is streamlined and the borrower is evaluated for all available loss mitigation options at the same time, rather than being required to apply multiple times for different options.[8] While these are worthy goals, they trade off with the ability of servicers to get help to borrowers quickly. Completing a loss mitigation application can be time-consuming, and the requirement to evaluate all options could delay or even prevent a borrower's entry into a loss mitigation program. This is especially true during emergencies, when borrowers may face even greater difficulty completing a loss mitigation application. In addition, because of the sharp increase in the number of borrowers needing assistance, servicers may have less capacity to work with borrowers to obtain a complete application and subsequently review the application for all possible loss mitigation options.

Prior to the issuance of this interim final rule, the CFPB has twice amended Regulation X to allow servicers some flexibility to offer certain types of loss mitigation based on the review of an *incomplete* application. First, in 2013, the CFPB amended the rules to permit servicers to offer short-term forbearance programs based on the review of an incomplete application, explaining that the exception would allow servicers to address borrowers' short-term problems quickly and efficiently. [9] In 2016, the CFPB expanded the exception to allow servicers to offer short-term repayment plans based on the review of an incomplete application.[10]

These exceptions have enabled servicers to offer forbearances to borrowers impacted by the COVID-19 pandemic based only on a request for assistance, as required by the CARES Act for government-backed loans and as permitted by similar programs offered by private investors. But as borrowers begin to exit these forbearance plans, it is unclear exactly what loss mitigation options servicers are permitted to offer borrowers without requiring a complete application. For example, a deferral that moves the amount forborne to the end of the loan may be helpful to borrowers exiting COVID-19-related forbearances because even if these borrowers are able to resume making regular monthly payments, many may not be in a position to immediately repay the forborne amounts. However, a deferral does not fit neatly into the existing regulatory exceptions to the anti-evasion requirement.

Regulation X defines a short-term forbearance broadly to mean "a loss mitigation option pursuant to which a servicer allows a borrower to forgo making certain payments or portions of payments for a period of time" and further provides that the option is short-term regardless of the amount of time a servicer allows the borrower to make up the missing payments.[11] The

regulation does not expressly address deferrals. Thus, the question is, if a servicer wants to offer a borrower the option to come out of forbearance and defer paying back those forborne amounts until the end of their loan term—or pay those forborne amounts back over time—can the servicer do so without requiring the borrower to submit a complete loss mitigation application and evaluating all options?

Much like a short-term forbearance, a deferral "allows a borrower to forgo making certain payments." And either option contemplates the servicer giving the borrower time to make up the payments. These similarities between a deferral and a forbearance make it seem logical that a deferral could qualify as a short-term forbearance plan under the rules. But the CFPB rules are simply not clear on this issue.

The question of exactly which loss mitigation options qualify for the exceptions under the servicing rules became particularly salient in the past several months as the Federal Housing Finance Agency ("FHFA") and the Department of Housing and Urban Development ("HUD") announced plans to offer borrowers deferrals and other loss mitigation options based on a review of an incomplete application.

In May 2020, FHFA announced that it would offer a COVID-19 deferral program designed to assist borrowers exiting COVID-19 forbearances who are able to resume making normal monthly payments. Under the program, the delinquent amount is moved into a non-interest bearing balance that is due and payable at the end of the mortgage loan or upon earlier payoff, resolving the borrowers' delinquency. Other terms of the mortgage remain unchanged.[12] (For more detail, see our Legal Update discussing this program.) Similarly, in April 2020, HUD announced that it would permit servicers of loans insured by the Federal Housing Administration ("FHA") to offer borrowers in a COVID-19 forbearance plan a loss mitigation option it termed a "COVID-19 National Emergency Standalone Partial Claim" that permits borrowers who meet certain criteria to defer mortgage payments covered by their forbearance plans.[13] (For more detail, see our Legal Update discussing this program.)

Borrowers are not required to submit a complete loss mitigation application to be eligible for either of these programs.

New Exception for Borrowers Impacted by the COVID-19 Pandemic

The CFPB's new interim final rule solved a conundrum for servicers. It provides an additional exception to the anti-evasion requirement, allowing servicers to offer loss mitigation to borrowers impacted by COVID-19 based on a review of an incomplete application—as long

as the loss mitigation option offered meets the three criteria described below. With this new rule, the Bureau announced that the FHFA's COVID-19 payment deferral and the FHA's COVID-19 partial claim satisfy these criteria, although the exception is not limited to these programs.

1. Moves Amounts Not Paid to End of Loan. The option must permit borrowers to delay paying "covered amounts" until the mortgage loan is refinanced, the mortgaged property is sold, the term of the mortgage loan ends, or, for a mortgage loan insured by FHA, the mortgage insurance terminates.[14] "Covered amounts" generally includes all principal and interest payments forborne under a payment forbearance program made available to borrowers impacted by the pandemic as well as all other principal and interest payments that are due and unpaid by a borrower impacted by the pandemic. "The term of the mortgage loan" means the term of the mortgage loan according to the obligation between the parties in effect when the borrower is offered the loss mitigation option.

The CFPB explained that "covered amounts" do not include escrow payments, so the rule is flexible with respect to how servicers treat any forborne or delinquent escrow amounts. The rule also provides flexibility in the way servicers structure repayment requirements. A lump sum payment due at the end of the loan is permissible under the rule, and because the rule defines "the term of the mortgage loan" to mean the term in effect when the loss mitigation offer is made, repayment over a specified period at the end of the loan term through additional periodic payments is also permissible under the rule. In addition, the rule does not address how borrowers indicate to servicers that they have been impacted by COVID-19. Presumably, servicers or the federal housing agencies have flexibility to establish these criteria.

2. Does Not Charge Interest or Fees. Second, to be eligible for the exception, any amounts that the borrower may delay paying, as described above, must not accrue interest.[15] The FHFA's COVID-19 payment deferral and the FHA's COVID-19 stand-alone partial claim, which the CFPB has stated comply with these requirements, accomplish this by moving the deferred balance to a non-interest bearing balance or second lien, respectively. What is less clear, however, is whether other COVID-19 loan modifications that capitalize the unpaid interest would also meet this criterion. We understand that certain servicers have received informal guidance from the CFPB suggesting that such COVID-19 loan modifications would satisfy this requirement; however, servicers and investors may wish to submit comments to the CFPB requesting clarity on this point.

In addition, the servicer may not charge any fee in connection with the loss mitigation option and must waive all existing late charges, penalties, stop payment fees, or similar charges

promptly upon the borrower's acceptance of the loss mitigation option.[16] The CFPB emphasized that these restrictions allow borrowers to be in a better position to address other financial needs that may arise during the pandemic.

3. Resolves Delinquency. Finally, to qualify for the exception, the borrower's acceptance of the loss mitigation offer must end any preexisting delinquency on the mortgage loan.[17] Importantly, this requirement not only addresses amounts forborne due to the COVID-19 emergency but also more broadly applies to *any* pre-existing delinquency. Because the servicing rules generally prohibit servicers from initiating foreclosure unless the borrower is over 120 days delinquent, this requirement provides borrowers with some protections against foreclosure.[18]

In addition, depending on the underlying agreements, servicers and investors should consider the implications this requirement may have for repurchase obligations. In many cases, a servicer will not be required to advance amounts the borrowers do not pay if the borrowers are considered current.

Waiver of Other Requirements

The interim rule provides that if a borrower accepts an offer pursuant to the new exception, the servicer is not required to comply with Regulation X's requirement to send a letter within five days of receipt of a loss mitigation application that acknowledges receipt of the application, and, if the application is incomplete, lists the additional information the borrower must submit to complete the application. However, because the rules require the letter to be sent within five days of receipt of an application, in order to take advantage of the waiver of this requirement, the servicer necessarily must obtain the borrower's acceptance no later than five days after receiving the application. The rule does not define what constitutes an acceptance, but it seems reasonable to interpret the rule to allow for an oral acceptance.

In addition, if a borrower accepts an offer pursuant to the new exception, the servicer is not required to comply with the requirement to exercise reasonable diligence to obtain a complete application from the borrower.[20]

A More Permanent Solution

The new interim rule is limited to borrowers impacted by the COVID-19 pandemic, but the pandemic is not the only emergency situation for which additional flexibility in the loss mitigation process could be useful. Smaller-scale federally declared natural disasters and emergencies, such as hurricanes or wildfires, occur with some regularity. Currently, when faced with these emergencies, servicers must choose between offering loss mitigation that fits the regulatory definitions of a short-term forbearance or a short-term repayment plan and

requiring a full application. These two options are not necessarily always in the best interests of the borrower, depending on the nature and urgency of the borrower's need. Additional flexibility in the rule could allow servicers and investors to offer loss mitigation to borrowers that is both expeditious and tailored to the particular emergency.

Those submitting comments to the rule may consider suggesting that the CFPB amend the interim final rule so that it is not limited to borrowers impacted by the COVID-19 pandemic but applies more broadly to federally declared national disasters or emergencies.

Comment Period

The CFPB promulgated the rule pursuant to the good cause exception of the Administrative Procedure Act. This exception generally allows agencies to publish a final rule without going through the usual notice and comment process before finalizing a rule where notice and comment are impractical, unnecessary, or contrary to the public interest. The rule went into effect on July 1, 2020, and the Bureau is accepting comments through August 14, 2020. The Bureau will evaluate comments received to determine whether to make revisions to the rule. We are available to assist entities in drafting comments to submit to the Bureau.

* * * * *

As the COVID-19 national emergency continues to disrupt the residential mortgage market, we can expect the CFPB and the federal housing agencies to continue to update the programs and guidance discussed in this Legal Update, as well as announce new requirements designed to address the unique circumstances presented by the pandemic.

Our prior Legal Updates discussing federal regulators' ongoing response to the COVID-19 crisis can be found on our Financial Regulatory COVID-19 Portal. We will continue to issue Legal Updates to keep you up-to-date on any significant future announcements.

If you have any questions about the CFPB's interim final rule, please contact Stephanie Robinson at 202.263.3353 or srobinson@mayerbrown.com, Krista Cooley at 202.263.3315 or kcooley@mayerbrown.com, or Christa Bieker at 202.263.3438 or cbieker@mayerbrown.com.

In addition, if you wish to receive regular updates on the range of the complex issues confronting businesses in the face of the novel coronavirus, please subscribe to our COVID-19 "Special Interest" mailing list.

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[1] Mortgage Bankers Association, Share of Mortgage Loans in Forbearance Decreases for Third Straight Week to 8.39%, July 7, 2020, available at: https://www.mba.org/2020-press-releases/july/share-of-mortgage-loans-in-forbearance-decreases-for-third-straight-week-to-839.

[2] Treatment of Certain COVID-19 Related Loss Mitigation Options Under the Real Estate Settlement Procedures Act (RESPA) (Regulation X), 85 Fed. Reg. 39055, June 30, 2020.

[3] A complete loss mitigation application is defined as "an application in connection with which a servicer has received all the information that the servicer requires from a borrower in evaluating applications for the loss mitigation options available to the borrower." 12 C.F.R. § 1024.41(b)(1). Generally, servicers have the flexibility to determine what information is needed to constitute a complete loss mitigation application.

[4] 12 C.F.R. § 1024.41(c)(1).

[5] *Id.* § 1024.41(c)(2)(i).

[6] Comment 41(c)(2)(i)-1.

[7] *Id.* § 1024.31 (defining loss mitigation application to mean "an oral or written request for a loss mitigation option that is accompanied by any information required by a servicer for evaluation of a loss mitigation option"). *See* Consumer Financial Protection Bureau, Supervisory Highlights, Issue 21 (Feb. 2020) at 5-6, available at: https://files.consumerfinance.gov/f/documents/cfpb_supervisory-highlights_issue-21_2020-02.pdf (stating that the CFPB considered oral conversations in which borrowers spoke to servicers about their financial concerns to be loss mitigation applications).

[8] Amendments to the 2013 Mortgage Rules Under the Equal Credit Opportunity Act (Regulation B), Real Estate Settlement Procedures Act (Regulation X), and the Truth in Lending Act (Regulation Z), 78 Fed. Reg. 60382, 60298, Oct. 1, 2013.

[9] *Id.*

[10] Amendments to the 2013 Mortgage Rules Under the Real Estate Settlement Procedures Act (Regulation X) and the Truth in Lending Act (Regulation Z), 81 Fed. Reg. 72160, Oct. 19, 2016.

[11] Comment 41(c)(2)(iii)-1.

[12] Fannie Mae, Lender Letter 2020-07, updated June 10, 2020, available at: https://singlefamily.fanniemae.com/media/22916/display. Freddie Mac, Bulletin 2020-15, May 13, 2020, available at: https://guide.freddiemac.com/ci/okcsFattach/get/1003811_7.

[13] Department of Housing and Urban Development, Mortgagee Letter 2020-06, April 1, 2020, available at: https://www.hud.gov/sites/dfiles/OCHCO/documents/20-06hsngml.pdf.

[14] 12 C.F.R. § 1024.41(c)(2)(v)(A)(1).

[15] *Id.* § 1024.41(c)(2)(v)(A)(2).

[16] *Id.*

[17] *Id.* § 1024.41(c)(2)(v)(A)(3).

[18] *Id.* § 1024.41(f)(1)(i).

[19] *Id.* § 1024.41(c)(2)(v)(B).

[20] *Id.*

January 29
2021

FHFA Issues Request for Input on Effects of Climate Change and Natural Disasters

Authors

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On January 19, 2021, the US Federal Housing Finance Agency ("FHFA") became the latest federal government agency to recognize the potential impacts of climate change and natural disasters on the mortgage industry when it issued a Request for Input ("RFI") on the risk of climate change and natural disasters to the national housing finance markets.[1] The FHFA cited a number of reports and research on the risks of climate change to the housing market, including a Commodity Futures Trading Commission report issued last year,[2] as part of the reason for issuing the RFI. Below, we summarize some of the risks previously identified by the entities regulated by the FHFA, Fannie Mae and Freddie Mac ("the Enterprises") and the Federal Home Loan Banks ("FHLBanks") pertaining to climate change and natural disasters and FHFA's RFI on how to identify and mitigate these risks.

Impacts of Climate Change and Natural Disasters on the National Housing Finance Markets

In their annual reports for the fiscal year 2019 filed with the US Securities and Exchange Commission, the entities regulated by the FHFA, the Enterprises and the FHLBanks disclosed the risks natural disasters pose to their businesses. The Enterprises noted that natural disasters can adversely affect their businesses or financial results because of increased delinquency rates, default rates, credit losses, credit-related expenses, loan loss frequency and severity, lower origination volume, changes in property values and impacts to local economies.[3] Although their financial exposure to natural disasters has been mitigated in the past,[4] the Enterprises recognized that more geographically widespread weather events due to climate change pose a greater financial risk. In addition, the Enterprises are exposed to greater risk where insurance coverage is inadequate to cover damages from natural disasters and climate changes. Fannie Mae also disclosed that generally, its credit enhancement and risk transfer transactions are not designed to reduce weather and disaster-related losses that they incur. The FHLBanks similarly disclosed in their financial report for the fiscal year 2019 that natural disasters, among other unanticipated or catastrophic events, can reduce the demand for lending, increase the risk of credit losses and adversely affect their cost of and access to funding.[5]

As we detailed in our prior Legal Update, mortgage servicers generally bear the risk of loss in excess of hazard and flood insurance when **government-insured or -guaranteed loans** go into default due to natural disasters, particularly when the loans are pooled to back securities guaranteed by the Government National Mortgage Association ("Ginnie Mae"). This is in marked contrast to conforming conventional loans sold to or pooled with the Enterprises, where servicers in non-recourse transactions do not bear the risk of loss in excess of insurance due to a natural disaster or weather-related event.

Fannie Mae in particular noted in its annual report that the increasing unpredictability of major natural disasters makes it more difficult for it to forecast losses from those disasters, negatively impacting its ability to address the likelihood of such losses in guaranty fees. In addition, Fannie Mae stated that legal or regulatory responses to climate change concerns could also impact the housing markets. Fannie Mae also indicated in its annual report that it recognizes the risk that the increased frequency, severity and unpredictability of natural disasters poses for all stakeholders in the housing system and is exploring ways that it, along with FHFA and others, can mitigate those risks for all stakeholders.

FHFA's Request for Input

In its RFI, the FHFA requested information on the current and future risk of climate change and natural disasters to the housing finance system, the Enterprises and the FHLBanks. The FHFA also requested input on strengthening its supervision and regulation of how the Enterprises and the FHLBanks manage risks arising from climate change and natural disasters. As the FHFA noted in the RFI, it does not have expertise in climate science and, through the RFI, seeks to gain further information about climate change risk exposure to the housing finance system and the entities it regulates. Comments on the RFI are due by April 19, 2021.

The RFI sets out a series of 25 questions for commenters to consider. These questions focus on identifying and assessing climate and natural disaster risk and enhancing FHFA's supervisory and regulatory framework. The FHFA also requested any studies, research, data or other information supporting commenters' responses or that is otherwise relevant to climate and natural disaster risks to Fannie Mae, Freddie Mac and the FHLBanks. The RFI does not address whether the risk of weather-related losses should be shifted to mortgage servicers, beyond a failure to follow servicing requirements. Among the questions, FHFA sought information on:

- How to define, measure and assess climate and natural disaster risk for the entities it regulates and for service providers;
- What risk management strategies are used by the industry to address climate change risks;
- How to evaluate the ability of the FHFA's regulated entities to manage climate change risks;

- Whether the FHFA should implement stress testing or scenario analysis;
- Whether there are alternative risk mitigation strategies, such as insurance or insurance-based financial instruments, that could transfer risk from the regulated entities' portfolios or products or assist with the market pricing of climate and natural disaster risks;
- Whether enough information is publicly available for stakeholders to exercise market discipline over the regulated entities' appetites for and management of climate and natural disaster risk;
- What additional information would assist interested parties in assessing climate and natural disaster risks to the regulated entities;
- What additional reporting requirements the FHFA should impose on the regulated entities, if any, related to management of climate and natural disaster risk;
- How to tailor approaches to manage risks to the Enterprises versus the FHLBanks;
- Whether the FHFA can create policies for managing climate and natural disaster risk that do not adversely affect lower income households;
- What type of organizational structures the FHFA and the regulated entities should consider adopting to support management of climate and natural disaster risk;
- What issues or topics the FHFA should consider for further research on climate and natural disaster risk;
- What organizations, agencies or programs could the FHFA partner with to enhance supervision and regulation of climate and natural disaster risk and what factors the FHFA should consider when determining whether to engage in such partnerships;
- Whether the FHFA should support efforts to develop standards of classification and data reporting on climate and natural disaster risk to the financial performance of companies; and
- What other enhancements the FHFA should consider to supervise and regulate the climate and natural disaster risk to its regulated entities.

The FHFA's RFI continues the trend of government agencies and other stakeholders recognizing the impacts that climate change and associated natural disasters have on financial services in the United States. The fact that the RFI was issued under FHFA Director Mark Calabria, who was appointed by former President Trump, reflects the reality that, regardless of the cause of natural disasters and climate change, these events are exposing the national housing finance markets to significant risk. Accordingly, the FHFA's efforts to gather comments on these risks and develop management policies and strategies based on those comments is an important step towards mitigating climate change risk to the housing markets.

[1] FHFA, Climate and Natural Disaster Risk Management at the Regulated Entities (Jan. 2021), https://www.fhfa.gov/Media/PublicAffairs/Documents/Climate-and-Natural-Disaster-RFI.pdf.

[2] CFTC, "Managing Climate Risk in the U.S. Financial System" (Sept. 9, 2020), https://www.cftc.gov/sites/default/files/2020-09/9-9-20%20Report%20of%20the%20Subcommittee%20on%20Climate-Related%20Market%20Risk%20-%20Managing%20Climate%20Risk%20in%20the%20U.S.%20Financial%20System%20for%20post.

[3] Fannie Mae 2019 Form 10-K, Annual Report for the fiscal year ended December 31, 2019, pp. 36-37, 116-117; Freddie Mac 2019 Form 10-K, Annual Report for the fiscal year ended December 31, 2019, p. 144.

[4] In its 2019 Annual Report, Fannie Mae indicated that its financial exposure from natural disasters is mitigated to the extent its business is geographically diverse.

[5] Federal Home Loan Banks Combined Financial Report for the year ended December 31, 2019, p. 22.

SEC Report Underscores the Interconnectedness of the U.S. Residential Mortgage Credit Markets

When John Donne wrote the famous book, *No Man is an Island*, he most certainly wasn't thinking about residential mortgage credit. But the idea of interconnectedness has universal applicability and lies at the heart of the SEC's newly released report titled "U.S. Credit Markets Interconnectedness and the Effects of the COVID-19 Economic Shock." This report, issued on October 14, 2020, describes in detail the stresses experienced by the credit markets immediately following the shutdown of the U.S. economy in early March 2020 in response to COVID-19. The report is thorough and data driven. It identifies a cohort of approximately $54 trillion of credit issued and outstanding in the U.S. financial system at the end of 2019 and traces the flow of that credit through various intermediaries during the period of time studied by the report. The data in the report supports a widely-held view that credit markets are interdependent, directly linked through a myriad of complex, interconnected transactions.

The report studies several different markets to illustrate their level of interconnectedness, namely, (i) short-term funding markets, (ii) corporate bond markets, (iii) leveraged loans and CLO markets, (iv) municipal securities markets, (v) residential mortgage markets and other consumer lending markets and (vi) the commercial mortgage markets. With respect to each of these markets, the report examines COVID-19-induced stresses of different types, which fall into three categories.

1. *Short-term funding stresses*: These are stresses caused by a sudden and immediate demand for liquidity in the short-term funding markets.
2. *Markets structure/liquidity-driven stresses*: These are stresses caused by an elevated demand for financial intermediation in the context of constrained capital and risk limits. Liquidity constraints were a limiting factor in the volume of trades that regulated intermediaries (specifically broker-dealers) could undertake when trading volumes spiked during the initial COVID-19 shutdown hindering their ability to be a countercyclical force in the market.
3. *Long-term credit stresses*: These are longer-term stresses from COVID-19, which may still be unfolding. Examples are building stress in the commercial real estate and leveraged loan markets. The health of financial intermediaries, which have significant holdings of these assets, will be highly correlated to the ultimate performance of these assets.

For this alert, we have chosen to focus on the aspects of the report that discuss the residential mortgage credit markets.

A. Changes in the Mortgage Credit Markets

As many of us who observe the residential mortgage credit markets know, the early days of the March 2020 COVID-19 lockdown produced tremendous challenges for non-bank entities that owned residential mortgage credit in the form of securities and loans and that depended on short-term funding to finance their assets. Mortgage REITs were impacted heavily by these market conditions, but so were non-bank mortgage originators and private credit funds, which originate and invest in residential mortgage credit.

The SEC report highlights the evolution of the non-bank mortgage intermediaries as a key reason for the COVID-19-related stress in the mortgage credit markets. Currently, 70% of mortgage loans are originated by non-bank mortgage originators. While banks have access to liquidity from deposits to fund their mortgage origination activities, non-bank mortgage originators do not have that source of liquidity and, therefore, must depend on the short-term repo markets for funding. Similarly, mortgage credit assets are increasingly held by mortgage REITs, which grew significantly after the 2008 subprime credit crisis from $168 billion in assets in 2009 to almost $700 billion in assets in 2019. The concentration of mortgage credit assets in the hands of mortgage REITs and other entities that depend on short-term repo funding to fund long-term assets exacerbated the impact of the COVID-19 shocks in the mortgage credit markets. The SEC report also points out that changes in the value of highly leveraged credit-linked securities, or "CRT," which are owned by many mortgage REITs, were directly correlated to the negative performance of the mortgage credit markets, potentially increasing the severity of the stress experienced by the mortgage credit markets in March 2020.

B. COVID-19 as a Triggering Event

In the early days of the COVID-19 crisis, the lack of certainty about future economic conditions and the scattered consumer payment relief policy initiatives among federal, state and local regulators that were often in conflict with one another drove severe and sharp declines in the value of mortgage credit assets. In an effort to deliver assistance to U.S. consumers who were increasingly losing their jobs and being furloughed as employers scaled back or shut down operations, the federal government and state governments announced legally mandated forbearance periods for the enforcement of residential mortgage loans. These legislative initiatives and executive orders were intended to bring quick and immediate relief to affected borrowers, providing very few hurdles for borrowers seeking relief to qualify for the various forbearance programs. As a result, anticipated and actual mortgage delinquencies increased quickly, causing the mark-down of mortgage credit assets. At about the same time, the Federal Reserve restarted a quantitative easing program to deliver stimulus to the economy and increase liquidity to the credit markets during a time of sudden need. Many of the bond purchasing programs created in the 2008 subprime credit crisis were reactivated, increasing demand for credit securities and, therefore, rapidly raising prices for those securities, including mortgage-backed securities issued or guaranteed by the Government Sponsored Enterprises ("GSEs") Fannie Mae and Freddie Mac, as well as by Ginnie Mae (collectively, "Agency MBS").

Along with mortgage REITs, the non-bank residential mortgage loan originators immediately felt the impact of these two events. Mortgage loans made and held in inventory by non-bank mortgage originators pending securitization or delivery to GSEs were marked down by the lenders that financed those loans on short-term repo facilities, triggering margin calls. When the Federal Reserve bond buying programs were resurrected causing prices of Agency MBS to rise rapidly, hedging arrangements used by these non-bank mortgage originators to hedge their pipeline of mortgage loans immediately dropped in value. This produced a separate set of margin calls that, when combined with the margin calls on the short-term warehouse facilities for mortgage loans, produced a sudden liquidity crisis for the non-bank mortgage originators.

Requests for relief, although reasonable, were difficult for repo lenders and hedge counterparties to grant, because they, too, were experiencing similar margin calls or write-downs of mortgage credit positions on their books, illustrating the interconnectedness of the mortgage credit markets. Although broker-dealers, for example, were sympathetic to non-bank mortgage originators' requests for more time to meet margin calls on hedging arrangements, they were unable to grant the requested extensions because of corresponding and interconnected transactions they had entered into. Similarly, mortgage REITs, facing margin calls, tried to convince their repo lenders to forego or reduce margin calls until the mortgage credit markets were able to reach more certainty on the true impact of the COVID-19-related forbearance initiatives. For margin calls made and enforced, the credit impact of the write-downs created a negative feedback loop; as holders of mortgage credit sold securities and loans into an illiquid market to meet margin calls, they drove prices lower, increasing the margin calls. The SEC report acknowledges this phenomenon and attributes additional stress to the lack of buyers in the Agency MBS market. Agency MBS buyers and market-makers are predominantly broker-dealers. However, the SEC report suggests that liquidity requirements, among other constraints, limited their trading capacity and their capacity to build inventories, which significantly undermined their ability to serve as market-makers at a time when large quantities of mortgage credit assets were being sold into the market. This is why the Federal Reserve's bond buying program was so important, even though it caused short-term stress on the non-bank mortgage originators that hedged their pipelines of mortgage loans.

Interestingly, the SEC report only gives passing mention to non-bank residential mortgage servicers, which have a unique role in the mortgage markets. Not only are they tasked with the responsibility of processing mortgage payments and working out COVID-19-related forbearance plans with borrowers, they are also mortgage credit holders to the extent that they own mortgage servicing rights and fund mortgage servicing advances. This is an interesting dynamic not replicated in other service industries. Mortgage servicers must not only be excellent operators, but they must also be astute financial managers. Mortgage servicing rights represent the right to a fixed payment on each mortgage loan in a pool of serviced mortgage loans. This right to payment is in excess of the cost of servicing and, therefore, has value and trades in the market. Because mortgage servicers don't receive payment of this amount on delinquent loans but are still required to service them, the value of mortgage servicing rights can drop severely in anticipation of a long period of elevated mortgage delinquency. An expectation of elevated delinquencies that reduces the value of mortgage servicing rights can produce liquidity strains for servicers, many of which depend on short-term funding arrangements to finance their ownership of mortgage servicing rights.

Similarly, mortgage servicers are responsible for making advances of principal, interest, taxes, insurance and other payments on delinquent mortgage loans in order to keep MBS payments current and to protect the related mortgaged properties from losses and claims. These advancing obligations generally are first supported by prepayments on other mortgage loans in the pool of serviced mortgage loans for principal and interest advances, but, to the extent that prepayments are insufficient to fund the monthly payments on delinquent mortgage loans, the mortgage servicer must come out-of-pocket or turn to third-party financing sources to fund advances. Funding advances on Agency MBS with third-party lenders is especially complicated, requiring the cooperation of the GSEs.

C. Conclusions of the SEC Report and Possible Solutions

The SEC report does not propose solutions to these past, present and emerging problems. It was not written to do so. It was intended to demonstrate the interconnectivity of the financial markets and, as a result, the exponential impact that a shock like COVID-19 can have throughout the system. The credit markets are analogous to a collection of interconnected circuits that may individually function but can produce an overall system failure if one or more of the circuits in the system malfunction. This result is magnified from the 2008 subprime credit crisis because of changes in the size, structure and function of the U.S. credit markets, which now depend more heavily on non-bank owners of credit and financial intermediaries. This is particularly true for the mortgage credit markets. The SEC report notes that, as of August 20, 2020, 7.4% of residential mortgage loans were in forbearance (although this percentage has been dropping recently) and concludes that, if mortgage delinquencies increase from that level going forward (which could happen as government support programs for small business, in particular, expire), it would escalate the financial stress for non-bank mortgage originators, owners of mortgage credit assets and non-bank mortgage servicers, and that stress would flow through the financial system given its interconnectivity.

The SEC report is rightly complementary of the bond buying programs restarted by the Federal Reserve to mute the impact of the stress in the credit markets, particularly the short-term funding markets. The report identifies securitization as a strength of the mortgage credit markets because it eliminates the mark-to-market and extension risk of short-term repo funding. This is an accurate observation, but it only holds true to the extent that those mortgage-backed securities ("MBS") are not themselves funded with short-term repo financing, which is how most non-bank holders of MBS, such as mortgage REITs and credit funds, finance their holdings of MBS.

Bond buying programs and other similar measures that add liquidity to the interconnected credit markets when it is most needed are an effective way to address temporary market dislocations of the type experienced shortly after the COVID-19 shutdown. Situational problems require situational solutions, such as the bond buying programs, that can be easily calibrated to the duration and severity of the problem. Unimaginative and inflexible solutions, like imposing leverage limits on mortgage REITs, for example, are attractive in theory but not ideal. They are blunt tools that may prevent future liquidity challenges, but, at the same time, they may unintentionally stunt the growth of the mortgage credit markets at a time when banks have exited the markets and non-bank capacity is needed to support consumer demand.

We think, however, the role the non-bank mortgage servicers play in the mortgage credit market was underplayed by this report. These are the entities tasked with the frontline work of collecting payments and working out forbearance plans with affected consumers, but, at the same time, they do not get paid for this work, because servicing fees are not paid on delinquent, non-remitting mortgage loans. Non-bank mortgage servicers now make up more than half of the mortgage servicing market, which is a significant change from the 2008 subprime mortgage crisis. Non-bank mortgage servicers use the mortgage credit markets to fund the financial obligations that go along with mortgage servicing, namely, owning mortgage servicing rights and making advances for delinquent loans. Creating and developing coordinated government crisis support programs to help non-bank mortgage servicers fund mortgage servicing rights and advances is necessary for the stable and proper functioning of the residential mortgage credit markets going forward, particularly following an economic shock similar to COVID-19. Expecting the banks to jump back in to pick up the slack, absent significant regulatory reforms, doesn't account for their regulatory capital impediments to holding mortgage servicing rights and their general hesitation to own them again as a result of the losses and reputation or harm they suffered from the asset during the 2008 subprime credit crisis.

We applaud the SEC's effort to put the data out in a comprehensive report and expect that this first step will lead to further action toward mitigating the effects of a future economic shock similar to COVID-19. The report intentionally leaves its readers with the open question of how contingency plans should be made for future events given the changing nature of the credit markets and the increasing participation by non-bank intermediaries. Over the coming weeks and months, we expect that market observers, regulators, including the Financial Stability Oversight Council, and participants will attempt to answer these and other questions posed by the report.

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November 9, 2020

Legal Update

Treating a Nonbank Like a Bank: New Proposed Prudential Standards for Nonbank Mortgage Servicers

Should US state nonbank mortgage servicers be subject to "safety and soundness" standards of the type imposed by federal law on insured depository institutions, even though the nonbanks do not solicit and hold customer funds in federally insured deposit accounts or pose a direct risk of a government bailout? Well, state mortgage banking regulators think so. On September 29, 2020, the Conference of State Bank Supervisors ("CSBS"), an organization made up of state regulators, released proposed prudential standards for state oversight of nonbank mortgage servicers (the "Proposal").[1] CSBS pointed to a "changed nonbank mortgage market" as the driver of the proposed standards, emphasizing that nonbank mortgage servicers now service roughly 40% of the total single-family residential mortgage market. Comments from interested parties are due by December 31, 2020.

Background

CSBS correctly noted in its Proposal that there are no uniform or comprehensive prudential standards that apply to nonbank mortgage servicers. Yet, there are numerous requirements that apply to nonbank mortgage servicers, including the mortgage servicing rules promulgated by the Consumer Financial Protection Bureau ("CFPB")[2] and licensing, consumer protection and other requirements of state regulators. The Federal Housing Finance Agency ("FHFA"), as the conservator of Fannie Mae and Freddie Mac, has instituted minimum capital, net worth and liquidity requirements, and Ginnie Mae also imposes financial strength requirements, but CSBS noted that these requirements do not apply across servicers' entire portfolios. For example, FHFA requirements apply only to the portions of servicers' portfolios that consist of Fannie Mae- and Freddie Mac-owned or -backed loans. The Proposal did not mention the fact that it is reported that third-party agency servicing presently comprises over 75% of the nonbank third-party servicing market. Nor did it highlight that the private investors on whose behalf nonbank mortgage services administer non-agency loans impose their own requirements as counterparties to their servicing agreements and are the ones most likely to bear the risk of loss on the serviced loans.

The idea of "prudential" standards generally is synonymous with "safety and soundness" standards.[3] Section 39 of the Federal Deposit Insurance Act obligates the applicable federal banking agencies to prescribe for all insured depository institutions standards relating to, among others, internal controls, information systems, internal audit systems and other operational and managerial standards as the

applicable agency deems to be appropriate.[4] The widely cited meaning of an "unsafe or unsound practice" is:

> Generally speaking, an "unsafe or unsound practice" embraces any action, or lack of action, which is contrary to generally accepted standards of prudent operation, the possible consequences of which, if continued, would be abnormal risk or loss or damage to an institution, its shareholders, or the agencies administering the insurance funds.[5]

Interestingly, the apparent purpose does not mention protecting bank customers, but, of course, safety and soundness standards, on one hand, and consumer protection requirements, on the other hand, are not mutually exclusive. Indeed, material, persistent violations of consumer protection-related laws and regulations could pose the very type of abnormal risk of loss that safety and soundness standards are designed to prevent. But managing legal risk is one small component of much more comprehensive safety and soundness standards that apply to insured depository institutions.

This is not the first effort to apply additional safety and soundness requirements to nonbank mortgage servicers. CSBS previously issued proposed prudential standards for nonbank mortgage servicers in 2015.[6] In addition, the Housing Finance Reform and Taxpayer Protection Act of 2014, a bipartisan congressional effort to reform Fannie Mae and Freddie Mac that did not become law, would have required the creation of enhanced standards for servicers approved to service certain government-backed loans, including, among other things, standards related to the maintenance of adequate liquidity and reserves.[7] The Homeowner Mortgage Servicing Fairness Act of 2018, a bill introduced by Congresswoman Maxine Waters that also did not become law, included some safety and soundness requirements for nonbank mortgage servicers modeled on similar requirements imposed on Fannie Mae and Freddie Mac.[8] In addition, the Financial Stability Oversight Council ("FSOC") has encouraged state regulators to work to develop prudential and corporate governance standards for nonbank mortgage servicers[9] and issued guidance describing the process FSOC would follow if it were to consider making a determination to subject a nonbank financial company to supervision by the Board of Governors of the Federal Reserve System and prudential standards.[10]

Description of the Proposal

CSBS' Proposal is designed to cover nonbank mortgage servicers and investors in mortgage servicing licensed by and operating in states, but it is not intended to apply to servicers solely owning and conducting reverse mortgage servicing and it would have limited application to entities that only perform subservicing for others. CSBS does not have any regulatory authority to require mortgage servicers to follow these standards. Instead, CSBS suggests that state regulators adopt these standards by enacting laws or regulations or through other formal issuances. In many cases, the standards are somewhat vague, simply stating that a standard will align with a certain previously issued bulletin, and if states were to adopt these requirements, they may need to further develop the standards. As vague as the proposed standards may be under the Proposal, they essentially are a crude "cut and paste" of federal banking requirements. While it hasn't done it in this case, CSBS has drafted model state laws in other areas.

CSBS explained that it has monitored nonbank servicers over the past several years and is concerned about the rapid growth of nonbank servicing and the financial stability and governance of nonbank servicers. According to CSBS, the Proposal aims to provide protection for borrowers, investors and

other stakeholders; enhance regulatory oversight over nonbank servicers; and improve transparency, accountability, risk management and corporate governance standards. The Proposal includes standards in the following areas:

Capital Requirements. The Proposal includes minimum net worth and capital ratio requirements that track FHFA requirements. CSBS indicated, that by leveraging existing FHFA requirements, it hopes to lessen the regulatory burden on nonbank mortgage servicers. FHFA has released heightened standards that are not yet effective,[11] and the Proposal requirements are designed to automatically adjust as FHFA's requirements are modified.

Specifically, the Proposal would require nonbank mortgage servicers to maintain the higher of (1) $2.5 million net worth[12] plus 25 basis points of owned unpaid principal balance for total 1 – 4 unit residential mortgage loans serviced or (2) FHFA eligibility requirements. CSBS noted that it would like interested parties to submit comments on whether "owned unpaid principal balanced" should include whole loans owned by the servicer or simply serviced on behalf of a whole third-party whole loan owner.

The minimum net worth requirements for subservicers that are not originators and do not own mortgage servicing rights or whole loans would be $2.5 million net worth without any additional amounts required for unpaid principal balance of subserviced loans.

With respect to capital requirements, nonbank mortgage servicers would be required to maintain the higher of (1) net worth / total assets >= 6% or (2) FHFA eligibility requirements.

If a servicer is required by Fannie Mae or Freddie Mac to maintain capital in excess of FHFA's minimum eligibility requirements, the Proposal would require the servicer to report that fact to state regulators.

Liquidity Requirements. The liquidity requirements in the Proposal also track FHFA requirements. Under the Proposal, nonbank mortgage servicers would be required to maintain liquidity at an amount that is the higher of (1) 3.5 basis points of agency servicing unpaid principal balance plus non-agency servicing unpaid principal balance or (2) FHFA eligibility requirements.

CSBS explained that because servicing loans in forbearance, delinquency or foreclosure imposes additional costs on servicers, the Proposal includes additional liquidity requirements for non-performing loans that is the higher of (1) an incremental 200 basis points charge on non-performing loans for the portion of agency and non-agency non-performing loans greater than 6% of total servicing or (2) FHFA eligibility requirements.

In addition, the Proposal would require servicers to maintain sufficient allowable assets to cover normal operating expenses in addition to the amounts required for servicing expenses. Allowable assets include unrestricted cash and cash equivalents and unencumbered investment grade assets held for sale or trade. Allowable assets do not include unused or available portions of committed servicing advance lines of credit or other unused or available portions of credit lines such as normal operating business lines.

The Proposal does not detail how the amount necessary for operating expenses should be calculated, but it would require servicers to develop a written methodology for determining and maintaining sufficient operating liquidity and maintain certain policies, procedures and plans related to operating liquidity.

If a servicer is required by Fannie Mae or Freddie Mac to maintain liquidity in excess of FHFA's minimum eligibility requirements, the Proposal would require the servicer to report that fact to state regulators.

Risk Management Requirements. Under the Proposal, nonbank mortgage servicers would be required to establish a risk management program under the oversight of the entity's board of directors that manages risks in numerous areas including credit risk, liquidity risk, operational risk, market risk, compliance risk and reputational risk.

Data Requirements. The Proposal references RESPA's Regulation X requirement that servicers maintain documents and data in such a way that they are able to compile a servicing file within 5 days that includes transaction history information, a copy of the security instrument, notes reflecting communications with the borrower, data fields relating to the borrower's loan and copies of certain information or documents provided by the borrower to the servicer.[13] This requirement already applies to most mortgage servicers, but, as CSBS notes, the requirement does not apply to small servicers, generally defined as servicers that service 5,000 or fewer mortgage loans for which the servicer is the creditor or assignee.[14] CSBS proposed to apply this requirement more broadly to nonbank mortgage servicers.[15]

Data Protection. The standards address data protection and would require servicers to have controls related to the governance of information technology and perform risk assessments as well as testing and monitoring.

Corporate Governance. Under the Proposal, nonbank mortgage servicers must establish a corporate governance framework that protects the interests of the servicer and the servicer's stakeholders.

Servicing Transfer Requirements. To address what CSBS described as widespread data quality and integrity issues in the context of servicing transfers, the Proposal includes servicing transfer requirements that align with a 2014 CFPB bulletin on servicing transfers.[16] This bulletin largely provides additional guidance on compliance with a Regulation X requirement that servicers maintain certain policies and procedures and discusses how other consumer financial laws, including other Regulation X provisions, the Fair Credit Reporting Act, the Fair Debt Collection Practices Act, and the prohibition on unfair, deceptive, and abusive acts and practices, are relevant in the servicing transfer context. Each of these laws already applies to nonbank mortgage servicers under certain circumstances, and other than stating that the standards will "align" with this bulletin, the Proposal does not explain exactly how the standards would apply this guidance. The Proposal also states that the servicing transfer requirements would align with a 2014 FHFA bulletin addressing servicing transfers.[17]

Change of Ownership and Control Requirements. Under the Proposal, nonbank mortgage servicers would be required to provide 30 business days prior notice of a change in ownership of 10% of more of a mortgage servicer. CSBS explained that the notice is designed to allow regulators to determine if additional information about a new owner is needed to evaluate whether the new owner has the financial and management capacity to operate the servicer. Note that many state licensing laws already require prior notice or prior approval of a change of control.

Complex Servicers. In addition to these requirements, the Proposal would apply enhanced standards to servicers that are deemed to be "Complex Servicers." Complex Servicers are servicers that own whole loans plus servicing rights with aggregate unpaid principal balances totaling the lesser of $100 billion or representing at least 2.5% of the total market share.[18] These servicers would be required to

meet enhanced capital and liquidity standards that require the servicer's management and board of directors to develop a methodology to determine and monitor its capital and liquidity needs. Complex Servicers would also be required to engage in stress testing analysis and develop a "living will" that provides a roadmap to recovery should the servicer face significant hardship.

Commentary

It's hard to be opposed in theory to anything that is labeled as "prudential" or "safe and sound." But the question is why should state-chartered, non-depository companies be subject to regulatory requirements that historically have been reserved for insured depository institutions? What the Proposal fails to do is describe in particularity why such standards are necessary for a non-depository. There is no federal deposit insurance in play. There is little likelihood of a direct government bailout of nonbank mortgage servicers. As of yet, there is little evidence that the failure of a nonbank mortgage servicer would have a material adverse impact on the larger economy. Why a state mortgage regulator should care about the fate of a private owner of a nonbank mortgage servicer is not at all clear and appears to go beyond their statutory authority. Consumer protection is the sweet spot of state regulation of mortgage servicers, but does achievement of that goal require the type and level of standards proposed here? At best, many of these broad standards have an attenuated relationship to consumer protection. Certainly, requiring compliance management plans, much like the CFPB does, seems like a more targeted and effective approach that is consistent with their authority and likely to strengthen "safety and soundness" without imposing prudential standards.

Moreover, these financial strength requirements could make it very difficult for smaller non-agency mortgage servicers to stay in the servicing game. The impact of these requirements on small businesses is an important consideration for further review.

If government regulators truly are concerned about the health and strength of nonbank mortgage servicers, perhaps they should consider providing lines of credit or advance lines to enable servicers to advance principal and interest to mortgage-backed securities holders and taxes and insurance to third parties in respect of mortgagor delinquencies.

Conclusion

CSBS has requested comment on numerous aspects of the Proposal, including whether the need for prudential standards is sufficiently established, whether the standards threaten the viability of servicers and whether it makes sense to require Complex Servicers to comply with enhanced standards. CSBS is accepting comments through the end of the year.

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Endnotes

[1] Conference of State Bank Supervisors, "Proposed Regulatory Prudential Standards for Nonbank Mortgage Servicers," Sept. 29, 2020, available at: https://www.csbs.org/system/files/2020-09/FinalProposedPrudentialStandardsForComment-2020_1.pdf.

[2] *See* 12 C.F.R. § 1024.1 *et seq*. and 12 C.F.R. § 1026.1 *et seq*.

[3] *See* our analysis of guidance issued by US federal banking regulators on sound practices for the largest US banking organizations here.

[4] 12 U.S.C. § 1831p-1. For example, the OCC has issued various standards for safety and soundness in the form of appendices to 12 C.F.R. pt. 30. https://www.law.cornell.edu/cfr/text/12/part-30

[5] Financial Institutions Supervisory and Insurance Act of 1966: Hearings on S. 3158 and S. 3695 Before the House Comm. on Banking and Currency, 89th Cong., 2d Sess. 50 (1966); 112 Cong. Rec. 26,474 (1966) (memorandum submitted by John Horne, Chairman of the Federal Home Loan Bank Board).

[6] CSBS explained that its most recent proposal relies heavily on the 2015 proposal.

[7] Housing Finance Reform and Taxpayer Protection Act of 2014, S.1217, 113th Cong. (2014).

[8] Homeowner Mortgage Servicing Fairness Act of 2018, H.R.6102, 115th Cong. (2018). See our prior analysis of this bill here.

[9] Financial Stability Oversight Council, 2014 Annual Report, available at: https://www.treasury.gov/initiatives/fsoc/Documents/FSOC%202014%20Annual%20Report.pdf. *See also* Financial Stability Oversight Council, 2019 Annual Report, available at: https://home.treasury.gov/system/files/261/FSOC2019AnnualReport.pdf.

[10] Financial Stability Oversight Council, "Authority to Require Supervision and Regulation of Certain Nonbank Financial," available at: https://home.treasury.gov/system/files/261/Interpretive-Guidance-on-Nonbank-Financial-Company-Determinations.pdf. See our prior analysis of this guidance here.

[11] Federal Housing Finance Agency, "Frequently Asked Questions: Updated Eligibility Requirements for Enterprise Single-Family Seller/Servicer," Jan. 2020, available at: https://www.fhfa.gov/Media/PublicAffairs/Documents/Servicer-Eligibility-FAQs-1302020.pdf

[12] Under the Proposal, "net worth" means total equity capital as determined by generally accepted accounting principles, minus goodwill and other intangible assets (excluding mortgage servicing rights) and minus receivables from related parties and pledged assets net of associated liabilities.

[13] 12 C.F.R. § 1024.38(c)(2).

[14] *Id*. §§ 1024.30(b)(1); 1026.41(e)(4)(ii).

[15] The Proposal references both Regulation X and Regulation Z, but it only mentions specific requirements detailed in Regulation X. It is unclear which provisions from Regulation Z the Proposal seeks to apply to all nonbank servicers.

[16] Consumer Financial Protection Bureau, Bulletin 2014-01, "Compliance Bulletin and Policy Guidance: Mortgage Servicing Transfers," Aug. 19, 2014, available at: https://files.consumerfinance.gov/f/201408_cfpb_bulletin_mortgage-servicing-transfer.pdf

[17] Federal Housing and Finance Agency, Advisory Bulletin 2014-06, "Mortgage Servicing Transfers," June 11, 2014, available at: https://www.fhfa.gov/SupervisionRegulation/AdvisoryBulletins/AdvisoryBulletinDocuments/2014%20AB-06%20Mortgage%20Servicing%20Transfers%20Advisory%20Bulletin.pdf

[18] The Proposal also provides that state regulators may determine that other servicers not meeting this definition are subject to the enhanced standards.

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CFPB Hatches a QM Proposal for GSE Patch

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As rumored, the Consumer Financial Protection Bureau ("CFPB") is proposing to revise its general qualified mortgage definition by adopting a loan pricing test. Specifically, under the proposal, a residential mortgage loan would not constitute a qualified mortgage ("QM") if its annual percentage rate ("APR") exceeds the average prime offer rate ("APOR") by 200 or more basis points. The CFPB also proposes to eliminate its QM debt-to-income ("DTI") threshold of 43%, recognizing that the ceiling may have unduly restrained the ability of creditworthy borrowers to obtain affordable home financing. That would also mean the demise of Appendix Q, the agency's much-maligned instructions for considering and documenting an applicant's income and liabilities when calculating the DTI ratio.

The CFPB intends to extend the effectiveness of the temporary QM status for loans eligible for purchase by Fannie Mae or Freddie Mac (the "GSE Patch") until the effective date of its revisions to the general QM loan definition (unless of course those entities exit conservatorship before that date). That schedule will, the CFPB hopes, allow for the "smooth and orderly transition" away from the mortgage market's persistent reliance on government support.

Background

Last July, the CFPB started its rulemaking process to eliminate the GSE Patch (scheduled to expire in January 2021) and address other QM revisions. For the past five years, that Patch has solidified the post-financial crisis presence by Fannie Mae and Freddie Mac in the market for mortgage loans with DTIs over 43%. The GSE Patch was necessary, the CFPB determined, to cover that portion of the mortgage market until private capital could return. The agency estimates that if the Patch were to expire without revisions to the general QM definition, many loans either would not be made or would be made at a higher price. The CFPB expects that the amendments in its current proposal to the general QM criteria will capture some portion of loans currently covered by the GSE Patch, and will help ensure that responsible, affordable mortgage credit remains available to those consumers.

Adopting a QM Pricing Threshold

Although several factors may influence a loan's APR, the CFPB has determined that the APR remains a "strong indicator of a consumer's ability to repay," including across a "range of datasets, time periods, loan types, measures of rate spread, and measures of delinquency." The concept of a pricing threshold has been on the CFPB's white board for some time, although it was unclear where the agency would set it. Many had guessed the threshold would be 150 basis points, while some suggested it should be as high as 250 basis points. While the CFPB is proposing to set the threshold at 200 basis points for most first-lien transactions, the agency proposes higher thresholds for loans with smaller loan amounts and for subordinate-lien transactions.

In addition, the CFPB proposes a special APR calculation for short-reset adjustable-rate mortgage loans ("ARMs"). Since those ARMs have enhanced potential to become unaffordable following consummation, for a loan for which the interest rate may change within the first five years after the date on which the first regular periodic payment will be due, the creditor would have to determine the loan's APR, for QM rate spread purposes, by considering the maximum interest rate that may apply during that five-year period (as opposed to using the fully indexed rate).

Eliminating the 43% DTI Ceiling

Presently, for conventional loans, a QM may be based on the GSE Patch or, for non-conforming loans, it must not exceed a 43% DTI calculated in accordance with Appendix Q. Many commenters on the CFPB's advanced notice of proposed rulemaking urged the agency to eliminate a DTI threshold, providing evidence that the metric is not predictive of default. In addition, the difficulty of determining what constitutes income available for mortgage payments is fraught with questions (particularly for borrowers who are self-employed or otherwise have nonstandard income streams). While the CFPB intended that Appendix Q would provide standards for considering and calculating income in a manner that provided compliance certainty both to originators and investors, the agency learned from "extensive stakeholder feedback and its own experience" that Appendix Q often is unworkable.
Continue Reading

The post CFPB Hatches a QM Proposal for GSE Patch appeared first on Retained Interest.

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US Mortgage Servicers – Key Considerations for Distressed Mortgage M&A Transactions

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Any company in a distressed scenario faces challenges, but this is especially true in the mortgage industry as residential mortgage loan servicers grapple with competing regulatory, licensing and bankruptcy law considerations. As forbearance requests rise as a result of the COVID-19 pandemic, so do liquidity challenges for residential mortgage loan servicers.

Servicers of mortgage loans are particularly susceptible to liquidity challenges because they are typically required to continue to make servicer advance payments, notwithstanding the requirement to provide forbearance for borrowers subject to a COVID-19 hardship. This naturally creates significant cash flow challenges because this requirement is likely coupled with the diminishing ability to borrow against these advances as a result of rising delinquencies and forbearances. Moreover, mortgage loan collateral securing credit facilities may be declining in value and making margin calls a greater issue.

Mortgage trade associations have requested a government-backed credit facility that would provide mortgage servicers with much needed liquidity. However, despite these lobbying efforts, according to Treasury Secretary Steven Mnuchin, the federal government currently has no plans to create a dedicated Federal Reserve facility to provide funding for nonbank mortgage servicers. Industry participants believe that the likely rise of borrower forbearances will lead to unsustainable pressure on these servicers and particularly on nonbank servicers. (Please see "The Case for Supporting Nonbank Mortgage Servicers" (Jon Van Gorp), April 8, 2020, and "Mortgage Servicers Are Getting the Short End of the Stick Under the CARES Act" (Laurence Platt), June 5, 2020.)

Fannie Mae and Freddie Mac (the "GSEs") and Ginnie Mae have provided some partial assistance, including by implementing the PTAP/C19 loan facility (in the case of Ginnie Mae) and clarifying the advancing requirements on forborne loans (in the case of Fannie Mae and Freddie Mac). In addition, the FHFA announced recently it would limit servicing advance

obligations to four-months' of forborne payments in Fannie Mae and Freddie Mac deals. While none of these programs offer a "silver bullet" to address all servicing liquidity issues, they are expected to help mitigate the capital outlay that otherwise might be required in these troubling times.

Given the challenges that mortgage servicers are facing in the current climate, market participants may be interested in pursuing distressed transaction opportunities—in particular, through Section 363 asset sales. Potential buyers should consider the following with respect to Section 363 asset sales in the mortgage context.

General Structure of a 363 Transaction

Section 363 transactions (named for the relevant part of Chapter 11 of the Bankruptcy Code) are sales of assets outside the debtor's (i.e., the seller's) ordinary course of business that are conducted as part of an in-court bankruptcy proceeding. Because Section 363 transactions are done within the confines of federal bankruptcy laws, these transactions have many unique features that a buyer should consider.

In Section 363 transactions, assets are typically sold "free and clear" of liens, claims, encumbrances and other liabilities, generally offering a buyer the opportunity to acquire assets with clean title (supported by a bankruptcy court order). This will expressly include any security interests and liens by any lenders on the purchased assets, the holders of any such liens being compelled to look solely to the proceeds of the sale for any satisfaction of their claims. In addition, buyers may have the ability to "cherry pick" assets, including, for example, with respect to mortgage servicing rights, and will typically have greater flexibility in not acquiring contracts that are burdensome or not economically attractive.

These features can provide many benefits to buyers. Buyers should note, however, that because buyers take the assets free and clear, sellers will usually take the position that the assets are being sold "as is" and will provide limited representations and warranties that do not survive the closing or that, as a practical matter, do not otherwise have a real or significant source of payment supporting them. Buyers, therefore, often have limited post-closing recourse against sellers with respect to any unanticipated liabilities related to the assets. In addition, there are several unique procedural challenges that a putative buyer should consider in any Section 363 transaction, including as a result of the open sale process subject to delineated sale procedures that usually occurs. (Please see the following Mayer Brown materials for a more in-depth look at the 363 process: Primer on Distressed M&A: 363 Asset Sales (Elena Rubinov, Nina Flax, Louis S. Chiappetta), Spring 2020, and "363 Preparedness: Practical Buy-Side Tips" (Louis S. Chiappetta, Nina L. Flax, Thomas S. Kiriakos, Elena Rubinov and Sean T. Scott), April 16, 2020.)

In addition to the unique challenges presented by COVID-19, transactions involving mortgage originators and servicers, including 363 transactions, typically present the following issues and should be considered by potential buyers.

Mortgage Loan Warehouse Financing

Since the last financial crisis, non-bank financial companies have grown in market share of origination volume and holders of mortgage loans as compared to depository institutions. To finance these originations and acquisitions prior to such nonbank's execution of its take-out strategy, these nonbanking entities must look to depository institutions to finance the mortgage loans. Typically, the financing takes the form of a repurchase agreement, whereby the nonbank entity transfers the mortgage loan to a banking institution in exchange for cash with an obligation to repurchase the mortgage loan at a date certain. While these arrangements are accounted for as loans for tax and accounting purposes, they are treated as sales for commercial law purposes and, so long as the agreements meet the definition of a "repurchase agreement" under the Bankruptcy Code, they are afforded protected contract status under the Bankruptcy Code. This means that, among other protections, the buyer of such mortgage loans pursuant to a repurchase agreement would not be subject to the automatic stay if the seller were to become insolvent.

A key feature in many of these repurchase agreements is daily mark-to-market valuations of the mortgage loans by the banks and the ability of such banks to issue margin calls if the value drops below the purchase price. If there is a market-wide disruption event, such as the market shock resulting from the COVID-19 pandemic, this market event may depress the value of mortgage loans on the books of lenders. Nonbank entities are then forced to come out of pocket within one to two business days to satisfy these margin calls across a large portfolio of assets. Margin calls across an entire portfolio of assets can create a huge liquidity crunch for these nonbank entities which, if not met, can create facility-level defaults which have the potential to bankrupt the non-bank entity. As a result of the liquidity crunch resulting from the COVID-19 pandemic and resulting margin calls, many nonbank entities are looking to restructure these warehouse lines to be non-mark-to-market but, as one might expect, the cost for warehouse facilities without mark-to-market pricing is relatively high.

Mortgage Servicing Rights

Buyers considering a transaction involving the purchase and financing of mortgage servicing rights ("MSRs") should appreciate the complexity and volatility of this type of asset, especially in a distressed scenario. MSRs are contractually created rights to service mortgage loans that can be owned and accounted for separately from the mortgage loans themselves. The GSEs

and Ginnie Mae, as counterparties to applicable servicing agreements, generally have the right to transfer servicing from a debtor to a more capable servicing platform if such party believes that the debtor is not capable of satisfying its obligations as servicer under the servicing agreement.

For Ginnie Mae transactions, this is the case even after the servicer becomes a bankruptcy debtor. Notwithstanding general Bankruptcy Code provisions that impose an automatic stay against taking action to terminate a servicing agreement, that render any bankruptcy/financial condition termination events ineffective, and that permit a debtor to assume or assume and assign an advantageous servicing agreement, there is a federal statute, 12 U.S.C. § 1721(g)(1), that expressly overrides those provisions in favor of Ginnie Mae. Specifically, this statute expressly authorizes Ginnie Mae to immediately terminate and move servicing in such a situation if it so chooses. While there is no such federal statute in favor of Fannie Mae and Freddie Mac, as a practical matter, each GSE nonetheless is likely to have a significant voice regarding the continued servicing of mortgage loans owned by them, including after the commencement of a servicer bankruptcy, particularly where the proposed buyer is not already approved as a servicer by such GSE. As a result, a buyer must be prepared to have an open dialogue with the applicable GSE and be in a position to readily take over servicing as part of its acquisition of the MSRs.

In addition, the value of an MSR is based on the servicing revenue less expenses related to such loan and adjusted for estimated prepayment speeds and delinquency rates. Because MSR assets are highly correlated to interest rates and default rates, the value can be quite volatile. The volatility of the MSR valuation and the rights of the owner of the loan vis-à-vis the owner of the MSR present complexities when trying to finance the asset. The key to detangling these complexities is understanding any rights and requirements the owner of the actual mortgage loan may have in connection with financing of the related MSR.

For loans owned by private entities and trusts (as for agency loans), the contract that created the servicing right will also detail servicing obligations and servicing fees of the MSR owner, which are factors in the MSR valuation. Because these private entity contracts are bespoke, it can be a complex undertaking to provide a valuation of the MSR. In addition, many of these agreements will prohibit a transfer of the MSR without the consent of the mortgage loan owner and satisfaction of certain other conditions. While this consent usually can be overridden in a bankruptcy of the servicer under general Bankruptcy Code provisions that vitiate such anti-assignment clauses, the debtor servicer would nonetheless still have to satisfy the Bankruptcy Code requirements for the assumption or the assumption and assignment of the servicing agreement, which are discussed in greater detail below. For a party lending against MSRs, this consent right of the mortgage loan owner to a transfer of the MSR can create a significant hurdle to foreclosing on the MSR if there is a default under the underlying credit agreement.

With respect to loans owned by Freddie Mac, Fannie Mae or Ginnie Mae or that comprise part of a Freddie Mac, Fannie Mae or Ginnie Mae bond, the MSR-secured creditor and the servicer are required to execute an acknowledgement agreement with the related agency, whereby such creditor will acknowledge that such agency has specific rights vis-à-vis the mortgage loans and MSR financing facility. While the acknowledgement agreements for each agency contain nuanced and disparate requirements and rights, as a general matter, under each of these acknowledgment agreements the secured creditor agrees to adhere to certain procedures following a default under its agreement and agrees to limitations regarding its rights to transfer servicing following such a default.

In addition, under each acknowledgement agreement, the MSR-secured creditor agrees that following a default under an agency agreement, the applicable agency can extinguish the secured creditor's rights to the related MSRs unless, in the case of Fannie Mae and Freddie Mac, such creditor (or some other party acceptable to such agency) assumes the servicing obligations and puts in place a new servicer or, in the sole case of a payment default under a Ginnie Mae agreement, the secured creditor cures such default within one business day. Finally, the secured party under each acknowledgement agreement agrees to fairly broad indemnity obligations with respect to the related agency. Because of the volatility of the MSR valuation and the agency rights that greatly limit creditor's rights, the advance rates for credits secured by MSRs tend to have higher haircuts and can be somewhat challenging to finance.

Servicing Advances

Similar to MSRs, to understand the issues that arise with servicing advances, buyers should first understand the interests of the mortgage loan holder/investor. Are the loans held in a private label securitization or are they part of a Fannie Mae, Freddie Mac or Ginnie Mae security?

With respect to loans held in private label securitizations or by other private entities, the devil is in the details. Each individual servicing agreement (which may be in the form of a pooling and servicing agreement or servicing agreement as modified by an assignment and assumption agreement) will detail whether servicers must make advances related to principal, interest, taxes, insurance or corporate advances, or some combination of these. Each of these documents will also specify in more or less detail the parameters surrounding when a servicer can seek reimbursement and the servicer's ability to obtain financing for the capital outlay related to the advance receivables. Having a basic sense of what specific advancing obligations exist and how quickly those advances can be reimbursed will help to provide metrics for the capital outlay needed to fulfil these obligations.

For loans held by trusts related to agency bonds, the risks can be more easily quantified because each agency has its own uniform set of rules and guidelines. In Fannie Mae and

Freddie Mac-related securitizations, Fannie Mae obligates servicers to fund principal and interest ("P&I") advances until the loan is re-characterized as delinquent and more generally to fund taxes and insurance ("T&I") and corporate advances. For Freddie Mac, principal payments do not need to be advanced but all other forms of advancing are required. Reimbursements for these advances will come from Fannie Mae or Freddie Mac, respectively, although the timeframes for these reimbursements will vary by agency and advance type. For loans held by trusts in Ginnie Mae-insured securitizations, P&I, T&I and corporate advances need to be advanced until the loan is bought out of the securitization. Reimbursements for these advances primarily comes from insurance claims proceeds or liquidation proceeds, not from Ginnie Mae, and the timing for the remittance of those proceeds similarly varies based on advance type and source of repayment.

In addition to understanding the advancing obligations and reimbursement rights and related timing therefor, what entity holds the loans will also dictate the ease of financing these obligations because private holders and each of the agencies have different restrictions on a servicer's ability to finance the capital outlay required for these advancing obligations.

Again, for loans held in private label securitizations or by other private entities, while it is generally permissible to finance these receivables, each underlying servicing agreement will be unique and needs to be diligenced to understand the scope of these rights.

For Fannie and Freddie Mac-related loans, the servicer and related creditor providing the financing of the advance receivables must obtain consent through either a consent agreement (with respect to Freddie Mac) or an acknowledgement agreement (with respect to Fannie Mae). Furthermore, Fannie Mae and Freddie Mac will recognize the rights to advance receivables as severable from the MSR and the rights of servicers to be reimbursed for those advances. They also will recognize the rights of secured parties to those advance receivables.

While Ginnie Mae will also require a secured creditor to execute an acknowledgement agreement, Ginnie Mae otherwise treats advances differently than the other two agencies. Until recently, Ginnie Mae would not recognize the advance receivable as distinct from the MSR. While Ginnie Mae will now recognize the advance receivable, Ginnie Mae will not recognize the rights of more than one secured party to the MSR and advance receivable on an aggregate level. In order to efficiently and more broadly finance these assets, a complex securitization structure is required pursuant to which the owner of the aggregated MSRs (which includes the advance receivables) issues participation certificates representing the beneficial interest in certain components of its MSRs (including the advance receivable income stream). Ginnie Mae also will not recognize a secured party's right to the receivables post-termination of the servicer. If Ginnie Mae terminates the servicer, unless the cause for termination is due to a payment default that the secured party cures within one business day,

the security interest of the secured party is terminated. Practically speaking, this means that any capital lent against Ginnie Mae servicing advances (or the MSR more generally), while technically recoverable from several sources other than the servicer, is inextricably linked to the performance and creditworthiness of the servicer.

The distinction in treatment between Fannie Mae and Freddie Mac advance receivables, on the one hand, and Ginnie Mae advance receivables, on the other hand, results in advance receivables related to Fannie Mae and Freddie Mac loans being simpler to finance and typically on better terms than Ginnie Mae receivables because more creditors are willing and able to finance Fannie and Freddie advance receivables.

Licensing

Asset sales in the mortgage space typically involve acquisitions of branch offices operated by seller, including transfers of mortgage loan officers and branch managers and pipeline loan assets. When a buyer considers a branch office acquisition, one of the first diligence questions should be whether buyer has the requisite entity-level state licensing approvals to operate the branch offices consistent with buyer's business plan. For instance, if seller originates loans under the California Residential Mortgage Lending Act ("RMLA"), buyer should consider whether a RMLA license would be necessary or advisable to allow buyer to operate the branch offices going forward. If buyer needs to obtain new entity level licenses, the license application process could delay closing. In the alternative, buyer may opt not to originate loans post-closing in certain states while the related license applications are pending, but decreased origination volume could have an adverse effect on revenue, not to mention an increased risk of losing high-producing mortgage loan originators ("MLOs") if they are unable to originate as expected in the impacted states.

State regulatory authorities also license specific branch offices. In a branch office acquisition, seller and buyer will seek consent from the state licensing authorities to transfer authority to buyer at closing. Seller and buyer should also consider whether notice to any federal agencies or investors may be required. Note that Fannie Mae, Freddie Mac and Ginnie Mae require 30–75 days' notice of branch office acquisitions. These state and federal agency approvals and notice requirements should be considered for purposes of identifying a target closing date. Depending upon the underlying circumstances, federal and state agencies may be prepared to accommodate a shorter notice period. Regardless, any putative buyer should be prepared to be proactive in engaging with these agencies.

If substantially all employees will transition to buyer at closing, a transition services agreement may be necessary to assist seller in closing down the remaining loan pipeline after closing, but

note that certain employees must remain with seller until the pipeline is fully closed in accordance with certain agency licensing requirements. In order to transfer the loan pipeline to buyer at closing, the parties must consider notice filings to HUD, VA and USDA to transfer loans in process, authorized personnel, and principal/agent relationships.

Rebranding and changes to dba names pose another challenge for branch office acquisitions. Buyer will be required to register the various dba names under which the branch offices operate with each state secretary of state office. However, secretary of state offices may not approve the name for use by buyer until the name has been surrendered by seller. This creates a tricky transition period at closing and may lead to a temporary hold on loan originations if dba names are not surrender/transferred on a timely basis.

Closing may be especially tricky during the annual "renewal" period in November and December of each calendar year. Many states focus strictly on renewals during the fourth quarter and there tend to be competing acquisition transactions stacked in the queue approaching the holidays. Planning ahead and good communications with the regulators may help facilitate closings during this more challenging time.

Treatment of Servicing Agreements in Bankruptcy

Buyers considering acquiring the assets of a mortgage originator or servicer through the 363 process should be aware that seller's servicing agreements would likely be treated as executory contracts within the meaning of Section 365 of the Bankruptcy Code. Buyers will need to identify which servicing agreements are profitable and should be included in the purchased assets and which are not profitable and thus should be excluded from the purchase. For those to be included, the Bankruptcy Code provisions governing the assumption and assignment of executory contracts, including the requirements that monetary defaults be cured and the assignor provides "adequate assurances" of its ability to perform going forward, would have to be satisfied. This may be a challenge for private equity and hedge fund buyers that do not yet have a servicing platform. Also, how these assumption/assignment costs will be allocated in a transaction—will they be borne by the bankrupt seller or by buyer in addition to the stated purchase price?—will be a subject of negotiation in a transaction. Buyers should also be aware that the general rule is that an assignee is bound by the provisions of the assumed servicing agreement as it is written and, absent the consent of (or the lack of an affirmative objection by) the counterparty to the servicing agreement, buyers cannot impose modifications to those provisions.

Representations and Warranties Insurance

With the likely rise of distressed transactions, Section 363 asset sales, including those involving a mortgage business, may provide opportunities for risk allocation to a transactional liability insurer through a representations and warranties insurance policy. As mentioned

above, Section 363 transactions typically allow buyer to acquire assets "free and clear" of liabilities. However, depending on the type of liability and/or the jurisdiction, there may be certain liabilities subject to which buyer may nonetheless be required to take the purchased assets. For example, Section 363(o) of the Bankruptcy Code provides that, "if a person purchases any interest in a consumer credit transaction that is subject to the Truth-in-Lending Act or any interest in a consumer credit contract (as defined in section 433.1 of Title 16 of the Code of Federal Regulations (January 1, 2004), as amended from time to time), and if such interest is purchased through a sale under this section, then such person shall remain subject to all claims and defenses that are related to such consumer credit transaction or such consumer credit contract, to the same extent as such person would be subject to such claims and defenses of the consumer had such interest been purchased not" in a Section 363 sale.

Depending on the jurisdiction, these liabilities also may involve product liability, regulatory compliance, environmental and intellectual property risks. If there are adequate representations and warranties in the purchase agreement covering these potential risks, then coverage could be available under a representations and warranties insurance policy. (For a more in-depth discussion on transactional liability insurance in distressed and mortgage M&A, please see the following recent Mayer Brown Legal Updates: "Transactional Liability Insurance in Distressed M&A: Challenges and Opportunities in Using Representations and Warranties Insurance in Section 363 Transactions" (Joseph A. Castelluccio, William R. Kucera and Sean T. Scott), April 28, 2020, and "Representations and Warranties Insurance in Mortgage M&A – Challenges and Opportunities" (Lauren Pryor, William Kucera, Libby Raymond and Michael Serafini), April 28, 2020.)

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If you wish to receive regular updates on the range of the complex issues confronting businesses in the face of the novel coronavirus, please subscribe to our COVID-19 "Special Interest" mailing list.

And for any legal questions related to this pandemic, please contact the authors of this Legal Update or Mayer Brown's COVID-19 Core Response Team at FW-SIG-COVID-19-Core-Response-Team@mayerbrown.com.

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VOLUME 03, ISSUE 04 | February 3, 2021

Editor's Note

After the Georgia Senate elections were decided in early January, CMTQ could see that 2021 would be a busy year tax-wise. As we told you in our last issue, with a new administration and a 50/50 US Senate, and with Vice President Kamala Harris as tiebreaker, there are more chances for President Joe Biden's ambitious tax agenda to become law. This could mean big changes for US capital markets taxation.

Front and center would be tax-rate increases. Most importantly, as we reported in CMTQ Vol. 3, Issue 1, and discuss in the article below, the Biden plan would eliminate the difference between ordinary income and capital gain tax rates. Both would be taxed at the maximum ordinary income rate which would go back to the pre-TCJA 39.6% rate. The new rate for capital gains would only apply to taxpayers with taxable income greater than $1,000,000. One other note: if one adds in the 3.8% Medicare tax on investment income, capital gains subject to that tax would apparently be taxed at an all-in 43.4% rate, higher than the rate on ordinary income. Of course, no one knows what any actual legislation might look like.

Equally important in our little world is the potential for mark to market taxation. Although not quite formalized as of this writing, Democratic Senator Ron Wyden will likely be the new chairman of the Senate Finance Committee. For a look at what he thinks capital markets tax-wise, see his 2019 paper: Treat Wealth Like Wages.[1] That plan also would eliminate preferential rates for long-term capital gains. It would go farther and require that gains and losses on publicly traded stock and debt (i.e.,

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1 Available at https://www.finance.senate.gov/imo/media/doc/Treat%20Wealth%20Like%20Wages%20RM%20Wyden.pdf.

* As described in the Editor's Note, this quote is attributed to, among others, Sen. Russell Long (D., LA).

tradable assets)[2] be recognized each year, i.e., a mark to market system. Wyden's plan would subject recognized gains on non-traded assets to retrospective taxation. That is, when gain was recognized, say on the sale of a business held for five years, the taxpayer would be required to pay an additional amount to compensate for the gain deferral. Wyden's plan asks for input on how this additional amount should be computed. Interestingly, one possibility is to impose a surtax on gain from the sale of assets with longer holding periods (thus wholly reversing the current tax system's capital gain preference). The new anti-deferral system would only apply to taxpayers with over 1 million in taxable income or $10 million in assets. According to the Wyden plan the revenue raised from this new anti-deferral system would be used to provide additional funding for Social Security.

Needless to say, these would be big changes in the US federal income tax system as it relates to capital markets and financial instruments. Of course, the new administration has many other priorities in 2021 so it will be interesting to see how they prioritize tax law changes over the next several months.

CMTQ, as always, will keep you up to date.

In this issue, we also cover a Revenue Procedure with extended relief for certain entities owning mortgages, insight into a couple of SPAC tax issues, and more.

Tax Plans of the New Administration

As discussed in a previous issue of CMTQ, President Joe Biden has put forward a variety of tax proposals.[3] With Democratic majorities in the House and a 50/50 Senate (with Vice President Kamala Harris as the tie-breaker), a path has potentially been cleared to advance Biden's tax proposals through Congress into law. Here, we touch on some of the new president's major tax proposals from the campaign trail.

CORPORATE AND BUSINESS TAX PROPOSALS

Biden's tax plan would increase the corporate income tax rate from its current 21% to 28%. In addition, Biden would institute a 15% minimum tax on book profits, or reported annual income net of annual expenses, for corporations with at least $100 million in annual income. When calculating this new minimum tax liability, corporations would still be allowed to claim deductions for losses carried forward from previous years and foreign taxes paid. The tax would function as an alternative

2 Tradable assets are those "for which there is a readily ascertainable fair market value including actively traded property." For this the Wyden plan refers to Treas. Reg. section 1.1092(d)-1 (personal property traded on an established financial market).

3 For the Biden tax plan, see A Tale of Two Tax Policies: Trump Rewards Wealth, Biden Rewards Work (available at https://joebiden.com/two-tax-policies/); The Biden Plan to Ensure the Future is "Made in All of America" by All of America's Workers (available at https://joebiden.com/made-in-america/); and Committee for a Responsible Federal Budget, Understanding Joe Biden's 2020 Tax Plan (July 20, 2020, available at http://www.crfb.org/sites/default/files/CRFB%20USBW%20Biden%20Tax%20Plan%20Analysis_FINAL%20DRAFT_07302020.pdf)

minimum tax, replacing one that was in effect until it was eliminated by the Tax Cuts and Jobs Act of 2017 (the "TCJA").

Under Biden's plan, the effective tax rate on global intangible low-taxed income ("GILTI") would double from 10.5% to 21%. GILTI would be calculated on a country-by-country basis, rather than using a worldwide average, which would, in general, prevent taxpayers from offsetting GILTI amounts between high-tax and low-tax jurisdictions. Further, Biden's plan would eliminate GILTI's exemption for deemed returns under 10% of qualified business asset investment.

Biden also proposes completely phasing out the qualified business income ("QBI") deduction under Code section 199A for filers making more than $400,000. Biden's plan would maintain the current QBI deduction for those making under $400,000 per year. Importantly, REIT dividends are currently eligible for the QBI deduction. One wants to see the fine print, of course, but presumably such dividends could be affected by these changes.

INDIVIDUAL TAX PROPOSALS

Biden's tax plan calls for restoring the top individual income tax rate for taxable income above $400,000 from 37% under current law to the pre-TCJA level of 39.6%. Biden proposes to cap the value of itemized deductions at 28% for those with taxable incomes exceeding $400,000 and restore the Pease limitation on itemized deductions, which was repealed under the TCJA through 2025. Biden would also eliminate the preferential treatment of capital gains and dividends for higher earners. Specifically, capital gains and dividends would be taxed as ordinary income at a rate of 39.6% for individuals and couples earning more than $1 million.

Biden's plan would also impose a 12.4% old-age, survivors, and disability insurance payroll tax on income earned above $400,000, evenly split between employers and employees. Under current law, this payroll tax only applies to wage income up to $137,700.

Finally, Biden's plan would eliminate the Code section 1014 basis step up at death and would return estate and gift tax exemptions to 2009 levels.

Mark-to-Market?

As noted above, in this, the 117th Congress, Senator Ron Wyden (D-Ore.) is poised to become the next chairman of the Senate Finance Committee. On September 12, 2019, Senator Wyden the then ranking Democratic member on the Senate Finance Committee, released his Treat Wealth Like Wages - a tax plan that would establish a mark-to-market tax regime.[4] This plan, which would only apply to

4 For further discussion of the 2019 plan, see Capital Market Tax Quarterly Vol. 2 Issue 3, available at https://www.mayerbrown.com/-/media/files/perspectives-events/publications/2019/10/capital-markets-tax-quarterly-volume-2-issue-3--oct-2019.pdf.

high income or high-net worth taxpayers, would generally impose annual "mark-to-market" accounting and taxation for tradable assets such as publicly traded stock and lookback taxation upon sale for assets that are less easily valued, such as real estate, closely held businesses and valuable collectibles. Wyden recently stated that he plans to move forward with this proposal now that there is a tie in the Senate with a tie-breaker from the vice president.[5]

Mark-to-market taxation currently only applies to dealers in securities under Code section 475 and regulated futures contracts under Code Section 1256. While there have been proposals going back to former Representative Dave Camp (R, MI) in 2013, mark-to-market was not included in the TCJA.

Select US Tax Considerations for SPACs

Special purpose acquisition companies ("SPACs") had an unprecedented run in 2020 which continues in 2021. At the close of 2020, more than 230 SPACs had raised more than $78 billion through initial public offerings ("IPOs"), surpassing the $13.6 billion raised through approximately 59 SPACs in 2019. While the SPAC profile is straightforward (typically, an IPO for cash followed by an acquisition), there are nevertheless US federal income tax issues in each SPAC offering and acquisition.[6]

For example, one question relates to the timing and character of tax imposed on receipt of founders shares. In a typical SPAC structure, the sponsors contribute nominal cash in exchange for founders shares, which ultimately become a 20 percent equity interest in the SPAC after its IPO. Thus, the sponsors effectively have a zero tax basis in their founders shares while receiving 20 percent of the SPAC's equity. Is this taxed at the time of the IPO, at the time a target is acquired, or when the sponsors sell their founder shares?

In a properly structured SPAC, Sponsors rely on the "realization" principle and determine that receipt of founder's shares does not result in gross income. Thus, under the current US tax system gain on an asset is not realized until the asset is disposed of. With founder's shares even though the SPAC does an IPO (thereby establishing value for the shares) no gain is generally recognized because the founder is not disposing of its shares in the IPO. Moreover, case law suggests that if a sponsor acquires its founders shares before the SPAC has taken any meaningful actions (i.e., when the value of the shares is most speculative), then the interest would not be characterized as compensation.[7] To bolster this position, founders shares should ideally be issued to sponsors as soon as possible in

5 Colin Wilhelm, Incoming Finance Chair Wyden to Move on Capital Gain Changes , Bloomberg Tax (January 13, 2021).

6 For a more in depth analysis of the mechanics of a SPAC, please see our article "*What's the Deal? – Special Purpose Acquisition Companies*" available at https://www.mayerbrown.com/-/media/files/perspectives-events/publications/2020/08/whats-the-deal--spacs.pdf.

7 *See Berckmans v. Commissioner*, T.C. Memo. 1961-100 (supporting the position that fair market value of stock purchased at par value ($1 per share) was not worth more at the time of a taxpayer's purchase since at the time of purchase the corporation had no assets and only speculative future plans); *but see Husted v. Commissioner*, 47 T.C. 664 (1967) (concluding that a taxpayer was permitted to acquire shares of stock of a corporation for less than its fair market value and that the difference was compensation income for his services in arranging the acquisition of a trailer business by the corporation.

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advance of the IPO. Of course, if Senator Wyden's mark-to-market proposal described above becomes law appreciation in a sponsor's founders shares might be taxed at the end of the first taxable year after the IPO because the shares would be traded on an established market at that point.

Note that the acquisition of a target (i.e., the de-SPAC transaction) is generally (although not always) structured as an acquisition by the SPAC of a target company with a business. In this case, the founders do not exchange their shares but continue to hold them so, again, there is no realization event to the founders at the time of the acquisition. Putting this all together, under current law gain on founders shares is only recognized when the founder sells or exchanges the shares.

Another SPAC question relates to the taxation of a "unit." One of the common features in a SPAC is that the IPO is of a unit consisting of common stock and a fraction (e.g., one-third or one-half) of a redeemable warrant. One whole warrant allows the holder of the warrant to acquire additional common stock. The stock and the warrant trade together initially but then, after a period of time, the warrant detaches and the common stock and the warrant trade separately. How is that treated for US federal income tax purposes?

For example, assume that in an offering a unit is offered for $10. Further assume that a few months after the IPO, the unit traded up to $18 and the warrant detached when the common stock price was $12 and the warrant price was $6. To understand the tax consequences of the acquisition, possession, and subsequent disposition of the unit to a holder, the holder must understand when and how the tax basis is allocated between the common stock and the warrant.

When an option or stock is coupled with a debt instrument, Treas. Reg. Section 1.1273-2 provides that—

(h) **Investment units**

(1) *In general*. Under section 1273(c)(2), an investment unit is treated as if the investment unit were a debt instrument. The issue price of the investment unit is determined under paragraph (a)(1), (b)(1), or (c)(1) of this section, if applicable. The issue price of the investment unit is then allocated between the debt instrument and the property right (or rights) that comprise the unit based on their relative fair market values . . . .

(2) *Consistent allocation by holders and issuer*. The issuer's allocation of the issue price of the investment unit is binding on all holders of the investment unit. However, the issuer's determination is not binding on a holder that explicitly discloses that its allocation is different from the issuer's allocation. Unless otherwise provided by the Commissioner, the disclosure must be made on a statement attached to the holder's timely filed Federal income tax return for the taxable year that includes the acquisition date of the investment unit . . . .

However, there is no such regulation dealing with the common stock and warrants that are issued as an investment unit. In Rev. Rul. 88-31, the IRS considered the tax characterization of an investment unit issued by a corporation, which consisted of common stock and a contingent payment right (the

value of which varied inversely with the value of the common stock). Similar to the units issued by SPACs, the investment unit in the revenue ruling initially could not be separated. After a short period of time, however, the parts could be separately transferred and traded on a national exchange. First, the IRS established that the contingent payment rights were property separate from the common stock. Then, the IRS quickly concluded that the tax basis should be allocated between the common stock and the contingent payment right on the basis of the fair market value of the common stock on the date of issuance. Note, however, that at the time the investment units were issued by the corporation, the corporation's common stock was widely held and publicly traded on a national securities exchange. Thus, the relative fair market values of the common stocks and the contingent payment rights were readily ascertainable.

When trying to allocate tax basis between the common stock and the warrant in a unit issued by a SPAC, one approach, as in Rev. Rul. 88-31, would be to allocate the purchase price initially between the common stock and the warrant based on their relative fair market values. For example, one SPAC that adopted this approach included the following disclosure regarding the tax basis of a unit—

"No statutory, administrative or judicial authority directly addresses the treatment of a unit or instruments similar to a unit for U.S. federal income tax purposes and, therefore, that treatment is not entirely clear. The acquisition of a unit should be treated for U.S. federal income tax purposes as the acquisition of one share of our [common stock] and [one-half of one warrant] to acquire one share of our [common stock]. For U.S. federal income tax purposes, each holder of a unit must allocate the purchase price paid by such holder for such unit between the one share of [common stock] and the one-half of one warrant based on the relative fair market value of each at the time of issuance. Under U.S. federal income tax law, each investor must make his or her own determination of such value based on all the relevant facts and circumstances. Therefore, we strongly urge each investor to consult his or her tax adviser regarding the determination of value for these purposes. The price allocated to each share of [common stock] and the one-half of one warrant should be the stockholder's tax basis in such share or warrant, as the case may be. Any disposition of a unit should be treated for U.S. federal income tax purposes as a disposition of the share of [common stock] and one-half of one warrant comprising the unit, and the amount realized on the disposition should be allocated between the [common stock] and the one-half of one warrant based on their respective relative fair market values (as determined by each such unit holder on all the relevant facts and circumstances) at the time of disposition. The separation of shares of [common stock] and warrants comprising units should not be a taxable event for U.S. federal income tax purposes.

The foregoing treatment of the shares of [common stock] and warrants and a holder's purchase price allocation are not binding on the Internal Revenue Service ("IRS") or the courts. Because there are no authorities that directly address instruments that are similar to the units, no assurance can be given that the IRS or the courts will agree with the characterization described above or the discussion below. Accordingly, each prospective investor is urged to consult its own tax advisors regarding the tax consequences of an investment in a unit (including alternative characterizations of a unit). The

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balance of this discussion assumes that the characterization of the units described above is respected for U.S. federal income tax purposes."

However, unlike Rev. Rul. 88-31, the ability to correctly allocate tax basis between the common stock and warrant at the time of issuance by a SPAC is not necessarily apparent to the naked eye because there is no separate trading at such time. Put another way, it would be much easier to allocate tax basis between the two pieces when they begin trading separately. For example, in our illustration above, $12 would be allocated to the common stock and $6 to the warrant. Unfortunately, the answer, as in so many financial instrument tax issues, is not clear. Moreover, as can be seen from the above disclosure, it appears that many issuers take the position that the allocation must be done at the time of issuance rather than separation.

PLR 202035003 – Guidance on Settlement Payments to REMIC Regular Interest Holders

On August 28, 2020, the Internal Revenue Service ("IRS") issued a private letter ruling offering guidance on the tax treatment of settlement payments to former real estate mortgage investment conduit ("REMIC") regular interest holders.

As background, the Code generally defines a REMIC as any entity that (i) has made an election to be treated as a REMIC for the current taxable year and all prior taxable years; (ii) all of the REMIC's interests are residual interests or regular interests; (iii) the REMIC only has one class of residual interest; and (iv) substantially all of the REMIC's assets consists of qualified mortgages and permitted investments. For purposes of satisfying the asset requirement, "substantially all" of a qualified entity's assets are qualified mortgages and permitted investments if the qualified entity owns no more than a de minimis amount of other assets. Further, the amount of other assets is considered de minimis if the aggregate of the adjusted basis of such assets is less than one percent of the aggregate of the adjusted basis of all of the REMIC's assets.

The Code also imposes a 100 percent tax on a REMIC's net income derived from a "prohibited transaction." A "prohibited transaction" is defined as one of the following transactions: (A) disposition of any qualified mortgage transferred to the REMIC other than a disposition pursuant to (i) the substitution of a qualified replacement mortgage for a qualified mortgage (or the repurchase in lieu of substitution of a defective obligation), (ii) a disposition incident to the foreclosure, default, or imminent default of the mortgage, (iii) the bankruptcy or insolvency of the REMIC, or (iv) a qualified liquidation; (B) the receipt of any income attributable to any asset which is neither a qualified mortgage nor a permitted investment; (C) the receipt by the REMIC of any amount representing a fee or other compensation for services; or (D) gain from the disposition of any cash flow investment other than pursuant to any qualified liquidation.

The settlement agreement at issue in the ruling arose from a dispute where investor plaintiffs that were holders of the REMIC's regular interests sued the trustee of the REMIC for breach of fiduciary duty. The parties eventually settled out of court and entered into a settlement agreement. In the PLR, the REMIC trustee requested guidance regarding the tax consequences from the execution of the settlement agreement and the distribution of a settlement amount in accordance with the agreement's terms. The IRS ruled that such amounts paid pursuant to the agreement, with respect to each taxpayer that made a timely REMIC election: (i) is a direct payment between trustee and the investor plaintiffs and will not result in a deemed payment to or made by the REMIC for federal income tax purposes; (ii) will not be treated as a "prohibited transaction"; and (iii) will not be treated as an asset of the taxpayers.

In making its determination, the IRS pointed out that, "the distribution of the Settlement Amount is consistent with its treatment as a settlement of direct claims between the [t]rustee and investors because: (i) [t]rustee paid the Settlement Amount into an escrow account for direct distribution to [i]nvestor [p]laintiffs who are eligible class members; (ii) no portion of such Settlement Amount was, or will be, taken from, or reimbursed from, the assets of any [t]axpayer; and (iii) no portion of the Settlement Amount will be paid to or through [t]axpayers."

CIC Services v. IRS: Injunction on Reportable Transaction Reporting?

The Supreme Court heard arguments in the case of *CIC Services v. Internal Revenue Service* on December 2, 2020, regarding the limits of the Anti-Injunction Act (the "Act"). The Act, contained in Section 7421 of the Internal Revenue Code and originally enacted in 1867, prevents persons from suing to enjoin the collection of tax. The primary consequence of the Act is that generally a person seeking to challenging a tax statute must first pay the tax and then sue for a refund.[8]

CIC Services LLC (the "Petitioner") acted as a material adviser to certain captive insurance arrangements. In 2016, the IRS issued Notice 2016-66 (the "Notice") which designated such captive insurance transactions as "reportable transactions" subject to enhanced reporting requirements and penalties. The penalty for failing to report a reportable transaction applies to both taxpayers and material advisors and is labeled by the Code as a "tax."[9]). The Petitioner sought to challenge the Notice on the basis that the issuance of the Notice did not comply with the notice and comment procedures provided for in the Administrative Procedures Act. Both the district court and the U.S. Court of Appeals for the Sixth Circuit ruled against the Petitioner, and the Supreme Court granted certiorari.

8 A major exception to the Act is Section 6213, which allows a taxpayer to litigate a tax in Tax Court prior to assessment. This exception does not apply to penalties under section 6707, at issue in this case.

9 Section 6671(a).

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At oral arguments, the Petitioner sought to draw a distinction between challenging the collection of tax (which is prohibited by the Act) versus challenging the Notice itself. The injury in the latter case, according to the Petitioner, was not the payment of a tax but rather the cost of complying with the Notice's reporting requirements. The Petitioner also argued that, if the Act applied to bar a challenge to the Notice, then the Petitioner's only path to challenging the Notice would be to risk large penalties and potential criminal sanctions. The government, on the other hand, argued that the Petitioner could avoid criminal liabilities by filing a good-faith letter with the IRS stating the Petitioner's belief that the Notice was unlawful. The Petitioner could then sue for a refund of the penalty.

According to one commentator, "While predicting an outcome from an argument is always tough, CIC seemingly has a slightly better chance at prevailing."[10] A decision in the case is expected by June 2021.

Rev. Proc. 2021-12: Extended Relief for Mortgages

The IRS previously issued Rev. Proc. 2020-26, which provided safe harbors to protect the federal income tax status of REMICs and investment trusts that provide certain forbearances of mortgage loans they hold or that acquire mortgage loans that have received certain forbearances. Additionally, the IRS issued Rev. Proc. 2020-34, which provided safe harbors to protect the federal income tax status of certain investment trusts whose trustees request or agree to certain forbearances of mortgage loans, make certain modifications of real property leases, or accept certain cash contributions.

The safe harbors, however, were set to expire and would not apply to forbearances and related modifications entered into after December 31, 2020. Due to the ongoing financial hardships posed by the COVID-19 pandemic, the Structured Finance Association submitted a letter to the United States Treasury and the IRS, requesting an extension of tax relief relating to forbearances and related modifications. In response to these comments, the IRS released Rev. Proc. 2021-12, which extends the expiration date relevant to the application of the safe harbors in Rev. Proc. 2020-26 and Rev. Proc. 2020-34 to September 30, 2021.

In the News

Mayer Brown announced the launch of its [10Hundred Series portal](), which provides global legal and business guidance on the top 10 key issues and pivotal developments that could affect businesses during a rolling 100-day period. The portal will feature thought leadership, legal updates, videos, podcasts, webcasts and live newsfeeds on global legal and business issues.

10 Blaine Saito, Argument analysis: Justices struggle to define boundaries of Anti-Injunction Act, SCOTUSblog (Dec. 2, 2020, 5:37 PM), https://www.scotusblog.com/2020/12/argument-analysis-justices-struggle-to-define-boundaries-of-anti-injunction-act/.

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The portal will showcase a series of 'Spotlights,' which will highlight key issues, historic moments or pivotal change events which clients should be aware of in the next 100-day period.

RECENT RECOGNITION

- Mayer Brown is pleased to announce that we have been shortlisted for *GlobalCapital*'s 2021 Americas Derivatives Awards in the "Americas Law Firm of the Year—Overall", "US Law Firm of the Year—Regulatory", and "US Law Firm of the Year—Transactions" categories. We were named the European Law Firm of the Year—Transactions and US Law Firm of the Year—Transactions by *GlobalCapital* in 2020.

- Mayer Brown named a finalist in the "Finance — unlocking capital" category in Financial Times' 2020 "North America Innovative Lawyers" report - December 10, 2020

  The Mayer Brown Structured Finance Practice was recognized as a finalist in the *Financial Times'* "Finance – unlocking capital" category for representation on the $6.8bn financing plan through United Airlines' loyalty program, MileagePlus, to help the airline increase revenue.

- Mayer Brown named a *Law360* 2020 "Structured Finance Practice Group of the Year" - December 21, 2020

  Mayer Brown was named a *Law360* 2020 "Structured Finance Practice Group of the Year," honoring the major deals that resonated throughout the legal industry throughout the year, including our groundbreaking transaction involving United Airlines and the financing of their frequent flyer program, MileagePlus.

- Mayer Brown ranked in *Asset Backed Alert's* "Law Firm" 2020 rankings, including #1 in "Top issuer counsel for US ABS/MBS" list on January 15, 2021 Mayer Brown was ranked in *Asset Backed Alert's* "Law Firm" 2020 rankings as #1 in "Top Issuer Counsel for US Asset- and Mortgage-Backed Securitizations" for the fifth consecutive year. The #1 spot holds with our highest number of deals stands at 85, while the #2 firm comes in at 56.

- Jennifer Keating and Anna Pinedo named "Top 20 Women in Dealmaking" by *The Deal* on January 26, 2021, Mayer Brown partners Jennifer Keating and Anna Pinedo were named in *The Deal's* "Top 20 Women in Dealmaking" for 2020. The list identifies U.S.-based women who have displayed excellence in their respective legal field, have shown the ability to navigate complex transactions, and who maintain strong client relationships and/or lead in and out of the boardroom. The list recognizes these women as doing great things in the world of dealmaking, as well as in mentorship, advancing gender diversity and thought leadership.

- Ryan Castillo named a *IFLR* 2020 "Rising Star Americas" honoree in "Capital Markets" category on January 28, 2021 Mayer Brown partner Ryan Castillo was named by IFLR a "*Rising Star Americas*" honoree in the "Capital Markets" category for 2020. The list recognizes future legal leaders.

RECENT SPEAKING ENGAGEMENTS

- ***Upcoming*** – Preparing Your 20-F Filing. Brian Hirshberg and Christina Thomas will address the modernization of the requirements applicable to SEC reporting companies on February 10, 2021. During this webinar, they will discuss SEC Staff guidance on COVID-19 disclosures; changes to Risk Factor disclosures; risk factors that are Staff areas of focus, including LIBOR, cybersecurity, Brexit, tariff issues, sanctions issues, etc.; key performance indicators and non-GAAP measures, including COVID related non-GAAP measures; amendments relating to financial statement requirements for acquired businesses; and disclosures for PRC-based companies.
Register for this session here.

- Commercial Paper Programs. On February 1, 2021, Jerry Marlatt was joined by Stewart Cutler of Barclays to review the considerations relating to the establishment and operation of the commercial paper financing tool used by investment grade corporate issuers. They will discuss the legal framework for commercial paper programs; the US commercial paper and Eurocommercial paper markets; market practice and documentation that is widely used; the US Federal Reserve's commercial paper funding facility; and investor base for commercial paper.

- De-SPACing: Overview, Special Securities Law and Financial Statement Considerations and Derisking the Process with a PIPE Transaction. Hosted by PLI on January 27, 2021, Anna Pinedo and Eddie Best went through the process of a de-SPACing transaction, covering the differences to consider from negotiating the letter of intent (LOI) to the definitive merger agreement and the various ancillary agreements. Specifically, they discussed the SPAC IPO market and notable de-SPAC transactions; negotiating the LOI; key considerations in connection with the definitive agreement; PIPE and other capital raising transactions in connection with de-SPACing; securities law and financial statement requirements; and the proxy statement, its forecasts and related considerations.

- Debt Capital Markets Seminar: 2021 DCM Developments in the Shade of the COVID-19 Pandemic. On January 26, 2021 we held the 4th annual DCM Seminar, led by Patrick Scholl, Barry Cosgrove, Anna Pinedo, James Taylor, Bradley Berman, Berthold Kusserow and Alexei Döhl. The panel covered many topics including electronic and crypto securities in Germany; updates on the IBOR transition, government actions, use of RFR in DCM products, new ISDA Euribor fallbacks and EURIBOR fallback consultation; bonds and Schuldscheine and COVID-19 restructuring; and sustainability-linked bonds and EU green bond regulation.

- The Next Phase of Financial Regulatory Reform: What's Ahead for Nonbank Financial Companies. On January 21, 2021, Andrew Olmem and Laurence Platt participated in a Global Financial Markets Initiative teleconference to talk about the regulatory spotlight on nonbank financial services companies. They discussed prospects of regulatory reform for nonbank financial companies and what it could mean for the future of US financial markets, especially the US mortgage market.

- ESG Investing: How to Do Well by Doing Good. A webinar event with The American Friends of Hebrew University and Professor Ronen Feldman on January 14, 2021 kicked the new year off. Paul Forrester, Stephanie Hurst, Phyllis Korff, Anna Pinedo and James Taylor were panelists for a discussion on ESG related developments. After Professor Feldman covered text mining, AI and natural language processing, Mayer Brown speakers focused on what ESG and ESG investing is; regulatory and other frameworks for ESG reporting; green, social and sustainable bonds and loans, as well as sustainability-linked bonds; ESG indices; ESG investors' expectations; and benefit corporations and corporate structures that incorporate ESG and other mission-oriented objectives with corporate purposes.

- Ethics for the In-House Tax Professional – Part II. On January 13, 2021, Mayer Brown hosted with TEI Silicon Valley Chapter the second part of the Ethics for the In-House Tax Professional seminar. Partners Paul DiSangro and Marjorie Margolies discussed "Common Ethical Issues Faced by the In-House Tax Professional" and associate Anthony Pastore participated in a panel discussion titled "Records Management for Tax Professionals (Including Privilege Policies)".

- A New Era for Qualified Mortgages: CFPB Finalizes QM Rules. On December 17, 2020, Kris Kully and Laurence Platt participated in a Global Financial Markets Initiative teleconference to give insight and an analysis on the finalized rules by the Consumer Financial Protection Bureau (CFPB) that reshaped boundaries for Qualified Mortgages (QMs).

- Mortgage Market Developments and Becoming a Public Company. Hosted by Mortgage Bankers Association (MBA) on December 14, 2020, Brian Hirshberg, Anna Pinedo and Remmelt Reigersman joined Michael Fratantoni of MBA to speak to mortgage originator and servicers that joined the ranks of SEC reporting companies. They discussed the 2020 US IPO market and its expectations; US IPO dynamics, aftermarket performance and IPO trends; assessing IPO readiness and IPO considerations; disclosure and governance; SPAC IPOs and what's been driving the trend; merging with a SPAC to become a public company; and mortgage market developments and learnings from recent deals.

- Time to Get Ready: Preparing for the 2021 US Proxy & Annual Reporting Season. On December 9, 2020, Intelligize invited Candace Jackson, Christine McDevitt, Anna Pinedo and Christina Thomas to discuss prep for success in proxy and annual report season. They covered SEC COVID-19 guidance and disclosures; changes affecting 2020's 10-K, including MD&A and other Regulation S-K changes; virtual meetings; pay ratio and say-on-pay; human capital and ESG disclosures; shareholder proposals; and proxy voting advice amendments.

- Becoming a US Public Company: The New Three-Track Process. On December 1, 2020, following IFLR's publication of *A Deep Dive into Capital Raising Alternatives*, IFLR partnered with us for a webinar to discuss the US IPO market in 2020. Anna Pinedo and John Ablan were joined by Brian DiCaprio and Zachary Dombrowski of BMO Capital Markets, Jennie Dong of the NYSE and Greg

McDowell of ICR Strategic Communications & Advisory to speak to the significant increase in SPAC IPOs and high-profile mergers of unicorns with SPACs. Due to popular demand, panelists discussed US IPO dynamics, aftermarket performance, and IPO trends; foreign private issuers, and potential actions affecting PRC-based companies; how direct listings work, and which types of issuers should consider a direct listing; how merging with a SPAC to become a public company works; and SEC developments that may facilitate capital formation.

- Every 10 Years I Have to Relearn Section 382. On November 16, partners Thomas Humphreys and Remmelt Reigersman with members of TEI New York Chapter discussed the net operating loss carryover provisions of Internal Revenue Code Section 382. They reviewed Section 382's basic rules and explored how its limitations on NOLs and NOL usage operate. They then applied the rules to examples, walking through some interesting current structures and transactions.

- Interesting Transactions of the Past Year. On October 15, Mayer Brown tax partner Thomas Humphreys participated on a panel for PLI's Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations and Restructurings virtual conference. Tom discussed the federal income tax issues surrounding special purpose acquisition companies.

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Mayer Brown is a distinctively global law firm, uniquely positioned to advise the world's leading companies and financial institutions on their most complex deals and disputes. With extensive reach across four continents, we are the only integrated law firm in the world with approximately 200 lawyers in each of the world's three largest financial centers—New York, London and Hong Kong—the backbone of the global economy. We have deep experience in high-stakes litigation and complex transactions across industry sectors, including our signature strength, the global financial services industry. Our diverse teams of lawyers are recognized by our clients as strategic partners with deep commercial instincts and a commitment to creatively anticipating their needs and delivering excellence in everything we do. Our "one-firm" culture—seamless and integrated across all practices and regions—ensures that our clients receive the best of our knowledge and experience.

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VOLUME 03, ISSUE 02 | August 4, 2020

Editor's Note

Not that working from home is getting old but CMTQ is really starting to miss the office. Everything is easier there. Logging on to the computer network, seeing your colleagues without having to arrange a Zoom call, keeping the good old paper files (remember those?) up-to-date, the list goes on and on. One thing we're not trying to let WFH affect is keeping our eye on the capital markets for new tax developments. While much of Q2 2020 was spent on figuring out the tax provisions of the Coronavirus Aid, Relief and Economic Security ("CARES") Act, there were also tax developments affecting financial instruments as we describe in this issue. As you can see from our coverage, one of the things we're focused on is how governments at all levels will repair the COVID-19 hit to their finances. In CMTQ Volume 02, Issue 04, we described a proposal by Sen Elizabeth Warren (D., Mass) to impose a super mark-to-market regime on wealthy US taxpayers. That was pre-COVID. Lo and behold, a similar proposal has surfaced in New York State whereby New York taxpayers with a net assets over $1 billion[1] would be treated as having sold their assets at fair market value on the effective date of the legislation and the last date of each taxable year.[2] This would apply not only to

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1 According to NY Governor Andrew Cuomo, there are 100 billionaires in New York. See "Cuomo Says Raising Taxes on Billionaires is Not Answer to State Budget Woes," NY1, July 29, 2020, available at https://www.ny1.com/nyc/all-boroughs/politics/2020/07/30/cuomo-balks-at-taxing-the-rich.

2 See "Billionaire Mark to Market Tax and the Worker Bailout Fund Act," NY State Senate Bill S8277A (introduced May 1, 2020). Revenue from the tax would be dedicated to a "worker bailout fund" which would provide emergency wage replacement for certain New York workers who

* As described in the Editor's Note, this quote is attributed to, among others, Sen. Russell Long (D., LA).

publicly traded stocks and bonds but also to privately held interests in entities and more. Also, in New York State our old friend the stock transfer tax (the "STT") has surfaced as a revenue raising proposal. The STT dates from the mid-1970s and has never been repealed although the tax has had a zero rate for decades. While NY Governor Andrew Cuomo has said he is opposed to both of these proposals (which means a lot), we have no doubt that other proposals will surface everywhere to raise taxes and some of these proposals, if adopted, will have an effect on capital markets transactions.

In this issue of CMTQ, we also cover the final anti-hybrid regulations under Code sections 267A and 245A(e), Rev. Proc. 2020-34, providing select relief for modifications of mortgages and leases held by certain entities, and more.

Update on US Tax Relief for COVID-19

As discussed in the last issue of CMTQ, both Congress and the Internal Revenue Service ("IRS") issued a host of new rules aimed at keeping the economy stabilized in the face of the COVID-19. The second quarter of 2020 focused on clarifying and refining those rules, as well as consideration of a new relief package as certain parts of the country experience an uptick in COVID-19 cases.

Perhaps the most hotly debated issue resulting from the first round of Congressional relief relates to the use of stimulus money to pay for deductible expenses. Under the CARES Act, the United States government launched a Paycheck Protection Program ("PPP"). Loans granted under the PPP can be forgiven if the proceeds are used to pay for certain types of expenses such as payroll, mortgage interest or rent. Ordinarily, the forgiveness of a loan results in "cancellation of indebtedness income" under Section 108 of the Internal Revenue Code of 1986 (the "Code").[3] However, the CARES Act explicitly overrides this general rule and provides that loan forgiveness under the PPP does not result in gross income to the borrower for tax purposes. A related question that has not been addressed explicitly by the CARES Act is whether expenses paid for with PPP proceeds that are forgiven are deductible. In Notice 2020-32, the IRS took the view that such expenses are non-deductible, on the basis that Code section 265 disallows a deduction for amounts allocable to tax-exempt income. The IRS reasoned that the purpose of section 265 is to prevent taxpayers from obtaining a double tax benefits, and that in the absence of such an interpretation, PPP recipients might be able to exclude forgiven loan proceeds from gross income and deduct expenses paid for with the forgiven amounts, resulting in such a double tax benefit. The stance from the IRS drew criticism from members of Congress as contrary to the goals of the PPP. It is possible that future legislation could provide a "fix" for the issue and explicitly state that any such expenses are deductible, however, the Senate Republican relief package does not include this provision.[4]

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do not qualify for unemployment insurance and financial assistance for certain New York households that suffer loss of income during a state of emergency declared by the governor. A video in support of the tax is available at https://www.youtube.com/watch?v=cIA1ex88faM&feature=youtu.be.

3 Unless otherwise stated, all section references herein refer to the Code and the regulations thereunder.

4 "Tax Issue Tangles Small Businesses' Pandemic Relief," The Wall Street Journal, July 30, 2020, page B6.

Another hotly debated topic is whether any future tax relief will include a cut to payroll taxes. President Trump has pushed the idea on social media; however the Senate Republican package does not include a payroll tax cut.

As Congress heads toward the August recess it remains to be seen whether there will be a relief package, what tax incentives might be included in the package, and how any such measures will impact tax planning for transactions occurring this year and beyond.

Proposal to Reactivate the New York Stock Transfer Tax

Enacted in 1905, the New York stock transfer tax ("STT") has been around for over 100 years, but has involved little more than shuffling paper and tax advisor hand-wringing for the last 40 years or so. New York State has allowed a rebate for the full amount of tax since 1981. Now, the economic distress caused by the pandemic, with its knock-on effects for state and local tax revenues, has New York taxpayers wondering where the State will look for money to fill the gap. A renewed proposal to eliminate the STT rebate, in Assembly Bill No. A07791B (July 1, 2020), may be one answer, and has attracted the attention of many anxious market participants. Elimination of the rebate could raise approximately $13 billion annually for New York.[5]

By way of background, the STT is currently imposed on any one of five (5) taxable events occurring in New York: sales, agreements to sell, memoranda of sales, deliveries, or transfers of shares or certificates of stock.[6] A taxable event may include any transfer on a securities exchange that facilitates the transaction, if the exchange is located, operates, or effectuates any aspect of the transaction in New York. Any person or persons making or effectuating a transfer or sale, including the person or persons to whom the transfer or sale is made, is responsible for payment of the STT.[7] The tax is only payable once—therefore, an option may be taxable, but the subsequent delivery of shares will not be taxable.[8]

For sales transactions, the STT is calculated on the value and number of shares sold. The tax rate varies between 1¼ cents to 5 cents per share. The maximum amount of STT is $350 for any single qualifying sale involving shares or certificates of the same class and issued by the same issuer, as long

5 In a similar vein, under Assembly Bill No. 4402 (July 16, 2020), New Jersey has proposed legislation in the form of a financial transactions tax on high-quantity processors of financial transactions to address its budget deficit. The Bill would impose a $0.0025-per-transaction tax on persons or entities that process 10,000 or more financial transactions through electronic infrastructure located in New Jersey during the calendar year.

6 NY Tax Law § 270; 20 NYCRR § 50.1. Also included are certificates of rights to stock; certificates of interest in property or accumulations; certificates of interest in business conducted by a trustee or trustees; and certificates of deposit.

7 NY Tax Law § 270.3; 20 NYCRR § 50.3. The parties to a transaction may agree which of them shall bear the liability and payment of the tax by either discharges the liability of both.

8 *See* 20 NYCRR § 50.2. "[I]f a sale, delivery of the certificates and record transfer to the name of the purchaser are all made within [New York], only one tax is payable."

as certain timing requirements are met.[9] For transfers other than a purchase and sale, the tax rate is 2½ cents per transaction. The current tax rates are as follows:[10]

Selling Price	**Rate (cents per share)**
Sale or agreement to sell at less than $5 per share	1 ¼ ¢
Sale at $5 or more but less than $10 per share	2 ½ ¢
Sale at $10 or more but less than $20 per share	3 ¾ ¢
Sale at $20 or more per share	5 ¢
Transfers of stock or certificates of interest other than by sale	2 ½ ¢

Though New York State effectively eliminated the STT many years ago, the rebate mechanism technically does not eliminate taxpayers' compliance obligations—they must still report and pay the tax and then request a rebate. The State therefore receives a fairly detailed picture of the revenue that could be gained from scaling back the rebate.

The Department of Taxation and Finance, pursuant to statutory authority, allows registered securities brokers and dealers to report the tax payable through a selected securities exchange and authorize the relevant clearing corporation to charge and remit the tax. As a result of the rebate, while brokers and dealers report the tax payable, the applicable clearing corporation merely charges and rebates the tax by book entry and then files a report with the Department.

Taxpayers other than registered brokers and dealers can pay the STT by purchasing tax stamps, affixing them to the bill of sale or stock certificate surrendered, and then canceling the tax stamps so they cannot be used again. The taxpayer can then file a rebate claim, provided the rebate claim is made within two years after the affixing and cancelling of stock transfer tax stamps or payment of the tax otherwise than by the use of stamps.[11]

Turning back to Assembly Bill No. A07791B, it would repeal the STT rebate in its entirety. It would also expand the tax, such that a transaction could be captured "if any activity in furtherance of the transaction occurs within [New York] or if a party involved in the transaction satisfies a nexus with New York state which shall be defined as broadly as is permitted under the United States Constitution." Rather than define nexus (and thus limit the STT) by taxable events that occur in New York, and capture transactions that are documented, executed, or delivered in New York, this

9 NY Tax Law § 270-e.1.

10 NY Tax Law § 270.2. Note that certain transactions are exempt from STT under NY Tax Law §§ 270.5 and 270-c and 20 NYCRR §§ 50.1(j) and 53.1.

11 *See* TSB-M-82(6)M *Stock Transfer Tax Rebate Program Stamp Users* (July 9, 1982); NY Tax Law § 280-a.3.

proposal would seemingly broaden nexus, and thus the STT, to include any transaction that, for example, had planning, analysis, or authorization occur in New York. It might also apply to transactions where execution and delivery occur outside New York, but the buyer, seller, or broker have nexus with New York. But could that really be constitutional? If every state enacted such a regime, double taxation would surely occur and the tax would have to be more narrowly administered.

On the subject of administration, it is likely that other significant amendments to the STT and regulations would be necessary because it has not been amended since 1977 to keep pace with changes in broker business models or the current stock trading environment. In particular, the STT was designed for open outcry trading instead of screens and would have to be updated for wholly electronic exchanges (most of which have their equipment located outside New York anyway). Overall, New York's desire to retain is dominance in financial markets and the ease with which trading could be shifted out of state, make the STT an unlikely candidate for solving New York's budget problems. The New York Legislature is currently out of session, but taxpayers should look for this proposal in the Governor's budget proposal for fiscal year 2022 to evaluate whether it has legs.

Rev. Proc. 2020-19 – IRS Cash Limitation Percentage for REITs and RICs

In the last issue of CMTQ, we covered a letter from the National Association of Real Estate Investment Trusts ("Nareit") requesting IRS relief for real estate investment trust ("REIT") distributions paid in cash and stock due to the global pandemic. On May 4, 2020, the IRS issued Rev. Proc. 2020-19.[12]

Although a REIT is generally subject to corporate-level tax, the Code provides a special deduction to REITs for dividends paid which can result in a complete elimination of US federal corporate income tax at the REIT level. Furthermore, a REIT is generally required to distribute at least 90% of its taxable income to shareholders in order to take advantage of the special rules applicable to REITs. In order for a distribution to be deductible by the REIT, and to count towards the 90% distribution requirement, the distribution must be a "dividend" for federal income tax purposes. REIT distributions paid in cash out of the REIT's current and accumulated earnings and profits are generally dividends that the REIT can deduct. On the other hand, distributions paid entirely in stock are generally not "dividends" and thus cannot be deducted by the REIT.

Rev. Proc. 2017-45 provided a safe harbor for publicly offered REITs[13] to satisfy the distribution requirement with a combination of cash and stock, provided in general that each shareholder can elect either cash or stock and the aggregate cash component of the distribution to all shareholders represents at least 20% of total distributions. Rev. Proc. 2020-19 temporarily reduces the cash

12 Rev. Proc. 2020-19 is available at https://www.irs.gov/pub/irs-drop/rp-20-19.pdf.

13 A publicly offered REIT is a REIT which is required to file annual and periodic reports with the Securities and Exchange Commission under the Securities Exchange Act of 1934.

limitation component to 10% with respect to distributions declared by a publicly offered REIT on or after April 1, 2020 and on or before December 31, 2020. This temporary relaxation also applies to publicly offered regulated investment companies ("RICs").

Rev. Proc. 2020-34 – Relief for Certain Modifications of Mortgages and Leases

On June 4, 2020, the IRS released Rev. Proc. 2020-34 to provide temporary safe harbors for rental property trusts with mortgages and lease holders who are experiencing financial hardship as a result of the COVID-19 pandemic.[14]

Rev. Proc. 2020-34 allows eligible trusts to make certain modifications to their mortgage loans in connection with a forbearance program, without jeopardizing their tax status as grantor trusts under Treas. Reg. section 301.7701-4(c) and Rev. Rul. 2004-86. Specifically, those modifications are not treated as replacing the unmodified obligation with a newly issued obligation, giving rise to prohibited transactions, or manifesting a power to vary when determining the federal income tax status of securitization vehicles that hold the loans.

In addition, Rev. Proc. 2020-34 provides that a cash contribution from one or more new trust interest holders to acquire a trust interest or a non-pro rata cash contribution from one or more current trust interest-holders must be treated as a purchase and sale under Code section 1001 of a portion of each non-contributing (or lesser contributing) trust interest-holder's proportionate interest in the trust's assets.

The modifications of mortgage loans must be related to the economic relief provided under the CARES Act or certain similar programs that are requested, or agreed to, from March 27, 2020 through December 31, 2020, and that are granted as a result of a borrower experiencing a financial hardship due to the COVID-19 pandemic.

Nareit Recommendations for IRS Priority Guidance Plan

In Notice 2020-47, the Department of the Treasury and the IRS invited the public to submit recommendations for items to be included on the 2020-2021 Priority Guidance Plan. The Treasury Department's Office of Tax Policy and the IRS use the Priority Guidance Plan each year to identify and prioritize the tax issues that should be addressed through regulations, revenue rulings, revenue procedures, notices, and other published administrative guidance. The 2020-2021 Priority Guidance Plan will identify guidance projects that the Treasury Department and the IRS intend to actively work on as priorities during the period from July 1, 2020 through June 30, 2021.

14 Rev. Proc. 2020-34 is available at https://www.irs.gov/pub/irs-drop/rp-20-34.pdf.

In response to Notice 2020-47, Nareit published a letter on July 20, 2020, making the following recommendations, listed in order of priority.[15] First, Nareit recommended the withdrawal of Notice 2007-55, which holds that REIT liquidating distributions and redemptions should be treated as capital gain liquidations that are subject to the Foreign Investment in Real Property Tax Act ("FIRPTA") if paid to foreign shareholders. Nareit argued that withdrawing Notice 2007-55 would encourage additional foreign investment in U.S. real estate and infrastructure and therefore be consistent with Executive Order 13924 (EO 13924). Issued in response to the COVID-19 public health and economic crisis, EO 13924 urges the heads of all agencies to rescind, waive, modify or otherwise take actions regarding regulatory standards that may inhibit economic recovery. Nareit further argued that withdrawal of Notice 2007-55 would be consistent with the Treasury Department's policy statement supporting the timely promulgation of regulations and the elimination of confusion and uncertainty. Nareit has repeatedly submitted letters requesting for the withdrawal of Notice 2007-55 since 2010.

Additionally, Nareit requested that the Treasury Department and the IRS exercise their regulatory authority to prevent otherwise qualifying rent payments from becoming nonqualifying income under the related party rent rules, solely due to the double downward attribution rules in section 318. Under the related party rent rules of section 856(d)(2)(B), payments that a REIT receives from an entity in which the REIT owns at least 10% of its equity are not considered qualified rents under the REIT income test. In determining the percentage interest of ownership, application of the attribution rules of section 318 not only complicates the determination but also leads to unintended results according to Nareit.

Lastly, Nareit requested that the IRS finalize regulations under Treas. Reg. section 1.337(d)-7, exempting transfers by a foreign corporation of appreciated assets to RICs and REITs if the foreign corporation is not otherwise subject to US tax.

IRS Delays Certain QI Certifications Due in 2020 and Issues FAQs to Confirm Postponement of QDDs Periodic Review

On April 30, 2020, the IRS amended the QI FAQs relating to the periodic review for Qualified Derivatives Dealers (QDDs).[16] *See* updated FAQ 1 and new FAQ 19 under the heading "Certifications and Periodic Reviews." In general, each Qualified Intermediary (QI) is required to make a certification (including a periodic review) to the IRS every three years. Under Notice 2020-2, 2020-3 I.R.B. 327, a QI that is a QDD is not required to perform a periodic review with respect to its QDD activities for a certification period ending in any calendar year prior to 2023. A QI that is a QDD (whether or not it acted as a QDD) may, however, still be required to conduct a periodic review of its QI activities that are not QDD activities for those years. Updated FAQ 1 provides that the IRS will permit a QI that is a QDD and that has a certification period ending in any calendar year before 2023 to apply for a waiver

15 The letter is available at https://www.reit.com/sites/default/files/Nareit_PGP_Recommendations_2020-21.pdf.

16 These FAQs can be found on the Qualified Intermediary (QI), Withholding Foreign Partnership (WP), and Withholding Foreign Trust (WT) FAQ webpage, which is available at https://www.irs.gov/businesses/corporations/qualified-intermediary-general-faqs.

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of the periodic review when it otherwise meets the requirements of section 10.07 of the QI agreement with respect to its QI activities that are not QDD activities. New FAQ 19 provides that a QI that is a QDD must make any required periodic certifications, including the Certification of Internal Controls, taking into account both its QDD and non-QDD activities. However, for its QDD activities in calendar years ending before 2023, the QI may certify by taking into account whether the QDD made a good faith effort to comply with the section 871(m) regulations and the relevant provisions of the QI agreement. The QI must retain information to support the good faith effort certification.

Additionally, due to COVID-19, each QI with a periodic certification due date of July 1, 2020 will have until December 15, 2020 to submit its periodic certification or an application to waive the periodic review requirement. There is no need to file a request for extension with the IRS. Each QI should confirm that this revised date is reflected on its Account Management System profile (the QI System).

US v. Bittner: Favorable District Court Ruling on Non-Willful FBAR Penalty

In *U.S. v. Bittner*,[17] a district court found that the penalty for a non-willful Report of Foreign Bank and Financial Account ("FBAR") violation refers to each FBAR form rather than each foreign financial account maintained but not timely or properly reported, in a significant win for non-filers.

The IRS alleged that the taxpayer, a Romanian-born and naturalized U.S. citizen, had non-willfully failed to file FBARs from 2007 to 2011 against which the United States sought nearly $3 million in penalties and accruals, assessing $10,000 per account per FBAR violation. The taxpayer argued that the maximum penalty allowed was $10,000 per FBAR form. Multiple accounts are reported on a single FBAR form.

31 U.S.C. 5314 requires U.S. citizens to annually report certain transactions and relationships with foreign financial agencies. The implementing regulations, 31 C.F.R. 1010.306(c), further require U.S. citizens to report to the IRS foreign financial accounts exceeding $10,000 maintained during the previous calendar year on a Report of Foreign Bank and Financial Account ("FBAR").

If a U.S. citizen fails to file an FBAR, the IRS may impose a civil monetary penalty on such person. Under 31 U.S.C. 5321(a)(5)(A), the amount of the penalty depends on whether the conduct at issue is willful or non-willful. If the failure is non-willful, under 31 U.S.C. 5321(a)(5)(B)(i), the amount of any civil penalty imposed cannot exceed $10,000.

In the June 29, 2020 opinion, the court concluded that its interpretation of non-willful FBAR violations is consistent with the plain language and overall statutory and regulatory scheme of the Bank Secrecy

17 No. 4-19-cv-415 (E.D. Tex. 2020).

Act ("BSA"). Specifically, the court explained that Congress used the word "account" or "accounts" over 100 times throughout the BSA, but omitted any mention of "account" or "accounts" in 31 U.S.C. 5321(a)(5)(A) and (B)(i). The court also found additional support for its reasoning that penalties apply by year in the FBAR form instructions, which state that a form must be filed if the aggregate balance in accounts exceed $10,000. Therefore, the court held that the non-willful FBAR penalty should be assessed on a per reporting basis rather than a per account basis.

In addition, the court acknowledged but declined to follow the rationale in another similar case, *U.S. v. Boyd*,[18] which held that the non-willful FBAR penalty should be imposed on a per account basis. The court found that the *Boyd* court failed to provide adequate guidance as to how it reached the conclusion that it did. It remains to be seen whether this ruling will be upheld on appeal.

Final Section 199A Regulations Address RICs Holding REITs[19]

On June 24, 2020, the IRS issued final Treasury Regulations under Code section 199A (the "Regulations"), which largely follow the proposed Treasury Regulations proposed in February 2019.[20]

Code section 199A, enacted under the Tax Cuts and Jobs Act, allows a 20% "qualified business income" deduction for dividends received by a non-corporate taxpayer from a REIT. Previous Treasury Regulations issued under Code section 199A in February 2019 addressed certain items related to the section 199A deduction but did not address the treatment of REIT dividends received by regulated investment companies ("RICs"). Without clarification, by the terms of Code section 199A, RIC dividends might be ineligible for the section 199A deduction.

As noted in the preamble to the Regulations, Code section 199A directs the IRS to prescribe such regulations as are necessary to carry out the purposes of Code section 199A, including its application to tiered entities. The Regulations provide rules for "conduit treatment" for qualified REIT dividends (i.e., not capital gain dividends) received by a RIC. Under these rules, a "section 199A dividend" paid by a RIC to a non-corporate taxpayer is eligible for the 20% Section 199A deduction to the extent derived from qualified REIT dividends received by the RIC. The Regulations impose a holding period requirement, only permitting the section 199A deduction for shareholders who hold the applicable RIC stock for more than 45 days within the 91-day period beginning 45 days before the date on which the stock becomes ex-dividend with respect to the section 199A dividend.

18 No. CV 18-803-MWF, 2019 WL 1976472 (C.D. Cal. Apr. 23, 2019), *appeal docketed*, No. 19-55585 (9th Cir. May 22, 2019).

19 CMTQ would like to thank Mayer Brown summer associate Ping Hsu for his assistance with this article.

20 The Regulations are available at https://www.govinfo.gov/content/pkg/FR-2020-06-25/pdf/2020-11832.pdf. For Mayer Brown's previous reporting on the proposed Treasury Regulations, see "Mutual Funds That Hold REIT Shares – Are the Fund Dividends Eligible for the 20% Code Section 199A Deduction?", Capital Markets Tax Quarterly, Volume 01, Issue 02, January 23, 2019, available at https://www.mayerbrown.com//media/files/perspectives-events/publications/2019/01/capital-markets-tax-quarterly/files/capitalmarketstaxquarterlyupdatejanuary222019/fileattachment/capitalmarketstaxquarterlyupdatejanuary222019.pdf.

The Regulations do not provide for conduit treatment in the case of income earned by a RIC from a publicly traded partnership (a "PTP"). In the proposed Treasury Regulations, the IRS had noted several difficulties in applying the same conduit treatment to qualified PTP income received by a RIC, including with respect to the potential of PTPs to generate losses and the treatment of those losses. A PTP may not net losses from a "specified service trade or business" against other income, and net losses must be carried forward for section 199A attribute purposes. The IRS noted that it was unclear how those losses could be passed through on the payment of a dividend to RIC shareholders. Additionally, the section 199A deduction is available with respect to "specified service trade or business" income for taxpayers with income below a threshold, with a phase-out for taxpayers with income above that threshold. The IRS indicated that these complexities would make it difficult for a conduit regime to treat RIC shareholders in a manner consistent with the treatment of direct ownership of PTP interests. The preamble to the Regulations note comments received on these issues, including suggestions for addressing the "specified service trade or business" issues, and indicates that the Treasury Department and the IRS are continuing to evaluate options for applying conduit treatment for PTPs.

The Regulations also address several other issues, including the treatment of certain previously disallowed losses and deductions that are allowed in the current year and the treatment of section 199A deductions for owners or beneficiaries of trusts and estates.

IRS Releases Final and Proposed Anti-Hybrid Tax Regulations

In 2017, the Tax Cuts and Jobs Act ("TCJA")[21] added sections 245A(e) and 267A to the Code. Section 245A(e) denies the section 245A dividends-received deduction for "hybrid" dividends. Section 267A concerns payments on hybrid instruments and payments by, or to, a hybrid entity, providing that no deduction is allowed for any amount (i) paid or accrued pursuant to a "hybrid" transaction or (ii) paid by, or to, a "hybrid" entity. At the end of 2018, the Internal Revenue Service ("IRS") issued proposed regulations under both of these Code provisions (the "2018 Proposed Regulations").[22] In April, the IRS finalized these regulations (the "Final Regulations"). The Final Regulations are generally consistent with the 2018 Proposed Regulations,[23] but in some cases include some tailoring or explanation into the government's thinking. As it frequently does when finalizing a complex set of regulations, the Treasury released a new set of proposed regulations adding some new components to the originally proposed guidance (the "Proposed Regulations").[24]

The statute and Final Regulations implement several recommendations from the OECD's Base Erosion and Profit Shifting ("BEPS") reports. In particular, the BEPS Action 2 reports are designed to address

21 For an overview of the TCJA's main provisions, please see our Legal Update "The Good, the Bad and the Ugly"—Fundamental Tax Reform Is Enacted Into Law."

22 The Proposed Regulations are available at https://s3.amazonaws.com/public-inspection.federalregister.gov/2018-27714.pdf. For a summary of the same, see our Legal Update "IRS Releases Proposed Anti-Hybrid Regulations."

23 The Final Regulations are available at https://www.govinfo.gov/content/pkg/FR-2020-04-08/pdf/2020-05924.pdf.

24 The Proposed Regulations are available at https://www.govinfo.gov/content/pkg/FR-2020-04-08/pdf/2020-05923.pdf.

hybrid transactions, namely transactions that exploit differences in the tax treatment of a transaction or entity under the laws of two or more countries. The BEPS Action 2 reports addressed a number of hybrid scenarios, including the particular scenario where, as part of one transaction, a taxpayer is allowed a deduction in one country while the recipient is not subject to tax on the receipt of the corresponding income under the laws of the recipient's country. This "Deduction/No Income" or "D/NI" outcome is what the Final Regulations are aimed at.

As discussed in more detail below, the Final Regulations generally supply technical mechanics for sections 245A(e) and 267A, but they also expand the scope of each provision in some ways. This article:

- analyzes the Final Regulations implementing the hybrid dividend rule in section 245A(e);
- analyzes the Final Regulations implementing section 267A;
- provides an overview of the reporting requirements imposed by the Final Regulations for both Code sections;
- discusses the content of the new Proposed Regulations; and
- summarized the effective dates for all of the above.

I. SECTION 245A(E) – HYBRID DIVIDENDS

A. Background

One of the major provisions of the TCJA was the enactment of a participation exemption regime. For the first time in the history of the Code, Congress provided, through the then-new section 245A, a 100% dividends-received deduction for the foreign source portion of dividends received by US corporate shareholders owning at least 10% of the shares of a controlled foreign corporation ("CFC"). This change brought the Code in line with the tax regimes in most other developed countries.

At the same time, Congress added section 245A(e) to exclude "hybrid" dividends as dividends eligible for the participation exemption and also require a subpart F inclusion for hybrid dividends received by a CFC. Moreover, if the dividend is a hybrid dividend, no foreign tax credits or foreign tax deductions are available with respect to the dividend. In addition, if a tiered hybrid dividend is received by a CFC, the dividend is treated as subpart F income to the US shareholder without regard to any other exclusions, including, for example, the earnings and profits limitation or the look-through provisions of section 954(c)(6).

B. Definition of a Hybrid Dividend

The Final Regulations define a hybrid dividend as a dividend otherwise eligible for the participation exemption but for which the paying CFC is or was allowed a tax deduction or other tax benefit under the laws of the CFC country or the laws of a third country where the CFC is liable to tax (for example, on branch profits) – termed a "hybrid deduction" by the regulations.[25] A basic example of a prohibited tax benefit is where the investment in the CFC is treated as debt in the CFC's country and

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25 *See* Treas. Reg. section 1.245A(e)-1.

equity for US purposes. Because the CFC would be entitled to an interest deduction for some or all of the putative dividend payment, the distribution is treated as a hybrid dividend.

The tax deduction or benefit must relate to the amount distributed with respect to the instrument treated as equity for US tax purposes. This includes a dividends-paid deduction and notional interest deductions ("NID") available in some countries, such as Belgium.

One uncertainty under the 2018 Proposed Regulations was whether section 245A(e) applies even if the foreign jurisdiction has hybrid mismatch rules in place that deny deductions in the foreign jurisdiction. The preamble to the Final Regulations states that whether a deduction or other tax benefit is a hybrid deduction under section 245A(e) should be determined without regard to foreign hybrid mismatch rules. The Final Regulations provide that the determination of whether a foreign tax law allows a deduction or other tax benefit for an amount is made without regard to the application of foreign hybrid mismatch rules, provided that the amount gives rise to a dividend for US tax purposes or is reasonably expected for US tax purposes to give rise to a dividend that will be paid within 12 months after the taxable period in which the deduction or other tax benefit would have otherwise been allowed.[26]

Comments to the 2018 Proposed Regulations requested flexibility for foreign deductions that were suspended by foreign law under a thin capitalization rule or where the foreign deduction was otherwise disallowed. The IRS declined to make either of these changes.

C. Lower-Tier CFCs

Section 245A(e) denies the participation exemption for hybrid dividends received by US shareholders and also provides similar tax consequences when the hybrid dividend is received by a CFC from a lower-tier CFC. In this case, the hybrid dividend is treated as subpart F income, notwithstanding any other provision in the Code. The legislative history and the Final Regulations make clear that the earning and profits limitation in section 952(c), deductions available under section 954(b)(5) and the look-through rules of section 954(c)(6) do not apply to a hybrid dividend.[27] The Final Regulations go a step further to turn off the provisions of section 964(e) (gain on certain stock sales by CFCs treated as dividends) with respect to sales of shares of CFCs with a hybrid dividend account, disallowing any participation exemption deduction.

D. Hybrid Dividend Accounts

Because there will often be timing differences between the prohibited tax benefit and the dividend for which the benefits of section 245A would be claimed, the Final Regulations require US shareholders of the CFC to maintain a "hybrid dividend account" for each share of stock for which section 245A may be available. The Final Regulations contain the plumbing for maintaining that account. A hybrid dividend account must be maintained for each share held by the US shareholder. Tax benefits are then allocated to each share based on the relative value of the CFC's shares. Tax

26 *See* Treas. Reg. section 1.245A(e)-1(d)(2)(ii)(B).

27 *See* Treas. Reg. section 1.245A(e)-1(g)(2), Example 2.

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benefits with respect to a share of stock increase the hybrid dividend account. A US shareholder's hybrid dividend account is further adjusted by such holders subpart F or GILTI inclusions to extent those inclusions neutralize the double non-taxation effect of a hybrid dividend or tiered hybrid dividend.[28] Distributions reduce the hybrid dividend account to the extent the distribution is allocable to a share of stock with a positive hybrid dividend account.

To the extent a distribution is received from a CFC and there is a hybrid dividend account relating to the shares on which the distribution is paid, the distribution is treated as a hybrid dividend and no participation exemption, foreign tax credits or foreign tax deductions are available with respect to the distribution. Importantly, even though hybrid dividend accounts are maintained for each share of CFC stock, to the extent any dividend is paid for which a hybrid dividend account exists, the distribution is considered a hybrid dividend even if a portion of the dividend relates to a share with no hybrid dividend account. An example in the Final Regulations illustrates this point.[29] In the example, a US shareholder holds two shares (Share A and Share B). Only Share A has a hybrid dividend account. The CFC pays a dividend with respect to both Share A and Share B. The example makes clear that even though Share B has no positive hybrid dividend account, since the dividend is paid with respect to both shares, Share A's hybrid dividend account is exhausted first before the participation exemption will apply.

E. Specified Owners and Sales/Exchanges

Section 245A(e) applies to a "specified owner" of a CFC. The Final Regulations define a specified owner as a domestic corporation that is a US shareholder of a CFC (as defined in section 951(b)) or an upper-tier CFC that would be a US shareholder if it were a domestic corporation. Thus, in general, a specified owner is any corporate US shareholder of a CFC as well as any upper tier CFC.

The Final Regulations contain a number of rules with respect to transfers of shares subject to a hybrid dividend account.[30] For example, where one specified owner sells a share of stock with a positive hybrid dividend account to a shareholder that is a specified owner immediately after the transaction, that hybrid dividend account transfers with the share to the new specified owner. As a result, hybrid dividend accounts will become a relevant tax due diligence item in M&A transactions involving CFCs. Where there is a section 338(g) election, the hybrid dividend account is reduced to zero, with no carryover to the purchaser.

The Final Regulations also provide that on a section 332 liquidation by a CFC with a hybrid dividend account to an upper-tier CFC, the upper-tier CFC increases its hybrid dividend account accordingly. Similar rules are provided in connection with other reorganization transactions covered by section 381(a)(1), with some special rules for spin-offs.

28 These rules are in the Proposed Regulations, discussed in Part IV below.

29 *See* Treas. Reg. section 1.245A(e)-1(g)(1), Example 1.

30 *See* Treas. Reg. section 1.245A(e)-1(d)(4).

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II. SECTION 267A – HYBRID TRANSACTIONS/ENTITIES

A. Background

Congress passed section 267A to limit those instances where a US taxpayer was claiming both a US tax benefit and a foreign country tax benefit from the same payment or transaction. For example, a US taxpayer might borrow money from a foreign person using an instrument that produced interest deductions for the US taxpayer but was treated as equity in a foreign jurisdiction where such distributions were eligible for a "participation" or other exemption. Such transactions have been around for many years although their popularity has waned for a number of reasons, including increased sophistication on the part of foreign tax authorities and increased scrutiny by US tax authorities.

The Final Regulations take a complicated and expansive approach in interpreting the statute, which denies a deduction for any "disqualified related party amount" or "DRPA" paid or accrued pursuant to a hybrid transaction or by, or to, a hybrid entity.

Code section 267A defines a DRPA as any interest or royalty paid or accrued to a related party to the extent that (A) such amount is not included in the related party's income under the foreign country tax law where the related party is a resident or is subject to tax or (B) the related party is allowed a deduction with respect to such amount under the foreign country tax law. Related party status is determined under section 954(d)(3) which provides for a more than 50% test. If an interest or royalty payment is included in the gross income of a US shareholder under section 951(a) (i.e., the CFC rules) then the provision does not apply.

The Final Regulations under section 267A generally implement the provision and try to neutralize the double non-taxation effects of certain hybrid transactions and transactions involving hybrid entities with interest or royalty components where, as part of one transaction, a taxpayer is allowed a deduction in one country while the recipient is not subject to tax on the receipt of the income under the laws of the recipient's country (as discussed above, also called a "D/NI"). The Final Regulations seek to accomplish this by denying a "specified party's"[31] deduction for any interest or royalty paid or accrued (a "specified payment").

The Final Regulations also provide specific definitions for both interest and royalties, with interest being defined broadly along the lines of the definition of interest in the proposed regulations under section 163(j).[32] In response to comments to the proposed section 163(j) regulations (which have not yet been finalized), the Final Regulations (a) treat a swap with significant non-periodic payments as two separate transactions consisting of an on-market, level payment swap and a loan, with the time

31 The Final Regulations define a "specified party" as a "tax resident of the United States, a CFC (other than CFC with respect to which there is not a United States shareholder that owns (within the meaning of section 958(a)) at least 10% (by vote or value) of the stock of the CFC), and a U.S. taxable branch." Accordingly, entities that are fiscally transparent for US federal income tax purposes are not specified parties (although the owners of these entities might be). For example, in the case of a payment by a partnership, a domestic corporation or a CFC that is a partner of the partnership is a specified party subject to section 267A's deduction denial.

32 For a more detailed description of the proposed regulations under section 163(j) and the definition of interest therein, please see our Legal Update High-Level Overview of the Proposed Regulations on Interest Deduction Limitation Rules.

value component associated with the loan treated as interest expense to the payor, (b) exclude from the definition of "interest" swaps cleared by a derivatives clearing organization, and (c) exclude from the definition of "interest" non-cleared swaps that require the parties to meet the margin or collateral requirements of a federal regulator.[33]

The Final Regulations deny a specified party's deduction for a specified payment in three situations:[34]

a. The payment is a "disqualified hybrid amount," generally defined as a specified payment that produced a D/NI outcome as a result of a hybrid or branch arrangement (addressed in Treas. Reg. sections 1.267A-2 and -3).

b. The payment is a "disqualified imported mismatch amount," generally defined as a payment that produces an indirect D/NI outcome as a result of the effects of an offshore hybrid or branch arrangement being imported into the US tax system (i.e., where payments of a specified amount are offset by a hybrid deduction) (addressed in Treas. Reg. section 1.267A-4).

c. A specified payment producing a D/NI outcome that the regulations classify as having a purpose of avoiding the section 267A regulations (addressed in Treas. Reg. section 1.267A-5(b)(6)).

The next section of this article provides an overview of each of these situations.

B. Hybrid and Branch Arrangement Giving Rise to Disqualified Hybrid Amounts

A disqualified hybrid amount generally arises under the Final Regulations where a specified payment is made pursuant to a hybrid transaction, a deemed branch payment, a payment to a reverse hybrid, or a branch mismatch payment, each discussed below. Where a transaction gives rise to a disqualified hybrid amount, the US deduction for the payment is permanently denied.

The Final Regulations provide operating rules that apply to each of the four types of specified payments discussed below. Under the Final Regulations, a D/NI outcome gives rise to a disqualified hybrid amount only to the extent that the D/NI outcome is a result of hybridity. This is not always the case; for example, a hybrid transaction could have a D/NI outcome as a result of the specified recipient's tax law containing a pure territorial system (thus exempting all foreign source income from taxation), or the specified recipient's tax law may allow a deduction with respect to a particular category of income. In these cases, the deduction is not disallowed since the hybridity does not cause the D/NI.[35]

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33 *See* Treas. Reg. section 1.267A-5(a)(12).

34 The Final Regulations provide a *de minimis* exception under section 267A, stating that a specified party is excepted from the application of section 267A for any taxable year for which the sum of its interest and royalty deductions (plus the interest and royalty deductions of any related specified parties) is below $50,000. Only payments that are from hybrid arrangements count towards the de minimis threshold.

35 *See* Treas. Reg. section 1.267A-3(a)(1).

In addition, a disqualified hybrid amount is reduced to the extent amounts are included or includible in a US tax resident's or US taxable branch's income.[36] This exception is meant to ensure that a specified payment is not a disqualified hybrid amount to the extent included in the income of a US tax resident or a US taxable branch, or taken into account by a US shareholder under the subpart F or GILTI rules. Source-based withholding by the United States or another country, however, does not reduce a disqualified hybrid amount, under the theory that source based withholding does not neutralize a D/NI outcome. The preamble to the Final Regulations indicates that the IRS considered comments recommending that certain types of withholding should reduce disqualified hybrid amounts on specified payments. However, the Final Regulations retain the approach of the 2018 Proposed Regulations in disregarding withholding.

Even if a specified payment is included in income in another foreign jurisdiction (other than the jurisdiction of the US payee and specified recipient), a specified payment is a disqualified hybrid amount if a D/NI outcome occurs as a result of hybridity. This rule is intended to prevent circumvention of section 267A by structuring a transaction so that the specified payment is included in income in a third, low-tax jurisdiction.

Finally, in determining whether a specified payment is made pursuant to a hybrid or branch mismatch arrangement, the Final Regulations generally only consider the tax laws of the tax residents or taxable branches that are related to the specified party. However, the tax laws of an unrelated tax resident or taxable branch are taken into account if the tax resident or taxable branch is a party to a "structured arrangement," generally defined as an arrangement where the hybrid mismatch is priced into the terms of the arrangement or, based on all the facts and circumstances, where the hybrid mismatch is a principal purpose of the arrangement.

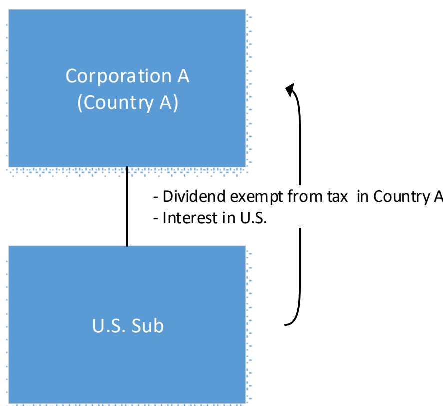
Hybrid transaction. The Final Regulations generally follow the statutory definition of "hybrid transaction," defining this term to include any transaction, series of transactions, agreement or instrument where one or more payments made are treated as interest or royalties for US federal tax purposes but treated differently for purposes of the tax law of the "specified recipient"[37] of the payment.[38] For example, a payment that is treated as interest in the United States but as a distribution on equity or return of principal under the tax law of the specified recipient could be a hybrid transaction within the meaning of the Final Regulations. This situation is illustrated in Figure 1.

36 *See* Treas. Reg. section 1.267A-3(b).

37 "Specified recipient" is broadly defined to mean any tax resident that under its tax law derives the specified payment and any taxable branch to which under its tax law the specified payment is attributable. *See* Treas. Reg. section 1.267A-5(a)(19).

38 Treas. Reg. section 1.267A-2(a)(2).

Figure 1



In addition, a transaction resulting in long-term deferral, generally defined as 36 months after the end of the taxable year in which the specified party would be allowed a deduction for the payment under US law, is a hybrid transaction (for example, a specified payment made pursuant to an instrument viewed as indebtedness under both the US and non-US tax law but, due to a mismatch in tax accounting treatment between the US and non-US tax law, results in long-term deferral). Here, the Final Regulations add a "reasonable expectation" rule to the approach in the 2018 Proposed Regulations, requiring that at the time of payment the payor assess whether it is reasonable to expect that the payee will include the payment in income within the 36-month period.

However, a specified payment is not considered made pursuant to a hybrid transaction if the payment is a "disregarded payment," defined as a situation where a specified payment is deductible in the United States but not included in income under foreign tax law. A deduction for a disregarded payment is only disallowed to the extent it exceeds "dual inclusion income" (a specified party's income or gain for US tax purposes to the extent included in income of the tax resident or taxable branch to which the disregarded payments were made over the specified party's items of deduction or loss for US tax purposes (other than deductions for disregarded payment) to the extent the items of deduction or loss are allowable under the tax law of the tax resident or taxable branch to which the disregarded payments are made). This calculation is intended to prevent the excess of the disregarded payment over dual inclusion income from offsetting non-dual inclusion income. For example, assume Corporation A, organized in Country A, owns a US corporation (US Sub), and under the laws of Country A, items of income of US Sub are included on Corporation A's consolidated Country A tax return, and payments from US Sub are disregarded. As discussed above, to the extent income items attributable to the specified payment are included in income on Corporation A's Country A consolidated tax return, such amounts are not disqualified hybrid amounts.

The Final Regulations provide specific mechanics for payments made pursuant to securities lending transactions, repos, and similar transactions where a payment on such an instrument is not regarded under non-US law but another amount connected to the payment is regarded under such law (a

"connected amount").[39] For example, consider a specified payment arising from a repo transaction involving stock, where a US person transfers the legal title to stock to a non-US person with an agreement to repurchase the stock back at a higher price, with the difference being treated as interest for US federal tax purposes. Suppose the tax laws of the non-US counterparty do not regard the payments from the United States as interest, but instead treat such payments as dividends. In this situation, the dividend under the non-US law is the connected amount under the Final Regulations, and the determination of the identity of the specified recipient of the specified payment is made with respect to the connected amount. These rules function as a glue for the application of the Final Regulations where the law of a non-US counterparty does not recognize payments on a repo or other similar transaction.

Deemed branch payment. A deemed branch payment is one where a specified payment is considered paid by a US permanent establishment to its home office under an income tax treaty between the United States and the home office country.[40] This can occur, for example, where an amount is allowed as a deduction in computing the business profits of a US permanent establishment with respect to the use of intellectual property developed by the home office. When a specified payment is a deemed branch payment, it is a disqualified hybrid amount if the home office's tax law provides an exclusion or exemption for income attributable to a branch.

Payments to reverse hybrids. Generally, the Final Regulations define a reverse hybrid as an entity that is fiscally transparent for purposes of the tax law of the country in which it is established but not for purposes of the tax law of its owner.[41] Payments to a reverse hybrid may result in a D/NI outcome because the reverse hybrid is not a tax resident of the country in which it is established, and the owner does not derive the payment under its tax law. Both US and non-US entities can be reverse hybrids, since this D/NI outcome may occur regardless of whether the establishment country is a foreign country or the United States.

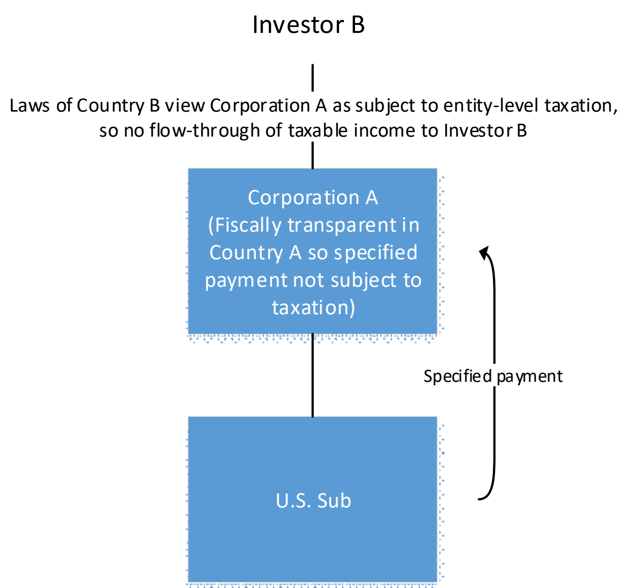
A specified payment made to a reverse hybrid is generally a disqualified hybrid amount to the extent that (a) an investor in the reverse hybrid does not include the payment in income and (b) the investor's no-inclusion would not occur if the investor's tax law treated the reverse hybrid as fiscally transparent. This situation is illustrated in Figure 2.

39 Treas. Reg. section 1.267A-2(a)(3).

40 Treas. Reg. section 1.267A-2(c).

41 *See* Treas. Reg. section 1.267A-2(d).

Figure 2



Branch mismatch payments. The Final Regulations treat a specified payment as a branch mismatch payment if (a) under a home office's tax law, the specified payment is treated as attributable to a branch of the home office and (b) either (i) the branch is not a taxable branch or (ii) the specified payment is treated as attributable to the home office and not the branch.[42] Generally, a branch mismatch payment is a disqualified hybrid amount to the extent the home office does not include the payment in income.

C. *Disqualified Imported Mismatch Amount*

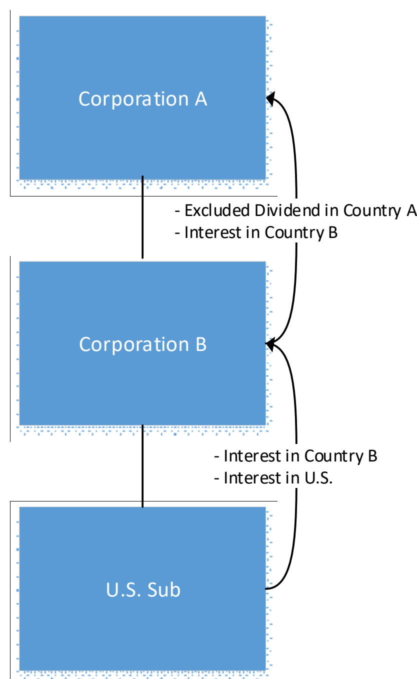
The rules in the Final Regulations disallowing the deduction for imported mismatch amounts are intended to prevent the effects of an "offshore" hybrid arrangement from being "imported" to the United States through the use of a non-hybrid arrangement. A payment is generally a disqualified imported mismatch amount where (a) the specified payment is non-hybrid in nature, such as interest paid on an instrument treated as debt for both US and foreign tax purposes and (b) the income attributable to the specified payment is directly or indirectly offset by a hybrid deduction of a foreign tax resident or taxable branch.[43] A hybrid deduction for purposes of the imported mismatch rule is generally an amount for which a foreign tax resident or taxable branch is allowed an interest or royalty deduction under its tax law to the extent the deduction would be disallowed if such tax law were to contain rules substantially similar to the Final Regulations. The Final Regulations provide the mechanics for determining (a) whether a hybrid deduction offsets income attributable to a specified payment and (b) what payments are treated as hybrid deductions where the foreign tax law for a relevant party contains hybrid mismatch rules.

42 Treas. Reg. 1.267A-2(e).

43 *See* Treas. Reg. section 1.267A-4.

For example, consider a situation where Corporation A is organized in Country A and holds all the interests of Corporation B, organized in Country B, which holds all the interests of a US corporation (US Sub). Suppose Corporation B holds an instrument issued by US Sub that is treated as indebtedness for both Country B and US tax purposes, and Corporation A holds a corresponding instrument issued by Corporation B that is still treated as indebtedness under the laws of Country B but is treated as equity under the laws of Country A, where Country A has a participation exemption for dividends from foreign subsidiaries. This fact pattern is illustrated in Figure 3.

Figure 3



In this situation, the interest payment by US Sub is not a disqualified hybrid amount. However, the interest payment is a disqualified imported mismatch amount, because (a) the interest payment is non-hybrid in nature and (b) the interest income to Corporation B is offset by the payment to Corporation A which would be disallowed as a deduction if Country B had rules similar to the Final Regulations (since the Final Regulations would treat the payment from Corporation B to Corporation A as a disqualified hybrid amount pursuant to a hybrid transaction). As a result, the deduction by US Sub is disallowed under the imported mismatch amount rules.

D. Payments Within the Anti-Abuse Rule

Finally, the Final Regulations contain an anti-abuse rule, which provides that a specified party's deduction for a specified payment is disallowed to the extent that (a) the payment (or income attributable to the payment) is not included in the income of a tax resident or taxable branch, and (b) a principal purpose of the terms or structure of the arrangement is to avoid the purposes of the

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regulations under section 267A.[44] This anti-abuse is an attempt to fill in any cracks that might be found in the Final Regulations down the road.

III. REPORTING FOR TRANSACTIONS UNDER THE FINAL REGULATIONS

The Final Regulations follow the reporting approach of the 2018 Proposed Regulations, with some additional color.[45] With respect to section 245A(e), the Final Regulations note that CFCs paying hybrid dividends must report such dividends on Form 5471. While previously unclear under the 2018 Proposed Regulations, the Final Regulations make clear that Form 5471 must contain any information relating to the rules of section 245A(e), including information related to a specified owner's hybrid deduction account.

With respect to specified payments and section 267A, the reporting imposed by the Final Regulations depends on the type of US entity making the specified payment. If the entity is a CFC, the Final Regulations state that if in an annual accounting period a corporation pays or accrues interest or royalties that carry a disallowed deduction, then Form 5471 must contain information about the disallowance. If the entity is a US corporation owned 25% by a foreign entity, or a foreign corporation engaged in a US trade or business, such entity's Form 5472 must provide information about the disallowance. Finally, if the entity is a controlled foreign partnership, the Form 8865 of a controlling 50% partner must provide information about the disallowance.

IV. NEW PROPOSED REGULATIONS

The Proposed Regulations generally (i) adjust hybrid deduction accounts under section 245A(e) for earnings and profits of a CFC that are included in income by a US shareholder, (ii) limit, for purposes of the conduit financing rules under section 881, equity interest arrangements that give rise to deductions or similar tax credits under the laws of foreign jurisdictions, and (iii) provide coordination rules relating to the treatment of certain payments under the GILTI provisions.

A. Reductions in Hybrid Dividend Accounts

The Proposed Regulations require hybrid deduction accounts to be reduced to the extent earnings and profits of the CFC which have not been subject to foreign tax as a result of certain hybrid arrangements, are included in income by a US shareholder. In particular, the proposed rules specify that hybrid deduction accounts should be reduced as part of the end-of-the-year adjustment by inclusions under (i) subpart F, (ii) GILTI, and (iii) sections 951(a)(1)(B) and 956.

Inclusions made under subpart F and GILTI are adjusted to the extent such inclusions are not offset by deductions or credits (e.g., a foreign tax credit). However, inclusions under sections 951(a)(1)(B) and 956 provide a dollar-for-dollar adjustment since deductions and credits are not generally available for such inclusions.

44 Treas. Reg. section 1.267A-5(b)(6).

45 *See* Treas. Reg. sections 1.6038-2(f)(13) and (14), 1.6038-3(g)(3), and 1.6038A-2.

In sum, these adjustments further ensure section 245A dividend received deductions are disallowed only for amounts sheltered from tax by virtue of hybrid financing arrangements. Specifically, the adjustments prevent potential (i) double taxation of earnings of a CFC that are already indirectly included in the income a US shareholder (e.g., US shareholders that have subpart F and GILTI inclusions) and (ii) double non-taxation by taking into account deductions and credits that offset subpart F and GILTI inclusions.

B. New Anti-Conduit Regulations

The Proposed Regulations expand the scope of financing transactions under the anti-conduit rules found in Treas. Reg. section 1.881-3(a)(2)(ii) to include equity interest arrangements that give rise to deductions under foreign law. Under current regulations, such equity interests are generally not considered financing transactions (unless the equity interest is redeemable under Treas. Reg. section 1.881-3(a)(2)(ii)(B)). In other words, currently, an instrument that is treated as equity (other than redeemable equity) for US tax purposes and indebtedness under the laws of a foreign jurisdiction is not considered a financing transaction.

To prevent taxpayers from structuring into such equity arrangements, bypassing the conduit financing rules, and exploiting foreign jurisdictions, the Proposed Regulations broaden the scope of financing transactions to include such equity arrangements by taking into account the tax treatment of such instruments in foreign jurisdictions.

Specifically, the Proposed Regulations consider an equity interest as a financing transaction if under the laws of the foreign jurisdiction of the issuer, the issuer is permitted a deduction or other tax benefit for amounts paid, accrued, or distributed with respect to the equity interest. A similar rule would apply if the issuer maintained a taxable presence in a separate jurisdiction (i.e., a permanent establishment) and that jurisdiction permitted a deduction or other tax benefit for amounts paid, accrued, or distributed with respect to the equity interest of the permanent establishment. The proposed rules also treat an equity interest as a financing transaction if a person related to the issuer is entitled to such tax benefits from taxes paid by the issuer to such foreign jurisdiction.

However, the proposed rules further provide that if the equity interest of an intermediate entity falls within the scope of the Proposed Regulations, it will not be subject to the conduit financing rules to the extent its participation in the financing arrangement is not pursuant to a tax avoidance plan.

C. Coordination with GILTI

The Proposed Regulations provide rules relating to the treatment of certain payments between related CFCs under the GILTI provisions. In particular, the preamble to the Proposed Regulations identifies transactions between related CFCs which generate payments, such as pre-payments of royalties, that create income during the disqualified period and a corresponding deduction or loss in tax years after the disqualified period.

Under the current rules, such deductions or losses could, for example, be used to reduce tested income or increase tested losses. The Proposed Regulations prevent the deductions attributable to

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such pre-payments from providing such tax benefits by allocating them solely to residual CFC gross income, similar to the treatment of deductions or losses attributable to disqualified basis as described under Treas. Reg. section 1.951A-2(c)(5)(i).

V. EFFECTIVE DATES

The 2018 Proposed Regulations were set to be generally effective for hybrid dividends and specified payments made in taxable years beginning after December 31, 2017 if they were finalized by June 22, 2019. Obviously, the summer of 2019 passed without the final regulations making an appearance. The various regulations therefore have the following applicability dates:

- Final section 245A(e) regulations. The Final Regulations under section 245A(e) generally apply to distributions made after December 31, 2017, provided such distributions occur during taxable years ending on or after December 20, 2018. Taxpayers can apply the Final Regulations before that date. Taxpayers can also elect to apply the 2018 Proposed Regulations in their entirety for all taxable years ending on or before April 8, 2020.

- Final section 267A regulations. Except in special cases, the Final Regulations under section 267A apply to taxable years ending on or after December 20, 2018, provided such taxable years begin on or after January 1, 2018.[46] Taxpayers can generally rely on the regulations under section 267A in their entirety for taxable years beginning after December 31, 2017 and ending before December 20, 2018. In addition, taxpayers may elect to apply the 2018 Proposed Regulations in their entirety for all taxable years ending on or before April 8, 2020. Certain rules, such as the imported mismatch rules discussed in Part II.C above, apply to taxable years beginning on or after December 20, 2018.

- Proposed 245A(e) regulations. The proposed rules relating to adjustments of hybrid deduction accounts will apply to tax years ending on or after the date that the final regulations are published in the Federal Register. However, a taxpayer may rely on Proposed Regulations before they are published as final regulations as long as the taxpayer does so consistently.

- Proposed anti-conduit regulations. The conduit financing Proposed Regulations will apply to payments made on or after the date the final regulations are published in the Federal Register.

- Proposed regulations coordinating with GILTI. These proposed rules apply to the tax years of foreign corporations ending on or after April 8, 2020 and to US shareholders in which or with which such tax years end. Thus, these rules are effectively limited to payments made during the disqualified period that give rise to deductions or loss in tax years of foreign corporations ending on or after April 8, 2020.

46 *See* Treas. Reg. section 1.267A-7.

In the News

RECENT RECOGNITION

On June 30, 2020, Mayer Brown launched Best Methods, a Transfer Pricing blog designed to provide in-house tax professionals, transfer pricing consultants, and tax administrations timely updates on the latest transfer pricing guidance, legislative and regulatory developments, and cases from the US, the OECD, and tax jurisdictions around the globe.

Mayer Brown was ranked in Tier 1 by *Legal 500* in all categories for Tax, including International Tax, Non-Contentious Tax, Contentious Tax and Tax-Financial Products in 2020. We are the only firm to receive the highest ranking in all four categories.

Mayer Brown is pleased to have been named the US Law Firm of the Year – Transactions for *GlobalCapital's* Americas Derivatives Awards 2020. We are also shortlisted for European Law Firm of the Year – Transactions, European Law Firm of the Year – Regulatory, and Global Law Firm of the Year (Overall) for *GlobalCapital's* upcoming Global Derivatives Awards 2020.

RECENT SPEAKING ENGAGEMENTS

TEI Virtual Midyear – Tax Controversy/Audit & Appeals

On July 30, William McGarrity joined Teri Wielenga, Gilead Sciences, and others on a panel discussing Transfer Pricing Controversy: Opinions, Appeals, Early Resolution. The discussion addressed the management of audits and tools for reaching early resolution, what is being learned from litigation and recently decided cases, and lastly forward looking trends, including the use of appeals, APA's and the survival of the Arm's Length Standard.

Convertible Bonds: Understanding the Key Benefits

On July 23, Anna Pinedo and Remmelt Reigersman, along with Claude DeSouza and Pete Pergola of Raymond James, hosted a webinar on convertible bonds and discussed topics such as: the state of the market, and provide a convertible bond overview; accounting and reporting implications for issuers; accompanying antidilutive strategies, including capped call and call/warrant structures; tax considerations for the issuer; addressing busted converts; and other securities and disclosure considerations.

PLI's Understanding the Securities Laws 2020

On July 16 and 17, Partner Anna Pinedo co-lead a discussion entitled Securities Act Exemptions, and covered topics such as: exempt securities versus exempt transactions; private placements, including offerings under Rules 504 and 506 of Regulation D; Regulation A+ offerings; "Intrastate" offerings; Crowdfunding; Employee equity awards; Rule 144A offerings; Regulation S offerings outside the U.S.; and resales of restricted and controlled securities: Rule 144, Section 4(a)(7) and "Section 4(a)(1½)."

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TEI Virtual Midyear – Tax Controversy/Audit & Appeals
On July 16, Brian Kittle and Gary Wilcox joined Patricia Rexford, Johnson & Johnson and others for the Statutory Interpretation & Regulatory Deference webinar exploring issues around statutory interpretation and judicial deference to administrative interpretations.

TEI Virtual Midyear – Tax Controversy/Audit & Appeals
On July 16, Thomas Kittle-Kamp and Scott Stewart joined Anthony O'Donnell, EMD Serono for the Transfer Pricing: The Arm's Length Standard after the TCJA webinar discussing the significant impact of the changes introduced in the TCJA and the role of the arm's length standard going forward.

Continuous Offerings: Equity Line Financings and At the Market Offerings
Equity line transactions often are confused with continuous offerings that are structured as at the market offering programs. Each financing alternative has distinct characteristics, and differ in important respects. On July 9, Anna Pinedo along with Nikolai Utochkin of Nasdaq and Steven Martin of Aspire Capital, discussed topics such as: basic structure of an equity line; public versus private; SEC's historic analysis of private equity lines; registration of securities sold in private equity line transactions; overview of, and application of Nasdaq 20% limitation / shareholder vote rules to equity line financings; at the market offering basics; application of Nasdaq rules to ATMs; and differences between equity lines and ATMs; and SEC's S-3 baby shelf rules applied to continuous offerings.

TEI Virtual Midyear – Tax Controversy/Audit & Appeals
On July 9, Michael Lebovitz, Jason Osborn and Elena Khripounova joined Kristen Mikolaitis, Nestle USA and others for The Future of the Functional Analysis: Pillar One and Beyond webinar. The panel discussed: identifying transfer pricing issues and the place of digital transactions within global value chains, how to adapt approaches for functional and value chain analysis for the post-digital era, including comparability factors and value drivers such as marketing intangibles and user base, and explore how Pillar One may impact transfer pricing analyses and some ways that functional and value chain analysis can be leveraged and adapted to prepare for both the possible implementation of Pillar One and the challenges likely to arise if Pillar One is not implemented.

TEI Virtual Midyear – Tax Controversy/Audit & Appeals
On July 9, Lucas Giardelli joined Eli Dicker of TEI and others for the The Tax Cuts and Jobs Act – Nuts & Bolts From a Tax Controversy Perspective webinar. The panel introduced key pieces of the TCJA architecture to in-house tax professionals who have yet to encounter live TCJA-related issues in their own company examinations. Also discussed, was what are the central components of the TCJA, how do they fit together and what are some of the tax controversy issues that could arise.

Navigating the Storm: Initial Structuring, Exit Strategies and Tax Controversy Considerations in Asia, the EU and Brazil On June 30, Andy Baik, Celso Grisi and Benjamin Homo, Pieter de Ridder and Jason Osborn discussed technical and practical tax considerations in the initial acquisition structuring in these regions, exit strategies and post-exit tax controversy in these regions, as an alternative fund

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structure (to the traditional Cayman offshore fund), onshore fund structures in Singapore and Hong Kong and the benefits and other considerations related to these options, and the venues for foreign tax dispute resolution and double tax relief available in the US for US MNCs and PEFs with US investors.

Opportunity Zone Expo Virtual Program
On June 24, Mark Leeds moderated a panel discussing "Powerful Collaborations: Strategies for Public and Private Partnerships and the Benefits of Community Driven Investment".

Market Developments Covering Late Stage Private Placements
On June 23, 2020, Anna Pinedo and Thomas Vitale of Mayer Brown led a discussion along with Anat Alon-Beck of Case Western School of Law, Kevin Gsell of Nasdaq Private Markets, and Brooke Parker of Barclays Capital on market developments affecting the private markets, including late stage private placements; unicorn investors and the emergence of new market actors; participation by CVCs; terms of late-stage private placements and how these are changing as a result of the market downturn; principal concerns for cross-over funds participating in private rounds; legal considerations, including diligence, projections and information sharing; issuer and third-party tender offers; and structuring private placements with existing security holders.

Tax Executive Institute's Virtual Midyear Conference
On May 27, Brian Kittle discussed "Transfer Pricing Policy, Planning and Practice in a Changing World" during the Tax Executive Institute's Virtual Midyear Conference.

Tax Executive Institute's Virtual Midyear Conference
On May 20, Jason Osborn discussed "Unilateral Taxation of the Digital Economy" at the Tax Executive Institute's Virtual Midyear Conference.

The Current Tax Landscape and What's on the Horizon in Asia, the EU and Brazil
On June 9, Mayer Brown hosted Part I of its two-part webinar series on the exit-related taxation of inbound fund investments in Asia, the European Union and Brazil. Tax Transactions & Consulting partners Andy Baik, Celso Grisi and Benjamin Homo discussed the current tax landscape and what may lie ahead pertinent to foreign fund investment exits in the two regions and Brazil.

Financial Transactions: OECD Guidance and COVID-19 Considerations
On May 28, Astrid Pieron, Scott Stewart and Elena Khripounova reviewed guidance on specific issues, including loans, treasury function and guarantees, and also discussed whether and how the analysis is affected by the COVID-19 environment in a Transfer Pricing webinar.

Liability Management – the Tax Angle
On May 6, 2020, Thomas Humphreys, Remmelt Reigersman and Brennan Young hosted a webinar discussing the tax implications to issuers and investors resulting from various liability management transactions, including: debt repurchases; debt modifications or exchanges;

recapitalizations; bankruptcy restructurings; and payment of consent fees.

Supply Chain Disruptions: Key International Tax Issues
On April 30, Astrid Pieron, Mike Lebovitz, Matthew Mortimer and counsel Kitty Swanson discussed how the COVID-19 crisis has highlighted the challenges a multinational enterprise faces when global supply chains are disrupted. The panel discussed some of the key international tax challenges associated with this disruption, including: transfer pricing challenges, such as how the crisis is affecting limited risk distribution models, how catastrophic costs are allocated among the group and how to manage the tax impact of distributor terminations and renegotiations, tax challenges arising from functional dislocation, including permanent establishment and controlled foreign corporation, and indirect tax issues associated with changes in place of supply.

Intelligize Webinar: Mind the Non-GAAP: A Look at Recent SEC Guidance on Non-GAAP Financial Measures
On April 29, 2020, Ryan Castillo and Laura Richman presented on the use of non-GAAP financial measures by public companies. Topics that were discussed included: the nature and purpose of non-GAAP financial measures; the current regulatory framework, including Regulation G, item 10(e) of Regulation S-K and the C&DIs issued by the SEC's Division of Corporation Finance; recent SEC guidance on key performance indicators (KPIs) and metrics used in MD&A and other company disclosures; recent SEC guidance on non-GAAP financial measures in COVID-19 disclosures; recent SEC comment letters on non-GAAP financial measures and areas of concern of the SEC's Division of Corporation Finance; SEC enforcement actions related to non-compliance; audit committee and management roles in compliance and effective disclosure controls; practical suggestions for ongoing compliance with SEC rules and guidance on non-GAAP financial measures, KPIs and metrics; and proposed amendments to MD&A.

REVERSEinquiries Workshop: US Taxation of Structured Notes
On April 28, 2020, Thomas Humphreys, Remmelt Reigersman and Brennan Young presented a workshop on the current US tax rules and any new developments regarding structured products, including: the tax characterization of structured notes; the dividend equivalent provisions and current state of play; the IRS basket option notices; and PFIC and FIRPTA considerations.

Private Placements and Hybrid Securities Offerings 2020
This two day PLI seminar featured panel discussions covering the basics of private placements, resales of restricted securities, Section 4(a)(1-1/2) transactions and block trades. Partner Anna Pinedo served as chairperson of the program and partner Marlon Paz spoke on a panel entitled, "Practical Considerations for Broker-Dealers Acting as Placement Agents in Exempt Offerings."

COVID-19: Forward-Looking Disclosure
On April 17, 2020, Partner Jennifer Carlson joined a panel organized by the Society for Corporate Governance where the speakers covered SEC Joint Statement: brief overview & key takeaways; Principles applicable to COVID-19 disclosures for earnings releases, Exchange Act reports, and analyst

calls and presentations, including forward-looking statement safe harbors, risk factors and recent disclosure guidance; practical challenges/considerations including Form 8-K item triggers and rapidly changing information; and additional resources including sample disclosures, best practices guidance and memos.

PIPE Transactions: Basics and Current Developments
On April 8, 2020, Jen Carlson and Anna Pinedo held a webinar on PIPE Transactions, in which they discussed topics such as: recent market trends; PIPE documentation and the principal negotiating issues; the securities exchange shareholder approval rules, recent changes to such rules, and the financial viability rule; using warrants and structuring approaches for at-market deals; venture capital and private equity PIPE transactions; and change of control PIPE transactions.

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What Energy Sector Should Expect From Biden's Tax Policies

By **Gregory Matlock** (February 8, 2021)

Gregory Matlock

As the Biden administration takes shape, energy companies will be monitoring potential tax policy initiatives, especially those that could impact the energy sector.

Companies throughout the sector could be treated disparately, depending on how closely the underlying businesses and future aspirations tie to the new administration's focus areas.

Although the incoming administration has put forth bits and pieces on a variety of potential tax reforms and incentives, two focus areas have clearly emerged: a reduction or rollback of certain provisions of the 2017 Tax Cuts and Jobs Act and a focus on clean energy and reducing carbon emissions — while promoting U.S.-based manufacturing.

Policy initiatives, as aspirational concepts, and the ability to affect tax reform are distinct topics; however, taxpayers ought to have an understanding of what is potentially at stake.

General Provisions

Potential changes may vary between the sectors — i.e., oil and gas, mining and metals, power and utilities and renewables — but also may vary between subsectors — i.e., coal production versus precious metals, base metals or other metallic minerals, as discussed in more detail below.

However, many of the potential tax reform changes could have general applicability to companies in the energy sector, including, but not limited to, the following:

- Increase in the corporate tax rate — potentially to 28% from 21%;

- 15% corporate minimum tax on global book income of $100 million or more;

- Changes to the international tax regime, which could include, in part, an increase to the global intangible low-tax income rate to 21% — and potentially to 28% under one proposal, a potential change to a country-by-country analysis, tighter anti-inversion rules, an offshoring penalty and certain other changes; and

- Expiration of certain TCJA provisions. Under the Biden administration, we query whether certain, temporary TCJA provisions will be allowed to expire, including, but not limited to:

- The Internal Revenue Code Section 163(j) limitation on interest moving from an earnings before interest taxes depreciation and amortization, or EBITDA, based limitation to an earnings before interest and taxes-based limitation starting in 2022;[1]
- The current rules for 100% bonus depreciation on certain qualifying expenditures beginning to phase down after 2022;
- Certain research and development expenses being required to amortize over five years — instead of expensed currently — starting in 2022;
- Deductions related to global intangible low-tax income and foreign-derived intangible income being reduced starting in 2026; and
- The base-erosion and anti-abuse tax rate increasing slightly, as scheduled, starting in 2026.

The increase in tax rates — including the addition of a potential corporate minimum tax — coupled with the expiry of certain cost-recovery favorable provisions could lead to an increase in the cost of doing business, which could extend throughout the energy sector.

However, for companies engaged in clean energy-related businesses — or carbon-reducing efforts, such as carbon capture and sequestration — silver linings may exist.

Impacts on Natural Resource-Related Businesses

With a stated goal of moving away from fossil fuel-focused energy sources, the incoming administration has messaged that potential tax changes may be en route for certain natural resource-related businesses.

Specifically, ending fossil fuel incentives has been a stated priority of the incoming administration. Although not expressly defined, the term fossil fuels generally encompasses coal, crude oil and natural gas, among others.

The following provisions, among others, may be at risk, for fossil fuel-related activities:

- The Section 263(c) deduction for intangible drilling and development costs for oil and gas wells;
- The Section 613 allowance for percentage depletion — although query whether any potential change could be limited solely to fossil fuel-related production, as opposed to nonfossil-fuel-related production — that may apply to independent producers of oil or natural gas, royalty owners and nonoil and gas production; and
- The Section 617 — related to certain mining exploration expenditures — and Section 616 — related to certain mining-related development expenditures — deductions, at least with respect to coal-related activities.

Although the Biden administration has expressed a clear preference for cleaner energy, demand for fossil fuels is expected to continue, which will require ongoing investment to maintain market stability.

For nonfossil-fuel-related extractive industries, such as base metals and precious metals, as examples, it is not clear whether any tax reform changes would be specifically tailored to such activities.

Minerals such as steel, aluminum, copper, lithium, cobalt, nickel, rare earths and certain others are necessary for the production of and advancement of numerous clean energy technologies, including renewable energy, electric vehicles and battery technologies, and also play a significant role in increasing U.S. manufacturing capabilities.

Further, aggregates — such as sand, gravel, crushed stone and numerous other particulate materials — are interwoven and symbiotic with increased manufacturing and infrastructure improvements.

Additionally and as a general matter, a potential increase in tax rates, the phase-down of bonus depreciation and the move to an earnings before interest and taxes-based Section 163(j) limitation — from the current EBITDA-based limitation — may not be welcomed with any enthusiasm by natural resource-related companies.

Importantly, however, the phase-down of bonus depreciation and change to an earnings before interest and taxes-based interest deduction limitation will happen as a matter of course, based on existing law.

Although there will no doubt be a focus on innovation to reduce carbon emissions and footprints, minerals and natural resources — and the companies that develop and produce such minerals or resources — are essential to the continued growth of the country.

Companies ought to carefully analyze potential tax changes — along with potential licensing and permitting limitations, implementation of aggressive pollution limits and other nontax measures, or U.S. Environmental Protection Agency or U.S. Department of Energy initiatives — and the attendant impact on the cost of capital and return on investment.

Impacts on Power and Utilities

Both regulated and nonregulated power and utility companies may be impacted by potential tax changes under the Biden administration; however, the impacts of those changes may vary.

For example, an increase in tax rate could cause rate recovery issues for regulated power and utility companies.

When the corporate rate was lowered to 21% from 35% pursuant to the TCJA, benefits related to the lower rate were generally refunded by utilities to their customers.

The flipside, however — where the tax rate increases — may not be so customer-friendly. If an increase in the rate is effected, utilities may charge customers more — although the overall impact of a rate change would need to factor in all attendant tax reform changes.

An increase in the corporate tax rate to 28% — an increase of 7% — as well as the impact of a potential 15% corporate minimum tax, and certain other potential changes, ought to be carefully evaluated by regulated power and utility companies.

Impacts on Renewable Energy

Given the Biden administration's stated focus on a clean energy revolution, historic investment is expected to be sought in clean energy and innovation.

Clean energy efforts have continued to progress over the past couple of administrations, including a number of recent legislative and regulatory developments, such as (1) the recent extension of the solar and wind tax credits,[2] (2) the recent grant of beginning of construction relief for offshore renewable projects and renewable projects on federal land;[3] and (3) the recently released, taxpayer-friendly final regulations on carbon capture and sequestration activities.[4]

The clear, renewable energy focus expected to be supercharged under the Biden administration could be effected through additional tax incentives or provisions related to growth in new or existing clean energy technologies.

Takeaway

Potential tax reform changes require thorough evaluation and diagnosis in order to identify potential opportunities and areas for investment or to refocus holdings and operations. Tax and other policy changes ought to be evaluated in light of the convergence, evolution and transition of the energy industry.

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[1] All "Section" references contained herein are to the Internal Revenue Code of 1986, as amended.

[2] Available at https://www.mayerbrown.com/-/media/files/perspectives-events/publications/2020/12/solar-and-wind-tax-credits-extendedagain_1220_v1.pdf.

[3] Available at https://www.mayerbrown.com/en/perspectives-events/publications/2021/01/irs-grants-beginning-of-construction-relief-for-offshore-renewable-projects-and-renewable-projects-on-federal-land.

[4] Available at https://www.mayerbrown.com/en/perspectives-events/publications/2021/01/irs-issues-final-carbon-capture-regulations.

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What a Biden Presidency Will Mean for Structured Finance

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The implications of the 2020 election for structured finance are coming into focus. Informed by our discussions in Washington, we can anticipate the likely direction of federal policy over the next two years that will impact the structured finance markets.

Although former Vice President Joe Biden has won the U.S. Presidency, the predicted "Blue Wave" that would have given Democrats control of both the White House and Congress did not materialize. Republicans will likely retain the Senate and unexpectedly gained seats in the House of Representatives, substantially reducing the Democratic House majority.

If Republicans retain their Senate majority following the two runoff elections in Georgia set for January 5th, the absence of unified Democratic control will mean that while financial policy will shift in a Biden Administration, that shift will be muted, though not insignificant, and will primarily be effected through presidential and regulatory actions rather than legislation. **However, it is important to note that if Democrats do win both of the runoff elections in Georgia (or later events occur that shift the Senate majority to the Democrats), then it is very likely that Democrats would aggressively use their narrow majorities in Congress, including to pass substantial tax legislation and far-reaching regulatory reforms. The course of financial policy over the next two years largely hinges on which party controls the Senate.**

From a macroeconomic perspective, if the Republicans hold the Senate, the U.S. would likely continue its current accommodative monetary and fiscal policies, since significant tax increases would be unlikely. The open question is the degree to which fiscal policy will be accommodative going forward.

With respect to interest rates, a critical factor for structured finance, yields on Treasuries fell when the predicted "Blue Wave" failed to materialize, which reduced expectations of the

amount of future borrowing by the federal government, including for a new COVID-19-related stimulus package. Indications are that interest rates will remain low for the foreseeable future, which is generally positive for the demand for consumer loans and ABS/MBS but potentially decreases the demand for some consumer receivables such as auto leases.

A Threshold Matter: Personnel is Policy

The likelihood that the Republicans will retain their majority in the Senate increases the importance of the Biden Administration's financial regulatory appointments. The Biden transition team has indicated that President-elect Biden's senior economic team will likely be rolled out in December. We expect to see first an announcement of the nominee for Treasury Secretary, followed by announcements of the nominees for Chair of the Securities and Exchange Commission, the Commodity Futures Trading Commission, and the Comptroller of the Currency.

How a Biden Administration will handle the Consumer Financial Protection Bureau ("CFPB") and the Federal Housing Finance Agency ("FHFA") is unclear at this time. Those agencies are led by Trump-appointed directors whose terms have not expired, but who, in the case of the CFPB, can be removed at will by the President, or, in the case of the FHFA, will be subject to removal at will by the President if, in a Supreme Court case to be decided early next year, the high Court follows its recent precedent permitting at-will removal of the CFPB director. Expectations that the Biden Administration would promptly terminate those directors may now be tempered by the likely need for the Biden Administration to work with a Republican-controlled Senate to confirm its nominees. Nevertheless, expectations are that the Biden Administration will seek to have a new director of the CFPB in place as soon as possible.

With respect to appointments to the Federal Reserve Board, President-elect Biden may open up a seat if he nominates Fed Governor Lael Brainard to be Treasury Secretary. Another seat is expected to open up in October of next year, when Randy Quarles's term as Vice Chair ends. The Senate is currently considering nominees for the two open seats at the Fed. If those nominees are not confirmed before the end of this Congress, the Biden Administration will immediately be able to nominate two individuals to the Fed Board.

Federal Deposit Insurance Corporation ("FDIC") Chair Jelena McWilliams's term lasts until 2023, but because the director of the CFPB and the Comptroller of the Currency are members of the FDIC Board, once President Biden appoints new leadership to those agencies, a majority of the FDIC board will consist of Democratic appointees.

Lame Duck Session: Prospects for Stimulus Bill

The most immediate impact of the election in terms of economic policy, with implications for structured finance, will be on the ongoing negotiations for another stimulus bill to address the

continuing impact of the COVID-19 pandemic. During the lame-duck period (the period between the election and the swearing-in of the new Congress in January), Congress will likely seek to pass another stimulus bill. Senate Majority Leader Mitch McConnell has said that he would like to pass a bill by the end of the year. Such legislation would still need to secure House Speaker Nancy Pelosi's support, and she has so far insisted that the price tag be north of $2 trillion. Senate Republicans voted in favor of a package with a $650 billion price tag in September, but a deal would likely be above that figure, as the White House has voiced support for a package above $1 trillion. It is possible that Congress passes another stimulus bill in the lame-duck, but it is not guaranteed.

Another stimulus bill would likely build on the programs established by the CARES Act and include:

- Reauthorization of the Paycheck Protection Program for small businesses (with additional restrictions on eligibility and new requirements for participating banks); and
- Extension of enhanced unemployment benefits at a rate below the $600 per week provided in the CARES Act.

The bill could also include:

- A new foreclosure moratorium and payment forbearance for federally-backed mortgages, which would impact mortgage servicers, the value of MBS, and the residential mortgage space more generally;
- A possible eviction moratorium; an eviction moratorium could adversely affect Single-Family Rental securitizations;
- An extension of funding for Federal Reserve emergency lending facilities (see below);
- Funding for state and local government, though in a far smaller amount than the $1 trillion sought by Speaker Pelosi; and
- A liability shield for COVID-19 pandemic-related lawsuits.

The Future of TALF and Other Federal Reserve Emergency Credit Facilities

The funding authorized by the CARES Act for the Federal Reserve's emergency lending facilities expires at the end of the year. Likely incoming Senate Banking Committee Chair Pat Toomey (R-PA) has already publicly stated that the Fed's emergency lending facilities should terminate at the end of the year. If the CARES Act funding for the emergency lending facilities is not reauthorized, the Fed would be prevented from making new loans through its

emergency lending facilities, though it would not have to terminate existing loans. The Term Asset-Backed Securities Loan Facility ("TALF") that supports structured finance utilizes funds appropriated in the CARES Act, and would likely be prevented from making new loans if the CARES Act funding is not reauthorized.

If the CARES Act funding is extended and the economy displays weakness next year, the Biden Administration will likely encourage the Fed to modify its underwriting criteria for its Main Street Lending Program to increase eligibility and participation.

GSE Reform

In the immediate term, the most significant reform on the horizon for structured finance is the Trump Administration's current effort to end the decades-old conservatorships of Fannie Mae and Freddie Mac (the "GSEs"). The Biden team has not indicated its policy views on the future of the GSEs. However, FHFA Director Mark Calabria has signaled his intention to finalize a new capital rule for the GSEs before the end of the year. Once that rule is finalized, or possibly beforehand, he is expected to announce how he intends to proceed with terminating the conservatorships. Director Calabria has indicated that the conservatorships could be terminated with an interim step being that the GSEs would operate under a consent order while raising capital.

It is important to note that the Supreme Court is hearing a case next month about the validity of the Third Amendment to the Preferred Stock Purchase Agreement between Treasury and FHFA, through which Treasury provides fiscal support for the GSEs. If the Supreme Court signals at its oral argument next month that it may invalidate the Third Amendment when it issues its decision, likely in March or April, it may compel the FHFA and the Treasury Department to proceed more quickly with reform. Alternatively, it is possible that the Biden Treasury Department will seek to halt the reform efforts upon taking office.

Legislative Possibilities Limited – IF Republicans Keep the Majority in the Senate

While significant legislation is always a possibility if there is a major event that galvanizes public support for a legislative response (such as the 2001-2002 accounting scandals that prompted Congress to pass the Sarbanes-Oxley Act), we anticipate that the votes will not exist for dramatic financial regulatory reform if the Republicans retain the Senate majority.

That said, we would still expect Congress to be active next year, as is the case during the first year of any presidency. Legislation could include the following areas affecting structured finance at least indirectly:

- Infrastructure legislation, as the Highway Trust Fund expires in September of 2021, requiring reauthorization and providing a vehicle for a substantial infrastructure bill;

- Additional funding for renewable energy research and production (including solar, which could increase the supply of solar-loan-backed ABS); and
- Additional subsidies for electrical vehicle purchases and charging stations.

A Republican-controlled Senate and a closely divided House would very likely prevent the passage of legislation that would:

- Enact major housing finance reform impacting the residential mortgage space and related securitization products;
- Use the Congressional Review Act to invalidate regulations adopted by the Trump Administration since May of 2020 (the statutory timeframe in which the CRA can be used with respect to a regulation); the regulations exposed to reversal under the CRA include the recent revisions to the Volcker Rule, including changes paving the way for liberalization of certain investment restrictions in CLOs that bank investors in many such vehicles had required in order to comply with the previous version of the Volcker Rule;
- Impose substantial tax increases;
- Establish interest rate caps on non-residential consumer lending; or
- Enact the "Green New Deal" or other environmental legislation that greatly expands corporate legal liability.

Again, it is important to emphasize that if Democrats win both of the Georgia Senate seats on January 5th (or other unanticipated events flip control to the Democrats), we would expect that Democrats would then aggressively use their legislative majorities - as narrow as they would be – to potentially pass some of the above items, in particular substantial tax reform and far-reaching environmental legislation, and a Senate rule change to eliminate the filibuster. Again -- a lot of financial policy that could impact structured finance hinges on the narrow margin of control in the Senate.

Given the substantial federal deficit and soaring debt-to-GDP ratio, the Biden Administration also is likely to examine how to place the federal government's finances on a more sustainable footing, including by reversing the Trump tax cuts. It will be extremely difficult to adopt substantial budget reforms on both the revenue and spending sides given the likely divided control of Congress and sharp divides in the Democratic caucus in Congress. Nevertheless, we expect that the Biden Administration will seek to include targeted tax increases (including raising the corporate and capital gains rates and treating carried interest as ordinary income) as part of future budget deals with Senate Republicans.

Executive Branch Regulatory Reforms

An inability to pass significant financial services legislation if Republicans retain the Senate majority will likely force the Biden Administration to implement its financial service policy agenda through existing presidential and regulatory authorities. President-elect Biden is expected to revoke many of the Trump Administration's executive orders and issue a series of new orders that set policy for his Administration. Although the president does not have substantial authority to change financial regulatory policy through executive orders, the issuance of executive orders will signal the direction of policy under a Biden Administration.

The groundwork for reform by financial regulators that could impact structured finance has already begun. Federal Reserve Vice Chair for Supervision and current Chair of the Financial Stability Board Randy Quarles and SEC Chair Jay Clayton have signaled that reforms are likely needed to address regulatory weaknesses in the non-bank sector that have surfaced in the wake of the COVID-19 economic shock. They have focused on the need to re-examine the regulation of securities dealers, in particular primary dealers, and non-bank mortgage lenders and servicers due to the continued movement of the mortgage credit market away from banks. This push for reform is likely to extend beyond the Trump Administration and set the stage for the Biden Administration to pursue new regulation that could have a substantial impact on structured finance.

One option for reforming non-bank finance would be for the Financial Stability Oversight Council ("FSOC") to designate large non-bank companies for enhanced prudential supervision by the Federal Reserve and/or to determine that lending or other activities by non-bank companies should be subject to additional regulation or a new statutory regime.

Biden appointees to financial regulatory agencies are likely to consider implementing a wide range of other rules that would impact structured finance, including:

- Reforms to the Volcker Rule to limit bank exposures to structured finance risks, either through supervision or modifications to the recently finalized rules (Fed Governor Brainard voted against the recently finalized Volcker changes, signaling that she may want to revisit the rules at a later date);
- New capital and liquidity requirements for non-bank mortgage companies;
- Reforms of the Treasury market, including potentially creating a central clearinghouse for Treasury securities;
- Relief with respect to Federal Direct Student Loans and FFELP student loans, including forbearance and forgiveness with respect to loans owned or guaranteed by the Department of Education;
- Reversal of the True Lender/Valid-When-Made regulations issued by the Comptroller of the Currency and the FDIC;

- Stronger oversight of consumer lending (including credit cards);
- Credit score and credit bureau reforms;
- Environmental, social and governance ("ESG") requirements for public companies and government contractors; and
- Capital charges or other supervisory restrictions on banks financing carbon-energy-intensive businesses or carbon-energy-producing businesses.

Enforcement

The Biden Administration will also likely use enforcement to advance its policy agenda due to both the difficulty of passing legislation and the discretion afforded to craft remedies. The Department of Justice and financial regulators (including in coordination with state regulators and attorneys general) will likely focus enforcement actions on the following areas of relevance to structured finance markets:

- Fair lending;
- Student loan and mortgage servicing violations;
- Unfair, deceptive, or abusive consumer lending (especially auto loans, non-bank lending, student loans, and credit cards);
- Debt collection practices;
- Consumer and investor protections, with larger penalties and less credit for self-reporting and cooperating with regulators upon the discovery of a violation; and
- Stricter application of antitrust laws, especially with respect to larger financial institutions.

For more information, please do not hesitate to contact us or any of the other listed Mayer Brown contacts. Mayer Brown continues to monitor developments relevant to structured finance as the Biden transition team identifies senior personnel, and as the incoming Biden Administration and Congress signal their policy priorities for the coming weeks and next year.

[PULSE] Ginnie Mae restricts long-time legitimate business activity of mortgage servicers

July 10, 2020, 1:02 pm By Laurence Platt

Ginnie Mae's newly imposed restriction on repooling of reperforming forborne loans yet again penalizes servicers acting as essential service providers in the continuing efforts to protect mortgagors facing financial hardship due to COVID-19.

Let me count some of the ways Ginnie Mae servicers are bearing the brunt of mortgagor forbearance under the CARES Act: no servicing fee income during forbearance of up to a year (and potentially longer should Congress decide its necessary); no relief from advance requirements for the period of such forbearance; no revision of the structural impediments to private financing to fund advances; and no reimbursement for the cost of funds for advances.

Laurence Platt

Yet, investors in Ginnie Mae securities generally are insulated against the risk of mortgagor forbearance under the CARES Act because they are timely paid on the securities they hold irrespective of borrower or servicer defaults.

In issuing APM-20-07 on June 29, 2020, Ginnie Mae decided to further protect investors from the potential enhanced prepayment risk resulting from early pool buyouts of forborne loans. This protection, however, comes at the expense of servicers.

By restricting servicers from relying on long-standing, legitimate business activity – early pool buyouts coupled with the repooling of reperforming loans – Ginnie Mae has elected to deem a routine activity as inappropriate because it is unnecessary and, gosh, may produce a profit.

Context

Under the Ginnie Mae program, servicers (labeled as "issuers") are required to advance to Ginnie Mae securities holders the regularly scheduled mortgage payments on the underlying pooled mortgage loans backing the securities if the mortgagors do not pay.

This obligation lasts until the defaulted loan is purchased out of the pool by the servicer or is paid off by either the mortgagor or through mortgage insurance or guaranty proceeds. Backed by the full faith and credit of the federal government, Ginnie Mae guarantees the servicers' advance obligations to securities holders.

A servicer purchases loans out of pools backing Ginnie Mae securities for one of three reasons:

1. It may elect to repurchase a loan that is unpaid for three consecutive months or is delinquent for four consecutive months (such as a loan that continues to be one month delinquent for four consecutive months). For this purpose, Ginnie Mae considers a loan in forbearance to be unpaid. Many servicers make this election if they have the funds to do so in order to cease the obligation to advance regularly scheduled mortgagor payments of principal and interest.
2. Except with respect to trial modifications, Ginnie Mae prohibits the modification of pooled loans, and, thus, a servicer effectively is required to repurchase a delinquent loan to be modified.
3. As a last resort after exhaustion of efforts to cure, Ginnie Mae requires the servicer to repurchase a loan that proves to be ineligible for mortgage insurance or guaranty, since such insurance or guaranty is a statutory requirement for Ginnie Mae to issue guaranteed securities backing a pool of mortgage loans.

Servicers routinely obtain private financing to fund loan repurchases, referred to as "early pool buyouts," and the cost of funds on such financing often is lower than the pass-through rate on the securities or the cost of continuing to make advances on the pooled loan.

A modified or delinquent loan that reinstates as a reperforming loan is eligible to be repooled to back newly issued Ginnie Mae mortgage-backed securities. Proceeds from the sale of these securities is the source of funds to repay the early pool buyout financing; depending on the interest rates of the repooled loans relative to current market yields, the sale also may generate secondary market gains.

One way to reinstate a delinquent **FHA**-insured loan and thereby make it eligible for repooling is through a "stand alone partial claim." The **USDA** has a similar concept called a "mortgage recovery advance." A "partial claim" is a no-interest junior loan secured by the mortgaged property, the proceeds of which are used to bring the loan current.

In the case of COVID-19, no payments by the mortgagor are due on the "stand alone partial claim" until the payoff, maturity or acceleration of the insured mortgage, including for the sale of the mortgaged property, a refinancing or the termination of FHA insurance on the mortgage.

By using a junior lien, the loan does not need to be modified. Presently, a servicer may accomplish a “stand alone partial claim” or a “mortgage recovery advance” without repurchasing the delinquent loan from the pool, but servicers routinely combine the permissible early buyout of a delinquent loan, a reinstatement through a “stand alone partial claim” or “mortgage recovery advance,” and a repooling of the reperforming loan into newly issued securities.

What did Ginnie Mae do?

Under the new APM, “any Reperforming Loan that entered into forbearance, of any type, regardless of duration, on or after March 1, 2020, and is bought out on or after July 1, 2020, as reflected in the Issuer’s servicing system of record, is ineligible collateral for Ginnie Mae securities backed by any existing pool types.”

Instead, Ginnie Mae is creating a new pool type to securitize this type of reperforming loan based on a seasoning requirement. First, the borrower under a reperforming loan must have made timely payments for the six months immediately preceding the month in which the associated mortgage-backed securities are issued. Second, the issue date of the mortgage-backed securities must be at least 210 days from the last date the loan was delinquent. This restriction does not apply to modified loans, only reperforming loans.

“Reperforming Loans” are not limited to loans that are reinstated through a “stand alone partial claim” or “mortgage recovery advance.” The term is broadly defined to be a loan that is not more than thirty days delinquent, previously was bought out of a Ginnie Mae pool, and has the same rate and terms as the originally pooled loans.

This means that the new policy prohibits repooling of loans that are reinstated solely as a result of the borrower’s repayment of forborne amounts and resumption of regularly scheduled payments.

Why did Ginnie Mae do it?

The APM only hints at the reason behind Ginnie Mae’s change in position, stating that “Ginnie Mae seeks to ensure that transactional activity related to these options does not impair market confidence in Ginnie Mae securities.” It highlights that FHA’s “Stand Alone Partial Claim” and USDA’s “Mortgage Recovery Advance” do not require pool repurchases unless the terms of the loan require modification.

Ginnie Mae states that it is implementing the new pooling eligibility restrictions “to ensure that loan buyout activity is aligned with borrower and MBS program interests … while continuing to provide for buyout transactions that are appropriate and necessary.”

While not expressly stated, the purpose seems to be to prevent any enhanced prepayment risk to Ginnie Mae securities holders resulting from early pool buyouts, which Ginnie Mae correctly notes are not required to effect a “Stand Alone Partial Claim” or “Mortgage Recovery Advance” in order to cause the delinquent loan to be reinstated as a reperforming loan.

What does it mean for issuers?

Simply put, Ginnie Mae is depriving servicers of a long-standing, legitimate, elective business strategy under the Ginnie Mae program apparently because this discretionary activity is not

necessary to enable a servicer to cease servicing advances in respect of forbearance. Generating a profit from repooling reperforming loans somehow is viewed as a nefarious activity.

But perhaps generating a bit of profit from such repooling is a necessary and appropriate survival tool for servicers to offset the costs they bear and the servicing fee income they lose in implementing the CARES Act's requirements.

In isolation, insulating investors in Ginnie Mae securities from enhanced prepayment risk relating to forbearance certainly is a worthy public policy goal. When compared to the costs, expenses and lost revenue servicers are bearing in respect of forbearance, one has to wonder whether Ginnie Mae is fairly balancing the interests of servicers and investors.

In this regard, the new restriction is a material adverse change on servicers, which is predicated on neither any legislative change requiring the revision nor any real abuse by servicers that the policy is designed to correct.

While Ginnie Mae may have the authority to revise the Mortgage-Backed Securities Guide from time to time, servicers have a right to reasonably rely on the basic construct of the program without material adverse changes not grounded in law or abuse. Servicers create, acquire and finance their Ginnie Mae MSRs based on this reasonable expectation.

As a matter of sound public policy, as well as acting in good faith and dealing fairly with its contract counterparties, Ginnie Mae should not unilaterally and materially alter the rights and obligations of issuers in an adverse way without just cause.

MAYER | BROWN

December 21, 2020

Legal Update

So You Want to Form an MSR Fund: Issues and Considerations[1]

Despite COVID-19 conditions, US residential mortgage loan origination volumes have been at historic highs, driven by a refinancing boom spurred by low interest rates and new home purchases outside of urban areas. The current mortgage market is supported by non-bank mortgage originators and servicers who lack the same access to capital and liquidity as traditional banks. To continue growing, non-bank entities have had to be creative with respect to capital sources—as we have seen through recent public offerings.

Non-bank owners of mortgage servicing rights ("MSRs") are seeking asset-specific alternative private capital vehicles to fund portfolios of MSRs. However, unlike whole mortgage loans, MSRs cannot be easily created and sold to investors. Fortunately, through creative thinking and structuring, investors are able to utilize and enable non-bank, non-servicer, alternative capital sources to participate in the economics of MSRs. This Legal Update provides an overview of the phases and areas of consideration related to private capital vehicles that offer investment opportunities in mortgage servicing rights.

State and Federal Agency Approvals

When investing in MSR assets, a threshold consideration is insuring that the entity holding the loans and MSRs, as well as the entity that is engaged in the mortgage servicing activities, holds the requisite state licenses and federal approvals to hold such assets and engage in such activities. Each investing strategy for these assets brings with it state licensing and other considerations that need to be evaluated at the outset of the investment. If the goal of the investment is to be directly involved in mortgage servicing, then one needs to invest in a mortgage servicer or an entity that is authorized to purchase and hold residential mortgage loans and the associated MSRs. Such entities may be created or acquired, and each option comes with unique investment considerations from a licensing perspective. In either circumstance, the planning for and timing of these licensing and approval considerations are crucial for a successful investment.

A significant number of states require a license to purchase, acquire or hold a residential mortgage loan even if the purchaser or holder does not hold MSRs or engage in actual servicing activities. Certain states also require a license to hold MSRs even if the actual servicing activities are outsourced to a third-party mortgage loan servicer, while other states require a license to engage in mortgage servicing activities.

[1] This update is a written summary of a Mayer Brown Global Financial Markets teleconference that Krista Cooley, Eric J. Edwardson, Haukur Gudmundsson, Laurence E. Platt, Lauren B. Pryor, Claire Gibson Ragen and Jon D. Van Gorp held on October 22, 2020.

Therefore, any entity purchasing or holding residential mortgage loans or MSRs or engaging in residential mortgage loan servicing needs to evaluate the state licensing requirements that may apply.

To acquire such licenses, the entity must meet each state's requirements, which can include, among other items, submitting audited financial statements, creating policies and procedures regarding the licensable activities, establishing in-state offices and designating qualified individuals who have the requisite industry experience to meet each state's specific criteria to engage in the licensable activity. The application process may also require officers and directors to complete personal disclosures, which may include personal financial statements and fingerprints, among other items, and can be burdensome and intrusive. Depending on the jurisdiction, personal disclosures may be required from individuals holding more than the requisite threshold of indirect ownership interests of the licensee and/or of an entity seeking to acquire an interest in a licensee. Once the requisite state licenses are obtained, the licensed entity will be subject to certain additional requirements, including certain business practice requirements, such as maintaining books and records, maintaining the requisite net worth, filing quarterly and annual reports with the regulator and renewing the license annually. The licensed entity will also be subject to regulatory supervision and examination by each state regulator.

If the goal is to invest in MSRs involving loans sold to or securitized by government-sponsored entities Fannie Mae or Freddie Mac (the "GSEs") or loans in Ginnie Mae pools, the entity purchasing, acquiring or holding residential mortgage loans or engaging in loan servicing activities will also need to secure approvals from the GSEs and Ginnie Mae to engage in these activities even if the purchaser will not engage in actual servicing activities. These approvals also require the entity to, among other things, provide audited financial statements, demonstrate compliance with the investor's minimum capital and liquidity requirements and demonstrate the requisite operating history.

Given the hurdles associated with obtaining the state licenses and federal approvals required to purchase and hold residential mortgage loans either alone or with the MSRs and potentially engage in actual mortgage servicing activities, many entities explore the acquisition of an existing entity that already holds the required licenses and/or approvals. This strategy comes with its own set of licensing considerations. First, the entity will be subject to "change of control" approval as it relates to Ginnie Mae, the GSEs and certain state residential mortgage finance licensing laws and may require personal disclosures of the ultimate indirect owners of the licensee. Depending on the jurisdiction, even acquisition of non-voting stock or non-voting equity interest investments may be subject to these requirements. The determination of whether the change of control provisions apply may be based on the form of organization of the licensee or entities in the chain of ownership. Debt structures also may warrant change of control analysis depending on the extent of the debt holder's ability to exercise control over or directly manage the policies of the licensee. Any changes to the existing entity's name as a result of the purchase or restructuring may also require regulatory filings or approvals. While several jurisdictions require only advance notice of such changes of control, some important jurisdictions, including New York, and certain federal agencies require prior approval, which can take additional time to secure.

Finally, depending on how the proposed investment will be structured, the parties may need to consider whether the GSE or Ginnie Mae cross default provisions will apply. The Ginnie Mae Mortgage-Backed Securities Guide (the "Ginnie Mae Guide"), Fannie Mae's Selling and Servicing Guides and Freddie Mac's Seller/Servicer Guides (together with the Ginnie Mae Guide, the "Guides") include cross default provisions applicable to parties under common ownership or control. The cross default provisions provide that a default under the applicable Guide or servicing agreement by one entity may be deemed to be a default with respect to another entity under common ownership or control. The determination as to what constitutes common ownership or common control varies

among Ginnie Mae and the GSEs and, therefore, is an important consideration to evaluate for an acquiring entity that is already invested in MSRs within its structure. In addition to the cross default provisions set forth in the Ginnie Mae Guide, Ginnie Mae has in the past exercised its discretionary authority to limit or prohibit common ownership or control of multiple issuers with the same issuer approval type regardless of whether or not the parties enter into a cross default agreement.

When to "Build" or "Buy"

In consideration of the licensing and approvals requirements noted above, investors in MSR funds often debate whether to form a new entity and obtain licenses on a de novo basis (the "build" strategy) or acquire an existing licensed entity through a stock or equity purchase (the "buy" strategy). Each approach carries advantages and disadvantages.

The "build" approach has been popular based primarily on timing considerations and execution speed. An investor interested in the de novo licensing approach is likely to face a time period of 12 to 24 months to ramp up to full operating capacity, including licensure in a material number of states and Ginnie Mae or GSE approvals. During this time, the investor would identify a management team, inject capital into the entity and ramp up operations on a rolling basis upon receipt of state and agency approvals.

By contrast, an acquisition generally may be consummated in 6 to 8 months (assuming that the target entity does not hold licenses in New York). During such time, an investor would identify a target entity with the desired state and federal licenses, perform due diligence, negotiate definitive purchase documents, obtain regulatory "change of control" approvals and close the acquisition.

While the "buy" strategy allows for increased speed to execution, the investor may carefully consider the potential for legacy liabilities associated with the target. In equity transactions, a buyer assumes the assets *and liabilities* associated with an acquired entity. Buyers may face claims post-closing arising from events pre-closing, including loan repurchases or legacy employment claims. Legacy liability risk may be mitigated through legal due diligence as well as indemnity protections in the definitive agreements from a well-capitalized indemnitor. Legacy liability risk is typically not a concern with the "build" approach if licenses are obtained de novo and operations are built organically because a newly formed entity would not have the same "tail liability" arising from prior operations.

Legal and licensing fees are likely to be higher for a "buy" versus "build" approach as a result of expenses related to due diligence, negotiation, drafting and "change of control" approvals. When investors consider the pros and cons of build/buy strategies, such costs and potential legacy liability exposure are often weighed against the speed of execution presented by a stock or equity deal.

Alternative Arrangements

Establishing or acquiring a licensed and agency-approved servicer can be costly and time-consuming. As a result, investors may look to alternatives approaches to MSR investments, either during the setup period or permanently. Generally, these consist of entering into contractual arrangement with third-party or affiliated servicers pursuant to which the servicer acquires and retains MSRs, but the economics associated with holding the MSRs are transferred to the investor. Generally, these types of arrangements expose the investor to additional risks related to the servicer counterparty, such as bankruptcy risk, the risk of termination of the related MSRs and other operational counterparty risks.

The most common way to accomplish this economic transfer is by the sale of the "excess servicing" to the investor, pursuant to which the servicer sells an economic participation interest in a portion of the servicing income to the investor. These arrangements can be secured by a security interest in the related

MSRs and must be approved by Fannie or Freddie, in the case of GSE MSRs, and Ginnie, in the case of arrangements that are secured by the related MSRs. The agencies impose several requirements on the related terms as a condition of such approval, including limiting the size of the portion of the servicing fee income that can be sold. As result of such limitations, excess servicing sales are an imperfect proxy for the entire economics of the MSRs because the portion of the servicing fee that the servicer is required to retain is still often significantly greater than the cost of servicing. Since the agencies prohibit any further participation interests (or other interests in the MSRs) being sold to the investor, the remaining economics will need to be transferred pursuant to unsecured contractual arrangements between the servicer and the investor. These can include preferred shares or tracking stock in the servicer, credit-linked notes or other derivative-type instruments pursuant to which the investor, in exchange for an upfront payment to the servicer, is entitled to receive ongoing payments. The amounts of which are calculated based on the difference between the servicing fee income received by the servicer with respect to the MSRs, on one hand, and the cost of servicing and the excess servicing fee sold to the investor, on the other hand.

Use of Fund Structures

Given the complexity of investing in mortgage servicing rights, formation of a private investment vehicle is a good option to bring together servicers and investors. A typical structure involves setting up a Delaware limited partnership or limited liability company as a pooled investment vehicle or "fund" that is managed by an investment adviser (an "IA") or its subsidiary. The IA enters into an investment management agreement with the fund to provide advice with respect to the making of investments. A fund structure allows the IA to interface with counterparties related to the underlying investments on behalf of fund investors. It also offers the fund investors limited liability protection under Delaware law and comfort through the regulatory oversight of the IA by the Securities and Exchange Commission and fiduciary obligations of the IA arising under the US Investment Advisers Act of 1940, as amended (the "Advisers Act").

A fund formed to invest in MSRs will look much like any private pooled investment fund formed to invest in a specific type of asset. Generally, the IA will be entitled to receive both a management fee and carried interest or other form of performance compensation from the fund. The market terms for fees and performance compensation can vary; it is common to see management fees based on a percentage of invested capital, but fees may also be based on net asset value of the portfolio or other measures. Performance compensation may be structured as a traditional carried interest taken out of profits of the fund once the investor achieves a certain IRR or a preferred return performance threshold.

As with any private investment fund, the IA and the investor(s) will need to agree on general governance terms. Two primary areas of negotiation are how much discretion the IA will have over the fund and the underlying investments and what rights do the investors have to terminate the relationship with the IA. In a "fund of one" separately managed account structure, the investor is more likely to retain tighter control over approval of investments and other investment terms and lower-tier service providers than in a pooled investment vehicle with multiple investors. Such rights may extend to reporting and other information the IA is obligated to deliver to the investor. Similarly, a single investor will likely have more meaningful rights to remove the IA or terminate the fund than in a pooled investment vehicle, which would require more parties to agree. Because margins on MSR investments can be narrow, investors typically retain more control over expenses that can be incurred by the fund—often through an annual cap on expenses or a budget approval process—than they would have in funds investing in other asset classes.

The IA advising the fund will want to make sure that the fund documents contain provisions allowing it to meet its obligations under the Advisers Act. For example, if an affiliate of the IA is either

warehousing investments for the fund or serving as an intermediary when purchasing the underlying MSRs, the IA will need to satisfy the principal transaction restrictions under the Advisers Act. This can be accomplished by building in a requirement of investor consent for those specific transactions or a batch consent-type structure where approval is given for transactions within certain parameters. If the IA is advising more than one client investing in MSRs, the IA will need to make sure that the investments allocated to each client are done so on a fair and equitable basis over time or that the client who is not given equal or priority access to investment opportunities has specifically consented to the process by which it will be allocated investments.

Fund Leverage

Of course, it may be desirable to lever the fund investments in hopes of boosting the return to investors. There are several ways to do this. First, the fund can enter into a subscription financing facility, which is secured by the capital commitments of the various investors. These arrangements are fairly common in the funds space and do not depend in any material respect on the type on investments made by the fund.

In addition to or instead of a subscription financing facility, the fund could enter into an MSR-backed financing facility. MSRs are generally difficult assets to finance because of their nature as collateral. They are difficult to value, difficult to foreclose on and can evaporate if the servicer breaches its obligations under the servicing agreement. Nevertheless, MSR financings are fairly common and range in complexity from relatively simple bilateral credit agreements secured by a lien on the MSRs or the servicing income to fairly complicated securitization-like structures pursuant to which the servicer sells excess servicing rights to a special purpose master trust that issues variable funding notes to bank lenders and term notes to capital markets investors that are secured by the related MSRs.

In the federal agency MSR context, a key document is the related agency acknowledgment agreement, entered into by the applicable agency, the servicer and the lender or collateral agent, depending on the context. Pursuant to the acknowledgment agreement, the lender will agree that its interest in the MSR collateral is subordinated to the interests of the applicable agency. The acknowledgment agreement will also set forth the procedures for foreclosing on the collateral in the event of a default under the facility.

Finally, funds may consider servicing-advance facilities to finance the obligation to make servicing advances required by the MSR. Servicing advances are cash advances by the servicer on behalf of the borrower to cover delinquent mortgage, tax, insurance and escrow payments. Servicing advances are significantly better collateral than MSRs. Compared to MSRs, their eventual repayment is relatively certain and the right of reimbursement, at least to a certain extent, survives the termination of the servicer under the servicing agreement. The most common way to finance servicing advances is by selling the servicing advance receivables to a bankruptcy-remote special purpose master trust that issues one or more advance-backed variable funding notes to one or more bank lenders and that may also issue term notes to capital market investors.

Servicing Rights Purchases

Whether an investor will take ownership of MSRs directly through its own approved servicer or will invest in the MSRs indirectly though purchases of "excess servicing" or other structures, someone will need to obtain the desired MSRs. If the investor controls a mortgage loan origination platform, the investor may "create" MSRs when it delivers the applicable whole loans to investors on a servicing-retained basis.

Owning an origination platform therefore may provide an investor with a controllable and predictable source of MSRs. On the other hand, an investor may prefer to focus on its investment in the MSR asset and not take the regulatory and business risks associated with operating an origination business. If so, the investor will need to enter into agreements with third-party sellers of MSRs. There are two principal types of transactions for acquiring MSRs: one-time "bulk" purchases and "flow" transactions under which sellers deliver newly created MSRs on an ongoing basis over a period of time.

In a bulk transaction, the seller puts a specific portfolio of MSRs out to bid, and prospective buyers review the provided data and perform other due diligence on the loans. The buyers may decide which MSRs to buy and the price that the investor is willing to pay. Note that because a bulk sale involves an existing MSR portfolio, it may include loans with less desirable characteristics. For example, some loans may be delinquent, in foreclosure or in bankruptcy (or, currently, in forbearance due to the COVID-19 pandemic and required relief for borrowers). These loans will cost more to service. Moreover, the owner of the MSRs will not receive a servicing fee for these loans during periods of delinquency or forbearance because the servicing fee is paid from the collections on the loans, and there are no current collections on those loans. The servicer will also need to come out-of-pocket to make servicing advances on these loans. A bulk offering may include those less-desirable MSRs, and buyers may have the opportunity to exclude them, depending on the terms of the transaction. However, a buyer may not exclude undesirable MSRs from a bulk purchase of Ginnie Mae MSRs because Ginnie Mae requires all of the MSRs backing a securitized pool of loans to be sold together, so a buyer has to take any problematic loans in a pool along with the performing loans.

A bulk transaction typically has a number of procedural steps. First, there's a sale date on which the economic benefits of the MSRs are transferred and a significant portion of the purchase price is paid. Then an interim servicing period follows, during which the seller of the MSRs continues to perform the servicing of the loans for the benefit of the buyer. The interim servicing period ends with a transfer date, when there is a physical transfer of the servicing work to the buyer or its subservicer, including transfers of loan data, loan documents and custodial funds, and notices to borrowers and other relevant parties are sent. In addition, on or shortly after the transfer date, the buyer makes another payment of a smaller portion of the purchase price and reimburses the seller for the advances on the mortgage loans. Those include advances of principal and interest made to the investor in the loans when borrowers do not make payments, payment of taxes and insurance that have not been funded by the borrower, and expenses related to actions taken to preserve the value of the loans or to foreclosure in the event of loan delinquencies and defaults.

A flow transaction, by contrast, involves a commitment of the parties to buy and sell MSRs in the future. Those MSRs do not exist at the time the parties enter the agreement, so there is no existing portfolio that a buyer may review and price. The buyer can and should review the seller's historic origination of loans to get a sense of what it may deliver in the future. Moreover, the buyer may include terms and limitations in the flow purchase agreement that will set parameters and requirements for the MSRs that should be delivered. Those terms, often called the "buy box," typically include a pricing matrix that provides pricing multiples and adjustments to properly value the MSRs based on their characteristics and incentivize the delivery of the most desirable types of MSRs. Although it's difficult to review and set pricing for flow purchases, flow transactions avoid the issue of delinquent, defaulted, foreclosure and bankruptcy loans. All the loans in a flow transaction will be new originations and generally need to be performing in order to be sold to or pooled with an investor.

Within the category of flow transactions there are two types. One type is typically referred to as a "mini-bulk" or "forward bulk" sale—which operates as a series of smaller bulk transactions, each with the

separate steps of a sale date, interim servicing period and a transfer date but occurring on a repeated basis over a period of time. For example, a "mini-bulk" transaction may call for monthly sale dates of the MSRs related to loans sold to or pooled with the investor during the preceding month, followed by quarterly transfer dates for the physical transfer of the MSRs sold over the preceding quarter.

The other type of flow transaction is generally referred to as a "co-issue" servicing purchase. (The agency investors in the loans use different terms for these sales.) In a co-issue transaction, the seller may deliver the servicing rights to a buyer simultaneously with the sale or pooling of that loan with a given investor. That may be attractive to sellers because it provides a "one-stop shop" for the disposition of the loan asset and MSR. The seller never has to service the loan for the investor, and it doesn't need to deal with the multiple steps and interim servicing obligations needed in bulk or mini-bulk sales.

For a buyer, however, a co-issue sale presents an unusual circumstance in that the buyer does not know what it is purchasing until the loan and MSR have been delivered. Because the seller is making decisions on which loans to sell or pool on a day-to-day basis, the seller may not know until *the day before a sale* which loans will be in or out of a sale. In addition, in a co-issue sale, the buyer takes over the physical servicing immediately upon the delivery of the loan to the investor, or nearly so. There is no interim period of servicing, and all documents and data on the loans have to be transferred very quickly.

One final comment on purchases of MSRs for Fannie Mae and Freddie Mac that many readers will be familiar with but may be surprising to new investors in MSRs. A buyer of Fannie Mae and Freddie Mac MSRs generally assumes liability to those investors for all of the origination and prior servicing of the related loan. Although the buyer had no involvement with the loan prior to the purchase of the MSRs, if there were errors in the origination or prior servicing that results in the investor seeking a repurchase, indemnification or a make-whole payment, the new owner of the MSR is responsible for those liabilities, and Fannie Mae and Freddie Mac will first look to the current owner to satisfy those remedies. A buyer of MSRs should, of course, have similar remedies back against the seller of the MSRs under its purchase agreement. However, those remedies will be of little use if the seller no longer exists when they remedies are needed. This is an especially significant concern in light of the uncertain environment for the economy, interest rates and mortgage lending over the next few years.

Subservicing

The other principal transaction for many MSR owners is a subservicing agreement. The MSR owner may, of course, perform the servicing of the loans itself. Mere investors in MSRs may prefer not to run a servicing business, opting to instead outsource the day-to-day servicing work associated with the mortgage loans. However, unlike using the rotisserie oven of the old infomercial, this is not a "set-it-and-forget-it" operation. The owner of MSRs may not simply delegate the servicing obligations to a subservicer and ignore the servicing work.

First, the MSR owner continues to bear significant economic burdens and risk associated with the MSRs even if it contracts out the day-to-day work. Compensation of subservicers is paid in the form of flat monthly and other fees for each loan and each task performed. Those fees increase as the subservicer has to perform more work on a loan and, therefore, escalate rapidly as the loan becomes more delinquent or enters default, foreclosure or bankruptcy. Meanwhile, as discussed above, those loans do not provide the MSR owner with any servicing fees. As result, there is a significant economic outlay associated with servicing the loans as they grow more delinquent. In addition, as the loans grow more delinquent, more and more servicing advances are required. While a subservicer will administer the servicing advance process for the MSR owner, it will require monthly reimbursements, if not a prefunding of those amounts

as the advance obligations accrue. An MSR owner therefore retains significant economic risk associated with the performance of the servicing even when outsourced to a subservicer.

In addition, there are significant investor and regulatory requirements regarding the oversight of subservicers. The Consumer Financial Protection Bureau and Office of the Comptroller of the Currency and state regulators all require MSR owners to take an active role in the monitoring and oversight of subservicers as consumer-facing vendors. Examinations by these regulators will include a review of the MSR owner's oversight practices, so even a somewhat passive owner of MSRs that engages a subservicer will need to have internal experts who understand the MSR asset and related loans and who actively oversee and monitor the subservicer's activities, auditing them from time to time. In addition, for the fund structures discussed above, managers of an MSR investment may need to engage in a certain amount of oversight in order to meet applicable securities and investment advisory requirements.

Finally, one last issue that involves subservicers (but is not limited to context of their use) is refinance risk and potential refinance recapture opportunities. When a loan pays off, the owner of the loan receives the principal balance received and can redeploy that capital. The MSR owner is not as fortunate, however. When that loan pays off, the related MSR asset evaporates and leaves the investor with nothing. In the present low-interest-rate environment, MSRs are especially vulnerable to refinance activity. Smart MSR owners therefore actively solicit borrowers for refinancing to preserve the asset. In other words, the MSR owner tries to refinance the loans before another lender can and thereby recapture a new MSR asset to replace what would otherwise be lost. MSR owners who also have an origination platform can, of course, use that origination platform to solicit the borrowers for refinance. If, as discussed above, the MSR investor has chosen not to operate a loan origination platform, the recapture effort can be more difficult. If the MSRs owner's subservicer can originate loans, however, it may be possible to leverage that capacity to engage in the refinance activity. How that can be structured is beyond the scope of this summary. There are numerous regulatory concerns, and the use of a subservicer is not the only option. Fund manager incentive fees are often directly tied to the success of these recapture programs.

Conclusion

As explained in this summary, investing in MSRs involves more than merely investing in an income stream. While investors grapple with a complex set of relationships and considerations involving a highly regulated asset class, we find that legal and business issues may be resolved through creative structuring and subject matter expertise.

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State Prudential Standards for Mortgage Servicers: “Ahead of the Curve” or “Dead Man’s Curve”?

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I was only 9 years old when Jan and Dean in 1963 released their hit song “Dead Man’s Curve.” I thought about this song when I read the Conference of State Bank Supervisors’ (“CSBS”) Proposed Regulatory Prudential Standards for Nonbank Mortgage Servicers (the “Proposal”). Published for comment on September 29 with comments due by the end of the year, the Proposal seeks to impose on US nonbank mortgage servicers many of the safety and soundness or prudential standards required of insured depository institutions by federal banking regulators. The goal, it appears, is to “get ahead of the curve” of the potential for mortgage servicer failures resulting from widespread mortgagor delinquencies. While that objective is reasonable in principle, the question is whether a state-imposed “one size fits all” financial strength requirement could cause the very mortgage servicer failures that the standards are designed to prevent.

We previously wrote a Legal Update describing the Proposal. The focus of this Legal Update is the financial strength requirements specified in the Proposal. CSBS seems to recognize that bank safety and soundness standards might not be a comfortable fit for nonbank mortgage servicers when CSBS asks interested parties, among other questions, to provide comments on a fundamental “gating” issue—namely, is the need for state prudential standards sufficiently established?

BACKGROUND

The Proposal includes minimum net worth and capital ratio requirements that in part track FHFA (the conservator and regulator of Fannie Mae and Freddie Mac) requirements, and the Proposal requirements are designed automatically to adjust as FHFA’s requirements are modified. One of the questions it asks is whether its financial strength standards should be tied to FHFA requirements.

Specifically, the Proposal would require nonbank mortgage servicers to maintain the *higher of* (1) $2.5 million net worth plus 25 basis points of owned unpaid principal balance for total 1–4 unit residential mortgage loans serviced or (2) FHFA eligibility requirements. The Proposal

would apply this methodology to all owned residential servicing rights, without regard to the terms of the servicing agreement, such as whether the servicer is contractually obligated to make monthly advances of principal and interest if the borrower does not pay. With respect to capital requirements, nonbank mortgage servicers would be required to maintain the higher of (1) net worth/total assets equal to or greater than 6% or (2) FHFA eligibility requirements. These align with FHFA's current requirements.

The liquidity requirements in the Proposal also track FHFA requirements. Under the Proposal, nonbank mortgage servicers would be required to maintain liquidity at an amount that is the *higher of* (1) 3.5 basis points of aggregate unpaid principal balances of agency and non-agency servicing or (2) FHFA eligibility requirements. CSBS explained that because servicing loans in forbearance, delinquency, or foreclosure imposes additional costs on servicers, the Proposal includes additional liquidity requirements for non-performing loans. This additional requirement would equal the higher of (1) an incremental 200 basis points charge on non-performing loans for the portion of agency and non-agency non-performing loans greater than 6% of total servicing or (2) FHFA eligibility requirements. This tracks FHFA's existing requirements, although FHFA discounts the size of the outstanding balances of loans in CARES Act forbearance. Also, the Proposal would require servicers to maintain sufficient allowable assets to cover normal operating expenses in addition to the amounts required for servicing expenses.

Allowable assets to satisfy these liquidity requirements include unrestricted cash and cash equivalents and unencumbered investment grade assets held for sale or trade. Allowable assets do ***not*** include unused or available portions of committed servicing advance lines of credit or other unused or available portions of credit lines such as normal operating business lines; prior to this month, this exclusion was part of the revisions to Fannie Mae's and Freddie Mac's financial strength requirements that FHFA proposed in January 2020 and later rescinded in June 2020 pending further rulemaking. To the surprise of the industry, Fannie Mae and Freddie Mac each announced the adoption of this exclusion on December 16, 2020, effective March 31, 2021.

In addition to these requirements, the Proposal would apply enhanced standards to servicers that are deemed to be "Complex Servicers." Complex Servicers are servicers that own whole loans plus servicing rights with aggregate unpaid principal balances totaling the lesser of $100 billion or representing at least 2.5% of the total market share. These servicers would be required to meet enhanced capital and liquidity standards that require the servicer's management and board of directors to develop a methodology to determine and monitor its capital and liquidity needs.

CONTEXT

Our prior Legal Update identifies the genesis of the Proposal. While not explicitly stated in the Proposal, there appear to be two types of major regulator concerns relating to the financial strength of nonbank mortgage servicers. The first is whether mortgage servicers can meet their contractual obligations to advance principal and interest to whole loan or mortgage-backed securities holders under the terms of the relevant servicing agreements, if a substantial percentage of borrowers go delinquent and do not soon reinstate. COVID-19 exacerbated this concern this year by virtue of the statutory right of eligible borrowers to seek mortgage forbearance under either the CARES Act for government-related mortgage loans or the laws of some states for other loans.

Luckily, in light of the continuing refinancing boom, the ability of servicers under their servicing agreements to use excess custodial funds from full prepayments as an interim source of funds to make principal and interest advances materially reduced the potential hardship on mortgage servicers to meet these advance obligations. But an increase in interest rates could diminish the availability of excess custodial funds to pay for principal and interest advances. What happens if a mortgage servicer cannot come up with the funds it needs to make required advances?

The second concern is whether mortgage servicers can meet their contractual obligations under their borrowing facilities that they obtained to finance the making of advances and the acquisition and holding of mortgage servicing rights. These facilities often are secured by the mortgage servicer’s interest in all or a portion of its mortgage servicing rights, based on a prescribed loan-to-value ratio. If the value of the servicing rights declines, the servicer either has to provide additional collateral or partially prepay the loan in order to maintain the required loan-to-value ratio—a so-called “margin call.” In a worst case scenario, the creditor could declare the mortgage servicer in default under the loan agreement and seek to seize the mortgage servicing rights, which most likely would result in a default under the agency servicing agreements. While the Proposal’s (and FHFA’s) financial strength requirements do not directly account for the financial covenants in a mortgage servicer’s borrowing facilities, the existence of the debt and the impact of margin losses would be reflected in the calculation of net worth.

In either case, a mortgage servicer’s default, under either a servicing agreement or a commercial loan agreement, theoretically could result in a mortgage servicer failure with resulting harm to borrowers. The fact that this “parade of horribles” could occur does not mean that it is reasonably likely to occur—that either a servicer would fail or, if it did, the failure would cause widespread harm to borrowers. Indeed, Fannie Mae, Freddie Mac, and Ginnie Mae have subservicers in place to take over the servicing functions on an interim basis for servicers terminated with cause. They have utilized these arrangements for years without reports of material consumer harm.

But that does not mean that state regulators want to wait until the risk of a servicer failure eventuates to find out for sure that the likelihood and severity of consumer harm is low; it understandably wants to get “ahead of the curve.” The Proposal is designed to minimize the likelihood of a mortgage servicer’s financial failure. Yet the good faith pursuit of a worthy public policy objective does not mean the Proposal as constituted makes sense.

ISSUE

A key issue under the Proposal is whether there should be prescriptive, state-mandated financial strength requirements, and, if so, what should they be and how will they be enforced? There is nothing unique or outlandish about a state licensing authority wanting to impose financial strength standards on a licensed entity. Many state mortgage banking licensing laws already do that, although there is little history of state requirements comparable to those in the Proposal.

The bigger issue is what should those standards be? Should they equal FHFA standards for Fannie Mae or Freddie Mac approved servicers? Should they be higher than these standards? Should FHFA standards even apply for servicers who only service non-agency loans? Is there another approach to address the same concerns?

Agency Financial Strength Requirements

As noted above, agency servicers already have to meet agency financial strength requirements on net worth, capital, and liquidity. Requiring an agency servicer to meet the financial strength requirement of the agencies for which it services has a simple logic to it. But converting a contractually imposed continuing eligibility requirement into a law or regulation could cause a problem in state enforcement. Each of Ginnie Mae, Fannie Mae, and Freddie Mac has the discretion to waive or alter these financial strength requirements based on its evaluation of the relevant circumstances. This flexibility to act quickly when necessary or appropriate may take many forms and is informed by their “hands-on” knowledge of the servicer’s performance and profile to support a judgment to take a less drastic alternative than declaring default.

Depending on the final form that the Proposal might take for any particular state, state regulators may not have the same flexibility when administering fixed laws and regulations. This difference between fixed and discretionary standards could create the anomalous result of a state or states imposing administrative sanctions on a mortgage servicer for failing to meet agency financial requirements when the agency itself determined in its informed judgement not to declare a default and exercise remedies. These state sanctions could create a series of cross-defaults resulting in the failure of a mortgage servicer even though the agency itself elected initially not to declare a default under the servicing agreement.

It is hard to fathom a compelling reason for state regulators to prescribe financial strength requirements that are higher than those of Fannie Mae, Freddie Mac, and Ginnie Mae for agency servicers. One of the primary risks about which the state regulators seem to be most concerned—meeting principal and interest advance requirements in a time of high borrower delinquencies—is the very risk to which these agencies manage because they bear the direct risk of loss if a servicer fails to meet this advance obligation. Moreover, Fannie Mae and Freddie Mac are subject to their own federal supervision and examination and are subject to regulatory safety and soundness standards, and Ginnie Mae is part of a federal agency, the Department of Housing and Urban Development. Where is the data-driven analyses to support the states' exercise of different judgments about the required financial strength of mortgage servicers in connection with federally related servicing agreements?

Similarly, why would state regulators require non-agency servicers to meet the financial strength requirements of Fannie Mae and Freddie Mac, if the non-agency servicing agreements do not require servicers to advance principal and interest and servicers may not have financed their mortgage servicing portfolio? There should be a rational relationship between the state financial strength requirements and the contractual obligations and financial profile of the mortgage servicer. Such a relationship is not readily apparent in the non-agency servicing world under the Proposal. As non-agency approved servicers tend to be smaller than their approved counterparts, a "one size fits all" approach pegged to agency financial strength requirements also could have a particular adverse impact on smaller mortgage servicers, again perhaps needlessly resulting in a smaller mortgage servicer's failure by virtue of the imposition of state administrative sanctions.

An Alternative Approach

An alternative approach is to abandon a fixed quantitative formula for determining financial strength requirements and instead utilize a pure "principles-based" regulatory perspective—namely, that a mortgage servicer must meet in all material respects the financial strength requirements under the servicing agreements to which it is subject. Under this approach, a state could not impose its judgement on how much net worth, capital, or liquidity is enough or not enough or how to calculate these metrics; it could not question the determinations of the counterparties to a mortgage servicer's servicing agreements. A decision by an investor under a servicing agreement to waive a potential breach of its financial strength requirements automatically would pass-through to the state standard. A principles-based approach recognizes that the risk of a mortgage servicer's financial failure would be the direct the result of a contractual counterparty declaring a default and exercising remedies based on a servicer's inability to meet material contractual obligations.

As noted above, aside from the risk of servicer licensees failing to make principal and interest advances, state regulators also are particularly concerned about the potential for a mortgage

servicer’s material losses resulting from margin calls on loans secured by mortgage servicing rights. But the impact of margin calls on a servicer’s financial strength is reflected in its financial statements through a reduction in indebtedness and a reduction in cash, with any resulting changes in the servicer’s net worth and liquidity. In any event, while the Proposal links a mortgage servicer’s financial strength requirements to those of FHFA, secured creditors have their own financial strength requirements for their mortgage servicer borrowers. In many respects, the financial risk profile of mortgage servicers under commercial loan agreements is very much like their profile under servicing agreements with the agencies and thus serve as a “second set of private eyes” to monitor a mortgage servicer’s financial profile.

First, commercial lenders impose sophisticated affirmative and negative financial covenants on its mortgage servicer borrowers in their credit agreements, including the continuing covenants to comply with state licensing laws and agency eligibility standards for financial strength. These agreements provide the creditor with robust remedies it may elect to exercise if the mortgage servicer defaults under the credit agreement.

Second, in each case, the investor under the servicing agreement and the commercial lender under the credit agreement bears the direct credit risk of loss if the mortgage servicer defaults on its contractual obligations and has a broad array of risk management controls and contract remedies to address this risk.

Third, federally insured depository institutions often serve as commercial credit providers to mortgage servicers and are themselves subject to safety and soundness standards and supervision and examination by their federal regulators. Fourth, commercial lenders have the discretion to waive, modify, or vary any of their contractually imposed affirmative and negative covenants, or elect not to declare a default and accelerate the outstanding indebtedness, based on their evaluation of the totality of the circumstances; if a state were to impose administrative sanctions on a mortgage servicer for failing to meet financial covenants in a loan agreement as to which the creditor elected not to declare a default, a series of cross-defaults could follow, resulting in the failure of a mortgage servicer.

The one problem with this approach is timing. Mortgage servicers annually upload their audited financial statements to the NMLS. A lot can happen in a year, and state regulators likely do not want to be caught “flat footed” if a licensee suffers a material adverse financial effect during the year. But that concern is easily resolved through the supervisory powers of a state mortgage regulator to request interim financial results to assess a licensee’s continuing compliance with the financial strength requirements of its servicing agreements.

Collective State Action

Financial strength requirements, regardless of how formulated, could wreak havoc if the states do not act in unison. As drafted, the Proposal seemingly would permit any single state

regulator to restrict or terminate a license of a servicer that allegedly is in violation of that state’s financial requirements. Such a unilateral act likely would set in motion a series of parallel state actions, even though the investors under the servicing agreements or the commercial creditors under loan facilities formulated their own action plans to address the financial issues without declaring a default. This makes no sense and again could cause the result that the Proposal is designed to limit.

CONCLUSION

One should not blame CSBS and state regulators for wanting to get *“ahead of the curve”* in monitoring for a potential collapse of a mortgage servicer. But imposing prescriptive, mandatory financial strength requirements in a “one size fits all” manner may have an unintended material adverse effect on mortgage servicers—*a regulatory “dead man’s curve”*—particularly if the states either disregard a servicer’s contract counterparties election not to declare a default or fail to act in unison in response to a servicer’s financial hardship.

Real Estate Investment Trusts

Real estate investment trusts ("**REITs**") are professionally managed companies that invest in real estate, mortgages and real estate-related assets on behalf of their investors. Established in 1960, REITs were designed to democratize real estate investing by providing retail investors with the opportunity to obtain passive gains from large-scale, income-producing real estate and mortgage portfolios. REITs typically receive preferential tax treatment in the form of no entity-level tax and are required to distribute at least 90% of their taxable income as dividends each year.

Due to the preferential tax treatment under Subchapter M of Chapter 1 of the Internal Revenue Code of 1986, as amended (the "**Code**"), REITs must comply with detailed requirements relating to their ownership structures, distributions and operations, all of which require careful planning. REITs must also comply with strict income, asset and ownership tests as detailed below. Further, REITs seeking to raise capital must ensure compliance with the Securities Exchange Act of 1934, as amended (the "**Exchange Act**"), Securities Act of 1933, as amended (the "**Securities Act**"), Investment Company Act of 1940, as amended (the "**Investment Company Act**"), Securities and Exchange Commission ("**SEC**") and Financial Industry Regulatory Authority ("**FINRA**") rules as well. Therefore, REITs must establish procedures, typically in coordination with its outside auditors, tax preparers, investment bankers and legal counsel, to ensure that they are investing in the correct types and proportions of assets, earning the right types and amounts of income and complying with ownership restrictions.

Types of REITs

The common stock of most REITs trade on a national securities exchange (referred to as publicly-traded REITs). However, there are also publicly registered but non-traded REITs (i.e., registered with the SEC but the securities of which are not traded on a national securities exchange), and private REITs, the securities of which are sold only in offerings that are exempt from the registration requirements of the Securities Act.

The industry and asset focus of REITs is diverse. REITs are broadly categorized as: equity REITs, which invest in real estate properties, and mortgage REITs, which invest in mortgages, real estate loans and other real-estate related assets.

Equity REITs typically lease their properties to tenants and concentrate their ownership on a specific market segment, such as office, retail, commercial or industrial properties, and may further differentiate between specific industry segments such as healthcare, malls or lodging. Recently, REITs investing in data center, healthcare, infrastructure and cell tower assets have been popular due in part to the COVID-19 pandemic, as the shift from in-person communication and commerce to the electronic platform helps those sectors at the expense of the traditional office, hotel and retail sectors.

Mortgage REITs generally have one of three investment strategies: arbitrage, operating and distressed. Arbitrage mortgage REITs acquire government-backed mortgage securities and other high quality mortgage securities with leverage to earn an arbitrage spread. Operating mortgage REITs originate and/or acquire residential or commercial loans. Distressed mortgage REITs invest in distressed mortgages and must comply with specific foreclosure property rules and restrictions.

Hybrid REITs, which own a combination of real estate properties and loans, are rare. At December 31, 2019, there were 179 equity REITs with an equity market capitalization of $1.245 trillion, 40 mortgage REITs with an equity market capitalization of $82.927 billion and no hybrid REITs (Source: NAREIT®).

REIT Formation Process

The REIT formation process is relatively simple and flexible. An entity eligible to be taxed as a corporation for U.S. federal income tax purposes is organized under the laws of any state (or the District of Columbia). Under the REIT regulations, an entity formed as a trust, partnership, limited liability company or corporation can be a REIT, provided any such entity is treated as a corporation for federal income tax purposes. Then, the entity elects to be treated as a REIT by computing taxable income as a REIT on its tax return (generally on Form 1120-REIT). Even if the entity could have qualified as a REIT for a prior year, an entity must affirmatively make this election for REIT tax treatment to apply. Once made, the election generally remains in effect until it is terminated or revoked under Code Section 856(g).

Unlike publicly-traded corporations (that are not intended to be REITs), which are typically incorporated or formed under Delaware law, most publicly traded REITs (approximately 75%) are formed as trusts under the Maryland REIT law or as corporations under Maryland law. There are a number of reasons why REITs prefer Maryland: Maryland has a specific statute for REITs; Maryland has developed an expertise in REIT law; and Maryland REIT law has distinct advantages over the relevant Delaware law. For example, Maryland REIT law not only provides that a REIT may issue shares of beneficial interest without consideration for the purpose of qualifying it as a REIT under the Code, but it also allows a majority of the REIT's board of trustees to amend the REIT's declaration of trust without shareholder action unless the trust's declaration specifically prohibits the board from doing so.

REITs may be formed for a finite life or in perpetuity. Unlike a REIT formed in perpetuity, a finite-life REIT does not reinvest the proceeds from the sale, financing or refinancing of assets or cash from operations in new real estate assets (subject to the REIT requirements). Instead, a finite-life entity distributes those proceeds to its partners or shareholders. At the end of the finite-life REIT's time period, the entity is dissolved and the partners or shareholders receive final distributions in accordance with the terms of the organizational documents.

Ownership and Holder Requirements

REITs must be beneficially owned by 100 or more persons and must not be "closely held." A REIT is "closely held" if five or fewer individuals directly or indirectly own more than 50% in value of its outstanding stock during the last half of the taxable year. Tax-exempt pension, profit-sharing, and bonus plans (i.e., "qualified trusts") described in Code Section 401(a), supplemental unemployment benefit trusts described in Code section 501(c)(17), private foundations described in Code Section 509(a) or the portion of a trust set aside for charitable purposes described in Code Section 642(c), are normally treated as single individuals.

There are certain exceptions to the REIT ownership and holder requirements. First, the entity must be beneficially owned by 100 or more persons only on at least 335 days of a taxable year of 12 months in which it wishes to qualify as a REIT, or during a proportionate part of a taxable year of less than 12 months. Second, the requirements that a REIT have at least 100 beneficial owners and that it not be "closely held" do not apply to the first taxable year for which a REIT election is made.

Although the Code does not require REITs to adopt ownership and transfer restrictions in their articles of incorporation or other organizational documents, REITs often do so. These restrictions generally prevent a person from not only beneficially or constructively owning more than 9.8% or 9.9% in value of the REIT's outstanding shares, but they also nullify and void attempted transfers of shares that result in a violation of the 9.8%-9.9% ownership limit. Further, these provisions may have the effect of functioning as an anti-takeover device for publicly traded REITs. Because sponsors or founders of a REIT typically own more than 9.9%, REITs with large shareholders usually have "grandfather" clauses and related decreases in ownership thresholds for other persons or may issue ownership waivers.

Income and Asset Tests

REITs are subject to two income tests. First, at least 75% of a REIT's gross income during a taxable year must derive from real estate sources, such as rents from real property or interest from real estate loans. Second, at least 95% of a REIT's gross income for the taxable year must be derived from items that meet the 75% income test above, other dividends, other interest and gain from the sale or other disposition of stock or securities that are not "dealer property" described in Code Section 1221(a)(1), i.e., inventory.

In addition to the two income tests, REITs must also satisfy certain assets tests. First, at least 75% of a REIT's assets by value must consist of real estate assets, cash and cash items (including receivables) and Government securities. Second, a REIT can invest a maximum of 20% of its assets by value in the securities of one (or more) taxable REIT subsidiary ("**TRS**"). Third, a REIT can invest a maximum of 25% of its assets by value in non-Government securities that are not otherwise treated as real estate assets (including securities of any TRS). Fourth, for those non-Government securities that are not otherwise treated as real estate assets, there are two specific restrictions: first, a maximum of 5% of the REIT's total assets by value may be represented by securities of any one issuer and second, the REIT may not hold securities possessing more than 10% of the total voting power, or having a value of more than 10% of the total value of, the outstanding securities of any one issuer. Each of the four assets tests described above are measured at the close of each calendar quarter.

A REIT may fail its income and asset tests but still qualify for relief under Code Sections 856(c)(6) and 856(c)(7). In the case of the income test, if the REIT files a schedule describing each item of its gross income and if such failure is due to reasonable cause, then it will still qualify as a REIT but is subject to a special tax approximately equal to a portion of the shortfall in qualifying income. With

respect to the asset test, if the REIT files a schedule describing each asset causing it to fail the asset test, if such failure is due to reasonable cause, and if the REIT disposes of the disqualifying asset within six months of disclosure, the REIT will still qualify as a REIT but may be subject to a potential penalty of at least $50,000.

Distribution Requirements

In general, a REIT must distribute at least 90% of its taxable income as dividends. Importantly, a REIT's taxable income does not include any capital gain and under Rev. Proc. 2017-45, a publicly traded REIT is allowed to pay 80% of its required dividend in stock (due to the COVID-19 pandemic, this percentage is increased from 80% to 90% for dividends declared on or after April 1, 2020, and on or before December 31, 2020). Provided that a REIT meets this 90% taxable income distribution requirement, a REIT is allowed to deduct these dividends from its taxable income as a dividends paid deduction under Code Section 562 and is taxed on any remaining taxable income at the entity level. Therefore, even though they are not required to do so (and even though a REIT is not required to distribute any capital gain), most REITs typically make distributions at least equal to their taxable income (including capital gains) to avoid being taxed at the REIT level. Publicly offered REITs often distribute amounts well in excess of REIT taxable income. Publicly offered REITs are also exempt from the preferential dividend rule, which prevents issuers from claiming a dividends paid deduction with respect to a distribution that gives preference to any share of stock over another stock in its class.

TRS Advantages and Drawbacks

Although REITs may own real property or mortgages and derive income therefrom, they are generally prohibited from earning income from more active management functions. For example, apart from charges for services customarily furnished or rendered in connection with the rental of real property, equity REITs are not allowed to derive income from providing hotel operations, health club operations or landscaping services, while mortgage REITs are not allowed to service third-party mortgage loans, modify loans, deal with foreclosures, create and hold mortgage loans for sale or engage in securitization. If a REIT engages in a "prohibited transaction," the REIT will be subject to a 100% tax on any net income derived from such a transaction.

However, as mentioned above, a REIT is allowed to hold a maximum of 20% of its assets by value in one more or TRSs. In general, a TRS is a corporation (other than a REIT or a qualified REIT subsidiary) in which the REIT directly or indirectly owns stock and for which the REIT and the corporation jointly elect treatment as a TRS. Notwithstanding certain restrictions, a TRS is generally able to engage in prohibited REIT transactions. For example, a laundry service operation should be conducted in a TRS and any income would be subject to corporate income tax in the hands of the TRS.

Nevertheless, there are certain TRS drawbacks. First, a TRS is taxable as a regular corporation, which is subject to an entity level tax. Therefore, REITs should ensure that income from real estate sources, as well as any income that may qualify under the 95% test described above, is, to the extent possible, flowing directly to a REIT and not to a TRS. Second, certain entities, such as corporations that operate or manage lodging or healthcare facilities, cannot be a TRS.

REIT Structures

Although there are a variety of possible REIT structures, publicly traded equity REITs are usually structured as umbrella partnership REITs ("**UPREITs**") because they provide tax advantages and liquidity. In a typical UPREIT structure, the REIT directly owns a majority of an operating partnership ("**OP**") that holds the real estate assets with minority limited partners ("**OP Unit Holders**"). After a lock-up period, the limited partnership interests in the OP ("**OP Units**") become redeemable for cash or, at the REIT's discretion, for shares of the REIT on a 1:1 basis.

The tax advantage exists because transferring real estate assets to an OP for OP Units, instead of transferring those same assets directly to a REIT for REIT shares, may qualify as a tax-deferred transaction under Code Section 721. The liquidity advantage exists because redemption of the OP Units not only results in cash or publicly traded stock, but it also allows OP Unit Holders to use the fair market value of their OP Units as collateral for loans and avoid being taxed upon redemption. Because redemption is a fully taxable transaction, OP Unit Holders usually do not redeem their OP Units unless they plan on immediately selling their REIT shares. If an OP Unit Holder is an individual and does not need to sell REIT shares, the OP Unit Holder may prefer to hold onto his or her OP Units until death, allowing his or her estate or beneficiaries to receive a "stepped-up" tax basis, and as a result, a chance to redeem or convert the OP Units on a tax-free basis.

A REIT can become an UPREIT either upon formation or upon acquiring particular assets. A newly formed REIT would contribute cash from an initial public offering ("**IPO**") to the OP, while an existing REIT would contribute its existing real estate assets. Simultaneously, other owners of real estate assets would contribute those assets to the OP, all in exchange for OP Units. Once the UPREIT is established, the UPREIT would use its OP to acquire additional assets in exchange for OP Units.

Despite their principal advantages of liquidity and tax deferrals, UPREITs introduce structural complexity and may also create conflicts of interest. For example, because the disposition of property by an UPREIT may result in gain recognition for the property's contributing partner, contributing partners often negotiate mandatory holding periods and other provisions to protect their tax deferral benefits.

DownREITs are extremely similar to UPREITs. The main difference is that instead of holding all of their assets in one OP, DownREITs typically hold their assets through multiple OPs. In addition to raising tax issues regarding tax-free contributions, the multiple OPs also reduce liquidity. Although the limited partnership units of each OP are also redeemable for cash or for a DownREIT share, the value of a DownREIT share is based on the assets in all of the OPs. Therefore, it is more difficult to determine whether a limited partnership unit for each OP is redeemable for a DownREIT share, and to prevent any uncertainty, most if not all DownREIT agreements tie redemption ratios at 1:1.

Externally and Internally Managed REITs

REITs are managed either internally or externally. In other words, either the REIT's own officers and employees manage the REIT's assets, or an external management company oversees the REIT's assets on the REIT's behalf. Under an external management system, the REIT compensates the manager through a private equity style arrangement: a flat fee based on assets under management and an incentive fee based on REIT performance. Some argue externally managed REITs create inherent conflicts of interest between managers and investors. For example, because the external manager's flat fee is based on the asset value under management, this may incentivize external managers to purchase additional assets even if those assets are unlikely to generate high returns.

Nevertheless, many private REITs are externally managed, and external management structures are more common in mortgage REITs than equity REITs. This is because mortgage REITs often invest in the same real estate loans, which enables external managers to operate more efficiently.

Financial Metrics Used to Measure REIT Performance

Funds from Operations ("**FFO**") is a non-GAAP measure of REIT operating performance. It has gained wide acceptance in the REIT industry primarily because FFO excludes historical cost depreciation and amortization, which REITs and investors believe artificially distorts GAAP net income. After a recent update to FFO's definition in 2018, Nareit defines FFO as: net income (calculated in accordance with GAAP), excluding (1) depreciation and amortization related to real estate; (2) gains and losses from the sale of certain real estate assets; (3) gains and losses from change in control; and (4) impairment write-downs of certain real estate assets and investments in entities when the impairment is directly attributable to decreases in the value of depreciable real estate held by the entity. While some REITs measure FFO strictly in accordance with Nareit's definition, most REITs disclose a modified or adjusted FFO. REITs also commonly use net asset value, adjusted funds from operations and net operating income to measure performance.

The SEC allows REITs to disclose FFO, adjusted FFO and even a per share FFO as a non-GAAP financial measure. However, Regulation G and Item 10(e) of Regulation S-K specify that if REITs disclose FFO, they must also present, with equal or greater prominence, the most directly comparable GAAP measure and to reconcile the two. Further, the SEC's 2016 Non-GAAP Compliance and Disclosure Interpretations clarify that if an adjusted FFO is intended to be a liquidity measure, it may not exclude charges or liabilities that required, or will require, cash settlement. The Compliance and Disclosure Interpretations also clarify that REITs may disclose a per share FFO, provided that it is used as a performance and not a liquidity measure.

Commodity Pool Exemption for REITs

Commodity pools are shared private pools of money from multiple participants to speculate in futures, swaps or options markets and are subject to the Commodities Exchange Act. According to the U.S. Commodity Futures Trading Commission (the "**CFTC**"), an equity REIT is not a commodity pool if it only uses derivatives for mitigating exposure to interest rate or currency risk, complies with all other REIT requirements under the Code and has identified itself as an equity REIT in Item G of its last U.S. income tax return or

intends to do so. Although the CFTC considers mortgage REITs as commodity pools, the CFTC will not take enforcement action if the mortgage REIT complies with certain detailed restrictions (*e.g.*, limits the initial margin and premiums required to establish its commodity interest positions to no more than 5% of the fair market value of the REIT's total assets) and files a claim of relief.

Financing Activities

Although investors benefit from REITs distributing at least 90% of their taxable income each year, this distribution requirement diminishes available capital necessary to fund future growth. Therefore, REITs often turn to capital markets to acquire additional assets and finance their operations. REITs also supplement their diverse equity and debt offerings with bank and non-bank financing arrangements, such as credit agreements, term loans, revolving loan facilities and warehouse lines of credit, as well as securitizing mortgage loans and incurring mortgage debt on real estate properties.

IPOs are a viable option for REITs seeking large amounts of capital, liquidity and reputational enhancement. The IPO process for REITs is the same as the IPO process for non-REITs (*e.g.*, filing a registration statement; roadshow), with a few caveats: REITs are subject to additional disclosure requirements under Form S-11, SEC Industry Guide 5 of the Securities Act, FINRA Rules 5110 and 2310, and potentially Section 14(h) of the Exchange Act. However, REITs may still qualify for significant IPO benefits provided to "emerging growth companies" ("**EGCs**"). Under Section 2(a)(19) of the Securities Act, a company qualifies as an EGC if it has total annual gross revenues of less than $1.07 billion during its most recently completed fiscal year and has not sold common equity securities under a registration statement. Given that most REITs considering an IPO will meet these requirements, they would enjoy advantages such as less extensive narrative compensation disclosure and filing audited financial statements for two instead of three fiscal years.

REITs are also eligible to confidentially submit draft registration statements and certain follow-on registration statements to the SEC. In general, if a REIT is pursuing an IPO or registration of a class of securities under Section 12(b) of the Exchange Act, the SEC will confidentially review the draft registration statement and related revisions in response to SEC staff comments; if a REIT conducts a follow-on offering within 12 months of the IPO or Section 12(b) registration, the REIT will still be allowed to confidentially submit its registration statement for SEC review, but the REIT must respond to any SEC comments with a public filing.

Most publicly registered and exchanged-traded REITs are listed on the New York Stock Exchange ("**NYSE**"). Therefore, the same NYSE rules that apply to non-REITs generally apply to REITs with one notable exception: for REITS with less than three years of operating history, the NYSE allows listing if the REIT has at least $60 million in stockholders' equity. The $60 million threshold includes funds raised in any IPO related to the listing.

The SEC requires REITs to file an initial registration statement using Form S-11 instead of Form S-1, which is the standard IPO registration statement form. Compared with Form S-1, Form S-11 mandates additional disclosures from REITs, such as investment policies and procedures regarding investments in real estate properties and securities; the location and description of all materially important properties; and operating data (e.g., occupancy rates; number of tenants) of each improved property.

Further, pursuant to FINRA Rule 5110, otherwise known as the "Corporate Financing Rule," FINRA does not allow members or persons associated with FINRA members to participate in any public offering of REIT securities unless the REIT timely files certain documents with FINRA. Such documents include, but are not limited to, the registration statement, the proposed underwriting agreement and an estimate of the maximum offering price.

Blind pool REITs

Blind pool REITs raise capital prior to acquiring any real estate assets and during the capital raising process; they do not inform investors of potential specific targets. Therefore, investors cannot evaluate the REIT's prior performance and must instead base their investment decision on the skills and reputation of the sponsor or general partner, who will then use the investment proceeds to acquire assets based on an investment strategy. Most publicly registered but non-trading REITs begin as blind pool REITs.

The SEC requires blind pool REITs to comply with SEC Industry Guide 5, which specifies additional disclosure requirements for registration statements. Such requirements include, but are not limited to, disclosing compensation and fees to the general partner; disclosing potential conflicts of interest that may arise between the general partner and investors; and disclosing risk factors relating to management's lack of experience, insufficient sources of capital and high leverage.

FINRA has also warned investors of higher risk associated with blind pool REITs, particularly because of the difficulties in evaluating prior performance and the uncertainty regarding future targets. Accordingly, some blind pool REITs may choose to reveal the

sponsor's or general partner's past performance when pursuing a similar investment strategy to increase investor confidence.

Limited Partnership Rollup Transactions

Traditionally, "rollup" transactions refer to when multiple finite life REITs are combined or "rolled-up" into one publicly traded perpetual life REIT, typically in an UPREIT structure. They were extremely popular in the late 1980s and remain a method for multiple limited partnerships, each holding real estate assets to consolidate and undergo an IPO today. The only difference is, the Exchange Act, the SEC and FINRA rules and regulations have made "rollup" transactions more onerous compared to the past. Further, if a "rollup transaction" does not fall under any allowed exemption, REITs are subject to even more disclosure obligations during an IPO.

Under Section 14(h)(4) of the Exchange Act and Item 901 of Regulation S-K, a limited partnership generally means a direct or indirect combination or reorganization of one or more limited partnerships through which some or all investors receive new securities or securities in another entity. Although roll-up transactions usually involve the partners of each limited partnership contributing their partnership interests into the new entity in exchange for shares in the new entity (i.e., creating a single operating partnership and thus, an UPREIT structure), roll-up transactions may be structured as an acquisition, a merger, a tender (exchange) offer or in some other fashion.

Some transactions are excluded from the definition of "limited partnership rollup transaction" under Section 14(h)(5) of the Exchange Act and Item 901 of Regulation S-K. Such excluded transactions include a transaction only involving a limited partnership or partnerships retaining cash for distribution and reinvesting the proceeds in accordance with SEC criteria; a transaction only involving the redemption of limited partnership interests for a securities of an operating company specifically identified at the formation of the original limited partnership; a transaction in which the securities to be issued or exchanged are not required to be and are not registered under the Securities Act; a transaction that only involves issuers that are not required to register or report under the Exchange Act both before and after the transaction; unless otherwise provided in the Exchange Act, the transaction is approved by a minimum of two thirds of the outstanding shares of each of the participating limited partnerships and the existing general partners will receive only compensation set forth in the preexisting limited partnership agreements; and unless otherwise provided in the Exchange Act, the securities of the new entity were reported and regularly traded for more than 12 months before the securities were offered to investors and the securities issued to investors do not exceed 20% of the total outstanding securities of the limited partnership.

Although qualifying for exclusion from a "limited partnership rollup transaction" requires considerable and proactive planning, failing to do so subjects the REIT and each limited partnership to significant additional disclosure under Section 14(h) of the Exchange Act, Items 902 through 915 of Regulation S-K and FINRA Rule 2310. For example, such disclosure includes a description of each material risk and effect of the roll-up transaction; a statement concerning whether the general partner reasonably believes that the roll-up transaction is fair or unfair to the partnership; a narrative description of the method of calculating the value of the partnership; and revealing the amounts of compensation and cash distributions made to the general partner and its affiliates during the last three fiscal years.

In addition, limited partnership rollup transactions also subject REITs to heightened listing requirements for both the NYSE and Nasdaq. NYSE Rule 105 prevents the listing of a security issued in a limited partnership rollup transaction unless the rollup transaction was conducted in accordance with procedures designed to protect the rights of limited partners, a broker-dealer registered with the SEC participates in the roll-up transaction and NYSE receives an opinion of outside counsel stating that the broker dealer's participation in the transaction was conducted in accordance with a national securities association designed to protect the rights of limited partners (*e.g.*, FINRA). Nasdaq also has similar listing requirements for limited partnership rollup transactions under Nasdaq Rule 5210(h).

Investment Company Act Considerations

REITs rely on Section 3(c)(5)(C) of the Investment Company Act to qualify for exemption from regulation as "investment companies." Exemption from the Investment Company Act is considered critical for REITs because the operations of most if not all mortgage REITs are incompatible with the Investment Company Act's rules and regulations.

Mortgage REITs usually rely on Section 3(c)(5)(C) of the Investment Company Act to qualify for exemption. The exclusion provided by Section 3(c)(5)(C) of the Investment Company Act is also used by issuers of mortgage-backed securities through SEC Rule 3a-7. Under Section 3(c)(5)(C) of the Investment Company Act, REITs are exempt from regulation if they are primarily engaged in "purchasing or otherwise acquiring mortgages and other liens on and interests in real estate." The SEC has generally interpreted this phrase to mean

that at least 55% of the REIT's assets must consist of mortgages and other liens on and interests in real estate, otherwise known as "qualifying interests," and at least 80% of its assets are comprised of qualifying assets and real estate-related assets.

In 2011, the SEC issued a Concept Release asking commenters for their views regarding mortgage-related pools and whether they should be exempt from registration as "investment companies." Even though the Concept Release did not propose any new rules, it raised significant regulatory uncertainty and created a significant negative reaction. The SEC Staff issued the first guidance following the Concept Release with the publication of the Great Ajax Funding LLC No-Action Letter dated February 12, 2018. In that No-Action Letter, the SEC expanded the application of Section 3(c)(5)(C) of the Investment Company Act to include a sponsor of securitization trusts that held whole mortgage loans, which should provide greater investor confidence that REITs should continue to be exempt from the Investment Company Act.

Non-Traded REITs

Non-traded REITs are registered with the SEC and must make regular SEC disclosures such as annual reports (i.e., Form 10-K), but their shares are not traded on a national securities exchange. Instead, their shares are sold directly and have high-up front fees of approximately 9-10% of the investment. Therefore, non-traded REITs have limited secondary markets and are much less liquid compared to publicly registered and exchange-traded REITs. Although some "Daily Net Asset Value REITs" offer periodic redemption options at net asset value, non-traded REITs traditionally provide liquidity through eventually listing on an exchange, selling their real estate assets, or entering into a merger or business combination. In the past, it was also standard to set the initial price at $10 per share and to maintain this price regardless of the REIT's operating performance.

The SEC and FINRA have both issued investor alerts regarding non-traded REITs due to their complexities and risks. While non-traded REITs may offer higher dividend yields than publicly traded and exchange-listed REITs, investors should be wary of certain non-REIT features, such as a lack of liquidity and share value transparency; distributions in excess of their FFO; uncertain and expensive early redemption; unspecified properties; limited diversification; and high front-end fees. Further, as non-traded REITs typically employ external managers, there may be additional conflicts of interest between management and investors.

FINRA Rule 2310 requires that non-traded REITs provide a per share estimated value to investors. Specifically, FINRA Notice 15-02 mandates broker-dealers involved in the sale of non-traded REITs to provide a per share estimated value using one of two methodologies: a net investment methodology, which is based on the "amount available for investment" percentage in the "Estimated Use of Proceeds" section of the offering prospectus and can be used until 150 days following the second anniversary of breaking escrow; and an appraised value methodology, which can be used at any time and consists of the appraised valuation disclosed in the REIT's most recent report filed with the SEC.

Private REITs

Private REITs are neither registered with the SEC nor traded on a national securities exchange. REITs may issue equity securities without registering with the SEC if there is an available exemption, such as the exemption under Regulation D permitting an issuer to sell securities to "accredited investors," or the exemption under Rule 144A, which permits securities issued to qualified institutional buyers.

In addition to the Code requirements of having at least 100 beneficial owners and the prohibition against being "closely held," private REITs are subject to ownership ceilings. If a company has at least 2,000 shareholders of record, 500 shareholders who are not accredited investors (i.e., individuals with a net worth of at least $1 million or with income exceeding $200,000 over two prior years), or 100 holders who are not qualified purchasers, companies must register under the Exchange Act and the Investment Company Act.

Therefore, private REITs are often structured to have one or a few shareholders owning all the common stock while having at least 100 holders owning a special class of preferred shares. For most private REITs, satisfying the "not closely held" rule is not problematic; the private REIT shareholders will often be corporations and partnerships and unless those entities are tax-exempt, the rule is generally applied by looking through those entities to their many investors.

Capital Raising Alternatives

Although REITs often turn to the public markets to raise capital, the IPO market for REITs has been inconsistent and uncertain during the past few years. Similarly to the non-REIT market, late stage private capital raises have become preferred methods of financing in lieu of IPOs for privately held REITs. Late stage private placements with institutional investors, cross-over investors, and strategic investors also eliminate a number of issues associated with an IPO and often provide more capital to the REIT than an earlier stage financing. Privately held REITs can also set up or sponsor liquidity programs for their early investors, employees and consultants to address concerns resulting from the lack of a public trading market.

Regulation A offerings have also became increasingly important for REITs seeking capital. Regulation A is an exemption from registration for public offerings with two offering tiers: Tier 1, for offerings of up to $20 million in a 12-month period; and Tier 2, for offerings of up to $50 million in a 12-month period. For the three years from effectiveness of the amendments to Regulation A in 2015 through September 30, 2018, 257 offerings were qualified and nearly $1.3 billion was raised in Regulation A offerings, with REIT offerings accounting for the largest percentage of those transactions.

Forward sale arrangements also provide REITs with an avenue to raise capital. Forward sales allow REITs to sell their shares in the future at a specified price, less a discount, by entering into a forward sale agreement with a forward purchaser as part of the REIT's follow-on offering. The forward purchaser borrows shares from the market in order to allow the affiliated underwriter to sell the REIT's shares in the follow-on offering. The number of REIT forward sale issuances increased substantially in 2018, with nine REIT forward sale issuances raising $5.2 billion with a median forward term of 12 months.

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Legal Update

SEC Adopts Significant Changes to MD&A and Related Disclosures

On November 19, 2020, the US Securities and Exchange Commission (SEC) continued its recent efforts to modernize and simplify certain financial disclosure requirements in Regulation S-K by amending Item 303 of Regulation S-K (Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A)) and revising or eliminating several other requirements of Regulation S-K.[1] The SEC adopted these changes "to eliminate duplicative disclosures and modernize and enhance MD&A disclosures for the benefit of investors, while simplifying compliance efforts for registrants." The amendments aim to provide investors with company-specific, tailored disclosure that will enable investors to see a company "through the eyes of management."

Over the past several years, the SEC has modernized, or proposed to modernize, several of its rules. The amendments further extend that effort to MD&A and certain related disclosure requirements in Regulation S-K.

Effective and Compliance Dates

The amendments will become effective 30 days after they are published in the *Federal Register*. To allow companies adequate time to adjust their disclosures to the new requirements, the SEC is requiring compliance with the amendments beginning with the first fiscal year ending on or after the date that is 210 days after publication in the *Federal Register* (mandatory compliance date). Companies must apply the amended rules in a registration statement and prospectus that on its initial filing date is required to contain financial statements for a period on or after the mandatory compliance date. Companies may comply with the amendments any time after the effective date as long as they provide disclosure responsive to an amended item in its entirety.

Changes to MD&A

The SEC made significant changes to MD&A by adding new requirements to Item 303, deleting some requirements, simplifying some of the instructions to Item 303 and revamping other requirements. The more significant changes to Item 303 of Regulation S-K include:

New paragraph (a) – objective

The SEC added a new paragraph (a) to Item 303 to clarify the objective of MD&A by incorporating much of current Instructions 1, 2 and 3 to the Item to emphasize the objective of MD&A for both full fiscal years and interim periods. According to the adopting release, disclosure responsive to this objective requirement generally is expected to better allow an investor to view the company from management's perspective. Current Items 303(a) and (b) have been recaptioned as Items 303(b) and (c), respectively.

Changes to current Item 303(a) – full fiscal years – to be reflected in new Item 303(b)

Capital Resources. The SEC has revised current paragraph (a)(2) to require companies to disclose material cash requirements, including commitments for capital expenditures, the anticipated source of funds needed to satisfy these cash requirements and the general purpose of the cash requirements, as now reflected in new Item 303(b)(1) and amended Item 303(b)(1)(ii). The objective behind this change is to revise the disclosure requirements to account for capital expenditures that are not necessarily capital investments, recognizing that expenditures for human capital or intellectual property have become increasingly important for some companies. The amendments also add product lines as an example of other subdivisions that may need to be discussed where necessary to understand a company's business.

Results of Operations. The SEC made three changes to current paragraph (a)(3) as now reflected in Item 303(b)(2)(ii). First, companies will be required to disclose known events that are reasonably likely to cause a material change in the relationship between costs and revenues, such as known or reasonably likely future increases in costs of labor or materials or price increases or inventory adjustments. The change uses a disclosure threshold of "reasonably likely," which is consistent with the SEC's guidance on forward-looking statements. Second, companies will be required to disclose the reasons underlying material changes in net sales or revenues. The change codifies existing SEC MD&A guidance. Third, the SEC has eliminated current paragraph (a)(3)(iv) with regard to specific disclosure with respect to the impact of inflation and changing prices. Companies will still be required to discuss these matters if they are part of a known trend or uncertainty that has had, or is reasonably likely to have, a material impact on net sales or revenue. This will allow companies to focus on material disclosure that is tailored to their business, facts and circumstances.

Off-Balance Sheet Arrangements. The SEC eliminated current paragraph (a)(4) and replaced it with an instruction to Item 303 that requires companies to discuss commitments and obligations arising from arrangements with unconsolidated entities or persons that have, or are reasonably likely to have, a material current or future effect on their financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, cash requirements or capital resources, even when the arrangements result in no obligation being reported in the consolidated balance sheet. As a result of this change, companies should consider off-balance sheet arrangements within the broader context of their MD&A.

Tabular Disclosure of Contractual Obligations. The SEC eliminated this disclosure requirement currently in paragraph (a)(5). However, in a change from the proposal, the SEC amended Item 303(b) to specifically require disclosure of material cash requirements from known contractual and other obligations as part of a liquidity and capital resources discussion, in recognition of commenter concerns that such information may be lost with the elimination of Item 303(a)(5). The adopting release explains that the "amendments are intended to focus only on material disclosures and

specifically, disclosure of those periods where the cash requirements or reasonably likely effect of these cash requirements on liquidity and capital resources is material."

Material Changes in Line Items. The SEC moved a portion of current Instruction 4 into new Item 303(b) to clarify that where there are material changes in a line item, including those that offset each other, disclosure of the underlying reasons for these material changes in quantitative and qualitative terms is required. The change codifies existing SEC MD&A guidance.

Critical Accounting Estimates. The SEC added a new paragraph (b)(4) to Item 303 to explicitly require disclosure of critical accounting estimates. This change is intended to codify existing SEC MD&A guidance, eliminate disclosure that duplicates the financial statement discussion of significant policies and promote enhanced analysis of measurement uncertainties. The rule directs companies to provide qualitative and quantitative information necessary to understand the estimation uncertainty and the impact the critical accounting estimate has had or is reasonably likely to have on financial condition or results of operations to the extent the information is material and reasonably available. This information should include why each critical accounting estimate is subject to uncertainty and, to the extent the information is material and reasonably available, how much each estimate and/or assumption has changed over a relevant period and the sensitivity of the reported amount to the methods, assumptions and estimates underlying its calculation. Notably, in a change from the proposal and in response to concerns of commenters that the proposed amendments could require disclosure that is not material, or is otherwise costly to prepare, new Item 303(b)(3) more clearly states that the "material and reasonably available" qualifier "applies to all information about a critical accounting estimate that has had or is reasonably likely to have a material impact on financial condition or results of operations, whether qualitative or quantitative, including whether the information relates to sensitivity of the reported amount or how much the estimate has changed."

Change to current Item 303(b) – quarterly periods – reflected in new Item 303(c)

The SEC is allowing companies to compare their most recently completed quarter to either the corresponding quarter of the prior year or to the immediately preceding quarter. This change gives companies the flexibility to choose how to best present quarterly disclosure to investors. Under the amendments, if a company changes the comparison from the prior interim period comparison, it will have to explain the reason for the change and present both comparisons in the filing where the change is announced.

Deletions to Item 303

In light of the changes and deletions to current Item 303(a) discussed above, the SEC also deleted current paragraphs (c), dealing with a safe harbor for the forward-looking statements, and (d), dealing with the requirements relating to smaller reporting companies.

Changes to Supplementary Financial Information and Selected Financial Data

In addition to the revisions to Item 303 discussed above, the SEC also amended Item 302 of Regulation S-K (Supplementary Financial Information) and eliminated Item 301 of Regulation S-K (Selected Financial Data). The changes are designed to modernize the disclosure requirements in light of technological developments, simplify disclosure requirements, reduce repetition and better focus disclosure on material information.

In a change from the proposal to eliminate Items 302(a) and 302(b), the SEC amended the current Item 302(a) requirement to provide two years of tabular selected quarterly financial data by replacing it with a principles-based requirement that requires disclosure only when there are one or more retrospective changes that pertain to the statements of comprehensive income for any of the quarters within the two most recent fiscal years and any subsequent interim period for which financial statements are included or required to be included by Article 3 of Regulation S-X and that, individually or in the aggregate, are material. When this disclosure is required, companies will need to provide an explanation of the reasons for the material changes and to disclose, for each affected quarterly period and the fourth quarter in the affected year, summarized financial information related to the statements of comprehensive income (as specified in Rule 1-02(bb)(ii) of Regulation S-X) and earnings per share reflecting such changes. Depending on the facts and circumstances, this disclosure could involve a single quarter in which the material retrospective change applies, or it may flow through to subsequent quarters during the relevant look-back period. The amendments did not change the type of companies that are not required to provide disclosure pursuant to Item 302(a), such as first-time registrants conducting an initial public offering or companies that are only required to file reports pursuant to Section 15(d) of the Securities Exchange Act of 1934 (Exchange Act). Amended Item 302(a) will apply beginning with the first filing on Form 10-K after the company's initial registration of securities under sections 12(b) or 12(g) of the Exchange Act.

Because the Financial Accounting Standards Board has not finalized amendments to US generally accepted accounting principles that would require incremental disclosure called for by Item 302(b), the SEC has not eliminated Item 302(b) but may do so in the future.

Foreign Private Issuers

Consistent with the changes discussed above and for similar reasons, the SEC is adopted conforming changes to Form 20-F (the annual report filed by foreign private issuers) and Form 40-F (the annual report filed by Canadian issuers pursuant to the Multijurisdictional Disclosure System).

Other Conforming Amendments

Consistent with the changes adopted by the SEC and to eliminate references to rules the SEC eliminated, the SEC made conforming revisions to Item 914 of Regulation S-K (addressing disclosure in roll-up transactions); Items 1112, 1114 and 1115 of Regulation AB (addressing disclosure in asset-backed securities transactions); Forms S-1 and F-1 (addressing disclosure requirements for summary prospectuses); Forms S-4 and F-4 and Schedule 14A (addressing disclosure requirements in business combination transactions); and Form S-20 (addressing disclosure requirements in standardized option offerings).

Practical Considerations

Although the compliance date comes after the next Form 10-K due date for many companies, it is important to understand the recent amendments and begin considering how they will be addressed in the future.

Companies should also evaluate whether it makes sense for them to voluntarily begin to provide disclosure pursuant to an amended item earlier. If they do, their disclosure must completely comply with the amended item. For example, once the amendments become effective, a company may immediately cease providing disclosure pursuant to former Item 301 and may voluntarily provide disclosure pursuant to amended Item 303 before its mandatory compliance date. However, if the company chooses to take this approach, it must provide disclosure pursuant to each provision of amended Item 303 in its entirety, providing such disclosure in any applicable filings going forward.

Companies should regularly revisit the objectives in Item 303(a) whenever they prepare their MD&A and consider ways they can enhance the quality of the analysis provided.

MD&A is an active area of focus for the SEC and its staff. For example, on January 30, 2020, the SEC provided guidance regarding the disclosure of key performance indicators and metrics companies use in MD&A. And on January 24, 2020, the staff of the SEC's Division of Corporation Finance issued three compliance and disclosure interpretations providing additional guidance regarding implementation of MD&A rule changes that were effective in May 2019, allowing companies to omit from an MD&A discussion the earliest of three years in a filing that includes financial statements covering three years to the extent certain requirements are complied with.[2] Interested companies should continue to monitor this area for continuing developments and guidance.

Companies should be aware that the amendments were adopted by a split vote of the SEC commissioners. Commissioners Lee and Crenshaw issued a joint dissent explaining why they voted against adopting the amendments. Although the amendments passed by majority vote, the commissioners in the minority now will soon be in the majority. Commissioners Lee and Crenshaw noted what they see as an "opportunity going forward to address climate, human capital, and other ESG risks, in a comprehensive fashion with new rulemaking specific to these topics." Although the SEC rulemaking process is lengthy and permits notice and comment, further changes to MD&A disclosure requirements could be on the not-too-distant horizon.

Companies should also note that on June 23, 2020, the Division of Corporation Finance published "Disclosure Topic No. 9A: Coronavirus (COVID-19) — Disclosure Considerations Regarding Operations, Liquidity, and Capital Resources." While Disclosure Topic No. 9A is staff guidance only and does not override any of the amendments in the more recent rulemaking, companies should look to Disclosure Topic No. 9A for further guidance in preparing disclosures regarding operations, liquidity and capital resources that the staff will review.

* * *

If you have any questions regarding these proposed changes, please contact the author of this Legal Update, Laura D. Richman, at +1 312 701 7304, any of the lawyers listed below or any other member of our Corporate & Securities group.

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Endnotes

[1] See Management's Discussion and Analysis, Selected Financial Data and Supplementary Financial Information, Securities Act Release No. 33-10890, available at https://www.sec.gov/rules/final/2020/33-10890.pdf.

[2] For more information on these actions, see our Legal Updates "SEC Issues MD&A Guidance," dated February 4, 2020, available at https://www.mayerbrown.com/en/perspectives-events/publications/2020/02/sec-issues-md-a-guidance and "SEC Adopts Rules to Modernize and Simplify Disclosure," dated March 27, 2019, available at https://www.mayerbrown.com/en/perspectives-events/publications/2019/03/sec-adopts-rules-to-modernize-and-simplify-disclosure.

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May 28, 2020

Legal Update

SEC Amends Business Acquisition and Disposition Disclosure Rules

On May 21, 2020, the US Securities and Exchange Commission (SEC) adopted amendments (Amended Rules)[1] to financial statement disclosures with respect to business acquisitions and dispositions required by Regulation S-X's Rule 3-05 (*Financial Statements of Businesses Acquired or to be Acquired* (Rule 3-05)), Rule 3-14 (*Special Instructions for Real Estate Operations to be Acquired* (Rule 3-14)), Article 11 on *Pro Forma Financial Information* (Article 11), and other related rules and forms. The Amended Rules also amended investment companies' financial reporting of acquisitions by adopting a new Rule 6-11 of Regulation S-X (*Financial Statements of Funds Acquired or to be Acquired* (Rule 6-11)) and revising Form N-14 for financial reporting of acquisitions involving investment companies. The Amended Rules' changes related to investment companies and business development companies are not addressed in this Legal Update.

Through the Amended Rules, the SEC aims to improve the quality of information being made available to investors as to the potential effects of significant acquisitions and dispositions, reduce the complexity and costs to disclose this information and promote capital formation.[2]

Among the most important amendments contained in the Amended Rules are:

- revising the investment test and income test used in determining which business acquisition or disposition is considered significant, thereby necessitating the inclusion of target financial statements;
- updating the required contents and period coverage of the acquired business' financial statements; and
- creating a new rule to address financial reporting for fund acquisitions by investment companies.

Background

Under the disclosure framework in existence prior to the Amended Rules, when a business combination (other than a real estate operation) involving a registrant has occurred or is probable, the registrant is required by Rule 3-05 to provide separate audited annual, and unaudited interim pre-acquisition, financial statements of that business (Rule 3-05 Financial Statements) if the acquired business is considered to be significant.[3] A registrant currently measures significance by applying the

investment, asset and income tests provided in the "significant subsidiary" definition in Regulation S-X's Rule 1-02(w), substituting 20% for the significance threshold. The specified periods of financial information that a registrant must provide depends on the relative significance of the acquisition to the registrant.

Pursuant to Rule 3-14, a registrant that has acquired a significant real estate operation (individually, or more than one in the aggregate) must file separate audited annual and unaudited interim abbreviated income statements (Rule 3-14 Financial Statements) with respect to such acquired operation. Only one year of Rule 3-14 Financial Statements is required if (i) the real estate operation is not acquired from a related party, (ii) the registrant discloses the material factors considered in assessing the real estate operation and (iii) the registrant indicates it is not aware of material factors that would cause the reported financial information not to be indicative of future operating results. If any of these conditions is not met, the registrant must file three years of Rule 3-14 Financial Statements.

In addition to filing the requisite target historical financial statements, Article 11 also requires a registrant to prepare and file pro forma financial information reflecting the acquisition or disposition. This customarily includes a pro forma balance sheet and pro forma income statements. The pro forma financial information also reflects adjustments to show how the acquisition or disposition might have affected the financial statements had the transaction happened at an earlier time.

Highlights of the Amendments

Below we summarize several of the principal amendments to the existing disclosure framework contained in the Amended Rules.

Investment and Income Tests

In order to determine whether the acquired business' financial statements are required, a registrant must first determine if the acquisition is significant under Rule 3-05. As discussed above, registrants currently measure the significance by using the three tests prescribed by Regulation S-X: the asset test, investment test and income test.

Before the Amended Rules, the investment test considered an acquisition significant if the registrant's investments in the target exceed 20% of the registrant's total assets as of the end of the buyer's most recent fiscal year. In order to closely align the acquisition's economic significance to the registrant where both entities or business are not under common control, the Amended Rules now compare the registrant's investments in and advances to the acquired or disposed business to the aggregate worldwide market value of its voting and non-voting equity (aggregate worldwide market value). The aggregate worldwide market value is the average of the registrant's worldwide market value for voting and non-voting common stock calculated daily for the last five trading days of the registrant's most recently completed month prior to the earlier of either the registrant's announcement date or the acquisition's or disposition's agreement date. This amendment is expressly limited to acquisitions and dispositions. If the aggregate worldwide market value is not available, the registrant would continue to apply the investment test existing before the Amended Rules. Under the Amended Rules, "investments" include the fair value of contingent consideration if required to be recognized at fair value at the acquisition date under US GAAP or IFRS-IASB.

Before the Amended Rules, the income test considered an acquisition significant if the registrant's share of pre-tax income from

continuing operations of the target exceeds 20% of its pre-tax income for the most recent fiscal year. To avoid immaterial acquisitions being deemed significant, the Amended Rules revised the income test by adding a new component (revenues less permitted expenses) which allows the deduction of intercompany eliminations from the target's total revenue from continuing operations when the registrant and the acquired business have material revenue in each of the two most recently completed fiscal years, and consider an acquisition significant only if both the existing and the additional components are exceeded. Therefore, when the revenue component of the income test applies, both the revenue and net income components must be exceeded to determine whether a subssidiary is signigicant.

Financial Statements Submissions in General

Before the Amended Rules, a registrant may be required to file Rule 3-05 Financial Statements relating to up to a three-year period, depending on the relative significance of the acquired or to-be-acquired business. The SEC has approved the Amended Rules (i) to limit the historical financial statement requirement to cover not more than two years of historical financial statements, (ii) to dispense with the filing of a third year of Rule 3-05 Financial Statements for an acquisition exceeding 50% significance and (iii) to require financial statements for the "most recent" interim period rather than "any" interim period for acquisitions with significance that exceed 20% but not 40%.

The SEC recognizes the difficulty in, and costs associated with, preparing the required financial statements when a registrant acquires a business (as defined in Regulation S-X's Rule 11-01(d)), which does not constitute a separate entity, subsidiary or division (e.g., product line). The SEC will now allow the registrant to provide abbreviated financial statements prepared in accordance with the presentation requirements prescribed in the Amended Rules (e.g., audited financial statements of acquired assets and assumed liabilities, and statements of revenues and expenses exclusive of corporate overhead, interest and income tax expenses), provided the following conditions, among others, are met:

- the total assets and total revenues (both after intercompany eliminations) of the acquired business constitute 20% or less of such corresponding amounts of the seller and its subsidiaries consolidated as of and for the most recently completed fiscal year;
- separate financial statements for the acquired business have not previously been prepared;
- the acquired business was not a separate entity, subsidiary, operating segment or division during the periods for which the acquired business financial statements would be required; and
- the seller has not maintained the distinct and separate accounts necessary to present (and it is impracticable for the seller to prepare) financial statements other than the abbreviated financial statements.

Rule 3-05 had been silent on industry-specific disclosures for acquisitions involving significant oil and gas producing activities. The Amended Rules create a new Rule 3-05(f) requiring a registrant in this sector to include in its Rule 3-05 Financial Statements the disclosures specified in FASB ASC Topic 932 Extractive Activities – Oil and Gas on an unaudited basis for each full year of operations presented for the acquired or to-be-acquired business. Rule 3-05 Financial Statements may consist only of audited statements of revenues and expenses that exclude expenses not comparable to the

proposed future operations, such as depreciation, depletion and amortization, corporate overhead, income taxes, and interest for debt that will not be assumed by the registrant or its subsidiaries consolidated if (i) substantially all of the revenues of the business are generated from oil and gas producing activities, (ii) the qualifying conditions of proposed Rule 3-05(e)(1) are met and (iii) the disclosures specified in Rule 3-05(e)(2)(iii) are provided.

As to which accounting standards to use in financial statement preparation, the Amended Rules now allow Rule 3-05 Financial Statements to be prepared in accordance with International Financial Reporting Standards as issued by the International Accounting Standards Board (IFRS-IASB) without reconciliation to U.S. GAAP if the acquired business would qualify to use IFRS-IASB if it were a registrant.

Upon effectiviness of the Amended Rules, Rule 3-05 Financial Statements are no longer required in registration statements and proxy statements once the acquired business is reflected in filed post-acquisition registrant financial statements for at least nine months. This eliminates the current requirement to provide the Rule 3-05 Financial Statements when these have not been previously filed or have been previously filed but the acquired business is of major significance.

Pro Forma Financial Information

The Amended Rules revised pro forma financial information requirements so that the adjustment criteria are broken out into three categories:

- "Transaction Accounting Adjustments" which reflect only the application of required accounting to the transaction;
- "Autonomous Entity Adjustments" which reflect the operation and financial position of the registrant as an autonomous entity if it was previously part of another entity; and
- "Optional "Management's Adjustments" depicting synergies and dis-synergies of acquisitions and dispositions for which pro forma effect is being given, if management's opinion, such adjustments enhance understanding of the pro forma effects of the transaction. As a condition for presenting Management's Adjustments certain conditions related to the basis and form of presentation must be met.

Financial Statements of Real Estate Operations

The Amended Rules amended Rule 3-14 to define a *real estate operation* as "a business that generates substantially all of its revenues through the leasing of real property."

The SEC found no unique industry considerations that necessitate a differentiated approach for real estate businesses. In order to standardize and simplify the requirements for acquired businesses while retaining the industry-specific disclosure necessary for investors to make informed investment decisions, the SEC aligned Rule 3-14 with Rule 3-05 as to, among other things, the significance thresholds, years of required financial statements for acquisitions from related parties, timing of filings and the omission of Rule 3-14 Financial Statements in registration statements and proxy statements once the acquired real estate operation is reflected in filed post-acquisition registrant financial statements for at least nine months.

Foreign Businesses

Pursuant to the Amended Rules, Rule 3-05 Financial Statements may be prepared in accordance with IFRS-IASB without reconciliation to US GAAP if the acquired business would qualify to use IFRS-IASB if it were a registrant. In

addition, foreign private issuers that prepare their financial statements using IFRS-IASB to provide Rule 3-05 Financial Statements prepared using home country GAAP are permitted to reconcile to IFRS-IASB rather than US GAAP. The Amended Rules also permit an acquired business that would qualify as a foreign private issuer if it were a registrant to to IFRS-IASB rather than US GAAP when the registrant is a foreign private issuer that uses IFRS-IASB.

Smaller Reporting Companies and Regulation A

The Amended Rules revised Rule 8-04 of Regulation S-X to direct smaller reporting companies to Rule 3-05 for requirements relating to the financial statements of businesses acquired or to be acquired. However, the form and content of these financial statements would continue to be governed by Article 8. The revised Rule 8-04 would also apply to issuers relying on Regulation A.

Effectiveness and Transition

The Amended Rules are effective January 1, 2021.

Registrants will not be required to apply the Amended Rules until the beginning of their first fiscal year begininning after December 31, 2020 (the mandatory compliance date). Acquisitions that are probable or consumated after the mandatory compliance date must be evaluated for significance using the Amended Rules. Registrants filing initial registration statements are not required to apply the Amended Rules until an initial registration statement is first filed on or after their mandatory compliance date. In such initital registration statement, all probable or consummated acquisitions, including those consummated prior to the mandatory compliance date, must be evaluated for significance using the Amended Rules.

Registrants are allowed to voluntarily comply with the Amended Rules prior to their mandatory compliance date, provided they apply the Amended Rules in their entirety in advance from the date of early compiance date.

Practical Considerations

Previously the difficulties in timely preparing and filing the required financial statements for acquired businesses has adversely impacted the ability of some registrants to access the capital markets either to help pay for an acquisition or to fund other capital needs. However, the changes to Rule 3-05 coupled with the ability to voluntarily comply with the Amended Rules immediately could substantially reduce or eliminate this deterrence in many cases. Accordingly, registrants that recently completed or are in the process of completing a significant acquisition should seriously examine whether the Amended Rules will ease their ability to timely access the capital markets without the need to provide provide financial statements for the acquired business.

The accounting departments of public companies that engage, or are considering engaging, in acquisitions and dispositions should review the Amended Rules carefully to determine how they will impact upcoming disclosures.

Companies should assess how the Amended Rules would impact their disclosure to determine whether they want to voluntarily comply with the Amended Rules in advance of their mandatory compliance date, recognizing that voluntary compliance requires complete compliance.

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Endnotes

[1] A copy of the Amended Rules is available at https://bit.ly/36HKyR1.

[2] However, Commissioner Lee pointed out that the Amended Rules will likely facilitate mergers and acquisitions without adequately assessing the risk of insufficient transparency to investors, and risk of increasing economic concentration, See Commissioner Allison Herren Lee, *Statement of Financial Disclosures About Acquired and Disposed Businesses*, available at https://bit.ly/2XF02Bm.

[3] *See* Target and Pro Forma Financial Statement Requirements for Significant Acquisitions, available at http://bit.ly/2Yfzx45.

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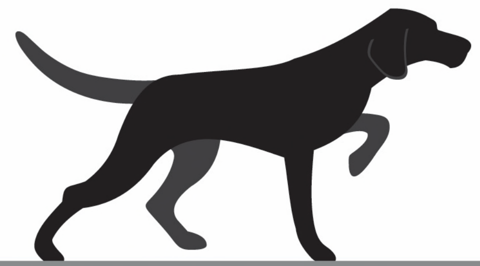
On point.



Target and Pro Forma Financial Statement Requirements for Significant Acquisitions

US reporting companies that are planning or have completed a significant acquisition of a business may be required to file separate target financial statements and related pro forma financial statements under Rule 3-05 and Article 11 of Regulation S-X. The specific US Securities and Exchange Commission ("SEC") rules and financial reporting obligations triggered by a significant acquisition can be quite complex, requiring careful evaluation by an acquiring company. These rules may also impact the ability of registrants to access the capital markets in a timely fashion, affecting the ability to offer securities in a registered offering, the proceeds of which would be used to fund the acquisition or to register securities to be used as consideration for the acquisition.

This note discusses the SEC's financial reporting and disclosure requirements triggered by a company's significant business acquisition. We outline key concepts and practice points helpful in determining if an acquisition is significant, which financial statements of the target are required to be included in the registrant's SEC filing or offering document, what related pro forma financial information is required, when and how these target and pro forma financial statements are to be filed or updated, and relevant market practice considerations.

We have updated this note to reflect the relevant amendments ("amendments") adopted by the SEC on May 21, 2020, to Rule 3-05 and Article 11 of Regulation S-X and related rules.[1] These amendments go into effect on January 1, 2021, although early adoption by companies is permitted as long as the amendments are applied in their entirety. In this note, we refer to existing Rule 3-05 and Article 11 of Regulation S-X and related rules as the "current rules" or "existing rules," and we refer to the amended rules as the "new rules"; when we refer to or cite a rule without mentioning the words "current," "existing," or "new," this means that the existing rule remains the same and is unchanged by the amendments. For brevity, we do not discuss the various other rules specifically applicable to investment companies, real estate operations, or smaller reporting companies.

Overview

In general, Rule 3-05 requires the filing of separate pre-acquisition, or historical, financial statements when the acquisition of a significant business has occurred or is probable. This means that the acquiring company must obtain separate audited annual and unaudited interim pre-acquisition financial statements of the target or business it acquires, if such business or acquisition is "significant" to the acquiring company. "Significance" is determined and measured by applying three significance tests prescribed by the SEC rules. The more significant an acquisition is, the more onerous the requirements relating to financial information of the target (*e.g.*, years of historical annual audited financial statements required). In addition, a registrant must also present pro forma financial statements that give effect to the acquisition, in compliance with Article 11. As a general rule, the registrant must file these target and pro forma financial statements within 75 days after an acquisition is consummated, with a Current Report on Form 8-K. However, a registrant that registers or offers securities may need to provide these financial statements much earlier and include these in the relevant SEC filing or offering document; for instance, in its registration statement, prospectus supplement or merger proxy statement, as applicable. Furthermore, while these rules technically only apply to SEC filings and registered offerings, market practice has evolved such that practitioners, in general, substantially adhere to them in the context of exempt offerings.

Rule 3-05 and Article 11 of Regulation S-X should be read and understood in conjunction with "Topic 2: Other Financial Statements Required" and "Topic 3: Pro Forma Financial Information" of the Financial Reporting Manual ("FRM")[2] of the SEC's Division of Corporation Finance ("Corp Fin").

[1] *See* adopting release, SEC Release No. 33-107861 (May 20, 2020), available at https://www.sec.gov/rules/final/2020/33-10786.pdf.
[2] The FRM, last updated on July 1, 2019, is available at https://www.sec.gov/files/cf-financial-reporting-manual.pdf.

Threshold Questions

In determining whether Rule 3-05 financial statements will be required in connection with an acquisition, the first order of business is to ask two threshold questions: (1) Do the assets and liabilities acquired or to be acquired by the registrant constitute a "business?" and (2) Has the transaction been consummated or is it "probable?"

Is the Target a "Business"?

The SEC prescribes a "facts and circumstances" analysis to determine whether an acquisition constitutes the acquisition of a "business," rather than of just assets.[3] The focus of the inquiry is whether there is sufficient continuity of operations so that disclosure of prior financial information is material to an understanding of future operations. There is a presumption in Rule 11-01(d) of Regulation S-X that a separate entity, subsidiary, or division is a "business" for Rule 3-05 purposes. However, a lesser component of an entity, such as a product line, also may be considered a business. In evaluating whether a component of an entity can be considered a business, Rule 11-01(d) requires registrants to consider (1) whether the nature of the revenue-producing activity of the component will remain generally the same as before the transaction and (2) whether the facilities, employee base, distribution system, sales force, customer base, operating rights, production techniques, or trade name of the component will remain with the component after the transaction.

Moreover, the SEC rules treat a group of related businesses as a single business for these purposes. Under Rule 3-05(a)(3), businesses shall be deemed to be related if they are under common control or management or their acquisitions are dependent on each other or a single common event or condition.[4] Finally, FRM paragraph 2010.1 cautions that what constitutes a "business" for SEC *reporting* purposes (*e.g*., the Rule 11-01(d) definition applicable to a Rule 3-05 analysis) may be different from what constitutes a "business" for *accounting* purposes (*e.g.,* under US GAAP).

Is the Transaction "Probable"?

Rule 3-05 applies not only when an acquisition has been consummated (*e.g.,* the business combination has closed), but also when an acquisition is "probable." The term "probable" is not defined in Rule 3-05. However, FRM paragraph 2005.4 provides that the assessment of "probability" requires consideration of all available facts and that an acquisition is probable where the registrant's financial statements alone would not provide adequate financial information to make an investment decision. In practice, factors that may be considered to determine whether an acquisition is "probable" include the following: (i) a signed definitive agreement; (ii) a binding letter of intent; (iii) approval from the board of directors or shareholders of the seller and target companies; (iv) submission of transaction terms to regulatory authorities for approval; (v) receipt of required third-party approvals or consents material to the transaction; (vi) incurrence of financial penalties if acquisition is not consummated; and (vii) a public announcement of the acquisition.

If the acquisition by the registrant is an acquisition of a "business" and such acquisition has been consummated or is probable, then the next query to be made in order to determine whether target financial statements are required is whether such acquisition is significant.

Significance Tests: Is the Acquisition "Significant?"

Registrants measure significance by using each of the three tests prescribed under the SEC rules: the asset test, investment test, and income test. These tests are based on the definition of a "significant subsidiary" under Rule 1-02(w) except that, for Rule 3-05 purposes, the 10% minimum threshold in Rule 1-02(w) is replaced by a 20% minimum threshold. For Rule 3-05 purposes, an acquisition is considered "significant" if it exceeds 20% on any of the three tests. The significance tests compare features of the acquired business (*i.e.*, acquisition purchase price, the target's assets, pre-tax income (and revenue under the new rules)) to the registrant buyer and measure these relationships as a percentage. These significance tests, under the current rules and under the new rules, are illustrated in the tables below. Per FRM paragraph 2015.2, as a general rule, one should use and compare the most recent pre-acquisition annual

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[3] *See* Rules 3-05 (a)(2) and 11-01(d). All rule references in this note are to Regulation S-X unless otherwise indicated.
[4] *See also* FRM Section 2015.12.

financial statements of the target with the registrant buyer’s most recent pre-acquisition consolidated annual audited financial statements to perform these tests.

Under the Current Rules

Table 1A: Significance Tests under the Current Rules

Investment Test	Asset Test	Income Test
$\frac{\text{Purchase Price}}{\text{Buyer's Total Assets}}$	$\frac{\text{Target's Total Assets}}{\text{Buyer's Total Assets}}$	$\frac{\text{Target's Pre-Tax Income}}{\text{Buyer's Pre-Tax Income}}$

- ***Investment Test.*** An acquisition is significant if the buyer’s investments in and advances to the target exceed 20% of the buyer’s total assets as of the end of the buyer’s most recent fiscal year.

  In performing the investment test, FRM paragraph 2015.5 states that the “GAAP purchase price” of the acquired business should be compared to the registrant’s consolidated total assets and that the term “GAAP purchase price” here refers to the ”consideration transferred” as defined in the applicable accounting standard (*e.g.*, under SFAS 141R and IFRS 3), adjusted to exclude the carrying value of assets transferred by the buyer to the acquired business that will remain with the combined entity after the acquisition.

- ***Asset Test.*** An acquisition is significant if the buyer’s share of the total assets of the target exceeds 20% of the buyer’s total assets as of the end of the buyer’s most recent fiscal year.

- ***Income Test.*** An acquisition is significant if the buyer’s share of ”pre-tax income” from continuing operations of the target exceeds 20% of the buyer’s pre-tax income for the most recent fiscal year.

  ”Pre-tax income” refers to income from continuing operations before income taxes, extraordinary items, and cumulative effect of a change in accounting principle, exclusive of amounts attributable to any noncontrolling interests. Per FRM paragraph 2015.9, if either the buyer or the target reported a pre-tax loss while the other reported a pre-tax income, then the absolute values must be used for purposes of the income test calculation.

After applying the three significance tests summarized above, the highest resulting percentage from among them will govern and will be used as the significance level for the acquisition.

Under the New Rules

The amendments adopted by the SEC made significant modifications to the investment test and the income test, as set out below. Note that, under the new rules, the denominator of the investment test has been modified and that the income test now has a revenue component, in addition to the pre-tax income component of the existing rule.

Table 1B: Significance Tests under the New Rules

Investment Test	Asset Test	Income Test
$\frac{\text{Purchase Price}}{\text{Buyer's Aggregate Worldwide Market Value of Common Equity}}$	$\frac{\text{Target's Total Assets}}{\text{Buyer's Total Assets}}$	The ***lower*** of: $\frac{\text{Target's Pre-Tax Income}}{\text{Buyer's Pre-Tax Income}}$ **and** $\frac{\text{Target's Revenue}}{\text{Buyer's Revenue}}$

- ***Investment Test.*** An acquisition is significant if the buyer's investments in and advances to the target exceed 20% of the buyer's aggregate worldwide market value of voting and non-voting common equity, if available (instead of the buyer's total assets). To determine the denominator, use the average of aggregate worldwide market value of common equity calculated daily for the last five trading days of the registrant's most recently completed month ending prior to the earlier of the registrant's announcement date or agreement date of the acquisition. If, however, the registrant has no such aggregate worldwide market value (*e.g.*, the registrant has no publicly traded common stock), then the denominator under the current investment test (*i.e.*, the buyer's total assets as of the end of the buyer's most recent fiscal year) should be used.

  Rule 1-02(w)(i)(A)(1) now explicitly provides that the term "investments in" the target means the consideration transferred, adjusted to exclude the carrying value of assets transferred by the registrant to the target that will remain with the combined entity after the acquisition. The consideration transferred must include the fair value of contingent consideration if required to be recognized at fair value by the registrant at the acquisition date under U.S. GAAP or under International Financial Reporting Standards as issued by the International Accounting Standards Board ("IFRS-IASB"), as applicable. However, if recognition at fair value is not required, it must include all contingent consideration, except contingent consideration for which the likelihood of payment is remote.

- ***Asset Test.*** An acquisition is significant if the buyer's share of the consolidated total assets of the target exceeds 20% of the buyer's total assets as of the end of the buyer's most recent fiscal year. The amendments do not affect the computation of the asset test under the current rule.

- ***Income Test.*** Under the new rules, the income test now has two components: a pre-tax income component (similar to the existing rules) and a revenue component (new).

  For the pre-tax income component, an acquisition is significant if the buyer's share of "pre-tax income" from continuing operations of the target exceeds 20% of the buyer's pre-tax income for the most recent fiscal year. "Pre-tax income" refers to income from continuing operations before income taxes, extraordinary items, and cumulative effect of a change in accounting principle, attributable to controlling interests. The new rules clarify that the "absolute value" of the registrant and target's pre-tax income or loss should be used when computing the pre-tax income component.

  For the revenue component, an acquisition is significant if the buyer's share of the consolidated total revenue from continuing operations of the target exceeds 20% of the buyer's consolidated total revenue from continuing operations for the most recent fiscal year. The revenue component does *not* apply if either the registrant or the target did not have material revenue in each of the two most recently completed fiscal years. In such a case, only the pre-tax income component of the income test should be applied.

  Both components should be tested where applicable, and the *lower percentage* of the two components should be used as the resulting percentage for the income test. Hence, if both components apply (*e.g.,* both registrant and target had material revenue for the last two fiscal years, hence the revenue component applies) and the acquisition does not exceed 20% significance under either the pre-tax income component or revenue component test, then such acquisition is not significant under the income test.

After applying the three significance tests summarized above, the highest resulting percentage from among them will govern and will be used as the significance level for the acquisition.

Practical Reminders When Performing Significance Tests

Below are a few practical points to take into account when carrying out the significance tests.

- *No Alternative Tests.* FRM paragraph 2020.1 provides that the Staff of Corp Fin ("Staff") will not accept alternative significance tests in order to achieve consistent application and fair treatment across all registrants and industries. If, after performing the

required significance tests, a registrant believes that the tests specify periods beyond those reasonably necessary to inform investors, it may make a written request to the Office of the Chief Accountant of Corp Fin to waive one or more years of financial statements.

- *Do Not Include Target in Denominator.* FRM paragraph 2015.10 provides that the acquired business is not considered part of the registrant's denominator in determining significance.
- *Use Audited Annual Financial Statements; Exceptions Allowing Use of Pro Formas in Measuring Significance.* As a general rule, when performing the significance tests, use the audited annual pre-acquisition financial statements of both the target and the registrant buyer.

  However, where the registrant has completed a previous significant acquisition for which it has previously filed target and pro forma financial statements in a Form 8-K, then the registrant may evaluate significance (for the subsequent acquisition and target) by using the registrant's pro forma financial information (that gave effect to the prior significant acquisition) rather than the historical pre-acquisition financial statements.

  In addition, the amendments have expanded the circumstances in which a registrant can use pro forma financial information for significance testing and eliminated the current requirement, in the exception immediately above, that the target and pro forma financial statements should have been filed in a Form 8-K. Specifically, the new rules permit registrants (including IPO companies) to measure significance using filed pro forma financial information that depicts significant business acquisitions consummated after the latest fiscal year-end for which the registrant's financial statements are required to be filed, provided that: (a) the registrant has filed Rule 3-05 financial statements and Article 11 pro forma financial information required for such acquired business with the SEC (including in initial registration statements); (b) the pro forma financial information includes "Transaction Accounting Adjustments" but not "Management's Adjustments" or "Autonomous Entity Adjustments"(each as described and discussed below); and (c) if the registrant presents such pro forma amounts, then it must continue to use pro forma amounts to determine significance of acquisitions through the filing date of its next annual report on Form 10-K.
- *Computing the Denominator in New Investment Test.* In computing the denominator for the investment test under the new rules, note that the buyer's aggregate worldwide market value of voting and non-voting common equity is different from the value used by registrants to determine accelerated filer status (including WKSI status) under Exchange Act of 1934, as amended (the "Exchange Act") Rule 12b-2. The former includes the value of common equity held by affiliates and is determined by averaging the last five trading days of the registrant's most recently completed month ending prior to the earlier of the registrant's announcement date or acquisition agreement date. In contrast, Exchange Act Rule 12b-2 uses the value of common equity held by *non-affiliates* and is determined as of the last business day of the registrant's most recently completed second fiscal quarter.
- *Using Buyer's Five-Year Average Pre-Tax Income for Income Test.* If the registrant's pre-tax income for the most recent fiscal year is 10% or lower than its average pre-tax income for the last five fiscal years, then such average pre-tax income of the registrant should be used to perform the income test (or the pre-tax income component of the income test under the new rules). In computing this five-year average:

  (a) under the current rules, a loss year (where a registrant reported a pre-tax loss instead of pre-tax income) should be assigned a value of zero, but the denominator should be "5". See FRM paragraph 2015.8 and the second computational note to current Rule 1-02(w).

  (b) under the new rules, and in a case where the revenue component of the income test does not apply, the absolute value of the pre-tax loss in a loss year should be used, instead of zero, and the denominator should be "5". See new Rule 1-02(w)(1)(iii)(B)(2).

- *No Rounding*. FRM paragraph 2015.13 provides that the results of the significance tests should not be rounded.
- *Intercompany transactions*. FRM paragraph 2015.11 provides that, when measuring significance for all three significance tests, intercompany transactions between the registrant and the target should be eliminated in the same way that would occur if the target were consolidated.

Significance Levels and Rule 3-05 Historical Financial Statements Required

Depending on the significance of the acquisition, under the current rules, the registrant must produce one to three years of the target's audited historical financial statements and, in all cases of significance, unaudited interim financial statements for the last interim period and for the corresponding interim period of the prior year.

In contrast, under the new rules, depending on the significance of the acquisition, the registrant must produce (i) one to two years of the target's audited historical financial statements; (ii) in all cases of significance, unaudited interim financial statements for the last interim period; and (iii) only in cases of significance exceeding the 40% significance level, unaudited interim financial statements for the corresponding interim period of the prior year.

Table 2 below summarizes the required target financial statements corresponding to a significance level of a ***completed*** acquisition under the current rules and the new rules.

Table 2: Periods of Required Target Financial Statements for Completed Acquisitions

<table>
<tr><th>Significance Level
(Individual acquisition or multiple acquisitions of related businesses)</th><th>Required Historical Financial Statements of the Target
Under Current Rules</th><th>Required Historical Financial Statements of the Target
Under New Rules</th></tr>
<tr><td>At or below 20% significance</td><td>No separate financial statements needed</td><td>No separate financial statements needed</td></tr>
<tr><td>Exceeds 20% significance but less than or equal to 40%</td><td>• Audited financial statements for the most recent fiscal year
• Unaudited interim financial statements for latest completed period that precedes the acquisition and for the corresponding interim period of the prior year</td><td>• Audited financial statements for the most recent fiscal year
• Unaudited interim financial statements for latest completed period that precedes the acquisition (corresponding interim period of the prior year is not required)</td></tr>
<tr><td>Exceeds 40% significance but less than or equal to 50%</td><td>• Audited financial statements for the two most recent fiscal years
• Unaudited interim financial statements for the latest completed period that precedes the acquisition and for corresponding interim period of the prior year</td><td rowspan="2">• Audited financial statements for the two most recent fiscal years
• Unaudited interim financial statements for the latest completed period that precedes the acquisition and for corresponding interim period of the prior year</td></tr>
<tr><td>Exceeds 50% significance</td><td>• Audited financial statements for the three most recent fiscal years
• Unaudited interim financial statements for the latest completed period that precedes the acquisition and for corresponding interim period of the prior year</td></tr>
</table>

Significance Level (Individual acquisition or multiple acquisitions of related businesses)	Required Historical Financial Statements of the Target Under Current Rules	Required Historical Financial Statements of the Target Under New Rules
	o Exception: If target had net revenues below $100 million in its most recent fiscal year, the audited financials for the earliest of the three fiscal years may be omitted o Exception: If registrant is an emerging growth company ("EGC"), it may present, in its initial registration statement, only two years of audited financial statements of the target	

As discussed in more detail below, notwithstanding the chart above, no financial statements need to be filed *yet* if the acquired business does not exceed the 50% significance level and the acquirer is in the 74-day grace period. An acquirer is within the 74-day grace period if the date of the final prospectus or prospectus supplement for the offering (or the mailing date in case of a proxy statement) is no more than 74 days after the acquisition is completed and the financial statements of the acquired business have not yet been filed. However, in many instances, it may be advisable to file the financial statements earlier in order to complete a financing.

With respect to a ***probable*** acquisition (as opposed to a completed acquisition), historical financial statements described in the row immediately above are only required if such acquisition exceeds the 50% significance level.

Target financial statements are not required if the significance level is at or below the 50% significance level and the acquisition has not yet been completed.

Note that the chart sets out general rules only, and there are a number of exceptions and considerations that may apply depending on the particular filing or offering document, level of significance, or timing.[5] Before we discuss some of these particular SEC filings, however, we first take a look at the pro forma financial statements required under Article 11, as these would need to be presented as well to accompany the required Rule 3-05 target historical financial statements.

Pro Forma Financial Information

As a rule, where a significant recent or probable acquisition triggers the need for Rule 3-05 target historical financial statements, then pro forma financial information that gives effect to the acquisition is also required to be presented under Article 11 of Regulation S-X. Article 11 pro forma financial information is intended to provide investors with information about the continuing impact of a particular transaction by showing how the transaction might have affected historical financial statements if the transaction had been

[5] In particular, new Rule 3-05(e) allows the filing of abbreviated target financial statements (in the form of statements of assets acquired and liabilities assumed and statements of revenues and expenses), in lieu of full target financial statements, for an acquisition of net assets that constitute a business (such as an acquired or to be acquired product line), provided certain qualifying and presentation conditions are met. The qualifying conditions are that: (a) the total assets and total revenues of the acquired business constitute 20% or less of such corresponding amounts of the seller and its subsidiaries consolidated as of the most recently completed fiscal year; (b) separate financial statements for the business have not previously been prepared; (c) the acquired business was not a separate entity, subsidiary, operating segment (as defined in U.S. GAAP or IFRS-IASB) or division during the periods for which the acquired business financial statements would be required; and (d) the seller has not maintained the distinct and separate accounts necessary to present required Rule 3-05 financial statements and it is impracticable to prepare such financial statements. The presentation conditions include, among others, that the statement of comprehensive income must include expenses incurred by the acquired business during the pre-acquisition financial statement periods to be presented including costs of sales or services, selling, distribution, marketing, general and administrative, depreciation and amortization, and research and development, but may otherwise omit corporate overhead expense, interest expense for debt that will not be assumed by the registrant, and income tax expense.

consummated at an earlier time. The pro forma financial statements are intended to assist investors in analyzing the future prospects of the registrant by illustrating the possible scope of the change in the registrant's financial position and results of operations caused by the transaction.[6]

Rule 11-02(b) of the current rule and Rule 11-02(a)(1) of the new rules provide that pro forma financial information should consist of a pro forma condensed balance sheet, pro forma condensed statements of income, and accompanying explanatory notes. In particular, Rule 11-02(d) of the current rule and Rule 11-02(c)(1) and (2) of the new rules require:

- a pro forma condensed balance sheet as of the end of the most recent period for which a consolidated balance sheet of the acquirer is required, unless the transaction is already reflected in that balance sheet; and
- pro forma condensed income statements for the acquirer's most recently completed fiscal year and the most recent interim period, unless the historical income statement reflects the transaction for the entire period.

The pro forma financial information should be accompanied by an introductory paragraph briefly setting forth a description of (i) the transaction, (ii) the entities involved, and (iii) the periods for which the pro forma information is presented.[7]

Under the Current Rules

Pro forma financial information should be presented in columnar form, with separate columns presenting historical results, pro forma adjustments, and pro forma results.[8] With respect to adjustments: [9]

- Pro forma adjustments related to the pro forma condensed balance sheet should be computed assuming the transaction was consummated on the date of the latest balance sheet included in the filing. Adjustments should give effect to events that are directly attributable to each specific transaction and factually supportable. Adjustments should include those items that have a continuing impact and also those that are nonrecurring.
- Pro forma adjustments related to the pro forma condensed income statement should be computed assuming the transaction was consummated at the beginning of the fiscal year presented and carried forward through any interim period presented. Adjustments should give effect to events that are (i) directly attributable to the transaction, (ii) expected to have a continuing impact on the registrant, and (iii) factually supportable.

Under the New Rules

The new rules modify the criteria for pro forma adjustments in the existing rule and provide three new categories of permitted adjustments, as follows:

- "Transaction Accounting Adjustments," which reflect only the application of required accounting to the acquisition, linking the effects of the acquired business to the registrant's audited historical financial statements. These adjustments reflect the accounting for the transaction under US GAAP or IFRS-IASB, as applicable, regardless of whether the impact is expected to be continuing or non-recurring.
- "Autonomous Entity Adjustments," which are adjustments necessary to reflect the operations and financial position of the registrant as an autonomous entity when the registrant was previously part of another entity.

[6] See current Rule 11-02(a). The amendments deleted the language of Rule 11-02(a) of the existing rule, which describes the objectives of the preparation requirements, "to avoid confusion and focus registrants on the requirements of the rule."
[7] See current Rule 11-02(b)(2) and new Rule 11-02(a)(2).
[8] See current Rule 11-02(b)(4).
[9] See current Rule 11-02(b)(6).

- "Management's Adjustments," which are adjustments depicting synergies and dis-synergies of the acquisition for which pro forma effect is being given and may only be presented if, in management's opinion, such adjustments would enhance an understanding of the pro forma effects of the transaction and certain conditions are met. Such conditions are that (a) there is a reasonable basis for each such adjustment; (b) the adjustments are limited to the effect of such synergies and dis-synergies on the historical financial statements that form the basis for the pro forma statement of comprehensive income as if the synergies and dis-synergies existed as of the beginning of the fiscal year presented; (c) if such adjustments reduce expenses, the reduction must not exceed the amount of the related expense historically incurred during the pro forma period presented; and (d) the pro forma financial information reflects all Management's Adjustments that are, in the opinion of management, necessary to a fair statement of the pro forma financial information presented and a statement to that effect is disclosed. Moreover, when synergies are presented, any related dis-synergies must also be presented.

Under the new rules, Transaction Accounting Adjustments and Autonomous Entity Adjustments are mandatory, while Management's Adjustments are optional, in the presentation of pro forma financial information under Article 11. Transaction Accounting Adjustments and Autonomous Entity Adjustments must be presented in separate columns in the pro forma financial statements, while Management's Adjustments, if presented, should be presented in the explanatory notes to the pro forma financial information in the form of reconciliations of pro forma net income from continuing operations attributable to the controlling interest and the related pro forma earnings per share data after giving effect to Management's Adjustments. The explanatory notes for Management's Adjustments must also include disclosure of the basis for and material limitations of each Management's Adjustment, including any material assumptions or uncertainties of such adjustment, an explanation of the method of the calculation of the adjustment, if material, and the estimated time frame for achieving the synergies and dis-synergies of such adjustment. Any forward-looking information supplied in Management's Adjustments are covered by existing safe harbor rules under Rule 175 under the Securities Act of 1933, as amended (the "Securities Act") and Rule 3b-6 under the Exchange Act.

Target and Pro Forma Financial Statements Required in SEC Filings

In connection with a significant completed or probable acquisition, a registrant may be required to include Rule 3-05 historical financial statements and Article 11 pro forma financial statements in different SEC filings, including in a Form 8-K, registration statements, prospectus supplements, and proxy materials for a business combination. We discuss these in more detail below. Note that, in all instances, the target's financial statements must satisfy the usual age of financial statement requirements or "staleness" deadlines, which, in turn, depend on the target's filer status.

Requirements Under Form 8-K

A significant acquisition usually triggers the requirement to file a Form 8-K at three different periods: (1) a *signing* 8-K to be filed after the acquisition agreement is signed; (2) a *closing* 8-K to be filed after the acquisition closes; and (3) a *Form 8-K/A* to be filed within approximately 75 days of the closing of the acquisition.

- *Signing 8-K*. Item 1.01 of Form 8-K requires a registrant to disclose in a Form 8-K its entry into a material definitive agreement not made in the ordinary course of business. The Form 8-K should be filed within four business days from the signing of such agreement and should disclose, among other things, the date of the agreement, identity of the parties, and a brief description of the material terms and conditions of the agreement. No financial statements (either target or pro forma) are required to be included in this Form 8-K.

- *Closing 8-K*. Item 2.01 of Form 8-K requires a registrant to disclose in a Form 8-K that it has completed the acquisition of a significant amount of assets, otherwise than in the ordinary course of business. The Form 8-K should be filed within four business days from the closing of the acquisition and should disclose, among other things, the date of completion of the acquisition, a brief description of the assets involved, the identity of the parties, and the nature and amount of consideration

given or received. As a general rule, no financial statements (either target or pro forma) are required to be included in this Form 8-K.

- *Form 8-K/A*. Items 9.01(a) and (b) of Form 8-K require the registrant to file the required Rule 3-05 historical target financial statements and Article 11 pro forma financial information, either in the Closing 8-K described above or in an amendment to such Closing 8-K, not later than 71 calendar days after the required filing date of the Closing 8-K (approximately 75 days from the completion of the acquisition). Note that, for purposes of applying the staleness rules to the financial statements filed in the Form 8-K/A, FRM paragraph 2045.13 provides that the age of such financial statements should be determined by reference to the filing date of the Form 8-K initially reporting consummation of the acquisition. This means that the target financial statements included in the Form 8-K/A would be deemed current if they would have met the permitted age requirements on the filing date of the Closing 8-K.

As previously mentioned, as a general rule, a reporting company that has completed a significant acquisition must file these target and pro forma financial statements within 75 days after the acquisition is consummated on a Form 8-K/A. However, a registrant that registers or offers securities may need to provide these financial statements much earlier and include them in the relevant SEC filing or offering document.

Registration Statements other than those on Form S-4

When Required

In general, a registrant is required to file target and pro forma financial statements of a significant business acquisition that was completed 75 or more days before a registration statement is filed or declared effective. Such financial statements are also required if an acquisition is probable and exceeds the 50% significance level. The financial statements can be included in the registration statement itself or incorporated therein by reference (for instance, from the previously filed Form 8-K/A that contains the target and pro forma financial statements).

When Not Required

No target or pro forma financial statements are required if the business acquisition does not exceed the 50% significance level and either (1) the acquisition is probable or has not yet been completed or (2) the acquisition was completed less than 75 days before the registration is filed or declared effective (stated otherwise, the date of the final prospectus or the prospectus supplement filed with the SEC is no more than 74 days from the consummation of the acquisition) and the financial statements of the acquired business have not yet been filed.

Special Rules When Significance Exceeds 50%

FRM paragraph 2050.5 provides that, if significance exceeds 50% and the financial statements of the acquired business have not yet been filed, then new registration statements and post-effective amendments to such registration statements will not be declared effective. In this scenario, at the more than 50% significance level, a registrant will need to file the required target and pro forma financial statements in the new registration statement or an amendment to an existing one, even if such acquisition is only probable or has closed only within the past 74 days. FRM paragraph 2060 provides a flowchart overview of Rule 3-05. This flowchart illustrates when target financial statements are required in a registration statement for an acquisition that has occurred or is probable.

Omission of Rule 3-05 Financial Statements in Registration Statements and Proxy Statements once Acquired Businesses have been included in Registrant's Financial Statements

The new rules eliminate the requirement to provide Rule 3-05 Financial Statements in registration statements and proxy statements, as long as the acquired business is reflected in filed post-acquisition financial statements of the registrant for a period of either nine

months (for acquired businesses with significance greater than 20% but not in excess of 40%) or a complete fiscal year (for acquired businesses with significance in excess of 40%).[10]

Considerations Applicable to Shelf Takedowns and Prospectus Supplements

A registrant may utilize a prospectus supplement to effect a takedown of securities under an existing, currently effective registration statement. However, a registrant must be mindful of certain rules under Rule 3-05 that may impact its ability to utilize an existing, effective shelf registration statement for a takedown.

FRM paragraph 2045.3 provides that offerings pursuant to effective registration statements cannot proceed if the significance of an acquisition exceeds 50% and financial statements have not been filed. FRM paragraph 2050.3[11] further provides that, if the significance exceeds 50% and the financial statements of the acquired business have not been filed, registrants should not make offerings pursuant to effective registration statements or pursuant to Rule 506 of Regulation D if any purchasers are not accredited investors until the required audited financial statements are filed. As an exception, however, the following offerings and sales of securities may proceed during the grace period notwithstanding that the financial statements of the acquired business have not been filed:

- offerings or sales of securities upon the conversion of outstanding convertible securities or upon the exercise of outstanding warrants or rights;
- dividend or interest reinvestment plans;
- employee benefit plans;
- transactions involving secondary offerings; and
- sales of securities pursuant to Rule 144.

The Staff has clarified that FRM paragraphs 2045.3 and 2050.3 above only apply to completed business acquisitions. They do not apply to probable business acquisitions, unless management determines that such probable business acquisition constitutes a "fundamental change."

FRM paragraph 2045.3 provides that, in general, after the effectiveness of a registration statement, a domestic registrant has no specific obligation to update the prospectus (*e.g.*, by filing an amendment to the prospectus or a prospectus supplement) except as stipulated by Section 10(a)(3) of the Securities Act and Item 512(a) of Regulation S-K with respect to any "fundamental change." If an acquisition would be significant under Rule 3-05, management should consider whether the probability of consummation of the transaction would represent a fundamental change to its business. It is the responsibility of management to determine what constitutes a fundamental change. The registrant should also consider whether individually insignificant acquisitions occurring subsequent to effectiveness, when combined with individually insignificant acquisitions that occurred after the most recent audited balance sheet in the registration statement but prior to effectiveness, may be of such significance in the aggregate that an amendment is necessary.

Registration Statement on Form S-4

A registrant may prepare a registration statement on Form S-4 in order to register securities to be offered to the security holders of a business to be acquired. FRM paragraph 2200.3 provides that, in general, the determination of the number of periods for which target company financial statements need be included in a Form S-4 should be made by reference to the requirements of Form S-4, not S-X 3-05. The financial statement and audit requirements for Form S-4 filings may be different from the Rule 3-05 requirements outlined above, depending on a number of facts and circumstances. These factors include, among others, (1) whether the registrant's shareholders are required to vote on the potential acquisition and (2) whether the target is an SEC reporting entity. In particular, as FRM paragraph 2200.1 illustrates:

[10] See new Rule 3-05(b)(4)(iii).
[11] See similar requirement in the Instruction to Item 9.01 of Form 8-K.

- the target company financial statement periods to present depend on whether (i) the target is a reporting company; (ii) the target is a non-reporting company and the issuer's shareholders are voting; (iii) the target is a non-reporting company and the issuer's shareholders are not voting; (iv) the target is a smaller reporting company; (v) the acquirer is an EGC; or (vi) the acquirer is a shell company.
- the need to audit the target company's financial statements depends on whether (i) the target is a reporting company or (ii) the target is a non-reporting company (irrespective of whether the issuer's shareholders are voting).

For instance, where the issuer's shareholders are required to vote on the transaction and the target is an SEC reporting entity, the following target financial statements would be required, *regardless of significance* under Rule 3-05: (i) balance sheets as of the two most recent fiscal years (audited); (ii) statements of operations, comprehensive income, cash flows, and changes in shareholders' equity for the three most recent fiscal years (audited); (iii) required interim information (unaudited), if applicable; and (iv) financial statements of the target's significant acquired or to-be-acquired business under Rule 3-05.

As another example, if the target is a reporting company, all target company fiscal years presented must be audited, whether or not the issuer's shareholders are voting.[12]

Merger Proxy Statement

FRM paragraph 1140.3 provides that the requirement for acquirer and target financial statements in a merger proxy statement depends on whose proxies are solicited and the nature of the consideration. If the consideration to be issued in a business combination includes registered securities, the registrant must comply with the financial statement requirements of Form S-4 described above. The following table, which is derived from the table found in FRM paragraph 1140.3, outlines when financial statements are required for transactions that do not involve registered securities.

Table 3: When Financial Statements Are Required for Merger Proxy Statements

<table>
<tr><th>Solicited Shareholders</th><th>Consideration</th><th>Financial Statements</th></tr>
<tr><td>Acquirer Only</td><td>Cash only</td><td rowspan="2">• Financial statements of the target are required.
• Financial statements of the acquirer are not required unless they are material to an informed voting decision.
• Pro forma financial information is required if it is material to a voting decision.</td></tr>
<tr><td>Acquirer Only</td><td>Exempt securities only or a combination of exempt securities and cash</td></tr>
<tr><td>Target Only</td><td>Cash only</td><td>• Financial statements of the target are not required unless it is a going private transaction.
• Financial statements of the acquirer are not required unless they are material to an informed voting decision.
• No pro forma information is required.</td></tr>
<tr><td>Target Only</td><td>Exempt securities only or a combination of exempt securities and cash</td><td>• Financial statements of the target are not required unless it is a going private or roll-up transaction.
• Financial statements of the acquirer are generally required.
• Pro forma financial information is required, if material.</td></tr>
<tr><td>Acquirer and Target</td><td>Cash only</td><td>• Financial statements of the target are required.
• Financial statements of the acquirer are not required unless they are material to an informed voting decision.
• Pro forma financial information is required if it is material to a voting decision.</td></tr>
</table>

[12] See also FRM paragraph 2200.6.

Solicited Shareholders	Consideration	Financial Statements
Acquirer and Target	Exempt securities only or a combination of exempt securities and cash	• Financial statements of the target are required. • Financial statements of the acquirer are generally required. • Pro forma financial information is required, if material.

Exempt Offerings – Rule 144A Transactions and Offering Memoranda

The target and pro forma financial statement requirements under Rule 3-05 and Article 11 also become relevant in Rule 144A offerings as a result of market convention. While these SEC requirements do not technically apply to Rule 144A offerings, it has become standard practice for practitioners to substantially adhere to these requirements as much as possible in their exempt offerings. Initial purchasers and QIBs have come to expect that the financial disclosures in a Rule 144A offering memorandum (in particular, the inclusion of target and pro forma financial statements in connection with a significant acquisition) would in all material respects be consistent with the needed financial disclosures in a registration statement. This is particularly the case where security holders have been granted registration rights or an A/B exchange offer would follow a Rule 144A notes offering, since, in these situations, compliance with the SEC requirements will then apply, at the back-end, to the registered offering. Inclusion of such financial statements in the Rule 144A offering memorandum assists the issuer and financial intermediaries in presenting investors with full and fair disclosure about the issuer's financial condition and results of operations and mitigates possible claims from investors that the offering document contained material misstatements or material omissions.

Since the SEC rules under Rule 3-05 and Article 11 do not technically apply to Rule 144A offerings, practitioners are afforded a certain degree of flexibility in a Rule 144A deal. For instance, it is not uncommon for practitioners to decide that two years of target audited financial statements would suffice, instead of the three years that may be required by current SEC rules, if such omission does not materially alter the total mix of information available to investors. Marketing considerations also come into play. For instance, in the case of a probable significant acquisition that exceeds 20% significance but not 40% significance, it is not uncommon for practitioners to decide to include target and pro forma financial statements in the offering memorandum, notwithstanding that these would not be required to be included in a registration statement, since the significance has not exceeded the 50% significance level applicable to probable acquisitions.

Rule 3-13 Waiver Requests

Finally, registrants that wish to seek relief from complying with Rule 3-05 and Article 11 financial statement requirements should remember and consider making Rule 13-3 waiver requests. Rule 3-13 of Regulation S-X allows the SEC, upon the informal request of a registrant and where consistent with investor protection, to permit the omission of financial statements otherwise required by the SEC rules or their substitution by financial statements of a comparable character.

Note that, in July 2017, SEC Chair Jay Clayton stated that, under Rule 3-13, issuers can request modifications to their financial reporting requirements in certain circumstances where disclosures are burdensome to generate but may not be material to the total mix of information available to investors. Chair Clayton encouraged companies to consider whether such modifications may be helpful in connection with their capital raising activities and assured them that Staff is placing a high priority on responding with timely guidance. Echoing Mr. Clayton's earlier remarks, then Corp Fin Chief Accountant Mark Kronforst also remarked in November 2017 that Rule 3-13 is intended to facilitate capital information and allows companies to be granted relief where consistent with investor protection. The SEC has also reiterated in the final release adopting the new rules, that Rule 3-13 waiver requests are available, and that Corp Fin, in the exercise of its delegated authority and consistent with investor protection, can grant these requests to relieve financial statement burdens imposed by Regulation S-X.

Conclusion

A significant business acquisition represents an important event in the life cycle of a registrant. Because a significant acquisition oftentimes results in significant changes to a registrant's financial position, results of operations, and future prospects, the SEC rules require registrants to include in their filings and disclose to investors historical financial statements of the target and pro forma financial statements giving effect to the acquisition under Rule 3-05 and Article 11. Understanding these rules is essential for registrants to discharge their reporting obligations and to carry out any contemplated securities offerings in a timely fashion. While this note provides an overview of the financial statement requirements under Rule 3-05 and Article 11, it is important to remember that the SEC's financial reporting and disclosure requirements triggered by a company's significant business acquisition are technical in nature and are subject to many exceptions and special cases, especially in light of the significant amendments recently passed by the SEC. In particular, companies should assess how the new rules would impact their existing disclosures and determine if voluntary early adoption of the new rules, ahead of the mandatory compliance date, would be advantageous, recognizing that early compliance means full compliance. Registrants should therefore carefully review the rules, evaluate the applicable facts and circumstances, and work with counsel and auditors in carrying out their significance analysis and financial reporting presentations.

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Legal Update

SEC Examinations Division Issues Risk Alert on ESG Products and Services

On April 9, 2021, the Division of Examinations of the US Securities and Exchange Commission ("Division" or "staff") issued a risk alert to highlight the staff's observations from its recent examinations of investment advisers, registered investment companies and private funds offering ESG products and services (Risk Alert).[1] The Risk Alert also provides observations of effective practices.

Noting that the US Investment Company Act of 1940, the US Investment Advisers Act of 1940 (Advisers Act) and the rules under those statutes do not define "ESG" or include ESG-specific provisions, the Division made it clear that its interest in the accuracy and adequacy of disclosures provided by advisers and funds offering clients ESG investment strategies is the same as it would be for advisers and funds offering any other type of investment strategy.

ESG investing has been an examination priority in both 2020 and 2021.[2] But that understates the matter. The SEC's new webpage titled "SEC Response to Climate and ESG Risks and Opportunities" says it much better:

> As investor demand for climate and other environmental, social and governance (ESG) information soars, the SEC is responding with an all-agency approach.

The webpage highlights no less than six recent SEC developments related to ESG regulatory matters. This Risk Alert is one of them.

Exam Observations

The first observation that the staff shared is highly charged: potentially *misleading* statements regarding ESG investing processes and representations regarding adherence to global ESG frameworks. The staff's follow-on observations were similarly serious:

- despite claims to have formal processes in place for ESG investing, a lack of policies and procedures related to ESG investing;
- policies and procedures that did not appear to be reasonably designed to prevent violations of law or that were not implemented;
- documentation of ESG-related investment decisions that was weak or unclear; and

- compliance programs that did not appear to be reasonably designed to guard against inaccurate ESG-related disclosures and marketing materials.

The staff then shared additional details about its exam observations:

- **Actual portfolio management practices were inconsistent with ESG disclosures –** In addition to observing a lack of adherence to global ESG frameworks where firms claimed such adherence, the staff also observed fund holdings predominated by issuers with low ESG scores, —as measured, for example, by a sub-adviser's proprietary internal scoring system,—where such predominance appeared inconsistent with those firms' stated approaches.

  According to the staff, these inconsistencies (as well as certain observed unsubstantiated claims, discussed below) were due to a weakness in controls over public disclosures and client/investor-facing statements, a lack of documentation of ESG investing decisions and issuer engagement efforts, and failures to update marketing materials timely (e.g., an adviser continuing to advertise an ESG investment product or service it no longer offered).

As is the case with any investment strategy, verifying that actual practice and disclosed practice are consistent is paramount. The SEC has brought enforcement actions against advisers whose investment management processes or practices materially differed from their disclosures regarding the same.

- **Unsubstantiated or otherwise potentially misleading ESG claims –** The staff observed such claims in a variety of contexts, including, for example, in:
  - marketing materials for some ESG-oriented funds that touted favorable risk, return and correlation metrics related to ESG investing without disclosing material facts regarding the significant expense reimbursement they received from the fund-sponsor, which inflated returns for those ESG-oriented funds;
  - claims by advisers regarding their substantial contributions to the development of specific ESG products where, in actuality, their roles were quite limited or otherwise inconsequential; and
  - an unsubstantiated claim that the adviser only invested in companies with "high employee satisfaction."
- **Inadequate ESG mandate controls –** The staff saw weaknesses in policies and procedures governing implementation and monitoring of ESG mandates, guidelines and restrictions. For example, some advisers did not have adequate controls governing clients' negative screens. These weaknesses were particularly acute where the mandates were ill-defined, vague or inconsistent. The staff also observed advisers that:
  - did not have adequate systems to consistently and reasonably track and update clients' negative screens; and/or
  - had not yet implemented client preferences to favor certain industries or issuers because the adviser had challenges with implementing and monitoring those preferences, yet the adviser had touted in marketing materials its process for implementing those types of preferences (i.e., a positive screen).
- **Proxy voting inconsistent with stated approaches –** The staff observed inconsistencies between stated ESG-related proxy voting claims and internal proxy voting policies and practices (e.g., a claim that ESG-related proxy proposals would be independently evaluated internally on a case-by-case basis to maximize value, but internal proxy voting guidelines did not provide for a case-by-case analysis). The staff also observed claims that clients could vote separately on ESG-related proxy proposals, but clients were never provided with the opportunity to do that and no policies about these practices existed.[3]
- **Inadequate compliance programs –** The staff observed:
  - firms that engaged in ESG investing lacked policies and procedures addressing their ESG analyses, decision-making processes (e.g., adherence to global ESG frameworks, per the firm's public statements), or compliance review and oversight;

- a lack of policies and procedures to ensure firms obtained reasonable support for ESG-related marketing claims[4];
- inadequate policies and procedures regarding oversight of ESG-focused sub-advisers;
- firms that had difficulties in substantiating adherence to stated investment processes, such as supporting claims made to clients that each fund investment had received a high score for each separate component of ESG (i.e., environmental, social, and governance), when relying instead on composite ESG scores provided by a sub-adviser;
- compliance programs that were less effective when compliance personnel had limited knowledge of relevant ESG-investment analyses or limited oversight of ESG-related disclosures and marketing decisions;

> In order to effectively perform as the chief compliance officer of a firm that is engaged in ESG investing for clients, the chief compliance officer needs to have sufficient knowledge and understanding of ESG matters, both generally and specifically as they relate to the firm's own processes. The staff observed that, where compliance personnel were integrated into firms' ESG-related processes and more knowledgeable about firms' ESG approaches and practices, firms were more likely to avoid materially misleading claims in their ESG-related marketing materials and other client/investor-facing documents. The compliance personnel in these firms appeared to provide more meaningful reviews of firms' public disclosures and marketing materials; test the adequacy and specificity of existing ESG-related policies and procedures, if any (or assess whether enhanced or separate ESG-related policies and procedures were necessary); evaluate whether firms' portfolio management processes aligned with their stated ESG investing approaches; and test the adequacy of documentation of ESG-related investment decisions and adherence to clients' investment preferences.

- ineffective compliance controls and oversight of reporting to sponsors of global ESG frameworks and responses to requests for proposals and due diligence questionnaires; and
- weaknesses in compliance controls regarding performance metrics included in marketing materials (such as risk, returns and correlation metrics) and a lack of compliance review of the data underlying those measures.

> In terms of what the staff is looking for, the staff specifically mentioned as a positive observation detailed investment policies and procedures that addressed ESG investing, including specific documentation to be completed at various stages of the investment process (e.g., research, due diligence, selection and monitoring). The staff observed that these types of detailed, comprehensive investment policies and procedures resulted in contemporaneous documentation of the ESG factors considered in specific investment decisions. In addition, where multiple ESG investing approaches were employed at the same time, specific written procedures, due diligence documentation and separate specialized personnel provided additional rigor to the portfolio management process.

Continuation of ESG Examinations

The staff stated that it will continue to examine firms to evaluate whether firms:

- are accurately disclosing their ESG investing approaches and
- have adopted and implemented policies, procedures and practices that are in line with their ESG-related disclosures.

If a firm *claims to engage in ESG investing*, the Division will focus on the following three main areas:

- **Portfolio management –** Citing to Advisers Act Section 206 and the SEC's fiduciary interpretive release,[5] the Risk Alert stated that the staff will review:

- the firm's policies, procedures and practices related to ESG and its use of ESG-related terminology;
- the firm's due diligence and other processes for selecting, investing in and monitoring investments (the staff will evaluate these processes in light of the firm's disclosures on ESG investing); and
- whether the firm's proxy voting decision-making processes are consistent with ESG disclosures and marketing materials.[6]

- **Performance advertising and marketing –** The staff will review the firm's:
  - regulatory filings;
  - websites;
  - reports to sponsors of global ESG frameworks (to the extent the firm has communicated to clients and potential clients a commitment to follow such frameworks);
  - client presentations; and
  - responses to due diligence questionnaires, requests for proposals and client/investor-facing documents, including marketing materials.

The Division noted that in December 2020, the SEC adopted amendments to the Advisers Act advertising rule.[7] The amended rule is effective on May 4, 2021, and has an 18-month transition period between the effective date and the compliance date.

Although the Division observed that some advisers might seek to comply with the new marketing rule before the compliance date, the SEC's Division of Investment Management has made it clear that an adviser may not choose to comply with only some of the marketing rule requirements before the compliance date while not complying with others (and instead continue to rely on the current rule and related staff positions).[8]

- **Compliance programs –** The staff also will review the firm's:
  - written policies and procedures and their implementation;
  - compliance oversight; and
  - ESG investing practices and disclosures.

Commissioner Peirce's Public Statement on the Risk Alert

Interestingly, on April 12, 2021, Commissioner Hester Peirce issued a public statement regarding the Risk Alert. In that statement, she made a number of points and offered her views on various matters, as summarized below:

- Firms are offering ESG products because it is lucrative to do so.
- Asset manager accountability in the ESG space is important. Firms that claim to be managing ESG strategies need to explain to investors what ESG means to them, and those firms' actual ESG management practices need to match their disclosures. In other words, a firm's disclosures should match reality.
- The above is true regardless of the name of or label on the strategy. Accordingly, the Risk Alert should not be interpreted as a sign that ESG investment strategies are unique from an examination perspective: "As with any other investment strategy, advisers and funds should not make claims that do not accord with their practices, and our examiners will be looking for that consistency between claims and practice."

- Regarding proxy voting, she warned that voting "to reflect the investment adviser's views when they do not also reflect those of the client would be a violation of the adviser's fiduciary duty."
- Firms do not need to have "a separate set of policies and procedures for any investment strategy." Instead, she says that policies and procedures should be designed in light of the firm's investment strategies, whatever those happen to be.
- As is the case with any investment strategy, compliance personnel "should be familiar with the firm's business so that they can build and operate an effective compliance program for the firm, but they need not be experts in ESG . . ."
- "As with many other ESG-related matters, this risk alert raises questions of its own . . ."

Concluding Thoughts

At the end of the Risk Alert, the Division "encouraged" firms to:

- **evaluate** whether their disclosures, marketing claims and other public statements related to ESG investing are accurate and consistent with internal firm practices;
- **ensure** that their approaches to ESG investing are:
  - implemented consistently throughout the firm;
  - adequately addressed in the firm's policies and procedures; and
  - subject to appropriate oversight by compliance personnel; and
- **consider** taking steps to document and maintain records relating to important stages of the ESG investing process.

We recommend that firms do so as well. As we've said in the past, examination risk alerts serve as "fair warning" to firms. But in this case, our warning for firms is a bit stronger. Given the intense and increasing legal and regulatory focus on ESG investing and the continued exponential popularity and growth of ESG investing (including with retail, senior and other groups of investors mentioned in the examination priorities), we would call this the perfect storm. In fact, the staff called out the fact that the rapid growth in demand for ESG products and services, coupled with the absence of standardized and precise ESG definitions, presents risks such as investor (particularly retail investor) confusion, particularly where investment advisers and funds have not clearly and consistently articulated how they define ESG, how they use ESG-related terms and how they employ investment strategies consistent with the foregoing.

We have seen this over and over again in the past, whether on a firm-specific basis or related to an industry trend (e.g., target-date funds; alternative fund strategies): whenever there is a rush to offer an investment product, strategy or service, for whatever reason, the marketing "cart" is often put before the compliance and risk management "horse," which can have dire consequences. The past is prologue, and we hope the foregoing warnings are taken seriously when implementing an investment strategy and marketing campaign designed around a popular, shiny and fairly new object attractive to many retail and institutional investors.

For more information about the topics raised in this Legal Update, please contact either of the following lawyers.

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Endnotes

[1] The Risk Alert uses the term "ESG" in the broadest sense to encompass terms such as "socially responsible investing," "sustainable," "green," "ethical," "impact," or "good governance" to the extent they describe environmental, social, and/or governance factors that may be considered when making an investment decision.

[2] See https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2020.pdf and https://www.sec.gov/files/2021-exam-priorities.pdf See also our Legal Updates at https://www.mayerbrown.com/en/perspectives-events/publications/2020/04/secs-ocie-risk-alerts-examination-focus-on-compliance-with-regulation-best-interest-and-form-crs and https://www.mayerbrown.com/en/perspectives-events/publications/2021/03/secs-division-of-examinations-2021-exam-priorities-investment-advisers-and-investment-companies

[3] See Commission Guidance Regarding Proxy Voting Responsibilities of Investment Advisers, Release No. IA-5325 (Aug. 21, 2019) and Supplement to Commission Guidance Regarding Proxy Voting Responsibilities of Investment Advisers, Release No. IA-5547 (July 22, 2020). See also our Legal Updates at https://www.mayerbrown.com/en/perspectives-events/publications/2019/09/sec-publishes-guidance-on-the-proxy-voting-responsibilities-of-investment-advisers and https://www.mayerbrown.com/en/perspectives-events/publications/2020/07/us-sec-issues-supplementary-proxy-voting-guidance-for-investment-advisers

[4] Under recently adopted amendments to the advertising rule under the Advisers Act, advisers may not include in an advertisement a material statement of fact that the adviser does not have a reasonable basis for believing it can substantiate upon demand by the SEC. See https://www.sec.gov/rules/final/2020/ia-5653.pdf

[5] See https://www.sec.gov/rules/interp/2019/ia-5248.pdf See also our Legal Update at https://www.mayerbrown.com/en/perspectives-events/publications/2019/06/sec-publishes-final-interpretation-of-investment-adviser-standard-of-conduct

[6] See our Legal Updates at https://www.mayerbrown.com/en/perspectives-events/publications/2019/09/sec-publishes-guidance-on-the-proxy-voting-responsibilities-of-investment-advisers and https://www.mayerbrown.com/en/perspectives-events/publications/2020/07/us-sec-issues-supplementary-proxy-voting-guidance-for-investment-advisers and blog posts at https://www.eyeonesg.com/2021/03/the-us-department-of-labors-non-enforcement-policy-on-recent-esg-and-proxy-voting-rules/#more-2487 https://www.fundsandim.law/2021/01/final-erisa-regulations-describe-fiduciary-duties-related-to-plan-proxy-voting/ https://www.freewritings.law/2020/07/amendments-to-proxy-rules/ https://www.usbenefits.law/2021/01/proxy-voting-erisa-regulations/ https://www.usbenefits.law/2021/02/2021-fiduciary-compliance-checklist/#more-2472, and https://www.usbenefits.law/2020/10/to-vote-or-not-to-vote-that-is-the-question/

[7] See our Legal Update https://www.mayerbrown.com/en/perspectives-events/publications/2021/02/what-is-the-fate-of-the-new-marketing-rule-for-investment-advisers

[8] See https://www.sec.gov/investment/marketing-faq

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Updates from the SEC's Acting Director of the Division of Corporation Finance

By Christina M. Thomas on April 8, 2021

SEC Division of Corporation Finance Acting Director John Coates participated in a fireside chat on April 7, 2021 during the annual Global Capital Markets & the US Securities Laws program hosted by the Practicing Law Institute (PLI).

Acting Director Coates, when asked about his priorities at the SEC, mentioned three items: the "unprecedented surge" in special purpose acquisition company (SPAC) filings, reporting company ESG disclosures (including disclosure of climate change and potentially political spending), and improvement of the proxy voting system (commonly referred to as "proxy plumbing").

With respect to ESG issues on a global scale, Acting Director Coates provided insight into the International Organization of Securities Commissions' recent statement announcing the creation of a Technical Expert Group co-led by the SEC to undertake an assessment of the recommendations to be developed as part of the IFRS Foundation's sustainability project. He explained that, while the outcome of the assessment remains to be seen, it is his hope that this project will result in a consistent, harmonized global standard for ESG disclosure.

Acting Director Coates also addressed the SEC's interim final rules implementing the Holding Foreign Companies Accountable Act, highlighting the fact that the SEC will need to wait for the Public

Company Accounting Oversight Board to put a process in place to identify jurisdictions in which authorities restrict the ability for audit firms to comply with US requirements. He also stated that there would likely be no disclosure required from reporting companies to the SEC until 2023.

In closing, Acting Director Coates returned to the topic of SPACs, warning the audience to "be careful what you wish for" and noting that there may be significant issues that have yet to be discovered.

Free Writings & Perspectives

News and Views on Securities Regulation and Capital Formation

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How do you value your social and human capital?

Human capital disclosures findings from 2020 10-Ks

The better the question. The better the answer.
The better the world works.

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Human capital disclosures

Trends and observations

Background

In August 2020, the Securities and Exchange Commission (SEC) introduced an important new requirement for registrants to provide disclosures about human capital. The new requirements were introduced in connection with the SEC rulemaking streamlining some of the disclosure requirements for business, legal proceedings and risk factors under Regulation S-K.

Commencing with most reports filed after 9 November 2020, companies now provide in their annual reports and registration statements a description of human capital resources to the extent material to an understanding of their business. Specifically, a registrant must disclose a description of "human capital resources, including the number of persons employed" and "measures or objectives that the registrant focuses on in managing the business (such as depending on the nature of the registrant's business and workforce, measures or objectives that address the development, attraction and retention of personnel)."

As companies adopted this new principles-based rule, many for the first time considered how to incorporate this type of data into their 10-K filings. Cross-functional teams came together to discuss questions such as these: What information should be included? How many pages should be provided? Should any, or how many, quantitative metrics be included? How should we align this disclosure with other human capital communications published outside the 10-K, such as in a sustainability report? Are any specific human capital topics considered more important to include than others? What are the aspects of disclosure controls and procedures that should be considered?

Undoubtedly, the disclosure will continue to evolve as a result of market and investor feedback and analyses, lessons learned from peer and sector practices, and the SEC comment and review process, as well as companies' enhanced data and information gathering practices in future years, given the need to comply quickly.

In this document, we outline how companies answered some of those questions during the initial year by providing some key takeaways from an analysis of selected filings of S&P 500 filers.

> "
>
> The rules we adopt today update various Regulation S-K items that essentially have not changed in over 30 years. Our economy, and the world economy, have changed markedly in that time, and many of our rules, which were well rooted in the characteristics of the economy of the 1970s and 1980s, simply have not kept up ... Today's rules reflect that important and multifaceted shift in our domestic and global economy.
>
> Our rules also are designed to elicit disclosure tailored to each company's particular industry and business model while being flexible enough to continue to allow for fulsome disclosure as businesses evolve in the future.
>
> **Jay Clayton**
>
> Former Chairman of the U.S. Securities and Exchange Commission

Findings

We included 143 S&P 500 companies in our results;[1] while this represents some early findings and does not present the entire population of the S&P 500, we believe our findings are useful to help inform those who are looking to make decisions about how to approach these disclosures in their future filings.

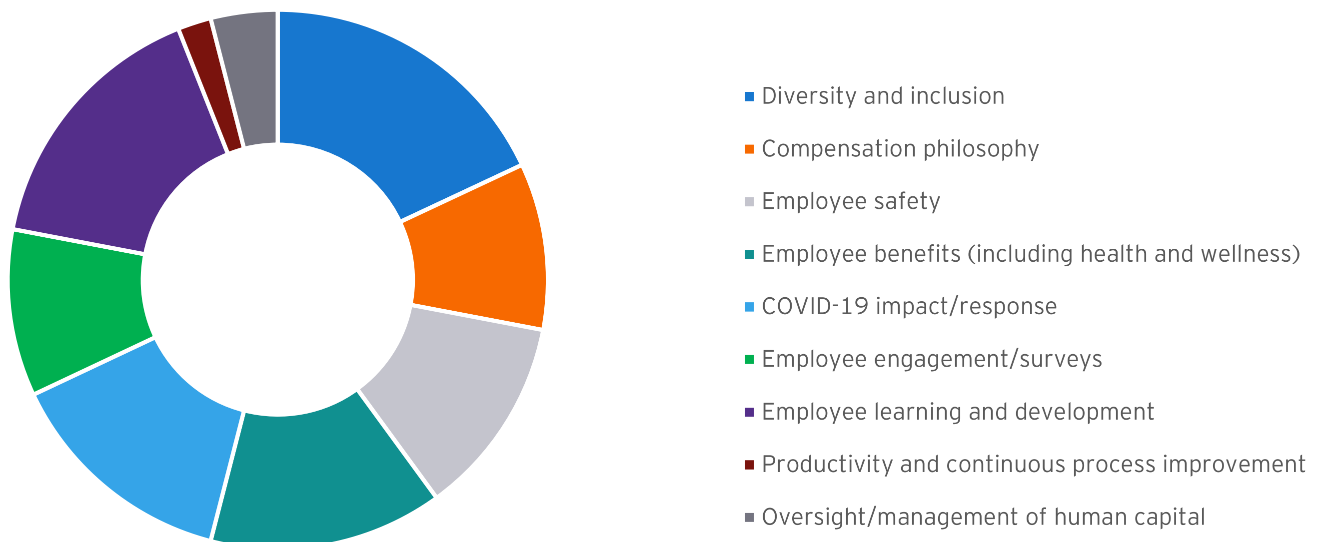
Length — We understand that companies had significant internal discussions about just how much information to include, given that the SEC rule outlined only one specific metric, the number of employees (which was previously required), while pointing to the inclusion of others using principles.

Not surprisingly, we observed a wide range of pages of human capital disclosures, from a single paragraph/quarter of a page to three pages. On average, companies included approximately one page, and the mode was one page as well.

Qualitative versus quantitative — A second area where a strategic decision needed to be made was the interplay between narrative discussion and specific metrics. The majority of companies employed mostly qualitative disclosure, describing how they considered human capital, including metrics to underscore and explain points. Approximately two-thirds of companies included at least one specific figure or metric in addition to the number of employees. As examples, some included a breakout of the employees by geography, number of part- and full-time employees, number or percentage of employees covered by collective bargaining agreements, or gender. Others included attrition rates and employee engagement survey results, as well as injury incident rates, to share information associated with employee safety.

Key themes — Below is a summary of human capital disclosure themes noted in 10-K filings. The bigger the slice of pie, the more frequently this theme was discussed in 10-K filings. An industry breakdown of this analysis can be found in the appendix.

Disclosure themes



[1] Obtained from filings made through February 15, 2021.

- Diversity, Equity and Inclusion (DE&I) — The most common theme discussed was DE&I. The majority had at least a qualitative discussion of the topic. More than a quarter of the companies included a metric showing the breakdown of employees by gender. A similar number also included specific figures around ethnic diversity.

Investors, particularly those teams focused on proxy voting and stewardship policies, continue to show interest in this area. For example, in a letter from State Street Global Advisors in January 2021, the investment firm indicated that its voting policies with respect to the nominating-governance committee of investees would depend on the specific disclosure of board-level diversity and workforce-level diversity in upcoming proxy seasons.

- Employee benefits — A description of benefits offered to employees was one of the top disclosure themes in our sample. Many companies noted that attracting and retaining talent was a key business objective, and the benefits offered to employees were described to highlight how the companies attempted to meet that goal using a variety of compensation and benefits means.
- Employee learning and development — Employee learning and development was another topic discussed, including objectives and practices to attract, develop and enhance employees' skill sets. Many disclosed, in a narrative form, training programs and opportunities offered, while some supplemented this discussion with a dollar amount invested in training during 2020.
- Employee safety — While COVID-19 impacts were often discussed separately, many companies highlighted employee safety as a focus area for management of the business, specifically those with manufacturing and industrial activities. Some disclosed specific incident rates or goals/objectives related to employee safety, while others described their policies and procedures at a higher level.

> "I would expect that the material human capital information for a manufacturing company will be vastly different from that of a biotech startup, and again vastly different from that of a large healthcare provider. And the human capital considerations for a multi-national car manufacturer will be different from that of a regional home manufacturer. It would run counter to our proven disclosure system, particularly as we first increase regulatory emphasis in an area of such wide variance, for us to attempt to prescribe specific, rigid metrics that would not capture or effectively communicate these substantial differences.
>
> **Jay Clayton**
>
> Former Chairman of the U.S. Securities and Exchange Commission

- Employee engagement/surveys — Many companies discussed their use of employee surveys to evaluate the level of satisfaction of their people and areas that can be improved. Most did not disclose specific findings from the surveys or trends.
- Compensation philosophy — Some companies discussed compensation philosophy, most often at a high level.
- COVID-19 impact/response — Many companies separately discussed their responses to the global COVID-19 pandemic, including as it relates to their workforce. In this disclosure, companies discussed aspects of well-being, health and safety, and work-from-home arrangements. Some included this discussion in the Management, Discussion & Analysis (MD&A) section of their 10-K, while others included it as part of the new human capital disclosures in Item 1.

Further information related to these disclosures by sector can be found in the appendix.

Future considerations

This was the first year of disclosures in this area. Our analysis shows a wide disparity in the extent and areas discussed, as well as depth and approach that companies used to craft their disclosures, including in their use of measures, quantitative goals and targets, as well as key human capital-related performance indicators. Such variation is inherent in the nature of a principles-based disclosure regime: the varying human capital practices employed by companies, coupled with it being a first year for these disclosures. It is our expectation that these disclosures will continue to evolve and be refined, with greater adoption of leading practices, and given the potential for greater investor scrutiny, as well as regulatory interpretation. As noted above, this SEC rule became effective November 2020, and, as such, the disclosures in our sample represent the initial efforts of companies to comply with the new requirements with little lead time. During 2021, as investor pressure increases and the SEC has signaled that environmental, social, and governance (ESG) will be a priority, we expect companies to continue to evolve their human capital disclosures, enhance their ability to collect data, and consider further disclosure controls and processes that could allow for more to be included in the 10-K.

Frequently asked questions

1. *When do we need to adopt the rule?*

It is effective for annual reports and registration statements filed on or after 9 November 2020.

2. *Where are the new disclosures made?*

They are to be included, to the extent appropriate, in Item 101 disclosures of Form 10-K (in the description of the business). The disclosures may also be made elsewhere (e.g., in the MD&A section. But, in that instance, Item 101 should have a cross-reference to the other section. Note that these disclosures are not required in quarterly filings.

3. *Who is required to adopt the rule?*

SEC registrants, except for most Foreign Private Issuers (FPIs). An FPI would be required to adopt the rule if it chose to file in the US using Form 10-K.

The rule is also required for Emerging Growth Companies.

It is not mandatory for Smaller Reporting Companies (SRCs). An SRC can choose to comply with paragraph (h) instead of any of the other paragraphs in Item 101. The SEC did not add human capital disclosures to paragraph (h), thus giving SRCs the option to disclose voluntarily.

4. *Should I talk about my supply chain personnel, or contractors, even though they are not technically employees?*

It depends on whether or not the disclosure would be material to an understanding of the registrant's business. The SEC included the following in the final rule:

"We note that, under the principles-based approach we are adopting, to the extent that a measure, for example, of a registrant's part-time employees, full-time employees, independent contractors and contingent workers, and employee turnover, in all or a portion of the registrant's business, is material to an understanding of the registrant's business, the registrant must disclose this information."

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Appendix

Methodology

We assessed 10-Ks filed by S&P 500 companies between 8 November 2020 (the effective date of the Rule) and 15 February 2021, capturing the following information:

- Company industry
- Page length of human capital disclosure section
- Themes (e.g., diversity, equity and inclusion) outlined in the disclosure
- Metrics included in the disclosure (yes/no)

Industry highlights

A few trends were noted in the human capital disclosures by industry:

- Four topics were observed by at least one company within each industry across all industries: diversity, equity and inclusion; employee safety; COVID-19 impact/response; and employee learning and development.
- In the compensation philosophy and employee engagement/surveys, two topics saw the greatest variability across industries. Approximately 80% of filings in the communication services and real estate industries discussed this, whereas 0% of the materials industry and the utilities industry discussed it.
- Less than 40% of companies disclosed oversight/management of human capital across all industries.
- On average, companies included in the real estate, industrials, energy, materials and communication services industries discussed the greatest number of themes in their human capital disclosure.
- The utilities industry discussed the fewest number of themes, which included the following four: diversity, equity and inclusion; employee safety; COVID-19 impact/response; and employee learning and development.

The details of our findings by sector are included below. These charts depict how frequently a theme was discussed as compared to other themes.

Industry insights

Communication services

- Diversity and inclusion
- Compensation philosophy
- Employee safety
- Employee benefits (including health and wellness)
- COVID-19 impact/response
- Employee engagement/surveys
- Employee learning and development

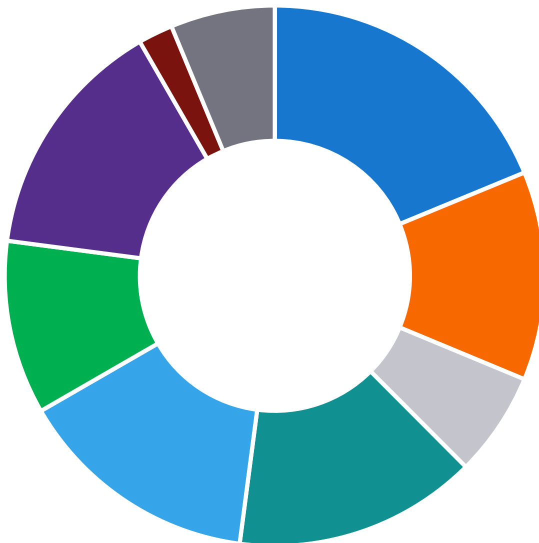
Consumer discretionary

Consumer staples

Energy

- Diversity and inclusion
- Compensation philosophy
- Employee safety
- Employee benefits (including health and wellness)
- COVID-19 impact/response
- Employee engagement/surveys
- Employee learning and development
- Productivity and continuous process improvement
- Oversight/management of human capital

Financials



- Diversity and inclusion
- Compensation philosophy
- Employee safety
- Employee benefits (including health and wellness)
- COVID-19 impact/response
- Employee engagement/surveys
- Employee learning and development
- Productivity and continuous process improvement
- Oversight/management of human capital

Health care

- Diversity and inclusion
- Compensation philosophy
- Employee safety
- Employee benefits (including health and wellness)
- COVID-19 impact/response
- Employee engagement/surveys
- Employee learning and development
- Oversight/management of human capital

Industrials

- Diversity and inclusion
- Compensation philosophy
- Employee safety
- Employee benefits (including health and wellness)
- COVID-19 impact/response
- Employee engagement/surveys
- Employee learning and development
- Productivity and continuous process improvement
- Oversight/management of human capital

Information technology

- Diversity and inclusion
- Compensation philosophy
- Employee safety
- Employee benefits (including health and wellness)
- COVID-19 impact/response
- Employee engagement/surveys
- Employee learning and development
- Oversight/management of human capital

Materials

- Diversity and inclusion
- Employee safety
- Employee benefits (including health and wellness)
- COVID-19 impact/response
- Employee engagement/surveys
- Employee learning and development

Real estate

- Diversity and inclusion
- Compensation philosophy
- Employee safety
- Employee benefits (including health and wellness)
- COVID-19 impact/response
- Employee engagement/surveys
- Employee learning and development
- Oversight/management of human capital

Utilities

- Diversity and inclusion
- Employee safety
- COVID-19 impact/response
- Employee learning and development

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