NO. 42514-9-II

COURT OF APPEALS, DIVISION II
OF THE STATE OF WASHINGTON

CASHMERE VALLEY BANK,

Appellant,

v.

STATE OF WASHINGTON, DEPARTMENT OF REVENUE,

Respondent.

BRIEF OF RESPONDENT

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I. INTRODUCTION

This case takes the Court to the world of bank investments and what an ordinary individual investor might consider high finance. The issue is the taxability of income Cashmere Valley Bank earned during 2004-2007 on investments in securities called "collateralized mortgage obligations" and "real estate mortgage investment conduits." During the tax period, financial businesses could deduct from the measure of their business & occupation ("B&O") tax "amounts derived from interest received on investments or loans primarily secured by first mortgages or trust deeds on nontransient residential properties." RCW 82.04.4292 (2004). There is no question that Cashmere is a financial business and that the securities Cashmere purchased were investments. The question before the Court is whether the amounts Cashmere received from these investments represented interest received on investments primarily secured by first mortgages or trust deeds on residential properties.

Applying the plain language of RCW 82.04.4292, the answer is in the undisputed facts in the record: The investments were a type of debt security (or bond), and Cashmere's right to receive interest was based on a defined set of rules set out in the disclosure documents pertaining to the particular class of bond Cashmere purchased, rather than by the terms of any mortgage loan. The interest Cashmere received was not from any

mortgage loans issued or purchased by Cashmere, and the investments were not secured by first mortgages or trust deeds on nontransient residential properties. Consequently, the income did not qualify for the deduction in RCW 82.04.4292 as a matter of law. The trial court properly granted summary judgment to the Department, and this Court should affirm that ruling.

II. COUNTERSTATEMENT OF THE ISSUE

During the tax period in this case, RCW 82.04.4292 allowed financial businesses a limited deduction from B&O tax for "amounts derived from interest received on investments or loans primarily secured by first mortgages or trust deeds on nontransient residential properties." Did interest income Cashmere received from investments in collateralized mortgage obligations and real estate mortgage investment conduits qualify for this deduction when: (a) the interest paid to Cashmere was owed by bond issuers, not by mortgage brokers; and (b) the investments were not secured by first mortgages or trust deeds on nontransient residential property?

III. STATEMENT OF THE CASE

Cashmere Valley Bank is a Washington corporation engaged in banking. CP 12-13, ¶¶ 1, 4. During the period at issue, Cashmere invested some of its excess funds in derivative mortgage-backed

securities, including collateralized mortgage obligations and real estate mortgage investment conduits. CP 124, ¶ 5.

A. History And Overview Of Mortgage-Backed Securities

To understand the investments at issue in this case, a brief introduction to mortgage-backed securities and the evolution of these securities is helpful. A "mortgage-backed security," or "MBS," is a generic term that includes a variety of instruments that represent investments related to a pool of mortgage loans. *See generally* Edward L. Pittman, *Economic and Regulatory Developments Affecting Mortgage Related Securities*, 64 Notre Dame L. Rev. 497, 499 (1989). The specific characteristics of each instrument determine whether income from the investment qualifies for the deduction in RCW 82.04.4292.

1. Mortgage pass-through certificates

Real estate mortgage loans are typically long-term obligations, and each individual loan "is unique in size, yield, and risk, much like the real property that serves as its collateral." 7 J. William Hicks, *Exempted Transactions Under the Securities Act of 1933* § 1:83 (2012) ("*Exempted Transactions*").[1] These unique characteristics historically made mortgage loans difficult to market as investments on a secondary market. *Id.* However, by the mid-1970s an active market for investments in

[1] Excerpts from this treatise are appended to this brief.

"mortgage-backed" securities began to develop. *Id.* at n.1. In general terms, a mortgage-backed security is created when individual mortgage loans are pooled and "securitized" by selling investors an interest in the pool. *See* CP 682-83 (testimony of Cashmere's expert Michael Gamsky discussing what is meant by "securitizing" assets). The manner in which these mortgage-backed investments are created is constrained in large part by federal income tax, securities, and bankruptcy considerations. The simplest form of a mortgage-backed security is the "mortgage pass-through certificate" (also referred to as a "mortgage pass-through security" or "pass-through MBS"). More sophisticated forms of MBSs include mortgage-backed bonds, collateralized mortgage obligations, and real estate mortgage investment conduits, discussed below.

A mortgage pass-through certificate is simply a participation interest in a trust where the purchaser of the certificate receives beneficial ownership of a fractional undivided interest in a fixed pool of mortgage loans. Pittman, 64 Notre Dame L. Rev. at 499. Each fractionalized interest is entitled to a pro-rata share of the interest and principal payments that are generated by the underlying mortgage loans. *Exempted Transactions*, § 1:92; CP 619 (testimony of Cashmere expert Chirag Shah regarding pass-through MBSs). Thus, "[p]rincipal and interest payments on a pool of mortgages, less servicing costs and fees, 'pass through' to the

holders of the securities." *Exempted Transactions*, § 1:92. As explained by Alan Crain, Cashmere's former chief financial officer, a mortgage pass-through certificate "has the characteristics of the mortgages themselves. So if it's all 30-year mortgages and you buy an interest . . . you have an interest in a 30-year payment stream." CP 413.

Creation of a mortgage pass-through certificate begins with the formation of a pool of mortgages. The mortgages in the pool may be originated by the issuer or purchased from other lenders. Pittman, 64 Notre Dame L. Rev. at 502. Once the issuer gathers the pool of loans, that pool is transferred into a trust. Investors then purchase participation interests in the trust, and the trustee typically delivers certificates to the investors evidencing beneficial ownership in the pool. *Id.* The originator (*i.e.*, the entity that pooled the loans and created the trust) will typically service the pool of loans by collecting mortgage loan payments on behalf of the investors and performing other duties "comparable to those of a lender including foreclosing on defaulted mortgage notes." *Id.*

Historically, the pool of mortgage loans was placed into a trust for federal income tax reasons. Often, the goal was to qualify as a "grantor trust," where the trustee "had to be essentially passive, so that it would not be viewed as being engaged in a business." *Id.* at 503. If the trust qualified as a "grantor trust" for tax purposes, "its existence was ignored

and investors were treated as owners of proportionate interests in the underlying pool of mortgages." *Id.* In this way, income the trust received and distributed to investors was subject to federal income tax only at the investor level. However, if the trust did not qualify as a grantor trust, then both the trust and the investors would owe federal income tax on income generated by the trust. Thus, to maintain grantor trust status, "the trustee could not have any power to substitute mortgage loans, allocate principal and interest payments, or reinvest prepayments from the mortgages for the benefit of investors." *Id.*

Because the trustee's actions with respect to the trust assets were severely constrained by these grantor trust rules, prepayments on the underlying mortgage loans resulting from the sale, refinancing, or foreclosure of mortgaged property were passed through pro-rata to the investors, making it difficult to accurately forecast the actual income an investor could expect from the investment. *Id.* at 503-04. In addition to the problems caused by prepayments on the underlying mortgage loans, the inability of the trustee to add to or otherwise alter the pool of loans made pass-through certificates less desirable for investors seeking short-term or medium-term investments. *Id.* at 505. Because of these limitations, more sophisticated mortgage-backed securities were developed.

2. Mortgage-backed bonds

"Mortgage-backed bonds" are another type of mortgage-backed security, although fundamentally different from mortgage pass-through securities. A mortgage-backed bond, like a corporate bond, is a general obligation of the issuer. Pittman, 64 Notre Dame L. Rev. at 500. Investors purchase the debt instrument (the bond) from the issuer, not a pro-rata participation interest in the assets. Thus, while the issuer receives payments of principal and interest on the underlying pool of mortgage loans when paid by borrowers, "a mortgage-backed bond will typically pay interest to investors semi-annually from the issuer's general funds, and pay principal at maturity." *Id.* In this respect, mortgage-backed bonds are essentially equivalent to traditional corporate bonds. *Exempted Transactions*, § 1:95.

3. Collateralized mortgage obligations

In 1983, the Federal Home Loan Mortgage Corporation ("Freddie Mac") developed a new type of mortgage-backed security "that seemed to provide an answer to" some of the problems encountered in marketing less sophisticated MBSs. Pittman, 64 Notre Dame L. Rev. at 506. This new instrument, called a "collateralized mortgage obligation" or "CMO," was a debt security (*i.e.*, a bond) issued by Freddie Mac and collateralized with mortgage pass-through securities that had been issued and guaranteed by

Freddie Mac. *Id.* The advantages of this new investment were "heralded widely," and before long other issuers began creating and offering CMOs to investors. *Id.*

A CMO is a type of "pay-through bond" that combines elements of both mortgage pass-through certificates and mortgage-backed bonds. *Id.* at 507 & n.47. Thus, while investors do not obtain a pro-rata participation interest in the CMO or its assets, the interest and principal payments made to bondholders are funded exclusively from interest and principal payments received by the issuer of the CMO from the underlying trust assets. Moreover, the CMO structure allows for active management of the trust assets without the adverse federal income tax consequences that limited active management of grantor trusts. *See id.* at 507 ("Since CMOs involve the issuance of debt, the issuer is able to deduct the interest paid to bondholders, thereby sheltering most of the mortgage income from double taxation.").

The first step in creating a CMO typically involves the purchase of mortgage pass-through certificates issued and guaranteed by the Government National Mortgage Association ("Ginnie Mae") or by the two "government sponsored enterprises" that purchase and pool mortgage loans – the Federal Home Loan Mortgage Corporation ("Freddie Mac")

and the Federal National Mortgage Association ("Fannie Mae").[2] Although not as common, issuers of CMOs may also purchase and pool whole mortgage loans. The pass-through certificates or whole loans are then placed in a trust or other conduit whose only assets consist of the pass-through securities or whole loans. "The conduit then issues debt with maturities linked to the income produced by the underlying mortgage securities." Pittman, 64 Notre Dame L. Rev. at 506.

The CMO issuer normally offers at least four classes of debt, also known as "tranches."[3] Those four classes are short-term, medium-term, long-term, and "zero coupon" tranches. *Id.*; *see also Exempted Transactions*, § 1:97. There may, however, be more tranches offered within a CMO, and the average term and pay-out characteristics of these more exotic tranches can vary widely.

For three of the four typical tranches (short-term, medium-term, long-term), the investor generally will receive periodic interest payments at a fixed coupon rate based on the outstanding principal balance of the bonds over the life of the investment. Pittman, 64 Notre Dame L. Rev. at 506-07. Principal payments are made differently, and the sequence in

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[2] Freddie Mac and Fannie Mae are privately held corporations, not instrumentalities of the federal government. *See* CP 757; Pittman, 64 Notre Dame L. Rev. at 499-500. Ginnie Mae, on the other hand, is a government-owned corporation within the United States Department of Housing and Urban Development. CP 730-31.

[3] The term "tranche" is French for "slice." Pittman, 64 Notre Dame L. Rev. at 506 n.44; CP 415.

which an investor will receive a return of principal depends on whether the particular tranche is designed as a "fast-pay" or "slow-pay" security:

> Principal payments from the underlying mortgage securities are allocated sequentially to the bondholders, so that all principal payments, including prepayments, are dedicated to retire the short-term tranche first, then the medium- and long-term tranches.

Id. at 507. The other typical tranche in a CMO, the zero coupon or "Z" tranche, receives interest in the form of additional or "accreted" principal, and investors in the Z tranche receive no payments of principal or interest until other designated tranches are retired. *Id.* at 507.[4]

The 2000 Bank Tax Guide provided a similar description of CMOs:

> CMOs are multi-tranche cashflow bonds that are collateralized with pass-through securities or whole loans. The cashflows of the mortgage-related products (principal and interest) are redistributed to different bond classes, known as tranches, creating long-term and short-term securities. The cashflows are used to retire the bonds, one at a time. Once the fastest paying tranche of bonds is retired, all payments are applied to the next fastest paying tranche until all are retired and the CMO is repaid.

CP 851-52 (2000 Bank Tax Guide).[5] One of the chief advantages of CMOs over earlier types of mortgage-backed securities is that CMOs are able to segment a group of pass-through securities or pool of loans into

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[4] Because one of Cashmere's representative investments was in a Z tranche, that type of investment is discussed in more detail below.

[5] Cashmere produced the excerpts from the 2000 Bank Tax Guide to the Department in discovery to support its claims. CP 325, 328.

different risk categories, allowing investors to choose the maturity and risk category of the bond suitable to their investment needs. *Id.* at 852. Issuers can even create different tranches to meet specific investor needs. CP 588-90 (testimony of Chirag Shah).

4. Real estate mortgage investment conduits

A "real estate mortgage investment conduit" ("REMIC") is essentially a CMO that qualifies for special federal tax treatment under the Internal Revenue Code. CP 852-53 (2000 Bank Tax Guide). *See also* Pittman, 64 Notre Dame L. Rev. at 508 ("In practice, REMICs operate so much like traditional CMOs, that the two terms have become almost interchangeable."); CP 594 (testimony of Chirag Shah).[6] Like CMOs, REMICs are mortgage-backed securities offering multiple tranches or classes of investments. The Fannie Mae website explains the basics of REMICs:

> A [REMIC] is a type of multiclass mortgage-related security in which interest and principal payments from mortgages are structured into separately traded securities. Introduced in the 1980s, REMICs further enhance the mortgage securities market with their increased efficiency.
>
> REMICs direct the cash flow from the underlying mortgage-related collateral into separately traded securities called classes. These classes are distinguished by their sensitivity to the prepayment risk of the underlying

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[6] Because CMOs and REMICs are indistinguishable for purposes of the issues in this case, the Department will use the terms interchangeably in this brief unless the context indicates otherwise.

> mortgage-related collateral. Therefore, they may be more or less sensitive to prepayment risk, bear different interest rates, and have various average lives and final maturities.

CP 855.

B. The Investments At Issue

During the years 2004 through 2007, Cashmere held a portfolio of investments that included collateralized mortgage obligations and real estate mortgage investment conduits. CP 15, ¶ 19.[7] During discovery, Cashmere identified six CMOs or REMICs as "representative" of all of its investments in CMOs and REMICs during the tax period. CP 328 (Interrogatory No. 17); CP 449-50.

The terms of each representative security are contained in various disclosure documents and summarized in a prospectus supplement pertaining to that security. The prospectus supplement pertaining to one of them, Fannie Mae REMIC Trust 2000-38 (hereinafter "Trust 2000-38"), is typical and explains the key provisions of a very complex financial instrument. *See* CP 355-79 (prospectus supplement). Trust 2000-38 offered sixteen "tranches" or classes, designated by letters. CP 355 (table listing 16 tranches). About half of the classes were bonds paying fixed interest, but several had floating interest rates. One class

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[7] In 2004, Cashmere's investment portfolio included 53 CMOs and REMICs. CP 419-27 (testimony of Alan Crain). By the end of 2007, Cashmere's portfolio included 78 CMOs and REMICs. CP 446.

paid principal only, and two classes paid interest only. *Id.* With the exception of the "R" class, each of the tranches was a debt instrument with specific term and pay-out characteristics. By contrast, the "R" class represented a "residual" interest in the REMIC and was more like an equity (ownership) interest in the trust than a debt instrument issued by the trust. CP 481-82; *see generally* Pittman, 64 Notre Dame L. Rev. at 509 (describing the residual interest in a REMIC).[8]

Cashmere purchased a "Z" class bond in this REMIC. CP 512; CP 630. Chirag Shah, one of Cashmere's designated expert witnesses, explained some of the key information pertaining to Z class bonds. First, he explained the sequential nature of the pay-out, or where the Z class fit within the payout scheme vis-à-vis other classes:

> Q. And what's a sequential principal type?
>
> A. Sequential, back to what we spoke about earlier, talks about the rules of cash flow. So as principal and interest comes in from the homeowners, when it comes into the deal, sequential states what order you receive the principal. So if there's two tranches, let's say the D and the Z, if the D is a first sequential, . . . until Class D . . . is gone, Tranche Z wouldn't receive any principal until it's gone.

CP 631-32. *See also* CP 369 (explanation of sequential pay-out in prospectus supplement pertaining to Trust 2000-38).

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[8] None of the CMO or REMIC investments Cashmere purchased was a residual or "R" class security. As a result, the Department has not provided a detailed explanation of residual interests.

Regarding payment of interest to investors, Mr. Shah explained that the Z tranche bond Cashmere purchased received a fixed interest rate, in this case seven percent, throughout the time Cashmere owned the investment. CP 632. However, because Cashmere held a Z class (or "accrual") bond, interest was paid in a very different way than a typical investor might expect. The interest was actually paid to two other bond classes, with equivalent amounts added to the principal amount of the Z class bond, rather than by regular interest payments to Cashmere. The effect was to postpone Cashmere's receipt of principal and interest payments on its investments until other bond class were paid fully. CP 632-35; CP 367, 369 (prospectus supplement describing how interest and principal was distributed to Z class bondholders).

Other provisions of Trust 2000-38 are explained in the prospectus supplement. CP 355-79. For instance, the assets held by the Trust for the Z class were not mortgage loans, but mortgage pass-through certificates commonly referred to as "Fannie Mae MBSs." CP 358, 362 (prospectus supplement); *see also* CP 697 (Fannie Mae REMIC prospectus regarding assets of trust).

Mortgage pass-through certificates such as those owned by Trust 2000-38 differ from CMOs and REMICs in two ways. First, there is only one class of security sold to investors. Second, mortgage pass-through

certificates (unlike CMOs and REMICs) represent a beneficial ownership of a fractional undivided interest in a fixed pool of mortgage loans. CP 619 (Chirag Shah); Pittman, 64 Notre Dame L. Rev. at 499. Simply put, investors in mortgage pass-through certificates have a beneficial ownership interest in the trust assets (the mortgage loans), while investors in CMOs and REMICs have an ownership interest only in the bond they purchased. With a CMO or REMIC, the underlying mortgage loans continue to be owned by the issuer. *See Exempted Transactions*, § 1:97; CP 845 ("Fannie Mae is at all times the owner of the mortgage note").

Chirag Shah confirmed that a mortgage pass-through security is different from a REMIC. In a pass-through MBS, the principal and interest payments from the mortgage borrowers are collected and transmitted pro-rata (by the proportion of ownership) to the holders of the certificates. CP 619. Michael Gamsky, another of Cashmere's designated expert witnesses, agreed: "[I]f you created one class of certificate, then [the cash flows are distributed pro rata]. If you created more than one class, the -- your rights to receive cash flow are whatever you . . . contractually agreed to by buying the certificate." CP 684. Likewise, Fannie Mae explains that an investor in a standard pass-through MBS "has an undivided interest in a pool of underlying mortgage loans," while

REMICs have multiple classes and "different cash flows" depending upon the class of certificate. CP 761-62.

As explained above, all of the investments at issue in this case were CMOs and REMICs, not mortgage pass-through certificates. This is undisputed. CP 15 (First Amend. Compl., ¶ 19). *See also* CP 510, 521.[9]

Another feature of Cashmere's REMIC investments is that the investments were not secured by first mortgages or trust deeds on residential properties. The REMIC trustees made a promise to pay Cashmere under the specific terms of the particular certificate or bond type, such as the Z class in Trust 2000-38. Most of the REMICs in which Cashmere invested were issued by government-sponsored enterprises, and those REMICs included a guaranty of timely payment of principal and interest on the certificates. CP 362. None of the REMICs, however, pledged any interest in real property to back up the trustees' commitment to pay.

[9] CP 510 and 521 are the last pages of lengthy spreadsheets produced to the Department by Cashmere in discovery showing the investments originally at issue in this case for 2004 and 2005. Column "DC" of the spreadsheets provides identification codes explaining the type of security listed. Securities identified by the code "4.b.1" are the securities that still remain at issue in this case. Code "4.b.1" identifies "[a]ll classes of collateralized mortgage obligations (CMOs) and real estate mortgage investments [sic] conduits (REMICs)." CP 339 (Federal Financial Institutions Examination Council's instructions for reporting various categories of bank-held securities). By contrast, mortgage pass-through securities are identified by code "4.a," a code that does not appear on the spreadsheets. *Id.*

The investors in REMIC certificates received a right to cash flow, but they possessed no rights against real property that secured the mortgage loans underlying the securities or mortgages in the trust. Michael Gamsky explained that an investor in a REMIC has no right to foreclose against the real property securing the mortgage loans or take other action against a defaulting mortgage borrower. CP 689-90; *see also* CP 691 (investor in REMIC has no say in loan modification upon borrower default). The trust for the mortgage pass-through security that owned the mortgage loans retained the risk of default by the borrower and the right to foreclose against the real property. CP 761 ("Because Fannie Mae guarantees the timely payment of principal and interest, it assumes the ultimate credit risk of borrowers' defaults on all mortgage loans"), CP 763 ("When a mortgage loan for which Fannie Mae bears the default risk is liquidated through foreclosure, Fannie Mae generally acquires the underlying property . . . and holds it for sale."); CP 845 (Fannie Mae servicing guide).

For REMIC investments accompanied by a guaranty, such as Trust 2000-38, investors were shielded from the effects of mortgage borrower defaults unless the trustee became unable to perform its guaranty obligations. CP 710 (Fannie Mae REMIC prospectus). The prospectus and prospectus supplement for Trust 2000-38 did not provide any rights to

REMIC investors related to borrower defaults on mortgage loans. *See* CP 355-379, 697-753. Instead, investors had rights related only to default by the REMIC trustee, such as failing to pay the investors in a class any required amount. CP 729. In that case, investors representing 25% or more of a class could terminate the trustee and appoint a successor. *Id.*

C. Procedural History

The Department audited Cashmere's B&O tax returns covering the 2004 through 2007 tax periods. The audit resulted in an assessment of additional B&O tax due on three sources of revenue: (1) mortgage servicing fees, (2) interest on SBA pool certificates, and (3) interest on investments in REMICs. CP 489-98. Cashmere paid the assessment and filed an action for refund under RCW 82.32.180. The first two audit issues have been resolved and are not at issue in this appeal. *See* CP 905-06 (settlement of mortgage servicing issue); CP 299-301 (order granting summary judgment to the Department on the SBA pool certificate issue). On the third issue, interest received on investments in REMICs, Cashmere moved for summary judgment, to which the Department responded by asking for summary judgment as the non-moving party. CP 260, 303. The trial court denied Cashmere's motion for summary judgment and instead granted summary judgment to the Department. CP 896-98. Cashmere appealed only from the order on the REMIC issue. CP 899.

IV. ARGUMENT

The B&O tax is imposed on every person "for the act or privilege of engaging in business activities" and, in the case of banks, applies to the "gross income of the business." RCW 82.04.220; .290(2)(a). The "legislature intended to impose the business and occupation tax upon virtually all business activities carried on within the state." *Simpson Inv. Co. v. Dep't of Revenue*, 141 Wn.2d 139, 149, 3 P.3d 741 (2000) (quoting *Time Oil Co. v. State*, 79 Wn.2d 143, 146, 483 P.2d 628 (1971)). As a result, unless an exemption or deduction applies, a taxpayer owes B&O tax on all income received in the course of doing business.[10]

For most businesses, income from investments may be deducted from the measure of B&O tax. RCW 82.04.4281(1). In contrast, banks and certain other financial businesses are excluded from that deduction and must pay B&O tax on most income from investments. RCW 82.04.4281(2)(b). However, during the tax period in this case, RCW 82.04.4292 allowed banks and other financial institutions the following limited deduction:

> In computing tax there may be deducted from the measure of tax by those engaged in banking, loan, security or other financial businesses, *amounts derived from interest received on investments or loans primarily secured by first*

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[10] The taxpayer has the burden of proving that it qualifies for a tax deduction and that it is entitled to a refund. *Washington Imaging Servs., LLC v. Dep't of Revenue*, 171 Wn.2d 548, 555, 252 P.3d 885 (2011); *Group Health Coop. v. Washington State Tax Comm'n*, 72 Wn.2d 422, 429, 433 P.2d 201 (1967); RCW 82.32.180.

> *mortgages or trust deeds on nontransient residential properties.*

RCW 82.04.4292 (2004) (emphasis added).[11]

Generally, taxation is the rule, and exemptions and deductions are the exception. Tax deduction and exemption statutes are narrowly construed. *United Parcel Serv., Inc. v. Dep't of Revenue*, 102 Wn.2d 355, 360, 687 P.2d 186 (1984); *Budget Rent-A-Car, Inc. v. Dep't of Revenue*, 81 Wn.2d 171, 174-75, 500 P.2d 764 (1972). If this Court determines that the statute is ambiguous with respect to investments in REMICs, it should be guided by the principle that ambiguities in a tax deduction or exemption statute are construed strictly, but fairly, against the taxpayer. *Lacey Nursing Center, Inc. v. Dep't of Revenue*, 128 Wn.2d 40, 49-50, 905 P.2d 338 (1995); *Group Health Coop. v. Washington State Tax Comm'n*, 72 Wn.2d 422, 429, 433 P.2d 201 (1967).

Applying the unambiguous language of the statute to the undisputed facts, the trial court correctly held that Cashmere's investments in REMICs did not qualify for the deduction in RCW 82.04.4292. The interest Cashmere received on its REMIC investments was interest

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[11] After the decision in *HomeStreet, Inc. v. Dep't of Revenue*, 166 Wn.2d 444, 210 P.3d 297 (2009), the Legislature amended RCW 82.04.4292 in 2010, removing the words "amounts derived from" and specifying the circumstances under which the deduction applies to loan servicing fees and other types of income associated with mortgage lending. Laws of 2010, 1st Sp. Sess., ch. 23, § 301. The 2010 amendments post-date the tax period in this case and do not address the investments at issue here.

determined by the terms of the particular bond classes (tranches) in which Cashmere chose to invest, not interest received from mortgage borrowers on mortgage notes. In addition, the investments were not secured by first mortgages or trust deeds on residential properties. This Court should affirm the order granting summary judgment to the Department.[12]

A. The Interest Cashmere Received On Its REMIC Investments Does Not Qualify For The Deduction In RCW 82.04.4292.

Cashmere has not proved that it was entitled to deduct its income from REMICs during the tax period, and the undisputed evidence demonstrates that it was not. As a matter of law, the REMIC income did not constitute "amounts derived from interest received on investments or loans primarily secured by first mortgages or trust deeds on nontransient residential properties" under RCW 82.04.4292 (2004).

1. Cashmere received interest on mortgage-derivative bond instruments, not interest on investments or loans secured by first mortgages on residential property.

The interest Cashmere received on its investments in REMICs cannot be equated with the interest any borrowers paid on first mortgage loans for residential properties. Cashmere does not dispute that borrowers on the underlying loans did not pay, owe money to, or have any valid and enforceable contracts with Cashmere. *See* Appellant's Br. at 25-26.

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[12] Here, there are no disputed issues of material fact. The issue is how RCW 82.04.4292 applies to the facts of this case, which is a question of law reviewed *de novo*. *See Washington Imaging Servs.*, 171 Wn.2d at (2011).

Instead, the interest Cashmere received was the interest the REMIC trustee committed to pay on the specific bond class (or "tranche") in which Cashmere invested.[13] Cash flows came into the trust, were shuffled around, and then were paid out to different class investors according to pay-out rules set out in the prospectus and prospectus supplement. CP 595 (Chirag Shah). Thus, mortgage borrower payments did not simply "pass through" to Cashmere.

The representative REMIC in the record demonstrates that the REMIC trustee's obligation to repay the bond principal and interest was separate and distinct from the mortgage borrowers' obligations to pay principal and interest on any underlying mortgage loans. In the case of Trust 2000-38, Fannie Mae committed to pay 7.00% as the coupon rate for Cashmere's Z-class investment. CP 355, 365, 632. However, the prospectus supplement also discloses that the weighted average coupon rate for the mortgage loans comprising the pools in the MBSs providing the income for the Z-class bond ranged from 7.25% to 9.50%. CP 365 (referring to mortgage loans in Group 1 MBS); CP 355 (Z class in Group 1). Accordingly, there was no direct correlation between the interest mortgage borrowers paid and the interest Cashmere received.

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[13] Stated another way, the interest Cashmere received was not based on any mortgage borrower's promise to pay for money loaned to that borrower, but based on the REMIC trustees' promises to pay Cashmere for money Cashmere effectively loaned to the trustee when it purchased the bonds.

Cashmere's Z-class investment in Trust 2000-38 also shows the difference between the borrowers' obligations and the REMIC trustee's obligations in another way. The Z class was an "accrual" class. Interest accrued on Cashmere's investment at the rate of 7.00%, but Cashmere did not receive regular interest payments. "[W]e will not pay any interest on the Accrual Class. Instead, interest accrued on the Accrual Class will be added as principal to its principal balance on each Distribution Date." CP 367 (describing how Z class receives interest). As Chirag Shah testified, Cashmere had no immediate right to payment of this interest, but instead received it as additional principal at a later time, dictated by the terms of the REMIC documents. CP 632-35; *see* CP 369 (Z class not paid until after the principal balances of the VA and VB tranches had been paid to those investors).

In other words, because Cashmere received interest on REMIC investments based on an obligation separate and distinct from the obligations of any borrowers to pay interest on their mortgage loans, the interest income was fully taxable and did not qualify for the deduction in RCW 82.04.4292.

2. The investments at issue here are not equivalent to investments in mortgage pass-through securities.

The foregoing features of a representative REMIC investment in this case also demonstrate the reason for distinguishing between investments in mortgage pass-through securities and investments in REMICs and CMOs. As discussed earlier, a mortgage pass-through security is a single-class security created from a pool of mortgage loans, and the cash flow of the pass-through certificate mirrors that of the underlying mortgages loans. CP 850 (2000 Bank Tax Guide). Shares in a mortgage pass-through security represent participation interests analogous to those of a partnership – payments from borrowers of the underlying loans are collected and transmitted by the proportion of ownership to the shareholders. CP 619 (testimony of Chirag Shah); CP 684 (testimony of Michael Gamsky).

In contrast, this "pass-through" characteristic of the cash flows does not exist with REMICs.[14] For REMICs, which are multi-class

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[14] The term "pass-through" can be confusing in the context of the investments discussed here. As used in this brief, it relates to whether mortgage borrower loan payments are paid to a person (or entity) that owns the rights to those payments, either as a purchaser or assignee of the loan or as an investor in a security with an undivided interest in the payments (i.e., MBSs). Although REMIC trustees do not "pass through" loan payments to investors, confusion can arise because REMICs are referred to as "pass through" entities for federal tax purposes. In the Tax Reform Act of 1986, Congress allowed CMOs to elect to be a REMIC to avoid taxation of the entity or trust. CP 852-53 (2000 Bank Tax Guide). Thus, for purposes of federal income tax, only the REMIC investor owes tax on that income. CP 594-95. Federal taxes are not at issue here. Similarly, the tax issue in this case is not related to whether a certain portion of a

securities, the rights to receive cash flow are dictated by the terms of the disclosure documents for the particular bond class that the investor agrees to purchase. CP 595; CP 684; CP 761-62. In other words, different REMIC classes created using the same source of cash flow (*i.e.*, the same pool of mortgages or MBSs) will have different terms – different interest payments, different periods of repayment, different risks – that are established contractually by the REMIC issuer.

Cashmere conflates the discussion of mortgage pass-through securities and REMICs throughout its opening brief, repeatedly referring to REMICs as if they were mortgage pass-through securities, comprised of nothing more than pools of mortgages in which borrower payments are merely "passed through" to REMIC bondholders.[15] They are not the same – the investments at issue here were not pass-through mortgage backed securities. CP 510, 521 (column DC listing investment codes); CP 339-40 (description of codes); CP 441 (Alan Crain confirming that none of the investments at issue were mortgage pass-through securities). And if they

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taxpayer's gross receipts merely "passes through" to a third party, for purposes of excluding the income from B&O taxes under WAC 458-20-111. *See, e.g., Washington Imaging Servs.*, 171 Wn.2d at 559-67 (payments a medical imaging business made to independent contractor radiologists for interpreting medical images were a cost of doing business and could not be excluded from the taxpayer's taxable gross income as "pass through" payments from patients).

[15] *See, e.g.*, Appellant's Br. at 2 ("the investments consisted of pools of loans secured by first mortgages"), 23 ("REMICs are structured . . . to receive mortgage payments, . . . which are passed through from the borrower to the mortgage servicer, and finally, to the bondholder"), 34 (REMICs "are pools of loans secured by first mortgages").

had been, there would have been no litigation here because the Department has long held that under RCW 82.04.4292, financial institutions could deduct interest received from investments in mortgage pass-through securities if the underlying mortgage loans were first mortgages on nontransient residential properties. *See* Determination No. 89-460, 8 WTD 241 (1989); Determination No. 90-288, 10 WTD 314, 317 (1990) (CP 874-78). In fact, Cashmere had investments in mortgage pass-through securities during the tax period, but they were never at issue in this litigation because the Department allowed the deduction for those investments as part of the audit. CP 442-43.

For purposes of applying the deduction in RCW 82.04.4292, the Department in 1990 drew a distinction between mortgage pass-through securities, on one side, and REMICs and CMOs, on the other, in Determination No. 90-288, 10 WTD 314, 317-18. In that published determination, the Department rejected the taxpayer's claim that investments in REMICs and CMOs should receive the same tax treatment as investments in mortgage pass-through securities. CP 876-78. The Department explained that while the primary security for investments in mortgage pass-through securities was the underlying mortgages, investments in REMICs and CMOs were backed by "a readily tradeable investment instrument rather than a qualifying mortgage." CP 878. Thus,

CMOs "are an additional step removed from the right of foreclosure against the underlying real property." *Id.*

The Department's assessment of Cashmere in this case is entirely consistent with this longstanding administrative interpretation of RCW 82.04.4292, which the Legislature has left undisturbed for two decades despite other amendments to the statute. The Court should affirm this interpretation and reject Cashmere's reading of the statute, which would allow the deduction whenever income paid on an investment allegedly can be traced back somehow to borrower payments on mortgage loans.

3. RCW 82.04.4292 does not allow a deduction for interest income simply because the payor may have used cash flow from mortgage loan payments to pay investors.

Cashmere relies on three words in RCW 82.04.4292, "derived from interest," and a misreading of two published cases to argue that its REMIC income is deductible because the trusts used cash flow from "loans primarily secured by first mortgages or trust deeds on nontransient residential properties" to make the payments to REMIC investors. Appellant's Br. at 20-29, citing *HomeStreet, Inc. v. Dep't of Revenue*, 166 Wn.2d 444, 210 P.3d 297 (2009), and *Department of Revenue v. Security Pacific Bank of Washington N.A.*, 109 Wn. App. 795, 38 P.3d 354 (2002). The Court should reject Cashmere's argument. Cashmere misreads RCW 82.04.4292, and the two cited decisions actually support the Department's

position in this case. Both decisions rest on critical facts about the investments at issue, and the absence in this case of those critical facts shows why this Court should affirm the summary judgment for the Department.

In *HomeStreet*, the taxpayer loaned money to mortgage borrowers to purchase residential properties. *HomeStreet*, 166 Wn.2d at 447. HomeStreet sold or securitized 90 percent of the loans. In some instances it sold all its rights in the loans ("servicing released" loans), and in other instances it retained the right to service the loans and receive a portion of the interest ("servicing retained" loans). *Id.* at 447-48. The issue was whether HomeStreet was entitled to take the deduction in RCW 82.04.4292 for the portion of the borrower interest payments HomeStreet received for servicing the servicing retained loans. *Id.* at 448, 451.

With respect to HomeStreet's servicing retained loans, "borrowers continued to make principal and interest payments to HomeStreet *because HomeStreet still owns a portion of the loan* and services the loans for the secondary market lenders." *Id.* at 448 (emphasis added). The court emphasized that ownership connection, explicitly distinguishing the loans HomeStreet sold in their entirety, without retaining servicing rights: "HomeStreet does not maintain any connection with loans sold on a service-released basis." *Id.*

Analyzing RCW 82.04.4292, the court identified five required elements of the statute and concluded that only the second element was at issue, whether the amount deducted "was derived from interest received." *Id.* at 449, 451. The court concluded that the amounts qualified as being "derived from interest" on the loans. The court relied on a direct connection between the mortgage borrowers and HomeStreet:

> The revenue at issue here is interest. It is the charge or price borrowers pay HomeStreet for borrowing money from HomeStreet. It is the amount owed to HomeStreet in return for the use of the borrowed money. The amount the borrowers pay to HomeStreet is on existing, valid, and enforceable contracts.

Id. at 453.

Here, in contrast, there is no dispute that the mortgage borrowers making the payments that eventually ended up being paid to Cashmere's REMIC trusts did not borrow money from Cashmere, pay Cashmere, owe Cashmere interest for the use of borrowed money, or have any "existing, valid, and enforceable contracts" with Cashmere.

Cashmere's cash flow tracing theory appears to rest on a broad statement the *HomeStreet* court made to address arguments in that case, but Cashmere ignores the context of the statement. The court stated, "Under the statute it is not essential to determine why the money is received or taken from a source. . . . The statute requires that the amount

only be '*derived* from interest.'" *Id.* at 454 (emphasis in original); Appellant's Br. at 24-25. It is a mistake, however, to sever this statement from the material facts in that case as Cashmere does.

Under *HomeStreet*, "interest" is the price paid to borrow money. *Id.* at 453. For an amount to constitute interest "it must be paid or received on an existing, valid, and enforceable obligation." *Id.* In *HomeStreet*, the court declared that HomeStreet "still own[ed] a portion of the loan." *Id.* at 448, 453. Therefore, the source of the interest HomeStreet received was the loan secured by a first mortgage. *Id.* at 454. The court distinguished the situation where HomeStreet sold the loan outright and no longer retained any portion of the loan, *i.e.*, relinquished all ownership rights. *Id.* at 448. By doing so, the court implied that if HomeStreet had been hired to service loans purchased by a trustee such as Fannie Mae – loans which HomeStreet had not originated – HomeStreet would not qualify for the deduction.

The earlier case, *Security Pacific*, also turned on ownership rights in the loans. Security Pacific loaned money to mortgage companies under revolving lines of credit to make residential loans. 109 Wn. App. at 798. In return for the funds, Security Pacific required the mortgage companies to make full assignment of the residential loans to Security Pacific. *Id.* at

798-99. Security Pacific sold most of these loans on the secondary market. *Id.* at 800.

The central issue in the case was whether the mortgage companies actually transferred ownership of the mortgage loans to Security Pacific, or merely "assigned" the promissory notes and deeds of trust as collateral for security purposes. The Court of Appeals concluded on the record before it that the assignments transferred ownership of the loans to Security Pacific. *Id.* at 807-08. The assignments therefore placed Security Pacific "in the shoes of the mortgage companies as beneficiaries under the deeds of trust executed by the underlying mortgage borrowers." *Id.* at 810. Because the assigned mortgage loans were primarily secured by first deeds of trust on nontransient residential property, any interest Security Pacific earned on a mortgage loan from the time of assignment until it sold the loan on the secondary market was deductible under RCW 82.04.4292.

Cashmere argues that ownership of the loans is not a requirement for taking the deduction. Appellant's Br. at 29, 32. Both *Homestreet* and *Security Pacific* held otherwise. Cashmere's argument is not supported by those decisions, and it should be rejected again in this case.

In related fashion, Cashmere argues that a taxpayer need not have the rights of a lender or the right to foreclose on the property to qualify for the deduction. *Id.* at 26, 35-36. Cashmere claims that to conclude

otherwise reads the word "investments" out of RCW 82.04.4292. Appellant's Br. at 26. In Cashmere's words, "[Cashmere] is receiving 'amounts derived from interest on *investments*' . . . , not amounts derived from interest on loans, and amounts derived from interest on investments is all that the statute required." Appellant's Br. at 28 (italics in original; citation omitted). The Department agrees that Cashmere received interest on REMIC investments, not interest on loans. But RCW 82.04.4292 requires more than that the taxpayer's income be "amounts derived from interest on investments."

First, Cashmere fails to appreciate that in both *HomeStreet* and *Security Pacific*, the decisions allowing the deduction under RCW 82.04.4292 were premised on the taxpayer having an ownership interest in the mortgage loans, as discussed above. *HomeStreet*, 166 Wn.2d at 448, 453; *Security Pacific*, 109 Wn. App. at 808, 810.

In contrast, Cashmere's interpretation of RCW 82.04.4292 would allow any financial business receiving interest on any investment to take the deduction when the entity paying the interest uses cash flow from mortgage loan payments to make the payments. *HomeStreet* does not support that argument, and it should be rejected as contrary to the plain language of the statute.

In addition, Cashmere's exclusive focus on the words "derived from interest" is not a proper reading of RCW 82.04.4292. The plain meaning of a statute "is discerned from all that the Legislature has said in the statute and related statutes which disclose legislative intent about the provision in question." *Dep't of Ecology v. Campbell & Gwinn, LLC*, 146 Wn.2d 1, 11, 43 P.3d 4 (2002). For Cashmere to narrow the focus to a few words is an improper approach to statutory interpretation that would expand the tax deduction beyond its plain language.

The question in this case is not merely what the words "derived from interest" mean, but what the Legislature intended by the clause "amounts derived from interest received on investments or loans primarily secured by first mortgages or trust deeds on nontransient residential properties." Under *HomeStreet*, qualifying for the deduction requires that the borrower making mortgage loan payments have an obligation to pay, or an enforceable contract with, the financial business claiming the deduction. *HomeStreet*, 166 Wn.2d at 448, 453. Under *Security Pacific*, the taxpayer claiming the deduction must be a secondary market purchaser of the loan or hold an investment such as a pass-through MBS, where the taxpayer has an undivided ownership interest in the loans equivalent to its share of the security. *See Security Pacific*, 109 Wn. App. at 800; Determination No. 89-460, 8 WTD 241, 245 (1989). In short, the

requirement of an ownership interest in the loans is just another way of stating what the statute plainly requires, that the investment be "primarily secured by first mortgages or trust deeds on nontransient residential property."

Rather than reading the word "investments" out of RCW 82.04.4292, as Cashmere argues, the Department is giving effect to all the words in the statute, including the requirement that qualifying loans or investments be secured by the specified real property interests indicated.

B. Cashmere's Investments In REMICs Were Not "Primarily Secured By" First Mortgages Or Trust Deeds On Residential Properties.

By focusing attention on the words "derived from interest" instead of reading all language in RCW 82.04.4292 together, Cashmere fails to appreciate the need for a taxpayer taking the deduction to have a secured interest in nontransient residential properties, and not merely rights to cash flow whose source may have been mortgage borrower cash flow. With arguments about "secured parties" and what is an "investment," Cashmere skirts the requirement that qualified investments be "primarily secured by first mortgages or trust deeds on nontransient residential properties." Under the undisputed facts, Cashmere's REMIC investments were not secured by first mortgages or trust deeds on nontransient residential

properties. Thus, the interest it received on these investments did not qualify for the deduction in RCW 82.04.4292.

1. To qualify under RCW 82.04.4292, interest on both "investments" and "loans" must be secured by first mortgages and trust deeds on residential properties.

In a similar vein to its arguments that ownership of the loans or having the rights of a lender is not a requirement to qualify for the deduction, Cashmere argues that the investor need not be the "secured party." Appellant's Br. at 32. Borrowing a phrase from *Security Pacific*, Cashmere claims the deduction covers "*loans* primarily secured by trust deeds on nontransient residential properties," without regard to who happens to be the "secured party." *Id.* at 33 (emphasis in original) (quoting *Security Pacific*, 109 Wn. App. at 804. It is true that the deduction in RCW 82.04.4292 does apply to interest received on *loans* primarily secured by trust deeds on nontransient residential properties. However, the deduction also applies to *investments* primarily secured by trust deeds on nontransient residential properties, and nothing in *Security Pacific* remotely hints that an investor claiming the deduction need not be a secured party.[16] Accordingly, Cashmere's argument must be rejected.

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[16] For *Security Pacific* to have made such a statement would have been nonsensical under RCW 82.04.4292: How can an investment be "secured by first mortgages or trust deeds" if the taxpayer receiving interest on the investment is not the secured party?

Cashmere also argues that loan assignments are not "investments." Cashmere disagrees with the answer the Department's counsel gave during a hearing when Judge Casey asked for an example of what would constitute an "investment" secured by real estate. Appellant's Br. at 26-27 n.16; VRP at 21-22. Counsel answered the question with the example of an investor in the secondary market who purchases the mortgage loan. *Id.* Cashmere argues strenuously that such purchasers are merely assignees who step into the shoes of the lenders, not "investors."

Cashmere's narrow view of what constitutes an "investment" or who is an "investor" is inaccurate. Washington courts have described the purchase of mortgage loans as "investments." *See Kueckelhan v. Federal Old Line Ins. Co.*, 69 Wn.2d 392, 397, 418 P.2d 443 (1966) (characterizing purchases of mortgage loans as investments). Similarly, in the REMIC prospectus, Fannie Mae described itself as "the largest investor in residential mortgage loans in the United States" because it purchases mortgage loans from lenders. CP 700. Even making mortgage loans qualifies as an "investment." *Pacific First Fed. Savings & Loan Ass'n v. Dep't of Revenue*, 92 Wn.2d 402, 405-06, 598 P.2d 387 (1979) (describing mortgage loan function of bank as "mortgage investment function"). The common and ordinary meaning of "investment" is any "expenditure of money for income or profit[.]" *Webster's Third New*

International Dictionary 1190 (2002). The Legislature gave no indication it intended any different meaning.

In all of these arguments, Cashmere essentially asks this Court to treat "investments" in RCW 82.04.4292 as something independent from "loans" for purposes of applying the deduction. Cashmere's interpretation of RCW 82.04.4292 is not reasonable. In fact, the legislative history leaves no doubt that the Legislature intended to require both "loans" and "investments" to be secured by mortgages or trust deeds on real property.[17] The trial court flatly rejected Cashmere's argument to the contrary, and this Court should too. *See* VRP 25-26.

The interest deduction was enacted in 1970 as part of an act extending the B&O tax to most financial institutions. Laws of 1970, 1st Ex. Sess., ch. 101, § 2 (CP 94). This 1970 act amended former RCW 82.04.430, adding a new subsection (10) to that section to create the first mortgage interest deduction.

Before 1970, banks and other financial institutions were exempt from the B&O tax under former RCW 82.04.400 with respect to their "banking, trust, or savings and loan business." *See* Laws of 1969, Ex.

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[17] If a statute is susceptible to more than one reasonable interpretation, it is ambiguous, and a court may resort to aids to construction, including legislative history. *Dep't of Ecology v. Campbell & Gwinn, LLC*, 146 Wn.2d 1, 12, 43 P.3d 4 (2002).

Sess., ch. 246, § 1.[18] As initially introduced in January 1970, House Bill 232 simply would have repealed former RCW 82.04.400. CP 97; *see also* House Journal, 41st Legislature (1970), at 62. Several days later, the bill was revised to allow banks and other financial businesses to claim specified deductions, including the following: "amounts derived from interest received on *investments* primarily secured by first mortgages or trust deeds on nontransient residential properties." Substitute House Bill 232, § 2(10) (CP 101) (emphasis added). In other words, even before the deduction mentioned "loans," the bill required qualifying "investments" to be primarily secured by first mortgages or trust deeds on residential property.[19]

Not until the next month did the House amend the bill to add the words "or loans" after "investments." With this and another amendment, the House passed the bill. House Journal, 41st Legislature (1970), at 503-04. The Senate immediately passed ESHB 232 as amended by the House. Senate Journal, 41st Legislature (1970), at 545-46. The amended bill

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[18] The Legislature repealed the exemption within weeks after Congress authorized states to impose nondiscriminatory gross receipts taxes on national banks. *See* Act of Dec. 24, 1969, Pub. L. No. 91-156, 83 Stat. 434.

[19] Likewise, the Department had the same contemporaneous understanding. In a fiscal note, the Department described the deduction in SHB 232 as applying to "interest received on *investments* primarily secured by first mortgages or trust deeds (on nontransient properties)." CP 104 (emphasis added).

became law, and it contained the same statutory language at issue in this case. Laws of 1970, 1st Ex. Sess., ch. 101, § 2 (CP 91-95).

As this legislative history demonstrates, from the moment the deduction was conceived, the Legislature intended to qualify the deduction by limiting it to interest from investments "primarily secured by first mortgages or trust deeds on nontransient residential properties." Cashmere's contrary interpretation must be rejected as contrary to the Legislature's intent.

2. REMICs give investors no security interest in nontransient residential real properties.

There is a significant gap in Cashmere's case – its failure to demonstrate that its REMIC investments were "primarily secured by first mortgages or trust deeds on nontransient residential properties." RCW 82.04.4292; *see HomeStreet*, 166 Wn.2d at 449. Cashmere did not offer any evidence that its REMIC investments were secured by first mortgages or deeds of trust on residential properties, either through its expert witnesses or otherwise. In fact, the undisputed evidence demonstrates that Cashmere's investments in REMICs were *not* secured by first mortgages or deeds of trust on residential properties. Cashmere failed to prove it satisfied the requirements for taking the tax deduction in RCW

82.04.4292, and the trial court properly granted summary judgment to the Department instead of Cashmere.[20]

In this case, Cashmere purchased investments in bond instruments that gave Cashmere the right to receive specific cash flows generated by the assets of the trusts at specific times. CP 595; CP 684; CP 761-62. The assets of the trust were mortgage pass-through securities comprised of pools of loans secured by first mortgages or deeds of trust on residential properties. CP 358, 362; CP 697. However, Cashmere's investments were not secured by those mortgages or deeds of trust. The REMIC trustees promised to pay Cashmere in accordance with the terms of the bond class Cashmere purchased. *See, e.g.,* CP 355, 367; CP 704. In the case of government-sponsored entities, such as Fannie Mae, the REMIC trustees also guaranteed those payments, even if mortgage borrowers defaulted. CP 355; CP 721.[21] But Cashmere's expert Michael Gamsky

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[20] *See Impecoven v. Dep't of Revenue,* 120 Wn.2d 357, 365, 841 P.2d 752 (1992) (where the facts and reasonable inferences can lead a reasonable person to only one conclusion, the court may also enter an order of summary judgment in favor of the nonmoving party); 15A Karl B. Tegland & Douglas J. Ende, *Washington Practice: Washington Handbook on Civil Procedure* § 59.4 (2002).

[21] The REMIC prospectus for Trust 2000-38 provides in part:

> Our guaranty requires that we pay Certificateholders in a timely manner the amounts of principal and interest described in the related prospectus supplement. We also must pay the full outstanding principal amount of the Certificates of each class no later than the Final Distribution Date for that class. Our guaranty is effective whether or not sufficient funds are available in the Trust Account for the series.

testified that the existence of a guaranty makes no difference with regard to whether a bond is secured or unsecured. CP 687. Therefore, these guaranties made Cashmere's REMIC investments safer, but they did not render them "primarily secured by first mortgages or trust deeds on nontransient residential properties."

The REMIC trustees provided no security interest to investors in residential real property to back their promises to pay.[22] Accordingly, the REMIC trustees' promises to pay Cashmere the principal and interest payments for the bond classes in which Cashmere invested were just that. They were backed by a guaranty in many instances and by the assets of the trust, but they were not secured by first mortgages or trust deeds on residential properties.

To avoid this explicit requirement of RCW 82.04.4292, Cashmere seems to argue, as it did to the trial court, that because the *underlying loans* in the MBSs comprising the assets of the REMICs at issue were secured by first mortgages or deeds of trust, Cashmere's investments in

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CP 721. By its explicit terms, this guaranty was independent of the mortgage loans that comprised the trust account.

[22] This Court in *Security Pacific* discussed the distinction between secured and unsecured transactions: "A promissory note is merely a promise to pay – it is not security." *Security Pacific*, 109 Wn. App. at 808. In contrast, a secured transaction provides security or collateral to back the promise to pay. *Id.*; *see also Black's Law Dictionary* at 192, 1384 (8th ed. 2004) (a "secured bond" is "[a] bond backed by some type of security," and a "security" is "[c]ollateral given or pledged to guarantee the fulfillment of an obligation"); *see also* CP 685 (Michael Gamsky's testimony that when a promise to pay is "secured by" something else, there is a separate asset outside of the deal that the creditor would own if the debtor failed to fulfill its obligation to pay).

the REMIC were similarly secured. Appellant's Br. at 28-29; CP 274 (arguing investment income may be deducted if it merely is "derived *from loans* primarily secured by" residential mortgages). This argument ignores the undisputed evidence in the record demonstrating the nature of Cashmere's REMIC investments, where Cashmere's rights to specific principal and interest cash flows were determined by the class of bond it purchased, rather than by any mortgage loans. Furthermore, Cashmere's interpretation of RCW 82.04.4292 changes the ordinary meaning of the statute to allow any financial institution receiving downstream cash flow from mortgage payments to qualify for the deduction, regardless of who originated or has any rights in the loan.

Ultimately, Cashmere confuses the rights of investors who have ownership rights in first mortgages on residential properties with its rights as a REMIC investor to receive specific sequential cash flows from the assets forming the corpus of each REMIC trust. If Cashmere's investments in REMICs were secured by first mortgages or trust deeds on nontransient residential properties, Cashmere would have rights in the event of borrower default (either as an assignee of the mortgage or participant owner holding the mortgage loans in a mortgage pass-through security). Under its REMIC investments, Cashmere has no such rights. *See* CP 689-91 (testimony of Michael Gamsky that individual investor in

REMIC would have no right to foreclose against defaulting borrower and no say in whether a borrower should be granted a loan modification). Instead, Cashmere's only rights as a REMIC investor relate to whether *the REMIC trustee* defaults, in which case a defined proportion of investors in the REMIC class (*e.g.,* the "Z" tranche) may vote to terminate the trustee and retain a successor. CP 729. Investor rights do not include selling the assets of the REMIC.

The multi-class nature of REMICs precludes treating REMIC investments as investments secured by first mortgages and deeds of trust. Unlike interests in mortgage pass-through securities, which have a single class of ownership, the bonds sold in REMICs do not provide the investor an undivided ownership right to the assets forming the trust. CP 619; CP 684; CP 761-62. Every class or tranche in a REMIC is designed to meet specific investment needs, including differences in risk, pay-out characteristics, duration, etc. CP 588-90, 592 (testimony of Chirag Shah); Pittman, 64 Notre Dame L. Rev. at 506-08. If one tranche in a REMIC had the ability to sell trust assets, the interests of investors in other tranches are likely to be impaired.[23] Accordingly, REMICs grant no such

[23] Selling the trust assets would have the same effect as all of the mortgages prepaying at once. *See* CP 708 (trustee repurchase of loans from underlying pools has the same effect as prepayment). In this situation, the principal-only bondholders would gain, while interest-only bondholders would suffer a loss. *See Glick v. United States*, 96 F. Supp. 2d 850, 863 (S.D. Ind. 2000) (when underlying mortgages are prepaid faster than

rights to investors. To the extent the investments in REMICs can be considered "secured," they are secured only by the cash flow generated by the entire group of assets in the trust, and not by any real property interests.

In summary, under the undisputed facts Cashmere did not receive "amounts derived from interest received on investments or loans primarily secured by first mortgages or deeds of trust on nontransient residential property." RCW 82.04.4292. Cashmere was not entitled to the deduction.

C. Allowing The Deduction In This Case Would Be Contrary To The Legislative Policy Expressed In The Unambiguous Language Of RCW 82.04.4292.

Cashmere argues that allowing the deduction in RCW 82.04.4292 to be applied to income from its REMIC investments would stimulate the housing market by reducing the transaction costs related to mortgages, and that denying the deduction here would frustrate the purpose of the statute. Appellant's Br. at 33-34, 36-37; *see Security Pacific*, 109 Wn. App. at 804. In effect, Cashmere asks this Court to broaden the scope of the deduction to investment income that does not otherwise qualify under the

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expected, the future interest rates that an investor was to receive are eliminated, while principal-only investor benefits by receiving payment much faster than anticipated); *see also* CP 371-72 (prospectus supplement stating that interest-only bondholders could lose money on their investments if prepayments are higher than expected). For bond classes receiving both interest and principal, the effects of a sale of trust assets or unexpected prepayment on underlying loans would depend in part upon whether the bond is a short-term, medium-term, or longer-term bond, and other specific characteristics of the bond class.

unambiguous language of the statute because doing so supposedly would be good for consumers. Cashmere asks too much of this Court.

The fundamental purpose in construing statutes is to ascertain and carry out the intent of the Legislature, which the court determines "primarily from the statutory language." *In re Schneider*, 173 Wn.2d 353, 363, 268 P.3d 215 (2011). If the statute's meaning is plain on its face, the court "give[s] effect to that plain meaning as the expression of what was intended." *Tracfone Wireless, Inc. v. Dep't of Revenue*, 170 Wn.2d 273, 281, 242 P.3d 810 (2010). The plain meaning of RCW 82.04.4292 is that the Legislature intended the deduction to apply only to interest received on investments or loans primarily secured by first mortgages or deeds of trust on non-transient residential properties. It did not allow the deduction for interest received from second mortgage loans, and it did not allow the deduction for interest received from commercial loans or car loans. Likewise, the Legislature did not allow the deduction for interest on the bond investments at issue here.

Cashmere's view that the Legislature's purpose in enacting this deduction would be served by extending the deduction to its investments in REMICs does not overcome the plain text in RCW 82.04.4292. "[N]o legislation pursues its purposes at all costs." *Rodriguez v. United States*, 480 U.S. 522, 525-26, 107 S. Ct. 1391, 94 L. Ed. 2d 533 (1987) *(per*

curiam) (rejecting argument that legislative purpose would be better served by reading statutory text more broadly). Cashmere has failed to meet its burden of proving it qualified for the deduction, and its policy arguments should be rejected.

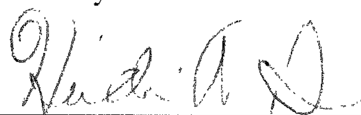
Moreover, Cashmere has not cited any evidence to support its argument that allowing the deduction for its income from investing in REMICs actually would stimulate the housing market in Washington or benefit consumers by lowering transaction costs. In fact, the legislative committee tasked with evaluating the effectiveness of various tax exemptions and deductions recently expressed doubt whether the deduction in RCW 82.04.4292 has achieved these public policy objectives since the deduction was enacted in 1970 or whether continuing the tax preference will ever do so. State of Washington, Joint Legislative Audit & Review Committee, *2011 Tax Preference Performance Reviews*, Report 12-2 at 97 (2012). One reason is that most loans in Washington are now made by out-of-state owned and operated banks, and do not depend upon the availability of local funds, unlike when the deduction was enacted. *Id.* The Committee's report underscores the reasons why courts should base decisions on statutory language and evidence in the record, rather than on unsupported policy arguments.

V. CONCLUSION

For all the foregoing reasons, the Court should affirm the trial court's order granting summary judgment to the Department.

RESPECTFULLY SUBMITTED this 3rd day of May, 2012.

ROBERT M. MCKENNA
Attorney General



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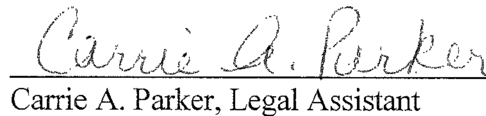

Carrie A. Parker, Legal Assistant

APPENDIX

Exempted Transactions Under the Securities Act of 1933
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J. William Hicks

Chapter
1. Introduction
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§ 1:83. Overview

West's Key Number Digest

West's Key Number Digest, Securities Regulation 5.13, 5.19

A real estate mortgage loan is customarily a long-term obligation which is unique in size, yield, and risk, much like the real property that serves as its collateral. Mortgage backed securities (MBS), which are securities collateralized by real estate mortgage loans, are traded on a securities exchange by the quasi-federal agencies, Federal National Mortgage Association and Federal Home Loan Mortgage Corporation, and by private firms. MBS serve to replenish mortgage issuers with capital funds for additional loans.

Primary market mortgage lenders have not always been successful in marketing mortgages because—unlike bonds or shares of common stock that are traded on a securities exchange—long-term mortgages traditionally have lacked liquidity.[1] With the development of an active secondary mortgage market, loans are packaged and sold at competitive prices and thereby attract more institutional investors into the market. For the loan originators, such as mortgage bankers, commercial banks, private conduits, and the recovering "thrift industry" (savings and loan associations),[2] which are all vulnerable to cyclical fluctuations in the cost of capital, the secondary mortgage market has been especially important. The market helps to assure a continuing flow of capital during periods of rapid growth when credit demand and supply vary significantly from one region of the country to another. The secondary market is able to tap funding sources outside the normal market and move capital to areas of greater demand.[3] Recent financial innovations and permutations of mortgage backed securities have increased liquidity, improved market efficiency, and have reduced risk.

Section 5 of the Securities Act of 1933 is a potential problem for lenders who intend to sell long-term mortgages in the secondary market.[4] "Security" is defined in Section 2(1) of the Act to include not only "evidence of indebtedness" but also "any certificate of interest or participation in" any evidence of indebtedness.[5] As discussed below,[6] mortgage backed securities take may different forms. Some of these securities are exempt from the registration requirements of the Act under Section 3(a)(2) which exempts "any security issued or guaranteed by the United States ... or any person controlled or supervised by and acting as an instrumentality of the Government of the United States pursuant to authority granted by the Congress of the United States."[7] Other mortgage related securities, including certain participation interests in promissory notes secured by a mortgage on real estate, are not eligible for exemption under Section 3(a)(2). Unless exempted, the offer and sale of these se-

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curities must comply with the registration requirements of the Act, an expensive and burdensome process. Section 4(2) of the Act is a possible exemption for this type of security transaction.[8] For most sellers of securities not exempted by Section 3(a)(2), however, neither Section 4(2) nor other transactional exemptions goes far enough to provide the liquidity that is really needed.[9]

Section 4(5) is an alternative exemption that certain sellers of mortgage backed securities have had available since 1975.[10] To understand its purpose and limited scope, one must first appreciate (1) the various mortgage market facilities as they relate to the secondary market, and (2) the primary characteristics of mortgage securities on the market. The first two of the three quasi-federal agencies—the Federal National Mortgage Association (FNMA) and the Government National Mortgage Association (GNMA)—are described *infra* in §§ 1:85 to 1:87. A discussion of the third agency, the Federal Home Loan Mortgage Corporation (FHLMC), and the private market immediately follow.

[FN1] The secondary mortgage market existed for years in a private and unorganized form. Prior to 1970, typical secondary mortgage financing activity occurred on a local level where the lender and investor negotiated a private sale face-to-face. See generally The Secondary Mortgage Market (Fed. Home Loan Bank Bd. 1981) (hereinafter cited as the *Secondary Mortgage Market*). The secondary market became more efficient and better organized as a result of the establishment of a not-for-profit corporation called Amminet, Inc., which was an acronym for Automated Mortgage Market Information Network. "Freddie Mac Launches Electronics Effort to Match Up Mortgage Buyers, Sellers," Wall St. J., March 27, 1974, at 30, cols. 103. AMMINET has given way to advances in computer technology and telecommunications. The information technology environment has spawned multiple vehicles for transferring information between the mortgage supply and demand markets. Compatibility of delivery systems and data format have become a prime concern for the industry. Currently, the Mortgage Bankers Association of America (MBA) Technology Committee, which provides research in mortgage banking automation and communications systems, has formed an Interagency Technology Liaison Group to meet with representatives of FNMA, FHLMC, and GNMA for purposes of (1) standardizing data transmission for loan documents and (2) integrating electronic data interchange (EDI) technology with artificial intelligence. Scally, "What's Hot in Technology," 52 Mortgage Banking 26–31 (March 1992). From supercomputing to a PC national electronic mail network, loan and pricing information are being rapidly transmitted and analyzed. See Davis, "Wall Street Discovers the Joys of Supercomputing," 26 Institutional Investor 19 (August 1992); "Freddie Mac Integrates ×.400 and Applications," 29 Communications News 20–21 (August 1992); Frank, "Low-Cost Alternative Delivers Rate Data," 110 Savings Institutions S42–S43 (January 1989).

[FN2] The assets of the thrift industry have diminished by one third since the mid-eighties and accordingly, this trend is reflected in an equally large industry-wide decrease of mortgage originations. Its leading position in the secondary mortgage market has given way to mortgage and commercial banks who are adsorbing market share at the thrift industry's expense.

During the early 1980s when interest rates were increasing, the thrift losses were the result of lending long and borrowing short. The surviving thrifts learned not to retain their fixed-rate loans and to sell them in the secondary mortgage market. The government-sponsored Federal National Mortgage Associ-

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ation (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC) purchased and/or swapped the fixed-rate mortgages in return for mortgage-backed securities (MBS). The surviving thrifts who chose not to provide fixed-rate mortgages in light of the losses experienced in earlier years, chose to invest strictly in adjustable-rate mortgages (ARMs) and, ironically, suffered debilitating losses when interest rates plummeted. ARM loans cannot grow when fixed mortgage rates fall below 9.5 percent-10.0 percent. The net result has been a dramatic decline in the thrift industry. Harting, "Residential Mortgage Business—Consolidation At Last," Fannie Mae and Freddie Mac - Company Report, Solomon Brothers, Inc. (March 10, 1992).

Currently, commercial bank holdings of MBS are 15 percent greater than the $179 billion held by savings institutions. Of the banks which hold MBS and have less than $10 million in assets, on average 57 percent of their MBS are backed by FNMA and FHLMC. However, banks with more than $10 billion in assets find GNMA two times more popular. Wilson, "Secondary Mortgage Market: Banks Become Bigger Players," 112 Savings Institutions 31–33 (1991).

[FN3] See generally *Secondary Mortgage Market.*

[FN4] 15 U.S.C. § 77e, as amended (hereinafter referred to as the Act or the 1933 Act).

[FN5] 15 U.S.C. § 77b(1), as amended.

[FN6] See *infra* §§ 1:91 to 1:98.

[FN7] 15 U.S.C. § 77c(a)(2)(1976), as amended. See, e.g., First Boston Corp., No-action letter from SEC (Sept. 13, 1982), [1982] Wash. Serv. Bur. Microfiche 526, frame F12 (undivided interests in pools of mortgage loans secured by mortgages on multi-family residential real estate projects insured by the Federal Housing Administration (FHA)); Collateral Inv. Co., No-action letter from SEC (April 12, 1982), [1982] Wash. Serv. Bur. Microfiche, fiche 479, frame C3 (GNMA mortgage-backed certificates); Salomon Brothers, No-action letter from SEC (Oct. 20, 1981), [1981–1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶77,078 (certificates evidencing interests in pools of mortgage loans insured by the FHA).

[FN8] 15 U.S.C. § 77d(2), as amended. See generally *supra* Chapter 11. See also Root & Russo, "Trading System for Mortgages Must Clear SEC Restrictions," SEC '74 105, 106 (N.Y.L.J. 1974).

[FN9] Rule 234, 17 C.F.R. § 230.234, which the SEC rescinded effective August 9, 1982, provided a transactional exemption for certain first lien promissory notes. See generally *supra* §§ 9:1 to 9:19 for a discussion of this exemption.

[FN10] 15 U.S.C. § 77d(5), as amended. See *infra* §§ 1:91 to 1:98 for a discussion of the legislative history to Section 4(5).

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§ 1:92. Mortgage backed securities—Mortgage pass-through securities

West's Key Number Digest

West's Key Number Digest, Securities Regulation ⚷5.13

Mortgage pass-through securities are instruments that are collateralized by pools of mortgage loans. Each fractionalized interest in a pool of mortgages is entitled to share in the interest income and principal prepayment and repayments that are generated by the underlying mortgages. Principal and interest payments on a pool of mortgages, less servicing costs and fees, "pass through" to the holders of the securities. Cash flow of pass-throughs may vary as a result of mortgage prepayments, which may also affect maturity date and bond yield, or defaults, which impact risk. Where the securities are accompanied by a guaranty of timely interest and principal payments, regardless of default or delinquency within the mortgage pool, risk can be minimized. An issuer guarantee may require the issuer to retain an interest in the mortgage pool or generate guarantee reserves to cover losses.[1] Qualified issuers may also consider issuing a modified pass-through security guaranteed by GNMA.

[FN1] FNMA pass-through securities were originally comprised of pools of fixed rate, conventional mortgages held in trust by FNMA. The FNMA program was expanded in 1982 to included FHA insured mortgages, VA guaranteed mortgages, and growing equity mortgages. Adjustable rate mortgages (ARMs), graduated payment mortgage loans and conventional multifamily loans were later included and currently diversify FNMA pools. The pools of mortgages, however, are not assets of FNMA, nor are the outstanding securities considered to be liabilities of the corporation. FNMA, an issuer and guarantor of the mortgage backed securities, is obligated to disburse scheduled monthly installments of principal and interest, whether or not the amounts have actually been received from the mortgagors, unscheduled principal payments when received, and the full principal balance upon liquidation of any foreclosed mortgage, whether or not the principal balance is recovered. An allowance for loss is provided by charges to income for those mortgage backed securities for which the FNMA has assumed the foreclosure loss risk. 1 Moody's Bank and Finance Manual 2618 (1992); FNMA, Guide to FNMA Debt Securities 42 (1982).

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The FHLMC issues participation certificates (PCs) which are the equivalent of pass-through securities. Participation certificates represent an undivided interest in groups of mortgages acquired by FHLMC from eligible seller-servicers. Principal and interest payments are remitted monthly as they are received from the underlying groups of mortgages. FHLMC guarantees interest at the certificate rate and the full payment of principal. Like the GNMA and FNMA mortgage backed securities, payments of interest pursuant to the FHLMC guaranty are made on a timely basis, regardless of the status of the underlying mortgage. FHLMC PCs mature, subject to possible extension by virtue of forbearance, when all underlying loans are paid or in thirty years, whichever comes first. FHLMC maintains a register of "Registered Holders" of PCs and holders must give notice to FHLMC before an assignment or transfer of certificate can be completed. Investors in PCs are not permitted to assign fractional interests in a particular PC without the prior written consent of FHLMC.

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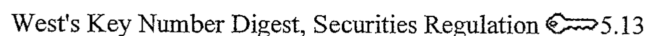
§ 1:95. Mortgage backed securities—Mortgage backed bonds

West's Key Number Digest



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Mortgage backed bonds are debt securities with a stated maturity that are collateralized by a pool of mortgages. These bonds are securitized by either conventional or government insured mortgage loans. This security differs from the pay-through obligation, discussed *infra* § 1:96, because the collateral structure is based on the market liquidation value as opposed to the level of cash flows generated. Unlike mortgage pass-through securities, discussed *infra* § 1:92, mortgage backed bonds do not provide for principal and interest payments to pass through the issuer to the holders of the securities. Instead, a separate schedule of periodic payments is arranged for each issue of bonds without regard to when the issuer of the bonds receives payments on the pool of mortgages held as collateral. In this respect, mortgage backed bonds resemble traditional corporate bonds.[1] Investors benefit from predictable payment schedules and maturity but will inevitably pay for the additional collateral burden issuers must carry to ensure the even payments.

[FN1] E.g., mortgage backed bonds are frequently issued pursuant to an indenture that provides for a sinking fund. Under such an arrangement, funds accumulated from the monthly payments made by the mortgage borrowers are placed into a sinking fund used to make periodic payments to the owners of the securities.

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§ 1:96. Mortgage backed securities—Mortgage pay-through securities

West's Key Number Digest

West's Key Number Digest, Securities Regulation 5.13

Mortgage pay-through securities are a hybrid of pass-through securities and mortgage backed bonds and are classified as debt. Like mortgage backed bonds, pay-throughs are collateralized by a pool of mortgages retained by the issuer. Like pass-throughs, interest and principal income from the mortgage pool is "paid-through" to the bond holders. Mortgage pay-throughs are additionally innovative since, unlike both bonds and pass-throughs, the payment schedule is not required to mirror the mortgage payments of the underlying loans or the scheduled debt maturity. Cash flows and maturities can be adjusted to investor preferences. The credit value of the security is based, however, on the predictability of cash flows. While investors can expect a predictable payment schedule, pay-throughs cannot assure investors that prepayments will not occur.
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§ 1:97. Mortgage backed securities—Collateralized mortgage obligations (CMOs) and real estate mortgage investment conduits (REMICs)

West's Key Number Digest

West's Key Number Digest, Securities Regulation 5.13

The collateralized mortgage obligation (CMO) is a pay-through bond divided into multiple classes or tranches, usually four, representing different maturities. Mortgages or mortgage pass-through certificates serve as the collateral for the bonds and may be retained by the issuer or pledged to the trustee or conduit as security. Traditional CMOs issued by private firms have required the creation of a subsidiary to act as trustee so as to insulate the parent company from default risk associated with the underlying mortgage loans.[1] A residual interest can be created for a CMO from additional mortgage collateral. For private firms, this supplies a form of credit enhancement. Mortgage payments, consisting of principal and interest, are paid into the trust and the interest is distributed to the holders of the tranches. The principal is disbursed depending on the maturity of the tranche held by the investor. The holder of the tranche with the earliest maturity receives all payments until the bond is retired. Each succeeding tranche is similarly paid off. The final tranche, a zero coupon bond or Z bond, is treated differently. Not only is principal withheld with a Z bond, but interest for the last tranche is accrued until all prior class have reached maturity and have been retired.[2] In place of the Z bond, floating rate tranches have been issued that receive interest from the very beginning. The CMO structure provides investors with the benefits of payment predictability and also call protection; however, the issuer must record the CMO as debt.

Prior to 1986, the trust provisions of the federal tax code presented serious limitations to issuing multiple class securities as pass-throughs. Most multiple-class investment trusts were to be treated as corporations and income from mortgage payments would be taxed at the corporate rate. The net effect was to subject security investors to the double taxation of mortgage income. Issuers then developed a multiple-class security that utilized a pay-through structure, which did not have adverse tax consequences, and called it a CMO. The disadvantage was that a pay-through was classified as debt and remained on the issuers balance sheet as such. As part of the Real Estate Mortgage Investment Conduit (REMIC) legislation in the Tax Reform Act of 1986, issuers have been provided with a new alternative to issuing a multiclass security. When specific Code provisions are satisfied, the conduit, REMIC, is not treated as a separate taxable entity and can issue both multiclasses of pass-throughs and pay-throughs (CMOs).[3] The security issued via the REMIC conduit is a REMIC security and is

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the product of Congress' intent to permit a CMO-like investment, without the corresponding taxation.[4] As of January 1, 1992, REMIC conduits are the sole means for issuing multi-class securities without being treated as a separate taxable entity. Issuance of CMOs by conduits not qualifying as a REMIC will be subject to taxes at the corporate level.

[FN1] Battles, "Making and Marketing Jumbo Loans and Products," 6 Real Estate Finance 37–44 (Summer 1989).

[FN2] Richards, " 'Gradable and Tradable': The Securitization of Commercial Real Estate Mortgages," 16 Real Estate L.J. 99, 108 (1987).

[FN3] FASB Financial Accounting Standard 77 governs the financial accounting treatment.

[FN4] Pittman, **"Economic and Regulatory Developments Affecting Mortgage Related Securities," 64 Notre Dame L. Rev. 497 (1989)**.

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J. William Hicks received his B.A. from the University of Notre Dame in 1962, his M.A. from New York University in 1968, and his J.D. from the University of Michigan in 1965. He was a member of the editorial staff of the Michigan Law Review. He is the C. Ben Dutton Professor Emeritus at Indiana University School of Law (Bloomington). Professor Hicks is a member of the faculty at the ALI-ABA Course of Study on Regulation D Offerings and Private Placements that is co-sponsored by the Securities Law Committee of the Federal Bar Association. He is the author of Civil Liabilities: Enforcement and Litigation Under the 1933 Act, Limited Offering Exemptions: Regulation D, and Resales of Restricted Securities, and the handbook International Dimensions of U.S. Securities Law, all of which are published by West, and has also contributed to law reviews.
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