**CLIFFORD CHANCE US LLP**
31 WEST 52ND STREET
NEW YORK, NY 10019-6131
TEL +1 212 878 8000
FAX +1 212 878 8375
www.cliffordchance.com

November 07, 2011

**Via E-mail**: rule-comments@sec.gov

Ms. Elizabeth M. Murphy,
Secretary,
Securities and Exchange Commission,
100 F Street, NE, Washington, DC 20549-1090.

Dear Ms. Murphy,

We are pleased to submit comments on File No. S7-34-11, a concept release (the "**Concept Release**") issued by the U.S. Securities and Exchange Commission (the "**Commission**") on August 31, 2011, seeking public comment regarding the status under the Investment Company Act of 1940 (the "**1940 Act**") of companies engaged in the business of acquiring mortgages and mortgage-related instruments, many of which rely on Section 3(c)(5)(C) for their exemption from registration under the 1940 Act. Section 3(c)(5)(C) excludes from the definition of investment company "persons primarily engaged in . . . purchasing or otherwise acquiring mortgages and other liens on and interests in real estate."

In the Concept Release, the Commission asks for guidance on "the steps that the Commission should take to provide greater clarity, consistency or regulatory certainty with respect to Section 3(c)(5)(C)." The Concept Release suggests that the Commission could potentially engage in rulemaking (such as creating a safe harbor or definitional rule), issue an interpretive release, and/or provide exemptive relief to address the scope of Section 3(c)(5)(C), or take no further action at this time.

The Concept Release states that the Commission's goals in this effort are to: "(1) be consistent with the Congressional intent underlying the exclusion from regulation under the 1940 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 1940 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."[1]

We support this framework as a proper basis for analysis by the Commission and believe that such framework is consistent with the organic limitations placed on Commission action under existing law. We note, for example, that Section 2(c) of the 1940 Act requires that whenever the Commission is engaged in rulemaking under the 1940 Act and is required to consider or determine whether an action is consistent with the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition and capital formation. We further note that under the Administrative Procedure Act (the "**APA**") the Commission is prohibited from creating any rule that is "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law." Together, the APA and Section 2(c) of the 1940 Act place a heavy burden on Commission rulemaking and other actions. They require the Commission to examine relevant data and articulate a satisfactory explanation for its actions, including a rational connection between the facts found and the choice made.[2] We hope that the publication of the Concept Release and the solicitation of comments from the public will aid the Commission in determining whether to take any further action under the Section 3(C)(5)(c) exemption and in fulfilling its obligations and responsibilities under the law.

We have organized our comments to address in order the four primary goals outlined by the Commission in the Concept Release: (1) Congressional intent under Section 3(c)(5)(C), (2) consistency with the purposes and policies underlying the 1940 Act, the public interest, and the protection of investors, (3) clarity, consistency and regulatory certainty, and (4) effects on capital formation. In our view, the historical interpretations as developed by the staff of the Commission ("**SEC Staff**") through the years have generally taken an intelligent, principles based approach in applying the exemption in Section 3(c)(5)(C). SEC Staff interpretations have consistently taken the view that the exemption requires entities primarily to hold mortgages directly or to hold interests that allow their holders to be in at least the same position as, and with rights equivalent to, direct mortgage holders. We believe that this interpretative approach has generally worked

1 Companies Engaged in the Business of Acquiring Mortgages and Mortgage-Related Instruments, Investment Company Act of 1940 Release No. IC-29778, (Aug. 31, 2011) 76 Fed. Reg. 55,300 (Sept. 7, 2011) (to be codified at 17 C.F.R. pt. 270) (Sept. 7, 2011) [hereinafter Concept Release] at 6.

2 In addition, because in several recent cases, the D.C. Circuit Court of Appeals held that a rule is "arbitrary and capricious" under the APA if an agency fails to consider factors "it must consider under its organic statute," the Commission must consider whether the rules it proposes will promote efficiency, competition and capital formation and consider reasonable alternatives or face the remedies under the APA which include vacating the rule.

well, provided a great deal of clarity to market participants and has allowed a significant amount of private capital to be raised around these interpretations.

**Congressional intent under Section 3(c)(5)(C)**

Section 3(c)(5)(C) generally excludes from the definition of investment company any person who is "primarily engaged in . . . purchasing or otherwise acquiring mortgages and other liens on and interests in real estate." As discussed in the Concept Release, Section 3(c)(5)(C) does not have an extensive legislative history. A review of the House and Senate Reports published around the time of the enactment of what is now the Section 3(c)(5)(C) exemption does not give any substantive insight into Congressional intent in adopting the exemption.

The starting point for determining Congress's purpose in adopting what is now the Section 3(c)(5)(C) exemption is a review of the language of the exemption itself and an analysis of that language in the historical context in which it was adopted. It is undeniable that in crafting the Section 3(c)(5)(C) exemption, Congress used exceptionally broad language and did not directly or indirectly impose conditions on the use or availability of the exemption, nor did Congress delegate any specific rulemaking authority under the exemption to the Commission. How then should this language be assessed in the historical context of the time?

As discussed in more detail below, we believe that when the broad language of the Section 3(c)(5)(C) exemption is assessed in light of the historical developments leading up to its enactment, the only fair conclusion is that Congress did not intend to freeze the reach of the exemption to only those forms of companies and structures that were in use in 1940, but instead intended the exemption to capture ongoing developments in the mortgage and mortgage financing industries.

The historical record of the mortgage financing business in the decades leading up to the adoption of the 1940 Act reveals a vibrant and innovative mortgage finance marketplace consisting of different types of both regulated and unregulated companies, offering a range of products and structures to investors, and not a market that was somehow limited to "mortgage banking."[3]

Even before the turn of the 20th century, mortgages were held as investments by many different types of businesses, including fire and marine insurance companies, life insurance companies,

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[3] *See* Concept Release, *supra* note 1 at 4, 15, 15 n.38, 25, 26, 28 (discussing legislative history of Section 3(c)(5(C)).

mutual savings banks, stock savings banks, benefit and aid societies, state banks, private banks, loan and trust companies, English debenture companies and other mortgage companies.[4] Not only were mortgages held by a variety of entities, but studies show that about 18% of mortgage loans in the country were held as investments by individual investors who were not local to the community in which the mortgage was made, while about 10% of mortgage loans were held by savings banks, 7% by building and loan associations, 5% by insurance companies and 55% by local investors, who in most cases, had made the loans or sold the property themselves.[5]

Mortgage finance evolved in the late 19th century when in 1881, the Iowa Loan and Trust Company became what we believe to be the first company to issue debenture bonds secured by mortgages deposited in trust.[6] Other companies soon followed with hundreds selling debenture bonds backed by mortgages through the early 1890s. Alongside these bonds, companies also sold individual mortgages or participation certificates in larger mortgages to numerous investors.[7]

As the country approached the 1930s, the real estate finance market continued to develop. As described by scholars at that time, "[a]ny one with small capital, and a mind to do so, could go into the business of lending money secured by mortgages on real property and distribute the burden among investors."[8] A variety of products existed in the mortgage markets at this time and billions of dollars in mortgages and participation certificates had been sold in the United States by the early 1930s.[9] History shows a range of different structures and the involvement in the mortgage finance business by a range of different players. This period was also characterized by extensive private enterprise and limited federal government involvement in the mortgage finance business.

The onset of the great depression ultimately led to significantly greater participation in the mortgage finance business by the federal government. Not unlike the current period, the 1930s were characterized by a great deal of experimentation as Congress enacted a number of laws aimed at encouraging the entry of more private capital into the mortgage finance business

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[4] D.M. Frederiksen, *Mortgage Banking in America*, 2 J. POLITICAL ECON. 203, 208 (1894).

[5] *Id.* at 209.

[6] *Id.* at 210.

[7] *Id.* at 216.

[8] John J. Clarke & Maurice Finkelstein, *Mortgage Banks: A Study in Real Estate Finance*, 12 ST. JOHN'S L. REV. 52, 55 (1937).

[9] *Id.* at 53.

supported by some form of government guarantee. These interventions were undertaken in an effort to address the challenges then facing the mortgage financing business. At its worst, in 1933, some 1,000 home loans were being foreclosed every day,[10] and at the beginning of 1934, approximately one-half of urban homes in the United States with an outstanding mortgage were in default.[11]

At the beginning of the crisis in 1932, Congress created the Federal Home Loan Bank System ("**FHLB**") to provide a stable source of funds to member firms for residential mortgage and economic development loans.[12] FHLB membership was required of all federally chartered savings and loan associations and was optional for state-chartered lenders. The system was patterned after the Federal Reserve System, with 12 regional Home Loan Banks and an oversight Board located in Washington, D.C. Member institutions were required to purchase stock in their local Home Loan Bank and could borrow from the Bank against the mortgage loans they made. Home Loan Bank operations were financed from their capital, deposits of member institutions and by issuing debt. Interest on Home Loan Bank securities was exempt from federal, state, and local income taxes, but the securities were not guaranteed by the U.S. government. In contrast with the glowing predictions of the benefits that would be immediately derived from the creation of the FHLB, little initial improvement was shown and the urban mortgage situation became worse instead of better.[13]

In 1933, the new Roosevelt Administration sought a more effective solution and created the Home Owners' Loan Corporation ("**HOLC**") to purchase and refinance distressed mortgages, subject to income and loan qualifications. The HOLC issued over one million loans between August 1933 and June 1936.[14] As the HOLC began operations, Congress and the Roosevelt Administration were quick to analyze what was or was not working and amendments were

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[10] David C. Wheelock, *The Federal Response to the Home Mortgage Distress: Lessons from the Great Depression*, 90(3) FED. RESERVE BANK ST. LOUIS REV. 133, 138 (May/June 2008).

[11] *Id.* at 139 (quoting David A. Bridewell, *The Federal Home Loan Bank Board and its Agencies: A History of the Facts Surrounding the Passage of the Creating Legislation, The Establishment and Organization of the Federal Home Loan Bank Board and the Bank System, The Savings and Loan System, The Home Owners' Loan Corporation, and the Federal Savings and Loan Insurance Corporation*, Federal Home Loan Bank Board at 172 (1938)).

[12] *Id.* at 141.

[13] E.S. Wallace, *Survey of Federal Legislation Affecting Private Home Financing Since 1932*, 5 LAW & CONTEMP. PROBS. 481, 489 (1938).

[14] Wheelock, *supra* note 10, at 142.

implemented in April 1934 to improve the operation and beneficial effects of the HOLC while cutting down on abuses and waste. Prior to the April 1934 amendments, the HOLC could exchange its own bonds for mortgages held by institutions or investors and would then work to restructure the mortgages acquired. Interest payments on the bonds issued by the HOLC were guaranteed by the U.S. government but the principal was not. Seeing that the guarantee on interest was not enough to give the bonds a market at par, Congress was quick to act at the request of the industry and the President and as part of the April 1934 amendments, the U.S. government guarantee was extended to the principal of the HOLC bonds as well.

Bringing private capital and innovation back into the mortgage market became a primary theme for Congressional actions through the mid- and late-1930s. When the establishment of federal savings and loan associations was authorized in June 1933, members of the Federal Home Loan Bank Board could request that the Secretary of the Treasury subscribe for preferred shares in federal savings and loan associations.[15] In setting up these associations, the Federal Home Loan Bank Board encountered resistance from private investors who were reluctant to invest in an entity in which stock owned by the government had preferred status as to the entity's assets.[16] Those same amendments in April 1934 allowed for both preferred and non-preferred investments in these associations in order to encourage a greater level of participation by private investors. Further amendments in 1935 allowed state-chartered building and loan associations to secure these types of equity investments and eventually the process was made easier by allowing these investments to be made by the HOLC rather than the Treasury.[17]

To further encourage private capital to enter the mortgage market, Congress created the Federal Savings and Loan Insurance Corporation, modeled after the Federal Deposit Insurance Corporation ("**FDIC**"), to insure certain accounts held at building and loan associations.[18] Congress also created an insurance program to insure mortgage obligations directly. The National Housing Act of 1934 created the Federal Housing Administration ("**FHA**") to administer a federal mortgage insurance program for approved private lenders on qualifying mortgage loans for the purchase, repair or alteration of existing homes and for the construction of new homes. As originally implemented, FHA insured loans were limited to $16,000 or less (as compared with a median U.S. house price of $5,304) and a maximum loan-to-value ratio of

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15 Wallace, *supra* note 13, at 493.

16 *Id.*

17 *Id.*

18 *Id.* at 497.

80%.[19] Congress further amended the National Housing Act in 1938 and extended insurance coverage to loans with a loan-to-value ratio of 90% if the total loan was no more than $5,400.[20]

Since it was expected that the National Housing Act would increase the flow of funds from commercial banks and other lending agencies into the mortgage market, Congress and the administration wanted to create some sort of a national mortgage market so that these institutions could sell their mortgage investments when necessary.[21] The National Housing Act authorized the creation of national mortgage associations, which were intended to be federally chartered private organizations that bought and sold qualifying first mortgages.[22] This provision of the National Housing Act was intended to promote a liquid national market for mortgages and thereby mobilize capital for housing finance.[23] However, no association was organized under the original provisions, so Congress moved once again to try to attract private capital by reducing the required capital needed to charter the associations and increasing the ability of such associations to use leverage so that they could issue notes, bonds, debentures or other obligations for up to 12 times the value of their outstanding stock.[24]

Despite these efforts, no private mortgage association was formed. However, in 1938, the Reconstruction Finance Corporation ("**RFC**") established the Federal National Mortgage Association ("**Fannie Mae**"), which became the principal government purchaser of FHA-insured loans. Fannie Mae was authorized to sell bonds to fund its mortgage purchases, and although the bonds were not explicitly guaranteed by the federal government, a government guarantee was implicit because the assets of Fannie Mae at that time were almost entirely invested in FHA-insured mortgages. Fannie Mae purchased some $82 million of mortgages in 1938 and somewhat smaller amounts over the next four years. By the end of 1941, Fannie Mae held a $207 million portfolio of mortgages.[25]

Mortgage insurance as enacted by Congress created further liquidity in, and began another step in the evolution of, the mortgage market. Mortgage companies, building and loan institutions and

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[19] Wheelock, *supra* note 10, at 144.

[20] *Id.*

[21] Wallace, *supra* note 13, at 505.

[22] Wheelock, *supra* note 10, at 145.

[23] *Id.*

[24] Wallace, *supra* note 13, at 506.

[25] Wheelock, *supra* note 10, at 145.

state banks began originating insured mortgages and then selling them to financial institutions and government agencies, essentially acting as brokers of insured mortgage loans.[26]

The dynamic nature of the U.S. mortgage finance business caught the attention of scholars writing in the 1930s who contrasted the U.S. system with the more static mortgage banking industries of France, Germany and other European countries at that time. One scholar, for example, hypothesized that the United States' more mobile population which moved from city to city or state to state necessarily created more diversification in mortgage finance structures and participants compared to Europe where it was typical at the time for generations of families to live in the same house and where "the task of distributing mortgage investments was intrusted almost entirely to mortgage banks."[27]

The extensive writings of economic, political and legal scholars in the decades leading up to the enactment of what is now the Section 3(C)(5)(c) exemption shed significant light on the state of the mortgage finance market in the period immediately preceding the enactment of the 1940 Act. These sources make clear that during this period this market was characterized by a great deal of change and experimentation, and the participation of a range of players, from unregulated mortgage companies to regulated banks, insurance companies and trust companies to government sponsored enterprises to the federal government itself. This period also saw the first mortgage backed securities ("**MBS**") issued by Fannie Mae, laying the foundation for what has become a very large market in MBS issued by government-sponsored enterprises[28] (hereinafter the "**Agencies**" and MBS issued by the Agencies, "**Agency MBS**"). In many ways, the issues facing mortgage and housing finance industries in the 1930s parallel the issues facing these industries in 2011 in the aftermath of the most recent financial crisis.

In the context of this historical record, we believe that the broad language of what is now the Section 3(c)(5)(C) exemption must be read to mean that Congress did not intend to freeze the reach of the exemption to include only those forms of companies and structures that were in use in 1940, but instead to allow the exemption to capture the changes in mortgage markets that Congress itself had a large role in initiating.

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[26] Spurgeon Bell, *Shifts in the Sources of Funds for Home Financing, 1930-1937*, 5 LAW & CONTEMP. PROBS. 510, 514 (1938).

[27] Clarke & Finkelstein, *supra* note 8, at 58.

[28] These include the Government National Mortgage Association ("**Ginnie Mae**"), Fannie Mae and the Federal Home Loan Mortgage Corporation ("**Freddie Mac**").

We do not agree with the view advanced in the Concept Release that, notwithstanding the broad language of the exemption, it was actually intended by Congress to be limited to businesses engaged in "mortgage banking."[29] As support for this idea, the Concept Release quotes a 1970 House Report which was published 30 years ***after*** the Section 3(c)(5)(C) exemption was enacted. We do not believe that a House Report published 30 years after the enactment of a law reflects evidence of Congressional intent at the time of its enactment and further note that the House Report itself never actually refers to "mortgage banking" at all. Instead, we believe that the language of the exemption in light of the historical record reflects Congress's intent to allow different and evolving forms of companies engaged in the mortgage and mortgage finance businesses to fit within the exemption.

In light of the foregoing, our view is that to be consistent with Congressional intent underlying the Section 3(c)(5)(C) exemption any Commission action must maintain the flexibility to allow mortgage markets to continue to innovate and evolve. In the last month, for example, new ideas from the current Administration have been floated to encourage more private capital to flow into the mortgage market. These include proposals for Fannie Mae and Freddie Mac to sell strips of securities that would not carry the normal Fannie Mae or Freddie Mac guarantee, but instead would offer investors a higher interest rate compared to guaranteed securities. We believe that the Section 3(c)(5)(C) exemption should be read to allow publicly traded companies, including mortgage REITs, to participate in these new strategies and structures, as well as future innovations that are rolled out as the nation continues to develop policies intended to bring more private capital into the mortgage and mortgage finance businesses.

**Consistency with the purposes and policies underlying the 1940 Act, the public interest, and the protection of investors**

The second goal that the Commission sets for itself in the Concept Release is that any actions undertaken by the Commission must ensure that the exemption set out in Section 3(c)(5)(C) is administered in a manner that is consistent with the purposes and policies underlying the 1940 Act, the public interest, and the protection of investors. As noted above, we believe that the Section 3(c)(5)(C) exemption was intended to exempt a range of mortgage and mortgage finance companies from regulation as investment companies under the 1940 Act. That such companies would somehow resemble investment companies is, in our view, beside the point since the purpose of the exemption is to exclude companies that, but for the exemption, would meet the

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[29] *See* Concept Release, *supra* note 1 at 4, 15, 15 n.38, 25, 26, 28 (discussing legislative history of Section 3(c)(5(C)).

statutory definition of an "investment company." We believe that any action taken by the Commission that artificially restricts or places material conditions or limitations on Section 3(c)(5)(C), such as restrictions on the amount of borrowings that can be used by mortgage REITs, would undermine the reach of the exemption and would impermissibly frustrate Congressional intent.

In terms of the public interest, our view is that a national policy consensus is emerging that the United States needs more private capital to flow into mortgage markets. A February 2011 report to Congress on "Reforming America's Housing Market," issued jointly by the U.S. Treasury and Department of Housing and Urban Development, recommends using a combination of policy levers to wind down Fannie Mae and Freddie Mac, shrink the government's footprint in housing finance, and help bring private capital back to the mortgage market. In order to achieve these goals, we believe that publicly traded mortgage REITS (which typically rely on Section 3(c)(5)(C)) have and can continue to play a prominent role. We further believe that creativity and experimentation will once again play a role in these next steps in the evolution of the mortgage finance market. We believe that the public interest will be best served by approaches that allow for flexible participation in this market by such mortgage REITs.

The Concept Release solicits comments on potential investor protection concerns relating to self-dealing, inflated valuations and other conflicts of interest between the company relying on Section 3(c)(5)(C) and its sponsors or external advisors. In our view, mortgage REITs and similar companies that are listed on an exchange are already subject to many forms of regulation that provide investor protections, including corporate governance rules relating to independent directors, independent committees and independent auditors alongside the widespread adoption and disclosure around related party transaction policies and corporate governance guidelines. In addition, publicly traded mortgage REITs, in preparing their quarterly and annual financial statements, are already required to comply with accounting rules and procedures that focus heavily on asset valuation. Our view is that these rules and procedures are both rigorous and effective in making sure that asset values are properly recorded and reported by the universe of existing mortgage REITs. The Dodd-Frank Act's expanded investment adviser registration requirements could also allow the Commission to address any remaining concerns raised about externally managed companies in the Concept Release.

We also note that the Commission is soliciting comments as to whether a company whose primary business consists of investing in Agency MBS is the type of entity that Congress intended to be encompassed by the exclusion provided by Section 3(c)(5)(C). We do not see how any action taken by the Commission that would exclude Agency MBS as qualifying assets under

Section 3(c)(5)(C) could be seen as enhancing investor protection in light of the fact that Agency MBS are naturally safer than their underlying mortgages because of the Agency guarantee if the mortgages do not perform. We also note that early forms of Agency MBS were in existence at the time of enactment of the 1940 Act.[30]

**Clarity, consistency and regulatory certainty**

The third goal the Commission sets for itself in the Concept Release is that the actions it will undertake should provide greater clarity, consistency and regulatory certainty in this area. As the Concept Release makes clear, the Section 3(c)(5)(C) exemption has not been comprehensively addressed by the Commission.[31] However, this exemption has been addressed by the SEC Staff in a number of staff no-action letters on a case-by-case basis. The Concept Release solicits comments on some of the SEC Staff's guidance, including the test the no-action letters have developed to determine whether an issuer is "primarily engaged" in the business of purchasing or acquiring mortgages or other liens and interests in real estate, and the SEC Staff's guidance on how to interpret "other liens on or interests in real estate." The Concept Release is helpful in clarifying and bringing together the current state of guidance issued by the SEC Staff.[32] In our view, the historical SEC Staff interpretations as developed through the years take an intelligent, principles based approach in applying the exemption in Section 3(c)(5)(C). SEC Staff interpretations have consistently taken the view that the exemption requires entities primarily to hold mortgages directly or to hold interests that allow their holders to be in at least the same position as, and with rights equivalent to, direct mortgage holders. We believe that this interpretative approach has generally worked well, provided a great deal of clarity to market participants and has allowed a significant amount of private capital to be raised around these interpretations.

One of the issues we see in adopting rules under the Section 3(c)(5)(C) exemption is that such rules may capture mortgage financing structures and companies in use today, but may miss the innovations of tomorrow. We also believe that any rules that do not allow the Section 3(c)(5)(C) exemption to accommodate future innovations run the risk of undermining the intent of the exemption. We also urge caution in any Commission action that materially limits SEC Staff guidance or reverses interpretations and approaches that have been used by the market for more than 30 years. We believe that any such action would likely cause substantial losses to investors

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30 *See* Bell, *supra* note 26, at 516.

31 Concept Release, *supra* note 1, at 5, 21.

32 *Id.* at 17.

participating in the mortgage REIT universe. For example, while multiple factors could have also been at play, from the date of announcement of the Concept Release (which raised questions about the continuing viability of the exemption) through November 4, 2011, an index of publicly traded mortgage REITs had a price return of -6.97% compared to the S&P price return of +3.31% over the same period.[33]

**Effects on capital formation**

The final goal set out by the Commission in the Concept Release is that any actions it takes should facilitate capital formation. We believe that any Commission action in this area must take into account the role of mortgage REITs in the United States, which, because they are publicly traded companies, rely on the Section 3(c)(5)(C) exemption in order to conduct their businesses.

*Role and Performance of Mortgage REITs*

REITs were first formed in the 1960s, when, in yet another action designed to bring private capital into the real estate market, Congress granted them favorable tax treatment. The evolution of this market continued in the 1970s with the formation of mortgage REITs. According to current estimates, the mortgage REIT sector has grown to 42 publicly traded companies with a combined market capitalization of approximately $43.1 billion.[34]

*Capital Formation*

Mortgage REITs provide a significant amount of capital and liquidity to the residential and commercial real estate markets. This support includes directly originating and purchasing mortgage loans, purchasing MBS and creating partnerships and joint ventures with select government institutions, including the FDIC. Mortgage REITs have directly or indirectly, funded millions of residential and commercial properties, including single family homes, multifamily units, office buildings, hotels, shopping malls, and other properties. Their presence has facilitated efficient capital raising during the recent financial crisis and provided significant support to the residential and commercial mortgage markets and to the housing market as a whole. Since the

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[33] FactSet Research Systems, Inc. (for the period from Aug. 31, 2011 through Nov. 4, 2011). The index referred to includes the following companies: MITT, AGNC, MTGE, ACMC, NLY, ANH, ARI, AMTG, ABR, ARR, BMNM, BRT, CT, CMO, CIM, CLNY, CXS, CYS, DX, ELC, GKK, HTS, IMH, IVR, SFI, JERT, MFA, NYMT, NCT, NRF, ORGN, PMT, PCC, RAS, RWT, RSO, STWD, TWO, VRTA, VRTB, WBSTP, and FUR.

[34] *Id.*

beginning of 2008, mortgage REITs have raised $31.9 billion of equity capital,[35] which in turn resulted in a buying power of mortgage-related assets of over $100 billion dollars.

Mortgage REITs have a significant and increasingly important role in the secondary mortgage markets. According to Credit Suisse fixed income research,[36] mortgage REITs were estimated to have owned $137 billion of MBS at the end of 2010 and are projected to increase their holdings by over $100 billion of mortgage REITs in 2011. As of June 30, 2011, mortgage REITs owned over $225 billion of MBS.[37] The role of mortgage REITs is becoming increasingly important because both Fannie Mae and Freddie Mac, by far the biggest purchasers of MBS prior to their conservatorship, are no longer actively acquiring MBS securities and are expected to sell down their portfolios over time. Mortgage REITs are now a critical provider of liquidity in this market helping to maintain lower mortgage rates for consumers. In addition, commercial and investment banks, historically large holders of mortgages and MBS, have been less aggressive in acquiring these assets as a result of new, more stringent regulatory capital rules that make holding mortgages and MBS less attractive to banks. As illustrated in Table 1 below, REITs added $73.5 billion of Agency MBS and $13.7 billion of home mortgages in the first half of 2011,[38] while banks reduced their total investment in the combined asset classes.

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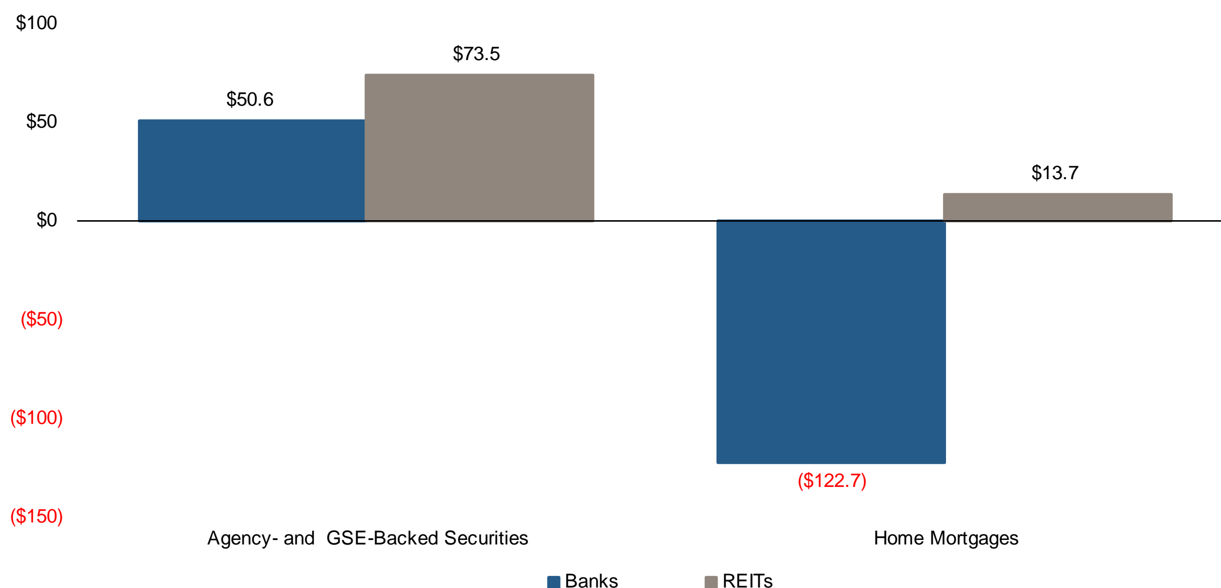
[35] Dealogic; FactSet Research Systems, Inc. (Nov. 4, 2011).

[36] Credit Suisse Fixed Income Research, *Mortgage Market Focus – H2:11 Outlook* (June 24, 2011).

[37] Sourced from company filings.

[38] Federal Reserve Flow of Funds data as of Oct. 21, 2011.

Table 1: Flow of funds comparison: REITs compared to Banks[39]
January 1st, 2011 – June 30th, 2011
(in Billions)




Note: "Banks" include: U.S. chartered commercial banks, foreign banking offices in the United States, banks in U.S. affiliated areas, savings institutions, and credit unions. "Banks" also includes bank holding companies for the Agency- and GSE-Backed Securities category.

*Use of Leverage in the Capital Structure of Mortgage REITs*

Though the Concept Release seems to note with concern the amount of leverage employed by some of the companies relying on Section 3(c)(5)(C)[40], the Commission solicited no specific comments on this point.

If the Commission were to adopt rules to narrow significantly the Section 3(c)(5)(C) exemption by imposing leverage limitations, mortgage REITs would be required to delever their balance sheets, selling a large volume of mortgages and MBS into the market. A wide range of constituencies, including homeowners/homebuyers, realtors, equity investors and most mortgage investors, all benefit from the flexibility of mortgage REITs to use leverage. A sharp

[39] *Id.*

[40] Concept Release, *supra* note 1, at 9, 12.

deleveraging of REITs is, in our view, inconsistent with the U.S. government's long-term goal of increasing private capital participation in the mortgage market.

Generally, the amount of leverage employed by a REIT is governed by the amount of risk embedded in the business strategy. Mortgage REITs, depending on the types of mortgage assets they acquire, employ various levels of leverage to generate returns for investors. The amount of leverage and borrowing capacity by these companies is generally governed by risks embedded in their assets and by their lending counterparties, such as commercial banks, who focus on counterparty risk management.

Mortgage REITs holding Agency MBS use more leverage to enhance their returns compared to other mortgage REITs because of the guarantee of principal and interest payments by the Agencies. As a result, banks, broker dealers and other financing providers feel comfortable lending against these assets due to the fact that they carry no credit risk, are acceptable collateral at the Federal Reserve Discount Window and can be used to access liquidity from the Federal Reserve.[41] The liquidity in the Agency MBS market has always been strong. We understand through our conversations with investment banks that cover the mortgage REIT industry that, even during the latest financial crisis, market participants were able to obtain liquidity against portfolios of Agency MBS, though at somewhat higher cost. On a debt-to-equity ratio basis, that translates into typical leverage of between 5:1 and 8:1 for Agency MBS portfolios.[42] This compares favorably to the banking industry which has an average leverage ratio of 9.5:1 for the top 50 banks in the United States[43]

Mortgage REITs acquiring non-Agency residential MBS and commercial MBS, carry much lower amounts of leverage in their strategies because, unlike Agency MBS, these assets retain the full credit risk of the underlying mortgages. The financing providers adjust their lending terms to reflect those risks and allow for much lower borrowing advances to limit potential losses.

In addition, we believe that the amount of leverage currently used by mortgage REITs, which, on average is 5.5:1,[44] is conservative, lower than in the past (mortgage REITs had an average of

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[41] *See* Federal Reserve Collateral Guidelines, June 27, 2011.

[42] Sourced from company filings.

[43] SNL Financial (reporting based on Tier 1 common capital ratio, average implied leverage is 9.5:1 as of June 30, 2011).

[44] *Id.* (reporting mortgage REIT financial data as of June 30, 2011).

11.5:1 debt-to-equity at the end of 2006[45]) and manageable considering current market conditions. Today's financing markets allow for much higher levels of borrowings than mortgage REITs currently employ. However, our experience is that mortgage REITs are mindful of not using leverage excessively and are, by and large, focused on preserving shareholder capital.

We also wish to reiterate our view that the imposition of leverage limitations as a condition to the availability of the Section 3(c)(5)(C) exemption would frustrate Congressional intent and therefore go beyond the Commission's authority under the 1940 Act. As discussed above, from at least the 1880s, companies engaged in the mortgage finance business (including the Agencies) were using leverage by issuing bonds to finance their mortgage ownership activities. We can presume that Congress (which was involved in creating many of the policies that encouraged the use of leverage by participants in the mortgage financing business) was well aware that leverage was being used but decided not to incorporate leverage limitations into the exemption.

*Performance of Mortgage REITs*

We believe that this risk-based approach to leverage and the crucial role of mortgage REITs in bringing private capital into the mortgage finance market is reflected in the positive performance of mortgage REITs during this past decade on a total return basis. The tables below show the absolute total return from an investment in the NAREIT Mortgage REIT index for various time periods in comparison to the returns from other broad indices.

[45] SNL Financial (2006) (reporting mortgage REIT financial data as of Dec. 31, 2006 for the top ten mortgage REITS by market cap as of June 30, 2011, which were in existence on Dec. 31, 2006).

Table 2: Total shareholder return: Mortgage REITs compared to S&P 500 and S&P Diversified Financials - *September 28th, 2001 - September 30th, 2011*

**Compound Annual Return**(1)

| **Year** | **NAREIT mREITS** | **S&P 500** | **S&P Diversified Financials** |
|---|---|---|---|
| 1 Year | 3.1% | 1.1% | (25.8%) |
| 3 Year | 12.6% | 1.2% | (20.1%) |
| 5 Year | (9.5%) | (1.2%) | (20.0%) |
| 10 Year | 3.8% | 2.8% | (5.4%) |

**Total return**(2)

| **Year** | **NAREIT mREITs** | **S&P 500** | **S&P Diversified Financials** |
|---|---|---|---|
| 1 Year | 3.1% | 1.1% | (25.8%) |
| 3 Year | 42.8% | 3.7% | (48.9%) |
| 5 Year | (39.4%) | (5.8%) | (67.2%) |
| 10 Year | 44.7% | 32.0% | (42.4%) |

Source NAREIT and Factset.

(1) Compound annual return includes capital gains and dividends (this calculation assumes dividends were reinvested). Compound annual return is calculated by taking the (ending value / beginning value)^(1 / number of years) – 1.

(2) Total return includes capital gains and dividends for the period stated (this calculation assumes dividends were reinvested).

**Additional considerations**

The Concept Release also discusses some of the fee structures that are in place in the mortgage REIT sector, especially for mortgage REITs which are externally managed.[46] We would like to note that most of the fees charged in this sector are based on shareholders' equity rather than on total assets. This approach discourages mortgage REITs from collecting higher fees by adding more leverage. As illustrated by the table below, fee structures for externally managed mortgage REITs generally include base management fees of between 1.25% to 1.50% of shareholders' equity. These management fees as a percentage of assets range from 0.14% to 1.4%. We understand that these base fees, adjusted for leverage, are comparable to fees charged by mutual funds. According to the Investment Company Institute and Lipper, the average fees charged by stock mutual funds are 0.95% of assets, while the average fees charged for bond mutual funds are 0.72% of assets.[47]

[46] Concept Release, *supra* note 1, at 11.

[47] Data provided by Investment Company Institute and Lipper, a Thomson Reuters Company. Data as of Dec. 31, 2010. Data excludes mutual funds available as investment choices in variable annuities and mutual funds that

Table 3: Selected Externally Managed Mortgage REIT Fee Structure Summary[48]

| Company | Base fee (% of equity) | Base fee (% of assets)[1] | Incentive fee |
|---|---|---|---|
| **American Capital Agency Corp.** | 1.25% | 0.14% | None |
| **Apollo Commercial Real Estate Finance, Inc.** | 1.50% | 0.49% | None |
| **Arbor Realty Trust, Inc.** | Negotiated annually | NA | 25% of greater of i) 9.5% and ii) T + 3.50% |
| **ARMOUR Residential REIT, Inc.**[2] | 1.45%[3] | 0.14% | None |
| **Chimera Investment Corporation** | 1.50% | 0.51% | None |
| **Colony Financial, Inc.** | 1.50% | 1.40% | 20% above 8% |
| **CreXus Investment Corp.** | 1.50% | 1.39% | None |
| **Hatteras Financial Corp.**[4] | 0.76%[5] | 0.18% | None |
| **Invesco Mortgage Capital Inc.** | 1.50% | 0.22% | None |
| **PennyMac Mortgage Investment Trust** | 1.50% | 0.89% | 20% above 8% |
| **Resource Capital Corp.** | 1.50% | 0.33% | 25% of greater of i) 2% and ii) 1/4T + 0.50% |
| **Starwood Property Trust. Inc.** | 1.50% | 1.02% | 20% above 8% |
| **Two Harbors Investment Corp.** | 1.50% | 0.22% | None |
| **Mean Externally Managed Mortgage REIT** | 1.41% | 0.55% | NA |
| **Median Externally Managed Mortgage REIT** | 1.50% | 0.33% | NA |
| **Typical Stock Mutual Fund** | NA | 0.95% | NA |
| **Typical Bond Mutual Fund** | NA | 0.72% | NA |

(1) As of June 30, 2011.

(2) Base fee % is based on end of period common stock and additional paid in capital as of Sept. 30, 2011.

(3) 1.5% of equity up to $1 billion and 0.75% of equity in excess of $1 billion.

(4) Base fee % is based on average balances of common stock and additional paid in capital for the quarter ended Sept. 30, 2011.

(5) 1.5% of equity up to $250 million, 1.1% of equity from $250 million - $500 million, 0.8% of equity from $500 million - $750 million and 0.5% of equity greater than $750 million.

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invest primarily in other mutual funds. Figure reports year-end asset-weighted average of annual expense ratios and annualized loads for individual funds. Stock funds include equity and hybrid funds.

48 Sourced from company filings.

The Commission also noted in the Concept Release that some mortgage REITs carry incentive compensation structures. We firmly believe that managing a portfolio of assets with significant exposure to various risks should incorporate an incentive compensation structure to provide some symmetry and align interests of the external manager with those of the REIT's shareholders.

**Conclusions**

As a country we find ourselves facing many of the challenges we faced in the mortgage and mortgage finance market during the 1930s. We again have an emerging national policy consensus around bringing more private capital into mortgage markets. In this environment, we believe that it would be a serious policy error to adopt rules that narrow and limit the exemption in Section 3(c)(5)(C) and therefore to rein in the balance sheets of mortgage REITs, which are significant private capital providers to the mortgage industry and are likely to play an even more prominent role in the future. We also need an approach to regulation under Section 3(c)(5)(C) that will allow the exemption to be adaptable to the market today and also allow for further evolution in the mortgage market of tomorrow. We trust that as new innovations come to market, the SEC Staff will be permitted to continue to provide principles based thoughtful guidance on questions relating to the proper scope of the Section 3(c)(5)(C) exemption.

* * *

We appreciate this opportunity to comment on the Concept Release, and would be happy to discuss any questions with respect to this letter. Any such questions may be directed to Jay L. Bernstein, Esq. (212-878-8527) or Andrew S. Epstein, Esq. (212-878-8332) in our New York office.

Very truly yours,

CLIFFORD CHANCE US LLP