November 7, 2011

Submitted by e-mail to rule-comments@sec.gov

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

Re: Companies Engaged in the Business of Acquiring Mortgages and Mortgage-Related Instruments, Release No. IC-29778, File No. S7-34-11

Ladies and Gentlemen:

The Securities Industry and Financial Markets Association ("SIFMA")[1] is pleased to respond to the request for comments by the Securities and Exchange Commission (the "SEC" or the "Commission") on the Commission's Release No. IC-29778, Companies Engaged in the Business of Acquiring Mortgages and Mortgage-Related Instruments (the "Concept Release").[2]

SIFMA is a diverse organization whose membership includes many of the largest and most significant participants in the United States capital markets. Our members and their affiliates include broker-dealers that act as underwriters, placement agents or initial purchasers in offerings of securities by mortgage-related entities relying on Section 3(c)(5)(C) of the Investment Company Act of 1940, as amended (the "Investment Company Act"), prominent companies or other entities engaged in the business of acquiring mortgages and mortgage-related instruments (referred to in this letter as "mortgage-related entities") that currently rely on Section 3(c)(5)(C) and a range of large institutional investment managers and investors. SIFMA's members are intricately involved in capital formation and other activities relating to mortgage-related entities.

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1 SIFMA brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association. For more information, visit www.sifma.org.

2 Companies Engaged in the Business of Acquiring Mortgages and Mortgage-Related Instruments, Investment Company Act Release No. 29778, *available at* http://www.sec.gov/rules/concept/2011/ic-29778.pdf (hereinafter Concept Release).

OVERVIEW

Mortgage-related entities are part of a significant and growing sector and many mortgage-related entities are well-performing and well-capitalized issuers of securities. Not only have mortgage-related entities thrived in the U.S. capital markets and provided significant and consistent returns on investment to stockholders, but mortgage-related entities also play a crucial role in, and provide an important source of liquidity to, the U.S. real estate markets generally. Real estate markets are a key component of the broader U.S. economy as residential and commercial real estate sales and related activities help drive job creation and demand for goods. However, in what could be characterized as the worst economic downturn for real estate markets since the Great Depression of the 1930s, the financing markets for real estate have been in a fragile state over the last several years, and continue to experience significant volatility with limited meaningful recovery in sight. Both the residential mortgage market[3] and the commercial real estate finance market[4] have experienced significant declines and increased volatility. The National Association of Realtors has stated that the residential housing market is underperforming and that the market continues "to experience a pattern in which financially qualified home buyers . . . are being denied credit . . . . The unnecessarily restrictive underwriting standards are attenuating the housing recovery and are a risk factor for the overall economy."[5] The Federal Housing Finance Agency projects that residential mortgage originations for 2011 continue to be on pace to be below 2010 levels.[6]

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[3] Residential mortgage originations (both purchase originations and refinancing originations) increased between 1990 and 2003, at a compounded annual growth rate of approximately 17.8%. BARCLAYS CAPITAL, U.S. CONSUMER FINANCE: PLENTY OF VALUE AMONG UNLOVED FINANCIALS 35 and 61 (2011). During 2003, there were nearly $4 trillion of originations, with refinancings constituting approximately 66% of these originations. *Id.* After 2003, the market for residential mortgage originations began a downward slide. Other than slight recoveries that occurred in 2005 and 2009, the value of residential mortgage originations has decreased every year since 2003. *Id.* In 2010, there were approximately $1.6 trillion in residential mortgage originations. *Id.* at 35 and 61. Of that $1.6 trillion, only approximately 30% represented purchase originations, with the remaining 70% being refinancing originations. *Id.* Between 1979 and 2007, between 4% and 6% of residential mortgages were delinquent at any time. *Id.* at 39. However, beginning in 2008, this number increased dramatically and as of the end of the first quarter in 2009, approximately 10% of residential mortgages were delinquent. *Id.* Likewise, between 1979 and 2007 approximately 0.5% to 1.5% of mortgages were in foreclosure. *Id.* However, foreclosure rates began to steadily increase in 2008, and by the end of the first quarter in 2009, approximately 4.5% of residential mortgages were in foreclosure. *Id*. In addition, a recent Wall Street Journal article noted that the United States Federal Reserve found that lenders originated 7.9 million mortgages in 2010, down 12% from 2009. The only year in which lender-originated mortgages were lower during the past decade was in 2008, when 7.2 million were originated. Nick Timiraos & Alan Zibel, *Housing Slump Hits New Mortgage Loans*, Wall St. J., Sept. 23, 2011, *available at* http://online.wsj.com/article/SB10001424053111904563904576587060606550174.html (hereinafter Housing Slump).

[4] 2007 represented a peak in the commercial real estate market with approximately $230.2 billion in domestic commercial mortgage-backed security ("CMBS") issuances and approximately $544 billion in commercial property sales in the 12 months through October 2007. David Fletcher, *Commercial Real Estate Losses Could Reach $1 Trillion*, Realty Times, Feb. 25, 2010, *available at* http://realtytimes.com/rtpages/20100225_losses.htm. However, in 2008 CMBS and property sales began to decrease rapidly. In 2009, only approximately $2.2 billion of CMBS were issued and in the 12 months through November 2009 only approximately $47 billion in property sales took place. *Id.* This volume was roughly a 91% decrease from the peak sales levels in 2007. *Id.* There was also a significant decline in commercial mortgage originations. The Mortgage Bankers Originations Index also illustrates a significant decline in commercial mortgage loan issuance. The Mortgage Bankers Originations Index tracks the total commercial loan originations on a quarterly basis. The index is scaled based on the 2001 average quarter equaling 100. The index peaked at more than 350 in the second quarter of 2007 and then plummeted to a low of 40 in the first quarter of 2009, increasing only slightly in the following six quarters. Mortgage Bankers Association, *Quarterly Survey of Commercial/Multifamily Mortgage Bankers Originations* (2nd Quarter 2011), *available at* http://www.mortgagebankers.org/files/Research/CommercialOriginations/2Q11CMFOriginationsSurvey.pdf. This decrease

We expect mortgage-related entities, and specifically mortgage real estate investment trusts ("REITs"), will play an increasingly important role in the mortgage and real estate finance market. In recent years, governmental agencies or government sponsored enterprises (the "GSEs"), including the Federal Housing Administration (the "FHA"), the U.S. Department of Veterans Affairs, the Federal National Mortgage Association ("Fannie Mae"), the Federal Home Loan Mortgage Corporation ("Freddie Mac") and the Government National Mortgage Association ("Ginnie Mae"), were the primary providers of capital or credit support to residential mortgage originators.[7] This is a significant change from 2005 and 2006, when nearly 70% of all originations were made in the private mortgage financing sector.[8] In September 2008, Fannie Mae and Freddie Mac were placed into conservatorship. More recently, in February 2011, the U.S. Department of the Treasury and the U.S. Department of Housing and Urban Development issued a White Paper highlighting a plan to reform the housing finance market in the U.S. by making private markets the primary source of mortgage credit and reducing the role of Fannie Mae and Freddie Mac (suggesting ultimately winding down both institutions).[9] The federal government's funding of Fannie Mae and Freddie Mac is expected to range between $124 and $317 billion.[10] We believe mortgage-related entities funded by institutional and retail investors are well positioned to provide necessary funding to the extent that the role of government funded or supported entities as the funding source for newly originated mortgage loans or mortgage-related securities diminishes. As governmental agencies and GSEs decrease their support

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demonstrates that commercial mortgage loan originations have fallen not just from peak levels, but from lower levels than existed a decade ago in 2001. For the first and second quarters of 2011, the index was at 83 and 126, respectively. *Id.* In addition, a recent Wall Street Journal article noted that the pipeline of commercial mortgage securities in the fourth quarter of 2011 is expected to fall to approximately $3 billion, which would be less than half the quarterly supply of commercial mortgage securities during the first half of 2011. Al Yoon, *That CMBS Recovery? It's Faltering*, WALL ST. J., Sept. 27, 2011, *available at* http://online.wsj.com/article/SB10001424052970204010604576597223639206518.html. The decrease in the market for newly issued CMBS has caused lenders to cut back their commercial lending and thus is dampening commercial property values.

5 National Association of Realtors, *Pending Home Sales Decline in August but Remain Above a Year Ago*, Sept. 29, 2011, *available at* http://www.realtor.org/press_room/news_releases/2011/09/phs_august?utm_source=dlvr.it&utm_medium=twitter (quoting Lawrence Yun, National Association of Realtors Chief Economist).

6 FEDERAL HOUSING FINANCE AGENCY, CONSERVATOR'S REPORT ON THE ENTERPRISES' FINANCIAL PERFORMANCE, SECOND QUARTER 2011 4, *available at* http://www.fhfa.gov/webfiles/22615/ConservatorsReport2Q2011.pdf.

7 The mortgage market continues to be heavily reliant on the federal agencies for origination. Housing Slump, *supra* note 3. Federal Agencies such as the Federal Housing Administration accounted for more than half of all loans for home purchases in 2010 and Fannie Mae and Freddie Mac accounted for nearly one quarter of purchase loans and more than half of refinances. *Id.* For the years 2008 through 2010, between 80% and nearly 100% of the liquidity provided to originators of residential mortgages was provided by the government, with private parties accounting for less than 20% of all originations. BARCLAYS CAPITAL, *supra* note 3, at 37.

8 *Id.*

9 TREASURY DEP'T, REFORMING AMERICA'S HOUSING FINANCE MARKET (Feb. 2011), *available at* http://www.treasury.gov/initiatives/Documents/Reforming%20America%27s%20Housing%20Finance%20Market.pdf.

10 Congressional Budget Office. *The Budgetary Cost of Fannie Mae and Freddie Mac and Options for the Future Federal Role in the Secondary Mortgage Market* (June 2011), before the U.S. House of Representatives Committee on the Budget.

for mortgage assets in the coming years, increasing amounts of private capital will be needed in the mortgage markets beyond the amounts that are currently available. As discussed below, there has been a significant increase in recent years in the number of mortgage-related entities and capital inflow into mortgage-related entities, with a particularly dramatic uptick in the aftermath of the recent financial crisis. These capital inflows are critical to the housing and residential mortgage markets given expectations that Fannie Mae and Freddie Mac are to be wound down or otherwise downsized. Moreover, we believe U.S. economic recovery and growth will be dependent upon the stability of domestic real estate markets.

SIFMA and its members believe that current regulatory frameworks and the industry practices of mortgage-related entities are successfully working to protect the investors against the types of potential abuses that the Commission expressed its concerns about in the Concept Release, including with respect to both mortgage-related entities that are publicly listed on a national securities exchange (e.g., New York Stock Exchange ("NYSE") or the NASDAQ Stock Market LLC ("Nasdaq")) and register their securities offerings with the Commission and mortgage-related entities that are unlisted and rely on private placement exemptions from SEC registration requirements for sales of their securities. The general structure and asset portfolio compositions of the many existing mortgage-related entities have been built around existing and long-standing SEC guidance regarding the exemption from the Investment Company Act provided by Section 3(c)(5)(C). Our members have serious concerns regarding any changes to current standards that would narrow or limit the activities of mortgage-related entities currently relying on Section 3(c)(5)(C). In particular, we believe that the imposition of increased regulatory limitations could have serious negative consequences on capital formation, the business models and practices of existing industry participants, and the ability of new mortgage-related entities to successfully enter the market in a fair and competitive environment, which we believe in turn would be damaging to real estate markets and the U.S. economy. In addition, we urge the Commission to continue to maintain a system flexible enough to continue to allow for the growth of mortgage-related entities.[11]

This letter is organized into six parts.

- Part I, as requested by the Commission, provides general background information on mortgage-related entities relying on Section 3(c)(5)(C).[12]

- Part II discusses the strong capital formation activities of mortgage-related entities that have occurred over the last decade leading to their vibrant growth. It also highlights our concerns regarding any changes to existing standards and guidance that would negatively impact these positive capital formation trends.

- Part III discusses the vital role that mortgage-related entities funded by institutional and retail investors play in the U.S. real estate industry generally, a role which we would expect

[11] For example, we believe any regulations that attempt to define specific limits on products or asset types in connection with Section 3(c)(5)(C) would inhibit future growth of the industry as real estate financing markets continue to evolve and new financing methods are introduced to the market. Similarly, as discussed in detail herein, imposing strict requirements on practices such as leverage policies would establish an inflexible system that would not allow many mortgage-related entities to continue to operate or grow their businesses and adapt to changing market conditions.

to continue to increase in coming years absent the imposition of a more restrictive regulatory environment.

- Part IV responds to the Commission's request for comment on safeguards that exist through industry practices and as a consequence of the current regulatory frameworks, which we believe more than adequately address the concerns that the Commission raises in the Concept Release.[13]

- Part V summarizes our view that the legislative and regulatory history of the Investment Company Act supports current standards, which are well-developed and understood by mortgage-related entities, and that any changes to the existing standards need to be carefully considered and weighed against the potential negative consequences for capital formation, market efficiency and the business models of mortgage-related entities.

- Part VI expresses our strong desire for the Commission to reaffirm, through an interpretive release, its key principles comprising the existing regulatory framework which are embodied within the applicable No-Action Letters, and to engage with industry participants in an active dialog to facilitate applying these principles to existing and future asset classes as real estate financings continue to evolve.

PART I
BACKGROUND ON SIGNIFICANT SECTOR PARTICIPANTS RELYING ON SECTION 3(C)(5)(C)

Most real estate finance entities that rely on Section 3(c)(5)(C) of the Investment Company Act are organized as REITs. Currently there are thirty-seven mortgage REITs listed on a national securities exchange (primarily the NYSE or Nasdaq).[14] In addition, there are also a small number of other mortgage-related entities that we were able to identify that are not REITs but rely on Section 3(c)(5)(C) based on a review of their filings with the Commission.[15] SIFMA believes that together these entities represent significantly all of the publicly traded mortgage-related entities that rely on

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12 Concept Release, *supra* note 2 at 13-14.

13 *Id.* at 15.

14 Based on our research, the following registrants constitute the mortgage REITs currently listed on a national securities exchange: AG Mortgage Investment Trust Inc., American Capital Agency Corp., American Capital Mortgage Investment Corp., American Church Mortgage Company, Annaly Capital Management Inc., Anworth Mortgage Asset Corp., Apollo Commercial Real Estate Finance Inc., Apollo Residential Mortgage Inc., Arbor Realty Trust Inc., Armour Residential REIT Inc., Bimini Capital Management Inc., BRT Realty Trust, Capital Trust, Inc., Capstead Mortgage Corp., Chimera Investment Corp., Colony Financial Inc., Crexus Investment Corp., CYS Investments Inc., Dynex Capital Inc., Eastern Light Capital Inc., Gramercy Capital Corp., Hatteras Financial Corp., Invesco Mortgage Capital Inc., iStar Financial Inc., MFA Financial Inc., New York Mortgage Trust Inc., Newcastle Investment Corp., Northstar Realty Finance Corp., PennyMac Mortgage Investment Trust, PMC Commercial Trust, RAIT Financial Trust, Redwood Trust Inc., Resource Capital Corp., Starwood Property Trust Inc., Two Harbors Investment Corp., Vestin Realty Mortgage I Inc. and Vestin Realty Mortgage II Inc.

15 These include entities that are not taxed as REITs, but rather as C-corporations, publicly traded partnerships or publicly traded limited liability companies.

Section 3(c)(5)(C), with mortgage REITs representing the vast majority of mortgage-related entities, not only by market capitalization or investor equity, but also based on the aggregate number of entities.[16] In addition, we are also aware of a limited number of mortgage-related entities which are not publicly listed or registered and which rely on an exemption from registration under the Securities Act of 1933, as amended (the "Securities Act") and the Securities Exchange Act of 1934, as amended (the "Exchange Act").[17]

Mortgage REITs have grown dramatically over the past decade and represent a significant sector in the capital markets. In 2001, there were approximately twenty-four mortgage REITs listed on a national securities exchange, with an aggregate market capitalization of approximately $6.5 billion. The sector has expanded since that time, growing to thirty-seven publicly listed mortgage REITs with an aggregate market capitalization of approximately $42.6 billion as of October 24, 2011, representing compounded annual growth in market capitalization of more than 20% over the past decade. The market capitalization of the largest mortgage REIT was approximately $15.9 billion as of October 24, 2011.[18] The top five largest mortgage REITs based on market capitalization had a combined market capitalization of approximately $28.4 billion as of October 24, 2011, with the top ten largest having a combined market capitalization of approximately $34.9 billion.[19]

The number of mortgage-related entities continues to grow steadily. In 2009 alone, in the aftermath of the depths of the financial crisis, seven mortgage REITs completed initial public offerings.[20] To date in 2011,[21] three initial public offerings for mortgage REITs relying on Section 3(c)(5)(C) have been completed, with the amount of securities ultimately sold totaling approximately $486 million.[22] An additional eight mortgage REITs relying on Section 3(c)(5)(C) are currently in

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16 Given the much more significant size of mortgage REITs and the far more important role to date that these entities have played on capital formation, much of the thrust of this letter focuses on these entities. Although in certain instances, publicly registered REITs do exist which are not listed on a national securities exchange, we are not aware of more than a very small handful of these that would fall within the definition of mortgage-related entities as contemplated by the Concept Release.

17 Given the private nature of these entities, it is difficult to gather information about the number or size of the private entities relying on Section 3(c)(5)(C) but from anecdotal information it appears that these entities are relatively limited in nature, particularly in contrast to the size of the thirty-seven publicly listed mortgage REITs.

18 Annaly Capital Management Inc.'s market capitalization measured $15.9 billion on October 24, 2011. The median market capitalization of the publicly listed mortgage REITs was approximately $350 million, and the average market capitalization was $1.1 billion.

19 This represented approximately 66.9% and 82.2%, respectively, of the total market capitalization of the thirty-seven publicly listed mortgage REITs.

20 Colony Financial Inc., Apollo Commercial Real Estate Finance Inc., CreXus Investment Corp., Starwood Property Trust Inc., PennyMac Mortgage Investment Trust, Invesco Mortgage Capital Inc., Cypress Sharpridge Investments Inc.

21 No initial public offerings have been completed since the date of the Concept Release.

22 American Capital Mortgage Investment Corp. raised $160 million, Apollo Residential Mortgage Inc. raised $200 million, and AG Mortgage Investment Trust Inc. raised $126 million.

registration with the Commission under the Securities Act for initial public offerings.[23] The amount of common stock associated with the offerings currently in registration totals $2.85 billion, with individual offering sizes range from approximately $250 million to $600 million.

Mortgage-related entities acquire a variety of assets for their portfolios. The major categories of assets are categorized as residential or commercial assets. Residential assets include Agency mortgage-backed securities which are issued or guaranteed by a GSE or U.S. government agency. Residential assets also include more credit sensitive products such as mortgage-backed securities that are not guaranteed by a GSE or U.S. government agency, as well as other assets including residential whole loans. Fifteen of the thirty-seven publicly listed mortgage REITs describe their primary asset class as residential assets, with seven of those fifteen identifying Agency mortgage-backed securities as their primary target asset. The remaining nine residential mortgage REITs acquire a combination of Agency mortgage-backed securities, non-Agency mortgage-backed securities and residential whole loans. Commercial assets include commercial mortgage-backed securities and commercial real estate loans (including first mortgage loans, mezzanine loans, collateralized debt obligations and construction loans, among others). Sixteen of the thirty-seven publicly listed mortgage REITs describe their primary asset class as commercial assets, with most identifying commercial whole loans and commercial mortgage-backed securities as their primary targets. The remaining six mortgage REITs currently listed on a national securities exchange acquire a general mix of mortgage-backed securities or mixed loan origination that are not distinctively residential or commercial assets.

As the Commission noted in the Concept Release, mortgage-related entities are either internally or externally managed. Of the thirty-seven publicly listed mortgage REITs, fifteen are internally managed and twenty-two are externally managed. Externally managed mortgage REITs typically pay the manager a management fee, based on a percentage of stockholders' equity, typically in the range of 1.0% to 1.5% per annum.[24]

As is evident from the vast preponderance of comment letters submitted to the Commission to date in response to the Concept Release, mortgage REITs are generally considered attractive investment opportunities for investors[25] and have traditionally provided strong and reliable dividend returns relative to many other public companies.[26] In 2010, publicly listed mortgage REITs paid

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23 Arbolada Capital Management Company, Ares Commercial Real Estate Corp., Avenue Capital Management REIT, PIMCO REIT, Inc., Provident Mortgage Capital Associates Inc., Putnam Mortgage Opportunities Company, Springleaf REIT Inc. and Western Asset Mortgage Capital Corporation.

24 Fourteen out of the twenty-two externally managed mortgage REITs currently pay the manager a fee ranging between 1.0% and 1.5% of stockholders' equity. Most of the remaining eight externally managed mortgage REITs pay the manager a fee based on a declining scale. Six of the twenty-two externally managed mortgage REITs also pay the manager an annual incentive fee ranging from 20% to 25% after exceeding specified return thresholds.

25 Note that REITs are entitled to a tax deduction under the Internal Revenue Code for dividends paid to shareholders. In order for a mortgage REIT to maintain its status as a REIT, the mortgage REIT must satisfy certain requirements, including a requirement that the REIT distribute at least 90% of its taxable income to shareholders. Failure to satisfy these requirements would cause the REIT to be taxed as a C-corporation for that taxable year, which could materially adversely affect the value of the stock of the mortgage REITs. *See generally* I.R.C. §§ 856-60.

26 As of June 30, 2011, the average dividend yield of the thirty-seven publicly listed mortgage REITs was approximately 9.5%, and the average dividend yield of the top ten companies in this group based on market capitalization

dividends to their shareholders totaling in excess of $3.6 billion; from January 1, 2011 through June 30, 2011, dividends paid to shareholders exceeded $2.3 billion.[27]

Institutional investors are the primary investor group in mortgage REITs. As of June 30, 2011, approximately 62% of the interests in the top ten mortgage REITs by market capitalization were held by institutional investors, including mutual funds. Retail investors held approximately 37%, with the remaining approximately 1% held by corporate insiders and other related parties. As discussed in detail below, there has been a significant increase in follow-on offerings by existing public mortgage REITs in the past several years (upwards of $23 billion from 2009 through 2011), reflecting investor confidence and the significant market opportunities for mortgage REITs to acquire mortgages and other real estate assets. We believe a significant majority of the demand for these follow-on offerings came from institutional investors, while retail investors represented a minority of this demand.

PART II
STRONG CAPITAL FORMATION THROUGHOUT THE SECTOR SHOULD CONTINUE TO BE SUPPORTED AND ENCOURAGED, NOT STIFLED

Whenever the Commission engages in rulemaking in connection with the Investment Company Act, it is specifically required to consider whether the action will promote capital formation.[28] SIFMA and its members believe that changes to the existing regulatory framework under which mortgage-related entities have developed and thrived could potentially curtail capital formation throughout the sector significantly and could make it more difficult and expensive for homebuyers or existing home owners to obtain residential mortgages. This capital formation is expected to be a critical source of liquidity for the housing and mortgage markets as private capital formation will need to significantly increase beyond current levels in order to support the market in the coming years.

As described above, mortgage-related entities have steadily grown over the course of the past decade. Capital formation throughout the sector has been strong and, assuming that current regulatory requirements remain in place, is expected to remain strong for the foreseeable future, subject to developments in broader macroeconomic conditions. As mortgage-related entities have established themselves as attractive, dividend-generating investment opportunities for investors, a loyal investor

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was approximately 15.0%. By comparison, the average indicated dividend yield for companies in the S&P 500 Index as of June 30, 2011 was approximately 2.2%. A chart demonstrating the average dividend yields of publicly listed mortgage REITs, the top ten publicly listed mortgage REITs based on market capitalization and the S&P 500 Index is presented below.

	2008Q1	**2008Q3**	**2009Q1**	**2009Q3**	**2010Q1**	**2010Q3**	**2011Q1**
Publicly listed mortgage REITs	15.1%	26.0%	31.2%	8.5%	10.7%	10.3%	8.9%
Top 10 mortgage REITs	7.9%	14.2%	15.5%	13.6%	16.0%	15.1%	14.5%
S&P 500 Index	2.1%	2.5%	2.9%	2.1%	1.9%	2.1%	2.0%

[27] The top twenty public mortgage REITs by market capitalization all paid dividends in 2010, representing approximately 96.7% of total dividends paid by mortgage REITs. The top twenty public mortgage REITs by market capitalization all paid dividends through June 30, 2011, representing approximately 97.2% of total dividends paid by mortgage REITs.

[28] Investment Company Act, 15 U.S.C § 2(c). This is consistent with the goals that the Commission identifies in the Concept Release. Concept Release, *supra* note 2, at 6.

base has developed that includes both institutional and retail investors. For example, since 2005 there have been seventeen mortgage REIT initial public offerings completed, raising a total of $4.3 billion in proceeds, with an average offering size of $254.1 million. Of the seventeen initial public offerings that were completed, seven of those offerings took place in 2009, at the recent height of the mortgage REIT initial public offering market. These seven initial public offerings alone raised approximately $2.2 billion of proceeds. Additionally, there have been approximately 107 follow-on offering by public mortgage REITs, raising proceeds of approximately $34.8 billion since 2005. In 2010 and 2011, the market witnessed a significant increase in the number of follow-on offerings by public mortgage REITs as the issuers that entered the market in the preceding years matured and raised additional capital to allow them to continue executing their business models. There were twenty-four follow-on offerings completed in 2010, raising proceeds of approximately $5.8 billion, and thirty follow-on offerings through September 30, 2011, raising proceeds of approximately $14.8 billion.[29]

The increasing and continued investor demand for mortgage-related entities and the resulting successful capital formation available to finance mortgage origination and real estate investment activities is intricately related to the fact that mortgage-related entities present attractive investment opportunities for investors given their relative high dividend yields, historically high return on investment and relatively lower volatility as compared to many other publicly listed financial industry companies. As of June 30, 2011, the average dividend yield of the thirty-seven publicly listed mortgage REITs was approximately 9.5%, and the average dividend yield of the top ten companies in this group based on market capitalization was 15.0%. Additionally, mortgage REITs have generally provided significantly higher total returns for shareholders than issuers in other industries. The comparison presented below showing the total returns from capital appreciation and dividends for the NAREIT Mortgage REIT Index, S&P 500 and the S&P Financial Index demonstrates that mortgage REITs generally outperform companies in other industries, and have consistently outperformed companies in the broader financial community.

	NAREIT Mortgage Index Total Return	**S&P 500**	**S&P Financial Index Total Return**
1-year	3.1%	1.1%	(25.8%)
3-years	42.8%	3.7%	(67.2%)
5-years	(39.4%)	(5.8%)	(48.9%)
10-years	44.7%	32.0%	(42.4%)

Note: The period-ending index levels and percent change presented above are as of September 30, 2011 and assume reinvestment of all dividends.

Despite the historically strong capital formation activities for mortgage-related entities, capital formation for publicly listed mortgage-related entities has slowed since August 2011. While general market conditions have likely been the primary factor contributing to the disruption in capital formation, we believe regulatory uncertainty in the aftermath of the issuance of the Concept Release

29 See discussion in Part III regarding the vital role of the private capital that mortgage-related entities introduce into the U.S. real estate markets.

may lead to continued disruption and could negatively impact capital formation going forward, both for new participants entering the market and, to a lesser extent, for existing mortgage-related entities seeking to raise additional capital.[30] In addition, the uncertainty created by the Concept Release may cause some existing investors to hesitate to invest additional capital in mortgage-related entities.

Changes to the current regulatory standards could have debilitating consequences for both existing sector participants and new entrants. For example, the amount and type of leverage that mortgage-related entities incur is one of several factors impacting dividends. While other factors, such as prevailing spreads between assets and liabilities and duration of assets and liabilities, are also important, limiting the amount, type or policies surrounding the leverage of mortgage-related entities could significantly reduce shareholder returns on investment and dividend yields, in turn, reducing the attractiveness of mortgage-related entities to investors. Mortgage-related entities must have flexibility to adjust the amount and type of leverage they incur with changing market conditions (as well as to engage in various types of hedging activities designed to mitigate risks from different interest rate environments). The exemption provided by Section 3(c)(5)(C) for mortgage-related entities specifically exempts these companies from the regulatory structure of the Investment Company Act by design, including limitations on leverage. Without continued and growing investor demand driven by attractive dividend profiles, capital formation in the sector would likely decline significantly for both existing and new mortgage-related entities. As described in Part III of this letter, such a decline in turn could have a significant adverse impact on the housing and commercial real estate markets and related real estate financing, depriving the market of an increasingly important source of liquidity.

Similarly, narrowing the classes of assets that mortgage-related entities may acquire while continuing to rely on the Section 3(c)(5)(C) exemption would also significantly impede future growth of the sector, require significant changes to asset composition and business models for existing mortgage-related entities and potentially force total liquidation of otherwise well-performing businesses as these entities would seek to continue to avail themselves of the Section 3(c)(5)(C) exemption. Target asset portfolio compositions are well disclosed and existing investors make investment decisions based on these portfolios and investment strategies. As noted above, the aggregate market capitalization of the thirty-seven publicly listed mortgage REITs totaled approximately $42.6 billion as of mid-October 2011. Any narrowing of asset classes would therefore fundamentally change the businesses that have attracted and are supported by large numbers of investors,[31] and could also negatively impact investors by significantly decreasing the value of the outstanding publicly held securities issued by mortgage-related entities.

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[30] For example, the Concept Release had an immediate negative impact on the stock prices and valuation of public mortgage REITs. The Concept Release was issued on August 31, 2011. The closing stock prices of each of the top ten publicly listed mortgage REITs based on market capitalization decreased between August 30, 2011 and September 1, 2011, by on average 4.1%. By comparison, the S&P 500 declined by less than 1% during the same three-day window. *See also* Ben Levisohn, *Mortgage REITs Hit by Uncertainty*, WALL ST. J., Oct. 15, 2011, *available at* http://online.wsj.com/article/SB10001424052970204774604576630990810819856.html (suggesting that shares of publicly listed mortgage REITs are "feeling the pressure" from uncertainty caused by the Concept Release).

[31] The portfolio strategies of mortgage-related entities are well disclosed and are an area of particular focus and interest to investors. Mortgage-related entities registering securities on Form S-11 are required to specifically describe their policies, principles and procedures with respect to the acquisition of various real estate mortgages and assets, including the types of assets, a description of each type of asset activity in which the entity intends to engage and the types of properties subject to those mortgages. *See* Form S-11, Item 13(b). In our members' experience, many private mortgage-related

Additionally, placing limitations on compensation and incentive structures used by mortgage-related entities could significantly impede capital formation activities for both new and existing mortgage-related entities. Management and sponsors may have less of an incentive to bring new entities to market at lower fee rates and they may be discouraged from publicly registering or soliciting investment from U.S. investors. This would deprive a large portion of U.S. investors from an opportunity to participate in the market and would unduly limit the investment choices available to the public.[32] Moreover, executives and managers may have reduced incentives to continue to try to grow existing mortgage-related entities.

PART III
MORTGAGE-RELATED ENTITIES ARE VITALLY IMPORTANT TO THE U.S. REAL ESTATE MARKETS

The real estate industry is a key component of the U.S. economy, affecting both recovery and growth. For example, the construction and development of real estate properties, a major component of the U.S. economy, helps to fuel job creation and demand for products.[33] According to the National Association of Home Builders, private residential investment and consumption on housing services historically contributes approximately 17% to 18% to the national gross domestic product.[34] Mortgage-related entities have become increasingly important participants in the real estate industry as sources of financing. By acquiring mortgages and real estate related assets and originating mortgage loans, mortgage-related entities help to provide critical support to the mortgage and real estate market generally by providing an important source of additional liquidity, which helps fund residential housing throughout the U.S., as well as offices, shopping centers and other commercial properties. This liquidity support in turn helps to maintain lower mortgage rates for consumers and businesses. Favorable rate environments help to increase affordability for existing and future property owners, promoting the recovery of the real estate industry.

As of June 30, 2011, publicly listed mortgage REITs held approximately $284 billion in total assets,[35] and owned over $227 billion of mortgage-backed securities. While mortgage-related entities

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entities provide similar disclosures in private offering memoranda, and investors expect and demand detailed descriptions with respect to these items.

32 See Part IV for a discussion of the significant protections and existing safeguards for investors.

33 According to NAIOP, the Commercial Real Estate Development Association, construction-related spending for commercial properties in 2009 was estimated to be $91.5 billion, contributed 2.4 million jobs, and contributed approximately $288.0 billion to the national gross domestic product. Stephen Fuller, THE CONTRIBUTION OF OFFICE, INDUSTRIAL AND RETAIL DEVELOPMENT AND CONSTRUCTION TO THE U.S. ECONOMY, 2010 EDITION 7 (December 2010), *available at* http://www.naiop.org/foundation/2011reports/2010contdev.pdf.

34 Peter Grist, HOUSING AND GDP (April 2010), *available at* http://www.nahb.org/generic.aspx?sectionID=734&genericContentID=136170&channelID=311. The National Association of Home Builders further estimates that each new single-family home built generates roughly $90,000 in government revenue and three jobs. Helen Fei Liu and Paul Emrath, The Direct Impact of Home Building and Remodeling on the U.S. Economy (October 2008), *available at* http://www.nahb.org/generic.aspx?sectionID=734&genericContentID=103543&channelID=311.

35 Calculated based on total assets from the most recent Form 10-Qs filed by the thirty-seven publicly listed mortgage REITs.

currently hold only a small portion of outstanding residential mortgage debt, we believe their ownership percentage has expanded significantly. Moreover, they are considered to be well positioned to absorb additional supply as Fannie Mae, Freddie Mac and the Federal Reserve sell their positions or, in the case of Fannie Mae and Freddie Mac, scale down their operations.[36] According to recent industry sources, GSEs, the Federal Reserve and the U.S. Department of Treasury have been reducing the amount of mortgage-backed securities in their portfolios, in aggregate by approximately $215 billion during the first half of 2011. As discussed in Part II above, significant capital formation activities have occurred in the mortgage REIT sector during the same time period, funding the increased demand for mortgage debt by mortgage REITs. In fact, mortgage REITs were a significant and growing source of demand in 2011, representing approximately 35% of the demand for mortgage-backed securities in 2011.[37] Furthermore, mortgage REITs, which currently hold only approximately 0.4% of the total non-Agency mortgage-backed securities outstanding, are also considered to be well positioned to purchase these assets as they are sold by insurance companies, banks, government sponsored enterprises and others.[38] Mortgage REITs are expected to serve as a source of additional origination activity when the non-Agency securitization market recovers.

In February 2011, the U.S. Department of the Treasury and the U.S. Department of Housing and Urban Development issued a White Paper highlighting a plan to reform the housing finance market in the U.S. by making private markets the primary source of mortgage credit and reducing the role of Fannie Mae and Freddie Mac (ultimately potentially winding down both institutions). Mortgage-related entities provide a unique and important tool for aggregating private capital to acquire mortgage related products and support loan origination. The White Paper notes that banks would become "the primary source of mortgage credit and bear the burden for losses,"[39] and that banks will in turn be required to hold more capital and adhere to more conservative underwriting standards.[40] Mortgage-related entities could be a crucial resource for relieving the pressure on bank and financial institution balance sheets that ultimately would result from this shift, particularly in light of the fact that banks have generally been reducing their ownership of mortgage debt.[41] We urge the Commission to ensure that any action that the Commission takes in connection with the Concept Release not conflict with the efforts of other federal agencies, whose policies are actively encouraging private solutions and would therefore benefit greatly from the continued growth of mortgage-related entities.

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[36] *See* BARCLAYS CAPITAL, *supra* note 3, at 43.

[37] BARCLAYS CAPITAL, SEC ACTION THREATENS REIT DEMAND FOR MBS 6 (noting that mortgage REITs represented approximately 35% of the demand for mortgage-backed securities out of net supply (i.e., inclusive of paydowns of mortgage-backed securities that were not reinvested into mortgage-backed securities).

[38] *See* BARCLAYS CAPITAL, *supra* note 3, at 44.

[39] Treasury Dep't, *supra* note 9, at 1.

[40] *Id*.

[41] From the end of 2008 through the end of the second quarter of 2011, commercial banks and savings institutions have decreased their holdings of residential mortgage debt by approximately 13%. See Board of Governors of the Federal Reserve System, Release: Mortgage Debt Outstanding (Sept. 2011), *available at* http://www.federalreserve.gov/econresdata/releases/mortoutstand/current.htm (hereinafter Federal Reserve Release).

We also note for the Commission's consideration that the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") generally called for inter-agency cooperation in some of its most significant provisions. We strongly urge the Commission to coordinate any action it may consider with respect to the Concept Release with the U.S. Department of the Treasury, the Federal Reserve and other related agencies, particularly in light of the White Paper. Moreover, we note the significant Congressional focus on GSE reform and would strongly encourage the Commission to be mindful of those efforts as it contemplates further action on the Concept Release.[42]

Commercial mortgage-related entities are also expected to play a meaningful role in the refinancing of significant commercial real estate debt scheduled to mature over the course of the next ten years. There are approximately $500 billion and $450 billion in commercial mortgages maturing in 2012 and 2013, respectively.[43] More than approximately 70% of these maturities are held by banks and thrifts.[44] Mortgage debt held by commercial banks and savings institutions as of the second quarter of 2011 has decreased by approximately 12% as compared to the end of 2008.[45] Similar to residential mortgage-related entities, commercial mortgage-related entities are poised to increase their acquisition of commercial mortgage loans and commercial mortgage products as commercial banks and thrifts are forced to reduce leverage to comply with increased regulatory capital requirements. Commercial mortgage-related entities also provide an important source of financing for commercial property owners that may not otherwise be available from traditional lending sources. Commercial lending markets have generally tightened over the last few years,[46] increasing the importance of commercial mortgage-related entities going forward as an alternative source of financing. Imposing regulations that directly or indirectly limit the ability of commercial mortgage-related entities to provide financing solutions for property owners will negatively impact the commercial real estate market by raising interest rates and reducing liquidity and will negatively impact domestic economic activity.

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42 See Lorraine Woellert, *Lawmakers Mulling Fate of Fannie, Freddie Split on U.S. Role*, Bloomberg, July 7, 2011, http://www.bloomberg.com/news/2011-07-07/lawmakers-mulling-fate-of-fannie-mae-split-on-u-s-housing-role.html (discussing various bi-partisan congressional options to create a replacement for Fannie Mae and Freddie Mac); Alan Zibel and Jeffrey Sparshott, *Divisions Emerge in Congress on Fannie, Freddie Overhaul*, WALL ST. J., March 29, 2011, http://online.wsj.com/article/SB10001424052748704471904576231253578726660.html (describing political divisions over the best way to overhaul mortgage markets).

43 KEEFE, BRUYETTE & WOODS, PUNCTUATED EQUILIBRIUM 134 (2011).

44 *Id*.

45 This statistic is based on the amount of nonfarm, nonresidential mortgage debt held by commercial banks according to the Board of Governors of the Federal Reserve System.

46 The July 2011 Senior Loan Officer Opinion Survey on Bank Lending Practices, published by the Board of Governors of the Federal Reserve System, noted that banks generally consider their lending standards for commercial real estate lending to be tighter than standards from 2005, with some banks noting that standards were tighter than ever since 2005. JULY 2011 SENIOR LOAN OFFICER OPINION SURVEY ON BANK LENDING PRACTICES, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM 3 (July 2011), *available at* http://www.federalreserve.gov/boarddocs/snloansurvey/201108/fullreport.pdf.

PART IV
SIGNIFICANT AND SUFFICIENT INVESTOR PROTECTIONS AND SAFEGUARDS EXIST

The Concept Release requests information regarding existing safeguards in the structure and operations of mortgage-related entities that address concerns similar to those addressed by the Investment Company Act.[47] The Commission also requests comment as to what extent potential abuses are addressed by any industry practices or other regulatory standards that may be applicable to mortgage-related entities.[48]

Mortgage-related entities have a relatively limited experience of abuses. We are not aware of any evidence that mortgage-related entities have been any more prone to accounting fraud, officer or director misconduct or other bad acts than companies in other industries, whether or not subject to Investment Company Act safeguards. Moreover, while mortgage-related entities experienced some turmoil during the financial crisis of 2007 and 2008 as was seen throughout the financial industry, this distress was not more significantly pronounced than that exhibited elsewhere within the financial industry.

We believe that there are more than sufficient investor protections based in existing regulatory standards and industry practices covering mortgage-related entities. While the regulatory standards are not identical to those that would govern an investment company registered under the Investment Company Act, there is a comprehensive and extensive regulatory and disclosure system in place for mortgage-related entities. Moreover, strong industry practices have evolved for mortgage-related entities that protect investors, in part as a consequence of investor feedback.

Some of the key existing regulatory safeguards applicable to publicly traded mortgage-related entities include the following:

- Disclosure requirements prescribed through the Securities Act and Exchange Act disclosure regimes, particularly requirements under Regulation S-K and, with respect to newly formed mortgage-related entities, Industry Guide 5 disclosure requirements regarding the "track record" or prior performance of sponsors of mortgage-related entities;[49]

- Corporate governance requirements of national securities exchanges including, among others, requirements for a majority of the members of the board of directors to be independent, a completely independent audit committee, independence requirements for nominating committee members, committee charter requirements and regularly scheduled shareholder meetings, as well as related disclosure obligations under Regulation S-K requirements through the Securities Act and Exchange Act disclosure regimes;

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47 Concept Release, *supra* note 2, at § II.D.

48 *Id.*

49 *See* SEC, Industry Guide 5, § 8.

- Annual financial statements which must be audited in accordance with the standards of the Public Company Accounting Oversight Board by a qualified and independent auditor,[50] and interim financial statements which must be reviewed by an independent auditor using the professional standards and procedures established by generally accepted auditing standards;[51]

- Requirements for annual and quarterly CEO and CFO certifications regarding financial statements and internal controls over financial reporting under Sections 302 and 906 of the Sarbanes-Oxley Act of 2002;

- Exchange Act proxy rules regarding content and form of proxy materials, including audit committee and compensation committee reports, as well as national securities exchange rules requiring annual stockholder meetings, shareholder approval of equity compensation plans and material revisions to those plans;

- Exchange Act Section 16 reporting requirements for officers, directors and beneficial owners of more than 10% of the mortgage-related entity's securities (i.e., Forms 3, 4 and 5), short swing profit restrictions and prohibitions on short sales;

- Code of ethics requirements prescribed by national securities exchanges listing rules, as well as related disclosure requirements under Regulation S-K; and

- Prohibitions on the ability to make personal loans to executive officers under Section 402 of the Sarbanes-Oxley Act of 2002.

In addition, some sponsors of externally managed mortgage-related entities are currently registered with the Commission as investment advisers under the Investment Advisers Act of 1940, as amended (the "Advisers Act"). Dodd-Frank recently expanded investment adviser registration requirements by eliminating the private adviser exemption, which previously allowed advisers with fewer than fifteen clients to remain unregistered.[52] As a result of eliminating this exemption, by March 2012 many sponsors that were previously exempt and had not otherwise registered with the Commission will now be required to register and comply with the panoply of client protection rules in the Advisers Act. For these externally managed mortgage-related entities, the Advisers Act and the rules promulgated thereunder provide additional investor protections, including through Section 206 thereof, which includes general anti-fraud provisions.[53] As registered investment advisers, these sponsors are fiduciaries and must exercise a heightened standard of care,[54] and are subject to the Commission's custody rule, which is designed to prevent misappropriation of client assets.[55] Registered investment advisers are also required to adopt and implement written policies and procedures designed to prevent the violation of applicable federal securities laws and must adopt and enforce a written code of ethics, which include policies designed to ensure that investment advisers meet certain standards of business conduct and satisfy fiduciary duties.[56] As a result of Advisers Act

[50] *See* Item 8 of Form 10-K; see also Article 2 of Regulation S-X (17 C.F.R. §§ 210.2-01-210.2-07).

[51] *See* Part I, Item 1 of Form 10-Q; see also 17 C.F.R. § 210.10-01(d).

registration, externally managed mortgage-related entities have a significant additional regulatory overlay and additional Commission oversight through the examination program.

In addition to requirements existing under the federal securities laws and listing requirements, as noted above, mortgage-related entities generally have a sophisticated investor base that often plays a significant and active gate-keeping role. Feedback from investors has helped shape current industry standards on issues such as the nature and size of equity investments by management, sponsors and their affiliates,[57] the size and characteristics of equity compensation plans, fee structures for externally managed mortgage-related entities[58] and the amount of compensation paid to underwriters in securities offerings.

Other safeguards exist throughout the sector, such as state corporate law requirements. Many mortgage REITs are organized as Maryland corporations,[59] whose corporate law imposes significant safeguards, including statutorily prescribed fiduciary duties on directors,[60] corporate opportunity requirements for directors and officers[61] and requirements regarding disinterested director or stockholder approval of interested director transactions.[62]

In addition, the securities offering process itself provides significant safeguards to investors through the due diligence process (which includes significant business, financial, legal and accounting due diligence, as well as the participation of sophisticated third party advisors such as lawyers and

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[52] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 403.

[53] Advisers Act § 206, 15 U.S.C. § 80b-6.

[54] *Id.*; *see also*, *SEC v. Capital Gains Research Bureau, Inc.* 375 U.S. 180 (1963) (holding that Section 206 of the Advisers Act imposes a fiduciary duty on investment advisers, by operation of law).

[55] 17 C.F.R. § 275.206(4)-2.

[56] 17 C.F.R. § 275.206(4)-7; 17 C.F.R. § 275.204A-1.

[57] Equity investments by management, sponsors and their affiliates as a percentage of total equity raised in mortgage REIT initial public offerings completed in the past four years has been 11.3%, based on approximately $415.7 million of management, sponsor or affiliates equity investments out of approximately $3.7 billion of total capital raised. Such significant equity investments are seen as important to investors for, among other reasons, demonstrating and contributing to an alignment of interests with the mortgage-related entity.

[58] In recent years, investors have driven changes in structure and reductions in management and incentive fees to be paid to sponsors for mortgage-related entities.

[59] Memorandum from the National Association of Real Estate Investment Trusts to Andrew Donohue, Director, Division of Investment Management, U.S. Securities and Exchange Commission 27 (Sept. 30, 2011) (hereinafter NAREIT White Paper).

[60] MARYLAND CODE ANN., CORPS & ASS'NS § 2-405.1(a) (2011).

[61] *See, e.g.*, JAMES J. HANKS, JR., MARYLAND CORPORATION LAW § 6.23 (Wolters Kluwer 2010).

[62] MARYLAND CODE ANN., CORPS & ASS'NS § 2-419 (2011).

accountants, as reflected by industry practices requiring delivery of legal opinions and comfort letters), the road show and marketing process where investors are given the opportunity to ask questions of management, the research analyst vetting and research report process, and ultimately, the final investment decision that an investor makes. Further, many publicly listed mortgage REITs are also subject to significant scrutiny by research analysts (including through thorough vetting prior to initial public offerings).

Despite the existence of the numerous safeguards noted above, in the Concept Release the Commission notes its particular concerns regarding four primary areas: (1) extensive leveraging, (2) deliberate misvaluation of assets, (3) overreaching by insiders and (4) the misappropriation of assets by control persons to further their own interests.[63] With respect to each of these concerns, we believe existing industry practices and regulatory and disclosure requirements are in place that are very effective in serving to protect investors against concerns about potential abuses. We have identified several of these more significant practices and requirements for each of the four areas of concern below.

A. Leverage

The Commission notes its concern regarding the "extensive leverage" of mortgage-related entities.[64] Although mortgage-related entities are generally more levered than registered investment companies, the trend over the last several years towards deleveraging by mortgage-related entities demonstrates what we believe to be the prudent approach taken by mortgage-related entities towards leverage and their willingness to respond to prevailing macroeconomic market conditions in a responsible fashion.[65] We believe that this downward trend has been driven by several factors, including the increased volatility of asset pricing and decreased availability of financing during the general economic downturn of the last several years. Mortgage REITs generally adjusted their leverage profiles in a responsible manner to respond to investor demands and market conditions, such as changing interest rate environments and the availability of financing.

In addition to the protections against excess leverage provided by natural market forces, a number of industry practices provide additional investor protections. Investors in mortgage-related

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[63] Concept Release, *supra* note 2, at 13.

[64] In discussing its concerns regarding extensive leverage, the Commission cites to an offshore fund that reportedly had a 32:1 leverage ratio. *See* Concept Release, *supra* note 2, at 13 n.35. We respectfully disagree with the Commission that this offshore fund is representative of potential abuses in the larger mortgage-related entity industry. Several key facts distinguish the offshore fund that the Commission identifies. As the Commission notes in the Concept Release, the mortgage-related entity in question was a private offshore fund, and differed from the vast majority of mortgage-related entities based on its jurisdiction of organization, investment guidelines, and disclosure and regulatory obligations. *See Huffington v. T.C. Group, LLC*, 637 F.3d 18 (1st Cir. 2011).

[65] Based on a review of the leverage ratios of publicly listed mortgage REITs from 2007 through June 30, 2011, the average and median leverage ratios were as follows:

	2007	2008	2009	2010	2011
Average Leverage	10.5x	6.8x	5.0x	4.0x	5.1x
Median Leverage	7.1x	5.3x	5.2x	3.7x	3.7x

entities often provide significant feedback to issuers on both the amount and types of leverage utilized by the issuer and on the level of detail of disclosure regarding leverage ratios and policies. In some instances, investors and research analysts have requested more detailed disclosures regarding leverage policies.

Financing sources utilized by mortgage-related entities also provide a practical governor on leverage. For example, mortgage REITs often utilize repurchase agreements to finance their acquisition of mortgage-backed securities or other assets for their portfolios. These repurchase agreements typically stipulate advance rates or “haircuts,” which effectively limit leverage. Accordingly, financing counterparties also act as a check on leverage activities for mortgage-related entities.

In addition to the practical limitations on excess leverage that have developed through these industry practices, the leverage of mortgage-related entities, leverage policies and the related risks associated with leverage are well disclosed in Securities Act registration statements and Exchange Act periodic reports due to existing and extensive regulatory and disclosure requirements. The comprehensive disclosure currently provided by mortgage-related entities helps to ensure that investors are well informed of the on-going leverage of the mortgage-related entities in which they invest and the associated risks. Investors are thus able to form judgments as to whether or not to maintain their investment. Investors themselves are able to assess if they consider an issuer to have excess leverage which, as noted above, can translate into higher returns on investment and dividend yields. Investors are also free to judge and compare leverage activities among different mortgage-related entities and are therefore free to reach their own decisions about their risk appetites. In addition, in the experience of our members, disclosure regarding leverage ratios and related policies has also been an area of particular comment and focus of the staff of the Division of Corporate Finance and the staff of the Division of Investment Management (the “Staff”) in reviewing Securities Act registration statements and Exchange Act periodic reports of mortgage-related entities.

Existing disclosure requirements are numerous and sufficient to help ensure that investors receive regular and accurate disclosure regarding leverage. The primary disclosure obligations related to leverage for both mortgage-related entities registering securities for offer and sale under the Securities Act and for mortgage-related entities currently filing periodic reports pursuant to Exchange Act requirements, include the following:

- **Management’s Discussion and Analysis and Results of Operations (“MD&A”)**: Disclosure is required regarding liquidity, including known trends, demand, commitments, events or uncertainties, as well as a discussion of liquidity on both a long-term and short-term basis.[66] Additionally, in September 2010 the Commission issued a new Interpretive Release providing all registrants, including mortgage-related entities, with additional guidance on the presentation of liquidity and leverage ratios within the MD&A section.[67] On at least an annual basis, disclosure is also required

[66] *See* 17 C.F.R. § 229.303(a)(1) (and related Instruction 5); Form S-11, Item 10; Form S-1, Item 11(h); Form S-3, Item 12.

[67] Commission Guidance on Presentation of Liquidity and Capital Resources Disclosures in Management’s Discussion and Analysis, Securities Act Release No. 33-9144, Exchange Act Release No. 34-62934 (Sept. 17, 2010). In

regarding known contractual obligations, including long-term debt obligations and other long-term liabilities reflected on their balance sheets.[68] Numerous mortgage REITs include a separate line item in this table identifying obligations under repurchase agreements.

- **Risk Factors**: A summary of risks related to the particular securities offering and the company generally are required, including items such as a lack of operating history, lack of profitable operations in recent periods, the company's financial position and the company's business or proposed business.[69] Mortgage-related entities often include risk factors specifically highlighting risks associated with leverage, including, among others, the potential implications of increased borrowing costs, the potential negative impact of being forced to liquidate collateral (including, with respect to mortgage REITs, the potential loss of REIT status) and the impact of increased borrowing costs on profitability. Many mortgage-related entities also include risk factors regarding risks associated with repurchase agreement, counterparty risks and hedging strategies.

- **Quantitative and Qualitative Disclosures About Market Risk**: Disclosure is required regarding quantitative and qualitative disclosures about market risks, as well as how market risks are managed.[70] Mortgage REITs often provide disclosure regarding interest rate risk and the potential impact on financial results.

- **Financial Statement Requirements**: Disclosure regarding long-term debt obligations as well as short-term obligations that are expected to be refinanced is required in both annual and interim financial statements.[71]

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particular, the Commission noted additional trends that should be discussed in the context of a liquidity discussion, including reliance on short-term financing arrangements, maturity mismatches between borrowing sources and the assets funded by those sources, changes in terms requested by counterparties, changes in the valuation of collateral and counterparty risk, additional narrative on intra-period liquidity, and the nature and composition of any portfolio of assets that is a material source of liquidity for the registrant and any related market risk, settlement risk or other risk exposure. The Commission also focused registrants on the importance of including a clear explanation of the calculation methodology behind any ratio (such as a leverage ratio) or other measure included in Exchange Act reports when there are no regulatory requirements prescribing the calculation of that ratio, or where such ratios are calculated using a methodology that is modified from its prescribed form. *Id.*

[68] *See* 17 C.F.R. 17 C.F.R. § 229.303(a)(5); Form S-11, Item 10; Form S-1, Item 11(h); Form S-3, Item 12.

[69] *See* 17 C.F.R. § 229.503(c); Form S-11, Item 3; Form S-1, Item 3; Form S-3, Item 3; Form 10-K, Item 1A; Form 10-Q, Part II, Item 1A.

[70] *See* 17 C.F.R. § 229.305; Form S-11, Item 30; Form S-1, Item 11(j); Form S-3, Item 12; Form 10-K, Item 7A; Form 10-Q, Part I, Item 3.

[71] *See* A.S.C. Topic 470-10-50, which requires disclosure of the combined aggregate amount of maturities and sinking fund requirements for all long-term borrowings for each of the five years following the date of the latest balance sheet presented. This section also requires the disclosure of any short-term obligations that are expected to be refinanced. These short-term obligations are generally excluded from current liabilities pursuant to A.S.C. Topic 470-10-45. The notes to the financial statement include a general description of the financing agreement and the terms of any new obligation incurred or expected to be incurred or equity securities issued or expected to be issued as a result of a refinancing.

In addition to the existing requirements identified above, the Commission is currently considering proposed rules that would enhance the disclosure required in MD&A regarding short-term borrowings. The proposed rules provide that a new subsection in MD&A would be required that provides a comprehensive explanation of an issuer's short-term borrowings, including qualitative and quantitative information.[72] Should the Commission adopt these rules, mortgage-related entities would also be required to provide this disclosure.

B. Misvaluation of Holdings

The Commission notes its concern regarding the "deliberate misvaluation of [a] company's holdings" in mortgage-related entities. Disclosures regarding methods for determining the fair value of mortgage assets are relatively robust for many issuers in the mortgage-related entity sector.[73] For example, when making fair value determinations, a number of mortgage-related entities utilize dealer quotes and third-party pricing services and include disclosures identifying these practices accordingly. In addition, according to NAREIT, even mortgage REITs not registered under the Securities Act or Exchange Act generally prepare and provide investors with audited financial statements prepared in accordance with GAAP,[74] which as discussed below includes specific requirements regarding fair value determinations of assets.[75] In addition to industry practices regarding value determination, several existing disclosure requirements serve to protect investors against misvaluation. The primary disclosure obligations related to valuation of assets for both mortgage-related entities registering securities for offer and sale under the Securities Act and for mortgage-related entities currently filing periodic reports pursuant to Exchange Act requirements, include the following:

- **Financial Statement Requirements**: Disclosure regarding fair value determinations with respect to mortgage-related entity assets is required in both annual and interim financial statements. GAAP standards provide a defined framework for measuring fair value.[76] As noted above, annual financial statements audited by independent auditors and interim financial statements reviewed by independent auditors are both required. These rules have recently been updated and have been a point of significant focus in the accounting community. NYSE corporate governance requirements also require audit committees to review annual and audited

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72 *See* Short-Term Borrowings Disclosure, Securities Act Release No. 33-9143, Exchange Act Release No. 34-62932 (Sept. 17, 2010).

73 To the extent the SEC believes a particular issuer has not sufficiently disclosed its policies, or found such policies to be deficient, as part of the Securities Act registration statement or Exchange Act periodic report review process, one would expect the SEC to take appropriate steps to address such a situation.

74 NAREIT White Paper, *supra* note 59, at 29.

75 In addition, as noted above, many sponsors of externally managed mortgage-related entities are also required to register as investment advisers under the Advisers Act, which imposes general anti-fraud provisions as well as other safeguards.

76 *See* A.S.C. Topic 820.

financial statements and discuss the financial statements with management and the independent auditor and require financially literate members.[77]

- **MD&A**: Disclosure is required regarding the critical accounting estimates or assumptions utilized by the company when preparing its financial statements.[78] A number of mortgage REITs summarize the estimates and assumptions utilized in making fair value determinations with respect to their assets.

- **Risk Factors**: As noted above, risk factor disclosure is required.[79] A number of mortgage REITs include specific risk factors regarding risks that may materially adversely affect the value of the assets that the entity acquires.

- **Sarbanes-Oxley Control Requirements**: Management is required to assess the effectiveness of internal controls annually, and independent auditors for accelerated and large accelerated filers must report on and attest to management's assessment of internal controls. Annual and quarterly certifications regarding financial statements and internal controls are also required.

- **Advisers Act Requirements**: Managers of externally managed mortgage-related entities have a fiduciary duty to value assets fairly and are subject to SEC enforcement actions for improper conduct.

C. Overreaching by Insiders

The Commission notes its concern regarding "overreaching by insiders" in mortgage-related entities. However, several industry practices have developed in the mortgage-related entity sector that mitigate this concern. As a general matter, the investor community has actively dialogued with mortgage-related entities on affiliate transactions and has required that mortgage-related entities impose strict limitations and policies on these transactions. Investor demands in this area have exerted competitive pressure and contributed to significant related party transaction policies. The practical result has been that mortgage-related entities have generally developed internal compliance procedures and structures that place limitations on affiliate and related party transactions. For example, we believe many externally managed mortgage REITs which could have allocation and conflict issues have established conflicts of interest policies to manage conflicts of interest between the company and the company's manager, and investment guidelines which, in certain cases for example, may require the approval of independent board members prior to making investments between the company and the manager. Policies regarding an external manager's allocation of opportunities among the manager's various entities have also developed.

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[77] NYSE Listed Company Manual, Rule 303A.07.

[78] *See* SEC Interpretation: Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations, Securities Act Release No. 33-8350, Exchange Act Release No.34-48960 (Dec. 19, 2003).

[79] *See* 17 C.F.R. § 229.503(c); Form S-11, Item 3; Form S-1, Item 3; Form S-3, Item 3; Form 10-K, Item 1A; Form 10-Q, Part II, Item 1A.

In addition to the industry practices noted above, we believe that existing regulatory and disclosure requirements adequately protect investors from overreaching. The primary regulatory and disclosure obligations for both mortgage-related entities registering securities for offer and sale under the Securities Act and for mortgage-related entities filing periodic reports pursuant Exchange Act requirements, include the following:

- **Related Party Transaction Disclosure**: Disclosure is required regarding transactions involving the company in which the amount involved exceeds $120,000, and in which any director or executive officer, 5% stockholder or any immediate family member of the foregoing had or will have a "direct or indirect material interest." Disclosure summarizing the related party transaction policies and procedures is also required, together with disclosure of instances were the policies or procedures were not followed.[80] Disclosure regarding related party transactions is also required in financial statements under GAAP.[81]

- **Policies with Respect to Certain Transactions:** Mortgage REITs registering securities for sale on Form S-11 are required to provide more detailed disclosures regarding related party transactions than companies in other industries by outlining limitations in the company's governing instruments or the company's policies with respect to the ability of any director, officer, security holder or affiliate to have any direct or indirect pecuniary interest in any investment to be acquired or disposed of by the company in any transaction in which the company is a party or has an interest, as well as the ability of these persons to engage for their own account in business activities of the types to be conducted by the company.[82]

- **Code of Ethics**: Both NYSE and Nasdaq corporate governance requirements require listed issuers to have a code of business conduct or code of conduct similar to the definition of a "code of ethics" under the Sarbanes-Oxley Act of 2002.[83] Disclosure is required regarding whether the company has a code of ethics that applies to the principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions. If the company has not adopted a code of ethics, it must explain why not. Companies are required to make the code of ethics publicly available.[84]

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80 *See* 17 C.F.R. § 229.404; Form S-1, Item 11(n); Form S-11, Item 23; Schedule 14A, Item 7(b); Form 10-K, Item 13.

81 A.S.C. Topic 850.

82 *See* Form S-11, Item 25.

83 *See* NYSE, Inc., Listed Company Manual, Rule 303A.10; Nasdaq, Inc., Marketplace Rules, Rule 5610. As defined under Item 406 of Regulation S-K, a "code of ethics" is a set of written standards reasonably designed to deter wrongdoing and to promote: "honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships; full, fair, accurate, timely, and understandable disclosure in reports and documents that a registrant files with, or submits to, the Commission and in other public communications made by the registrant; compliance with applicable governmental laws, rules and regulations; the prompt internal reporting of violations of the code to an appropriate person or persons identified in the code; and accountability for adherence to the code."

84 *See* 17 C.F.R. § 229.406; Form 10-K, Item 10.

- **Stock Exchange Corporate Governance Standards**: Most publicly traded mortgage-related entities are listed on either the NYSE or Nasdaq. As listed companies, mortgage-related entities are subject to the corporate governance requirements of these national securities exchanges, including the requirement to have a majority of independent directors, a completely independent audit committee, nominating committee and compensation committee and specified requirements for committee charters, among others.

- **Conflict of Interest Disclosure**: Mortgage-related entities registering securities on Form S-11 are required to provide disclosures regarding each type of transaction that might result in a conflict of interest between the shareholders and the sponsor of mortgage-related entities, including the proposed methods for dealing with conflicts.[85]

- **Sarbanes-Oxley Prohibitions on Executive Loans**: Section 402 of the Sarbanes-Oxley Act of 2002 prohibits an issuer from making personal loans to executive officers.

- **Section 16 Reporting Obligations**: As noted above, compliance with Section 16 of the Exchange Act is required for mortgage-related entities registered under the Exchange Act, and specifies numerous reportable transactions by corporate insider and affiliates.

- **Maryland Corporation Law**: As noted above, many mortgage-related entities are organized as Maryland corporations and are therefore subject to Maryland corporate law requirements, which include significant statutory safeguards to protect against overreaching by corporate insiders.

- **Advisers Act Requirements**: Both registered and unregistered advisers have a fiduciary duty to clients. Registered advisers must adopt a code of ethics, appoint a compliance officer to oversee the implementation and effectiveness of the adviser's compliance program, and are subject to SEC examination and enforcement authority.

D. Misappropriation of Assets

The Commission notes its concern regarding instances in which "controlling persons of companies that hold mortgage-related assets used such companies' assets to further their own interests." We are not aware of any such instances by mortgage-related entities. As noted above, industry practices regarding affiliate and related party transactions have developed for mortgage-related entities that help ensure assets are not misappropriated or improperly used to an insider's advantage. Additionally, many mortgage REITs enter into custody arrangements with third-party and established financial institutions, which also minimizes the risk of misappropriating assets.[86]

In addition, we believe that many of the existing regulatory and disclosure requirements we noted above with respect to the Commission's other concerns equally help protect investors from the misappropriation of assets by corporate insiders and affiliates. These protections include, for example,

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85 *See* SEC, Industry Guide 5, § 5.

86 *See* NAREIT White Paper, *supra* note 59, at 29.

financial statements audited by independent auditors, disclosure requirements regarding related party transactions and conflicts of interests, code of ethics requirements under both national securities exchange listing rules and SEC disclosure requirements,[87] and CEO and CFO certification requirements and internal control attestations required under the Sarbanes-Oxley Act of 2002. Each of these items described in more detail above also serve to further the goals of protecting the assets of mortgage-related entities.

E. Private Mortgage-Related Entities

While differing from the aforementioned safeguards protecting investors in publicly registered mortgage-related entities, there are also numerous protections for investors in private mortgage-related entities. These protections are similarly based on existing regulatory standards and industry practices. Furthermore, institutional investors in private mortgage-related entities often engage in significant negotiations with sponsors with respect to corporate governance matters and deal terms. While not all of the regulatory safeguards noted above directly apply to private mortgage-related entities, several key regulations do apply and industry practices akin to many of the safeguards noted above have developed and afford substantial protection to investors in private mortgage-related entities. These protections often include the following:

- Limitations imposed on type and number of investors to satisfy private placement exemptions;

- SEC anti-fraud rules for all private securities offerings and Financial Industry Regulatory Authority ("FINRA") advertising rules, requiring communications with the public to be "fair and balanced" and provide a "sound basis for evaluating the facts in regard to any particular security or type of security,"[88] which have led to industry practices for detailed disclosures regarding risk factors associated with investment in a mortgage-related entity, including leverage, market risk, and the risks caused by lack of liquidity in private entities;

- Information requirements for sales of securities to non-accredited investors under Regulation D, including requirements for both financial and non-financial information and the opportunity to ask questions and receive answers regarding the offering and to obtain additional information;[89]

- General reporting practices that include annual financial statements audited by a qualified and independent auditor and meeting the requirements of GAAP;

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[87] In fact, the NYSE corporate governance standards require that the listed issuer's code of business conduct and ethics address the "protection and proper use of listed company assets." *See* NYSE, Inc., Listed Company Manual, Rule 303A.10.

[88] National Association of Securities Dealers Rule 2210(d).

[89] See Rule 502(b) of Regulation D.

- Advisers Act regulatory requirements affecting the managers subject thereto, including fiduciary duty and compliance requirements noted above;

- State corporate law requirements, including statutorily prescribed fiduciary duties and stockholder approval of interested director transactions as noted above;

- A sophisticated and generally institutional investor base that often individually weighs in on corporate governance, leverage restrictions, manager compensation, conflict of interest disclosure, and other deal terms; and

- Protections provided by the private securities offering process itself, including due diligence obligations of broker-dealers in offerings made under Regulation D[90] and regulations related to the marketing of private placements of securities.[91]

PART V
<u>LEGISLATIVE AND REGULATORY HISTORY SUPPORTS CURRENT REGULATORY REGIME</u>

Section 3(c)(5)(C) was enacted as part of the original text of the Investment Company Act. At the time the statute was enacted, the real estate industry generally was dealing with significant negative pressures in real estate and housing markets, not dissimilar to the turmoil experienced in recent years discussed above. The section was intended to specifically exclude "companies dealing in mortgages"[92] from the definition of "investment company" for purposes of the Investment Company Act,[93] as well as companies dealing in other liens on and interests in real estate. As the Commission noted in the Concept Release, however, Section 3(c)(5)(C) itself does not have an extensive legislative history.[94]

The Commission notes in the Concept Release that Section 3(c)(5)(C) was enacted "to exclude from regulation under the [Investment Company Act] companies that were engaged in the mortgage banking business and that did not resemble, or were not considered to be, issuers that were in the investment company business."[95] However, to our knowledge nothing in the Investment Company

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90 See Regulatory Notice 10-22, Regulation D Offerings, FINRA (April 2010), outlining the due diligence obligations of broker-dealers recommending an issuer's securities in a securities offering made under Regulation D.

91 See Rule 502 of Regulation D, which prohibits any form of general solicitation or general advertising, including advertisements, articles or other communications or meetings with attendees who have been invited by any general solicitation or general advertising, and requires issuers to provide specific and detailed information to non-accredited investors as well as giving investors the opportunity to ask questions and receive answers regarding the offering.

92 H.R. Rep. No. 2639, 76th Cong., 3d Sess. 12 (1940); S. Rep. No. 1775, 76th Cong., 3d Sess. 13 (1940).

93 *See* Explanatory Statement by Mr. Wagner on S. 3580, Mar. 14, 1940, 86 Cong. Rec. 2846 (1940) ("The bill does not cover companies which are not investment companies. It therefore excludes companies primarily engaged . . . in the management and operation of a noninvestment business . . . .").

94 *See* Concept Release, *supra* note 2, at 4 nn.6-7, 5 nn.7-8 and accompanying text.

95 *See Id.*

Act's legislative history indicates that Congress intended for Section 3(c)(5)(C) to be limited to companies engaged in the "mortgage banking business." Rather, the legislative history more generally refers to companies "dealing in mortgages."[96] We do not believe that the legislative history suggests, nor do the words of the statute indicate, that Congress intended to draw a distinction between companies that originate mortgages and then continue to hold all or portions of those mortgages, and companies that acquire mortgages and mortgage-related instruments in the secondary market. Section 3(c)(5)(C) was intended to exclude companies such as mortgage-related entities, that "do not come within the generally understood concept of a conventional investment company investing in stocks and bonds of corporate issuers."[97] In fact, the words of the statute are expressly contrary to any view that the exemption is limited to mortgage originations.[98]

Despite the limited legislative history on Section 3(c)(5)(C), the Staff has issued a long line of No-Action Letters that, over the past 30 years, have developed into a reliable and well-understood regulatory framework for mortgage-related entities. For instance, it is well established that an issuer relying on Section 3(c)(5)(C) must have at least 55% of its assets in "qualifying interests," at least 25% of its assets in real estate-related interests and no more than 20% of its assets in miscellaneous investments (the "55/25/20 Test").[99] In addition to actual interests in real estate and loans or liens fully secured by real estate, the Staff has interpreted other asset classes as qualifying interests and has developed general standards to classify other assets. Assets that can be viewed as the functional equivalent of, and providing their holder with the same economic experience as, an actual interest in real estate or a loan or lien fully secured by real estate, may be treated as qualifying interests.[100] The Staff has further provided specific guidance on particular assets and whether they satisfy this "economic experience" test. For example, the Staff has explained that a holder of Agency whole pool certificates has the same economic experience as a person who purchases underlying mortgages directly, including receipt of principal and interest payments and risk of prepayment on underlying mortgage loans, notwithstanding the guarantees provided by the agencies.[101] In addition, the Staff has stated that privately issued mortgage-backed securities must not only be whole pool certificates but they must also provide the holder of the securities with the right to foreclose on the underlying real estate in order to constitute qualifying interests.[102] There is nothing in the long and extensive

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96 H.R. Rep. No. 2639, 76th Cong., 3d Sess. 12 (1940); S. Rep. No. 1775, 76th Cong., 3d Sess. 13 (1940).

97 H.R. Rep. No. 1382, 91st Cong., 2d Sess. 17 (1970); S. Rep. No. 184, 91st Cong., 1st Sess. 37 (1969). *See* Concept Release, *supra* note 2, at n.38.

98 "…*purchasing* or *otherwise* acquiring mortgages and other liens on and interests in real estate." Section 3(c)(5)(C) of Investment Company Act (emphasis added).

99 *See, e.g.*, Greenwich Capital Acceptance, Inc., SEC No-Action Letter (Aug. 8, 1991); United Bankers, Inc., SEC No-Action Letter (Mar. 23, 1988).

100 *See, e.g.*, Capital Trust, Inc., SEC No-Action Letter (Feb. 3, 2009); NAB Asset Corp., SEC No-Action Letter (June 20, 1991).

101 *See* DIV. OF INV. MGMT., SEC. & EXCH. COMM'N, PROTECTING INVESTORS: A HALF CENTURY OF INVESTMENT COMPANY REGULATION 72 (1992). *See also* American Home Finance Corp., SEC No-Action Letter (May 11, 1981).

102 *See, e.g.*, Marion Bass Sec., Inc., SEC No-Action Letter (July 9, 1984).

interpretation by the Staff of Section 3(c)(5)(C) to suggest that there is any support for a narrow view of the exemption in the legislative history.[103]

Additionally, the Staff has issued numerous No-Action Letters that have established the framework around which the entire sector of mortgage-related entities has developed. More than 80 No-Action Letters have been issued, addressing the treatment of a wide variety of asset classes including:

- fee interests in real estate;[104]
- mortgage loans, deeds of trusts and other interests fully secured by real estate;[105]
- installment land contracts secured solely by real property;[106]
- liens on leasehold interests in real property;[107]
- loans backed by interests in oil and gas properties;[108]
- Tier 1 real estate mezzanine loans;[109]
- B-Notes;[110]
- Agency whole pool certificates;[111]
- Agency partial pool certificates;[112]

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[103] Congress has revisited the Investment Company Act several times since its initial enactment in 1940, and to our knowledge has not taken issue with the interpretations and industry practices under Section 3(c)(5)(C). The most significant amendments to the Investment Company Act in recent years were enacted by Congress in 1996 as part of the National Securities Markets Improvement Act. Additionally, there have been subsequent, less expansive, amendments to the Investment Company Act, as recently as 2010 as part of Dodd-Frank. The interpretations and industry practices applicable to mortgage-related entities that are noted in the Concept Release were largely in place at the time these amendments to the Investment Company Act were enacted. We believe the fact that Congress has had ample opportunity to modify the implementation of the exemption under Section 3(c)(5)(C) and has chosen not to do so, further demonstrates that the current implementation of Section 3(c)(5)(C) is consistent with Congressional intent.

[104] United Bankers, Inc., SEC No-Action Letter (Mar. 23, 1988); Great Am. Mgmt. and Inv., Inc., SEC No-Action Letter (Sept. 27, 1982).

[105] United Bankers, Inc., SEC No-Action Letter (Mar. 23, 1988); Am. Dev. Fin. Inc., SEC No-Action Letter (July 23, 1987); Prescott, Ball & Turben, SEC No-Action Letter (Feb. 19, 1982).

[106] Am. Housing Trust I, SEC No-Action Letter (May 21, 1988).

[107] Health Facility Credit Corp., SEC No-Action Letter (Feb. 6, 1985).

[108] Prudential-Bache Sec., Inc., SEC No-Action Letter (Aug. 19, 1985); Apache Petroleum Co., SEC No-Action Letter (Apr. 30, 1982).

[109] Capital Trust, Inc., SEC No-Action Letter (May 24, 2007).

[110] Capital Trust, Inc., SEC No-Action Letter (Feb. 3, 2009).

[111] Centext Credit Corp., SEC No-Action Letter (Dec. 15, 1988); Home Investors Trust, SEC No-Action Letter (Sept. 29, 1988); Bear, Stearns & Co., SEC No-Action Letter (Oct. 3, 1986).

[112] CDW Mortgage Sec., Inc., SEC No-Action Letter (Sept. 4, 1987); Landmark Funding Corp., SEC No-Action Letter (Sept. 20, 1984); Nottingham Realty Sec., Inc., SEC No-Action Letter (Apr. 19, 1984).

- condominium and cooperative housing loans;[113] and
- loans where at least 55% of the fair market value is secured by real estate.[114]

These no-action letters, taken together with the basic principles established by the Staff, have served as a long-standing regulatory framework that has facilitated efficient and cost-effective mortgage and real estate financing markets.

Congress had two goals when it adopted the Investment Company Act in 1940—capital formation and investor protection.[115] These goals are consistent with the Commission's own goals in reexamining the application of Section 3(c)(5)(C).[116] In light of the efficient market that has developed based on existing standards and guidance, as well as the strong capital formation highlighted in Part II above that has thrived on existing business models, we respectfully urge the Commission to be mindful of the requirements of Section 2(c) of the Investment Company Act, which requires the Commission's rulemaking to "promote efficiency, competition, and capital formation" in connection with any rulemaking. The Commission should carefully consider the disruption any changes to existing interpretations, guidance and standards may have on this well-functioning sector, including with respect to on-going capital formation activities of current participants in the sector and the ability of new participants to enter the market.

In addition to the requirements of Section 2(c) of the Investment Company Act, we respectfully remind the Commission that its rulemaking authority under Section 38(a) is limited to "defining accounting, technical, and trade terms" used in Section 3(c)(5)(C).[117] Section 3(c)(5)(C) does not specifically grant any additional rulemaking authority to the Commission. As stated above, we note that Section 3(c)(5)(C) was broadly and explicitly drafted to exclude from the definition of investment company all businesses that purchase or otherwise acquire mortgages and other liens on and interests

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113 Greenwich Capital Acceptance, Inc., SEC No-Action Letter (Aug. 8, 1991); D.B.G. Prop. Investors, Inc., SEC No-Action Letter (Dec. 29, 1986); P&B Realty Dev. Corp., SEC No-Action Letter (Dec. 4, 1985).

114 NAB Asset Corp., SEC No-Action Letter (June 20, 1991); La Quinta Motor Inns, Inc., SEC No-Action Letter (Jan. 4, 1989).

115 *See* S. Rep. No. 1775, 76th Cong., 3d Sess. 2 (1940) ("We are hopeful that if this legislation passes it will constitute a stimulus to the investment company industry's contributing to venture capital."); *Id*. at 5 ("[I]t is the hope of the committee, as well as of the investment company industry and of the Securities and Exchange Commission, that regulation of investment companies, as provided for in this bill, may stimulate venture capital and the financing of industry."); *Id*. at 6 ("The committee believes that this bill will provide safeguards without undue restriction, so that those who desire to put their savings to work in this manner may do so with greater confidence.").

116 The Commission's goals are to: "(1) be consistent with the Congressional intent underlying the exclusion from regulation under the Act provided by Section 3(c)(5)(C); (2) ensure that the exclusion is administered in a manner that is consistent with the purposes and policies underlying the Act, the public interest, and the protection of investors; (3) provide greater clarity, consistency and regulatory certainty in this area; and (4) facilitate capital formation." Concept Release, *supra* note 2, at 6.

117 Section 38(a) of the Investment Company Act authorizes the SEC "to make, issue, amend, and rescind such rules and regulations and such orders as are necessary or appropriate to the exercise of the powers conferred upon the Commission elsewhere in this title, including rules and regulations defining accounting, technical, and trade terms used in this title…" 15 U.S.C. § 80a-38(a).

in real estate—whether they originate these instruments or assets or purchase or otherwise acquire them. We also respectfully note for the Commission's consideration that courts have determined that "if Congress employs a term susceptible of several meanings ... it scarcely follows that Congress has authorized an agency to choose any one of those meanings. As always, the 'words of the statute should be read in context, the statute's place in the overall statutory scheme should be considered, and the problem Congress sought to solve should be taken into account' to determine whether Congress has foreclosed the agency's interpretation."[118]

We respectfully remind the Commission that any changes it seeks to adopt must also comply with the Administrative Procedures Act, which generally prohibits a federal agency, such as the Commission, from creating a rule that is "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law."[119] Numerous cases under the Administrative Procedures Act have established the bounds of the Commission's authority. Without strong evidence that Congressional intent was to limit the ability of real estate financing-related entities to rely on Section 3(c)(5)(C), an intent which we do not see as being evident from the legislative history, any limitations on the mortgage-related entity sector must be carefully considered. In *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, the U.S. Supreme Court determined that "if the intent of Congress is clear . . . the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress."[120] If the intent of Congress is not clear, then statutory construction should be evaluated based on the plain meaning of the statute, the overall structure, and the legislative history.[121] The Commission can only depart from long standing precedent or policy if it provides "a reasoned analysis indicating that prior policies and standards are being deliberately changed…."[122] As such, courts have found that heightened scrutiny is "particularly useful when for some reason the presumption of agency authority is rebutted, as … when an agency has departed from its consistent and longstanding precedents or policies."[123] The current standards for evaluating the treatment of assets under Section 3(c)(5)(C) have been developed over the course of more than 30 years and in fact represents a long standing policy of the Commission. When a long standing policy or interpretation is altered, the Commission must adequately justify departure from its own prior interpretations of a statute through rulemaking.[124]

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118 *Phillip Goldstein, et al. v. Securities and Exchange Commission*, 451 F.3d 873, 878 (D.C. Cir. 2006), *citing, PDK Labs. Inc. v. DEA*, 362 F. 3d 786, 796 (D.C. Cir. 2004).

119 5 U.S.C. § 706.

120 *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc., et al,* 467 U.S. 837, 842-843 (1984).

121 *See Dunn v. Commodity Futures Trading Commission*, 519 U.S. 465 (1997).

122 *Michigan Public Power Agency v. FERC,* 405 F. 3d 8, 12 (D.C. Cir. 2005), *citing, Greater Boston Television Corp. v. FCC*, 444 F. 2d 841, 852 (D.C. Cir. 1970); *See also, Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto Ins. Co.,* 463 U.S. 29, 41-42 (1983).

123 *National Resources Defense Council, Inc. v. SEC*, 606 F. 2d 1031, at n.23 (D.C. Cir. 1979).

124 *Phillip Goldstein, et al. v. Securities and Exchange Commission*, 451 F.3d 873, 883 (D.C. Cir. 2006); *See also, Northpoint Technology, Ltd. v. FCC,* 412 F. 3d 145, 156 (D.C. Cir. 2005).

PART VI
SUGGESTIONS FOR IMPROVING REGULATORY FRAMEWORK

As highlighted throughout this letter, we believe that current regulatory standards and industry practices are working to maintain the significant and efficient capital formation activity of mortgage-related entities, while simultaneously providing numerous safeguards against the abuses the Commission identifies as its primary concerns in the Concept Release. While we would be supportive of requests from industry participants for prudent improvements to the regulatory regime that would facilitate future capital formation, first and foremost we urge the Commission to "do no harm" as it considers any action following its issuance of the Concept Release. As discussed above, the real estate markets continue to be in a fragile state. We are concerned that altering existing regulatory standards would unnecessarily introduce an additional negative variable into the marketplace. In addition, given the dampening effect any future action could have on the sector generally, we urge the Commission to clearly indicate to the market that the Commission is not seeking to impose any changes that will be disruptive to mortgage-related entities or that would negatively impact their current business models, which are based on years of guidance, and that the Commission will not create any impediments or delays in clearing the Securities Act registration statements of mortgage-related entities that are pending with the Commission as the Commission determines its course of action, if any. A clear statement to this effect would help to avoid undue confusion and disruption to near-term capital formation.

In addition to a clear statement to this effect, we would strongly encourage that the Commission reaffirm the key principles which have been articulated in the numerous No-Action Letters that define the existing regulatory framework and which mortgage-related entities have been relying on (in some instances for decades). We would hope that this guidance would reaffirm the 55/25/20 Test and the treatment of all asset classes which have previously been determined in No-Action Letters to be qualifying interests including, among others, reaffirming the treatment of Agency whole pools as qualifying interests. We would also encourage the Commission to actively engage industry participants to analyze whether certain other assets should become qualifying interests in light of the key principles. We believe an interpretive release or some similar interpretive guidance would be the most suitable form for this reaffirmation. We would not suggest any rulemaking.

In particular, we would advise the Commission against adopting any strict definitional or other similar standards related to asset determinations under Section 3(c)(5)(C). We believe any attempt to craft such specific regulations would ultimately limit the development of new real estate and mortgage products in the marketplace since specific definitional standards would likely not be able to adequately anticipate all of the types of mortgages and other liens on and interests in real estate that will arise in the future. Any action taken by the Commission should maintain a system flexible enough to continue to allow for the growth of this dynamic sector. Moreover, we would encourage the Staff to actively engage with industry participants in the future to ensure that as real estate financing markets evolve, the regulatory framework continues to be able to evolve along with it to enable continued growth of mortgage-related entities.

We also note the Commission's concern in the Concept Release that some mortgage-related entities are perceived by investors as being investment vehicles and not as companies engaged in the mortgage banking business.[125] While we do not believe that there is any general confusion in the market place that mortgage-related entities relying on Section 3(c)(5)(C) are not investment companies registered under the Investment Company Act, if the Commission is particularly concerned we would support disclosure guidance from the Staff requiring that these mortgage-related entities include prominent disclosure highlighting for investors that they are not regulated as investment companies.[126]

CONCLUSION

SIFMA greatly appreciates the opportunity to comment on the Concept Release. We believe our comments above highlight for the Commission the potential for significant negative consequences of changes to the current regulatory regime.

We urge the Commission to strongly consider the potentially negative impact on capital formation of any changes to existing requirements and guidance, the business models of existing and future mortgage-related entities (and the resulting harms to investors) and the overall U.S. residential and commercial real estate and real estate financing markets. We urge the Commission to reaffirm its existing and long-standing guidance and not adopt any narrowing changes to the interpretations mortgage-related entities currently rely on. No matter what further action the Commission determines to take following the Concept Release, if any, we strongly urge the Commission to continue to solicit input from industry participants who live with the existing regulatory requirements on a daily basis, and consult with them concerning any actions as they can provide valuable insight to the Commission on any potential implications.

125 Concept Release, *supra* note 2, at 11.

126 We note that the Staff cites several news sources to support the proposition that there is confusion as to the status under the Investment Company Act of mortgage-related entities. *Id.* Our members do not believe there is general confusion among investors or the press as to the status of mortgage-related entities, and we urge the Staff not to rely on what can be characterized as "loose" terminology used in certain news articles to support such a proposition.

We would be pleased to have the opportunity to discuss these matters further with you or with any member of the Staff. Please feel free to contact the undersigned at the contact information listed below, Sean Davy of SIFMA at (212) 313-1118 or via e-mail at sdavy@sifma.org, Paul D. Tropp of Fried, Frank, Harris, Shriver & Jacobson LLP at (212) 859-8933 or via e-mail at paul.tropp@friedfrank.com or Jessica Forbes of Fried, Frank, Harris, Shriver & Jacobson LLP at (212) 859-8558 or via e-mail at jessica.forbes@friedfrank.com.

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