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November 7, 2011

Re: Keefe, Bruyette & Woods Response to SEC Release No. IC-29778; File No. S7-34-11 (*Companies Engaged in the Business of Acquiring Mortgages and Mortgage-Related Instruments*)

To Whom It May Concern:

On behalf of Keefe, Bruyette & Woods, we are writing in response to the SEC Release No. IC-29778; File No. S7-34-11 (*Companies Engaged in the Business of Acquiring Mortgages and Mortgage-Related Instruments*). Keefe, Bruyette & Woods is an investment bank that specializes in the financial services sector. We publish research on more financial services companies than any other investment bank in the country. We believe that this gives us a strong vantage point on the mortgage and housing markets.

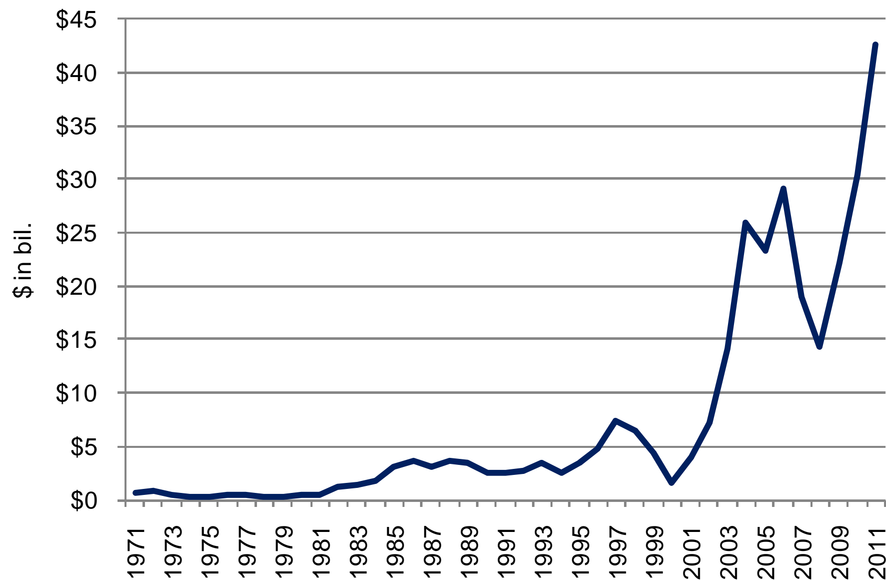
In this letter we respond to the key questions raised by the SEC Concept Release. We will address the issues raised in the following order: 1) A brief history of the sector and the different types of companies that use or have used the Section 3(c)5(C) exemption to operate; 2) the difference between mortgage originators that invest in a portion of their own mortgages and pure mortgage investors; 3) differences and similarities between mortgage related pools and investment companies regulated under the Act; 4) existing safeguards in structure and operations; and 5) the importance of mortgage REITs in capital formation in the mortgage sector.

We believe that mortgage REITs have been playing a central role in attracting permanent capital back to the mortgage market, and we believe this will continue for the foreseeable future. As a result, regulation under the Investment Company Act could meaningfully impede the housing market recovery. However, we do believe that some changes, such as increased disclosure requirements, could be positive for investors and potentially help in the capital formation process.

A Brief Look at the Mortgage REIT Sector

According to data from the National Association of Real Estate Trusts (NAREIT), mortgage REITs have been in existence for over fifty years. However, the sector historically played a peripheral role in the mortgage market. This started to change in the late 1990s and most of the growth in the mortgage sector has taken places over the past decade. Exhibit 1shows the growth in mortgage REIT common equity over the past fifty years.

Exhibit 1: Growth in Mortgage REIT Sector Since 1971
As of November 4, 2011



Source: NAREIT and KBW Research.

Mortgage REITs can be divided into residential and commercial mortgage REITs. Residential REITs are a much bigger sector and with $38 billion of equity it accounts for almost 90% of total mortgage REIT equity. The residential mortgage REIT sector can be further subdivided into companies that take credit risk and ones that do not (Agency MBS REITs).

Exhibit 2 breaks out the universe of residential mortgage REITs by type. Agency MBS REITs now account for over 70% of residential mortgage REIT market capitalization.

Exhibit 2: Residential Mortgage REITs by Market Segment
As of November 4, 2011

Company	Ticker	Mkt. Cap. ($ in millions)	% Share	Business Model
Annaly Capital Management, Inc.	NLY	$15,867.8	41.5%	Agency MBS
American Capital Agency Corp.	AGNC	$6,153.1	16.1%	Agency MBS
Chimera Investment Corp.	CIM	$2,947.9	7.7%	Hybrid MBS
MFA Financial, Inc.	MFA	$2,400.6	6.3%	Hybrid MBS
Hatteras Financial Corp.	HTS	$2,004.8	5.2%	Agency MBS
Invesco Mortgage Capital Inc.	IVR	$1,774.7	4.6%	Hybrid MBS
Two Harbors Investment Corp.	TWO	$1,297.6	3.4%	Hybrid MBS
CYS Investments Inc.	CYS	$1,055.1	2.8%	Agency MBS
Capstead Mortgage Corp.	CMO	$1,046.9	2.7%	Agency MBS
Redwood Trust, Inc.	RWT	$860.8	2.2%	Non-Agency MBS
Anworth Mortgage Asset Corp.	ANH	$832.6	2.2%	Agency MBS
Armour Residential REIT Inc.	ARR	$608.6	1.6%	Agency MBS
PennyMac Mortgage Investment Trust	PMT	$475.0	1.2%	Non-Agency MBS
Dynex Capital, Inc.	DX	$344.4	0.9%	Hybrid MBS
AG Mortgage Investment Trust Inc.	MITT	$179.7	0.5%	Hybrid MBS
American Capital Mortgage Investment Corp.	MTGE	$179.2	0.5%	Hybrid MBS
Apollo Residential Mortgage Inc.	AMTG	$159.3	0.4%	Hybrid MBS
New York Mortgage Trust, Inc.	NYMT	$77.9	0.2%	Hybrid MBS
Total		**$38,266.0**		

Source: FactSet and KBW Research.

Exhibit 3 shows the commercial mortgage REIT universe.

Exhibit 3: Commercial Mortgage REIT Universe
As of November 4, 2011

Company	Ticker	Mkt. Cap. ($ in millions)	% Share	Business Model
Starwood Property Trust Inc.	STWD	$1,748.6	32.1%	Commercial
Crexus Investment Corp.	CXS	$732.5	13.4%	Commercial
iStar Financial Inc.	SFI	$599.0	11.0%	Commercial
Colony Financial Inc.	CLNY	$479.8	8.8%	Commercial
Northstar Realty Finance Corp.	NRF	$412.6	7.6%	Commercial
Resource Capital Corp.	RSO	$408.2	7.5%	Commercial
Newcastle Investment Corp.	NCT	$359.2	6.6%	Commercial
Apollo Commercial Real Estate Finance Inc.	ARI	$281.5	5.2%	Commercial
RAIT Financial Trust	RAS	$210.0	3.9%	Commercial
Arbor Realty Trust Inc.	ABR	$90.3	1.7%	Commercial
PMC Commercial Trust	PCC	$80.9	1.5%	Commercial
Capital Trust Inc. (Cl A)	CT	$49.2	0.9%	Commercial
Total		**$5,451.8**		

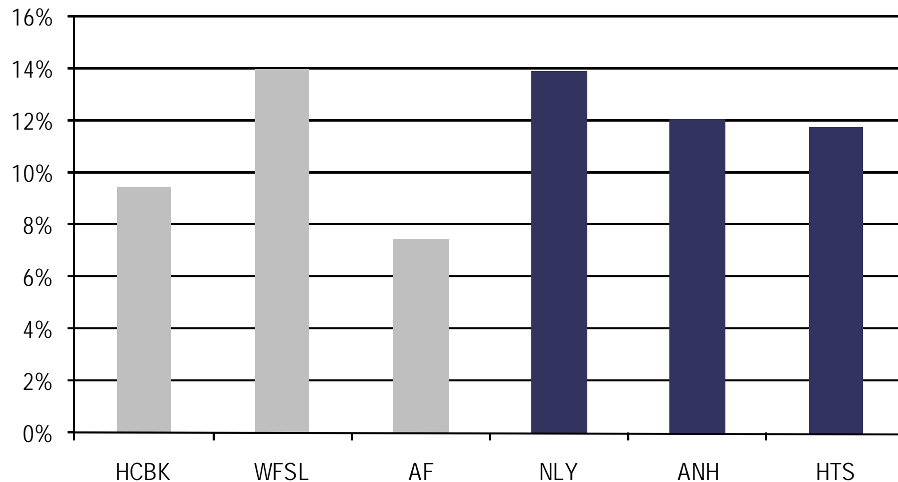
Source: Factset and KBW Research.

Agency MBS REITs

The Agency MBS REIT business model is many ways very similar to that of a thrift. Agency MBS REIT capital is invested largely in Agency MBS. Their borrowings are done through the repurchase (repo) market where they pledge their assets to borrow. This is a multi-trillion dollar market that is used by large numbers of investors in Treasuries, Agencies and other securities. This market remained open for Agency MBS investors throughout the crisis in 2008.

Agency MBS REIT balance sheets are levered between 6x-8x (debt/equity). Tangible equity/assets ratios are generally in the 11%-14% range. This cautious level of leverage is below that of most thrifts that originate and invest in mortgages (see Exhibit 4). It is also well below the theoretical peak leverage, which is effectively set by the overcollateralization requirements (haircut) in the repo market. Haircuts effectively act as a minimum capital requirement and these are generally in the 5% range.

Exhibit 4: Mortgage REIT versus Thrift Equity/Asset Ratios
As of 2Q11



Note: REITs (blue bars), Thrifts (gray bars).
Source: SNL and company data.

Exhibit 5 breaks out the key metrics for the mortgage REITs that invest all their capital into Agency MBS.

Exhibit 5: Agency MBS REIT Key Operating Metrics
$ in billions, unless indicated

Company	Ticker	Market Cap.	Total Assets	Leverage
Annaly Capital Management, Inc.	NLY	$15.87	$113.6	5.5
American Capital Agency Corp.	AGNC	$6.15	$47.0	7.9
Hatteras Financial Corp.	HTS	$2.00	$18.4	7.9
Capstead Mortgage Corp.	CMO	$1.05	$12.5	8.2
CYS Investments Inc.	CYS	$1.06	$9.5	7.0
Anworth Mortgage Asset Corp.	ANH	$0.83	$8.8	7.3
ARMOUR Residential REIT, Inc.	ARR	$0.61	$6.4	9.1
Total / Average		**$27.57**	**$216.28**	**7.5**

Note: Market capitalization as of 11/4/11. Assets and leverage as of 3Q11.

Source: Company reports, FactSet, and KBW Research.

While Agency MBS REIT returns are sensitive to changes in rates, the business model has proved very resilient over the past fifteen years and no pure play Agency MBS REIT had difficulty navigating the mortgage market crisis in 2007-08.

Mortgage Credit and Hybrid Mortgage REITs

Hybrid mortgage REITs invest in a combination of Agency MBS and non-agency MBS. There are only two residential mortgage REITs that invest exclusively in credit risk – Redwood Trust (RWT) and PennyMac (PMT). Exhibit 6 shows the list of companies in the sub-sector.

Exhibit 6: Non-Agency / Hybrid MBS REIT Key Operating Metrics
$ in billions, unless indicated

Company	Ticker	Market Cap.	Total Assets	Total Leverage
Chimera Investment Corp.	CIM	$2.95	$10.1	1.9
MFA Financial, Inc.	MFA	$2.40	$12.0	3.4
Invesco Mortgage Capital Inc.	IVR	$1.77	$15.2	6.3
Two Harbors Investment Corp.	TWO	$1.30	$8.8	5.7
Redwood Trust, Inc.	RWT	$0.86	$5.6	0.1
PennyMac Mortgage Investment Trust	PMT	$0.47	$1.2	1.1
Dynex Capital, Inc.	DX	$0.34	$2.6	6.1
Total / Average		**$10.10**	**$55.49**	**3.5**

Note: Market capitalization as of 11/4/11. 3Q11 data for all companies except CIM (2Q11).

Source: Company reports, FactSet, and KBW Research.

Mortgage REITs that take credit risk generally control their credit exposure through careful underwriting. However, because their business model is to take credit risk they generally do not hedge this exposure.

The shutdown of the securitization market has changed the liability structure and business models of these companies. Historically, mortgage REITs could invest in credit risk by originating or purchasing loans and securitizing them. Securitization provided permanent non-recourse leverage. With the shutdown of the securitization market, there is no longer a way for mortgage REITs to act as long term investors in credit risk on newly originated mortgages since there's no other way for them to obtain leverage.

As a result, most of these companies invest in credit risk through purchasing legacy MBS. Since these securities are generally trading at a discount to par, they can provide reasonably attractive returns with modest leverage, generally through the repurchase market. While this can provides attractive returns with low leverage, purchased non-agency MBS are not considered qualifying assets since they are pieces of structured securities, not whole pools.

Once the securitization market comes back, mortgage REITs should be able to once again create their own securitizations which would allow them to be exempt from the act under Section 3(c)5(C) without needing to use the 55% qualifying interest exemption. Mortgage credit REITs that securitize mortgages would clearly be considered investors in mortgages as securitization is just a way of obtaining permanent financing on their investment in mortgage loans.

Commercial Mortgage REITs

Commercial mortgage REITs invest in a combination of commercial mortgage assets.
Commercial mortgage REITs either originate their own loans or purchase distressed loans and securities (CMBS). Unlike the residential mortgage REITs, commercial mortgage REITs are largely focused on taking credit risk as opposed to interest rate risk. This primarily reflects the fact that a lack of a government role means that private investors need to hold credit risk. The commercial mortgage-backed securities (CMBS) market is also functioning, albeit tenuously, which provides an opportunity for originators to obtain leverage. It is also possible to obtain leverage through insurance companies.

Exhibit 7 shows the key operating metrics for the commercial mortgage REITs. We separate out the ones that went public since 2009 which are all fairly traditional commercial investors in commercial mortgages of CMBS. The older peers have a more complex mix of assets and higher leverage because of securitization funding (which is generally no longer available). Going forward, we expect commercial REIT leverage to be more consistent with what we've seen from the newer commercial mortgage REITs.

Exhibit 7: CMBS REIT Key Operating Metrics
$ in billions, unless indicated

Company	Ticker	Market Cap.	Total Assets	Leverage
New CMBS REITs				
Starwood Property Trust Inc.	STWD	$1.75	$2.50	0.4
Crexus Investment Corp.	CXS	$0.73	$0.97	0.1
Colony Financial Inc.	CLNY	$0.48	$0.66	0.0
Apollo Commercial Real Estate Finance	ARI	$0.28	$0.91	2.0
Legacy CMBS REITs				
iStar Financial Inc.	SFI	$0.60	$7.75	3.7
Resource Capital Corp.	RSO	$0.41	$2.17	3.4
Newcastle Investment Corp.	NCT	$0.36	$3.69	NA
RAIT Financial Trust	RAS	$0.21	$3.05	1.9
Arbor Realty Trust Inc.	ABR	$0.09	$1.76	5.8
PMC Commercial Trust	PCC	$0.08	$0.25	0.6
Total / Average		**$4.99**	**$23.71**	**0.6**

Note: Market capitalization as of 11/4/11. Data for STWD, SFI, RSO, NRF, ARI, and RAS as of 3Q11, all other data as of 2Q11.

Source: Company reports, FactSet, and KBW Research.

Response to Questions Raised in the SEC Concept Release

The difference between mortgage originators that invest in a portion of their own mortgages and a pure mortgage investor

Section 3(c)5(C) exempts from the Act companies that are "primarily engaged in … purchasing or otherwise acquiring mortgages and other liens on and interests in real estate". The SEC has used the 55% whole pool test as the primary determinant of whether MBS investors meet the exemption. A whole pool investment has been deemed by the SEC to be the functional equivalent of owning an interest in real estate.

This directly leads to the question of whether there is a meaningful difference between a mortgage originator that invests in credit risk on one hand and a pure mortgage investor. While we believe that there is a distinction, this reflects the structure of the mortgage market. There is currently no role for mortgage originators who invest in a portion of their own originations.

Over the past few decades, with the development of the secondary mortgage market, the mortgage origination role has largely been separated from the mortgage investing role. Only about 30% of mortgage debt outstanding is held on balance sheet by mortgage originators. These loans are often adjustable rate mortgages that banks and thrifts are willing to hold because they match up well with their liabilities. Most fixed-rate

mortgages, which account for the bulk of the mortgage market, are sold into securitizations, and no risk is retained by the originator. This situation has been even more pronounced in the past few years as around 90% of new mortgages are fixed-rate loans that are being guaranteed being guaranteed by the government through Fannie Mae, Freddie Mac, or FHA.

Because the government guarantees most fixed-rate mortgages, the private sector by definition cannot compete and invest in mortgage credit risk because the government is investing at a subsidized rate. So the private sector has ceded that portion of the market to the government and at the moment, private mortgage capital, including that at the mortgage REITs, is not investing in credit risk in newly created loans (except in the $625,500 and above jumbo space where the government cannot compete). This situation is unlikely to change until the government meaningfully reduces its role in the mortgage market, either by reducing conforming loan limits or by increasing

Differences Between Mortgage Investment Pools and Investment Companies

We believe that there are several meaningful differences between mortgage REITs and Investment Companies that are regulated under the Act.

1) Mortgage REITs and Investment Pools have permanent capital and through leverage play a role similar to that of a bank or thrift. Investment funds, even ones that are dedicated to the mortgage sector, increase or reduce their commitment to the sector based on the desire of investors.

2) Most of the large mortgage REITs are publicly traded companies and as such are under meaningful scrutiny from analysts and investors. They hold quarterly earnings calls and interact regularly with investors through presentations at conferences.

3) Mortgage REITs are able to underwriters and invest in mortgage credit risk. Investment funds generally purchase investment grade bonds but are generally not interested in getting exposure to the underlying credit risk.

Existing safeguards in structure and operations

We believe that there are meaningful safeguards in the mortgage REIT sector as a result of industry best practices. The most uniform part of the market is the Agency MBS REIT sector. They all operate within a tight band in terms of leverage. See Exhibit 8.

Exhibit 8: Agency MBS REIT Leverage Ratios
As of 3Q11

NAME	Ticker	Leverage (Debt/Equity)
Annaly Capital Management, Inc.	NLY	5.5
American Capital Agency Corp.	AGNC	7.9
Anworth Mortgage Asset Corp.	ANH	7.3
Armour Residential REIT Inc.	ARR	9.1
Capstead Mortgage Corp.	CMO	8.2
Cypress Sharpridge Investments, Inc.	CYS	7.0
Hatteras Financial Corp.	HTS	7.9

Source: Company data and KBW Research.

While some mortgage REITs (but not Agency MBS REITs) did get hurt by the market downturn in 2007-8, this was driven by problems in the mortgage market and not the mortgage REIT structure. In fact, almost all large public mortgage companies, except the Agency MBS REITs, went out of business or were saved by a larger company as a result of the crisis in the mortgage market in 2008-2008. While two of the top five mortgage REITs also went out of business, one (American Home Mortgage) was a large mortgage bank that operated as a REIT and went out of business like most mortgage banks during that period because of a lack of liquidity for non-government mortgages that they originated. The other, Thornburg, was a mortgage originator and investor in non-government guaranteed mortgages. Exhibit 9 shows the top mortgage companies and mortgage REITs at year-end 2006 versus today. While the market capitalization of the mortgage sector has plummeted since 2006, mortgage REIT capitalization has moved up sharply. The exhibit does not include some large mortgage REITs since they became came public or were not in the top five list back in 2006.

Exhibit 9: Key Portfolio Characteristics

$ in millions

	Market Capitalization		
	12/31/2006	11/4/2011	Current Status
Mortgage Companies			
Fannie Mae	$57,734	$281	In conservatorship
Freddie Mac	$44,899	$158	In conservatorship
Countrywide Financial	$24,841	NA	Acquired by BAC
MGIC Investment Corp.	$5,178	$515	Active
Radian Group Inc.	$4,281	$378	Active
PMI Group Inc.	$4,092	$50	Active; in runoff
IndyMac	$3,297	NA	Seized by FDIC
Total	$144,322	$1,383	
Mortgage REITs			
Thornburg Mortgage	$2,859	NA	Filed for Bankruptcy
Annaly Capital Management	$2,856	$15,868	Active
KKR Financial Holdings	$2,156	$1,457	Active
American Home Mortgage	$1,763	NA	Filed for Bankruptcy
Redwood Investment Trust	$1,553	$861	Active
Total	$11,187	$18,186	

Source: FactSet and KBW Research.

Further, many of the mortgage REITs that went out of business during the downturn were exempt under Section 3(c)5(c) without using 55% whole pool because they were mortgage originators that choose to invest in a portion of their own originations.

Finally, the SEC Concept release twice highlights Carlyle Capital Group as a mortgage investment vehicle with excess leverage. We believe that the failure at Carlyle, which was not a mortgage REIT, highlights a lot of the safeguards that exist in the mortgage REIT sector. Carlyle Capital Corporation (CCC) was an investment fund with $21.7 billion in Agency MBS at the time of its liquidity crisis in early 2008. CCC was listed on the Euronext in Amsterdam.

The company was levered more than 30x in early 2008 versus the 6x-8x for the Agency MBS REITs currently. Leverage in the sector was higher (8x-10x) back in 2008. No pure Agency MBS REIT had meaningful funding difficulties during that period.

The company was not listed on NYSE and only sold shares in the U.S to qualified institutional buyers under a 144A transaction. As a result, it had no analyst coverage and operated under far less investor scrutiny than the publicly listed mortgage REITs.

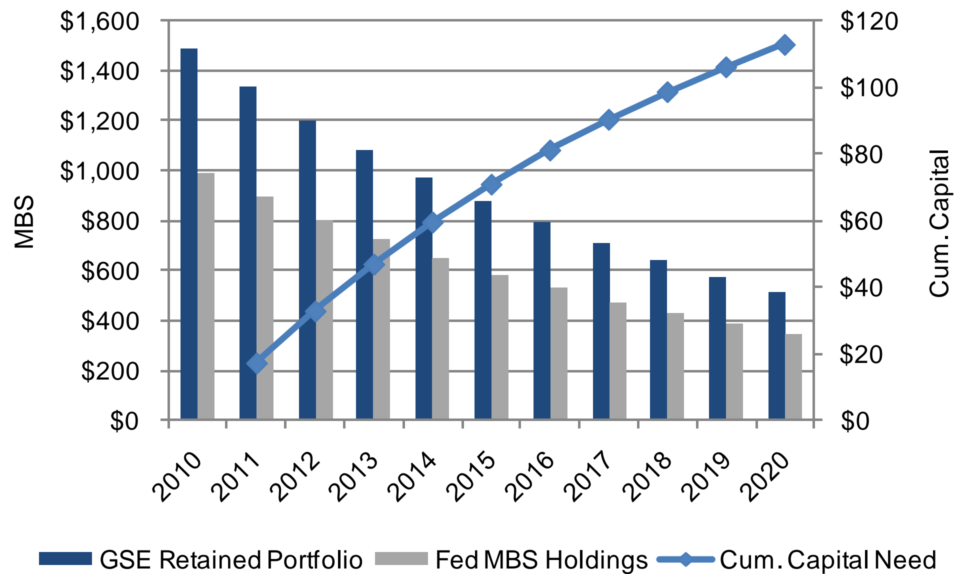
The importance of mortgage REITs in capital formation in the mortgage sector

While the mortgages REIT sector has historically been a relatively small player in the mortgage market, we believe that this is likely to change. Mortgage REITs have grown meaningfully over the past decade and we see this as part of a secular trend.

The main driver of current growth in the sector is the runoff of the GSE balance sheets. The Preferred Stock Purchase Agreement (PSPA) which the GSEs entered into when they were put into conservatorship in late 2008 mandates that they shrink their retained portfolios at 10% a year. At the same time the Federal Reserve will also be shrinking its $1 trillion portfolio (although this has been deferred until mid-2012 as a result of Operation Twist).

Exhibit 10 shows our estimate of the amount of incremental capital that the mortgage market will need over the next 10 years. The exhibit assumes that all mortgages held by the Fed, Fannie Mae, and Freddie Mac run off at a rate of 10% a year and are replaced by private capital. Assuming a 7% capital requirement, this suggests that the mortgage industry would need about $110 billion of new private capital in the next 10 years. Over the last two years the only source of new private capital into the mortgage sector has been through the mortgage REITs.

Exhibit 10: GSE / Fed Portfolio Run-Off and 7% Cumulative Capital Need
$ in billions



Source: Company reports, Federal Reserve and KBW Research.

Importance of Leverage

Leverage is crucial to the mortgage sector. The U.S. mortgage market is a roughly $10 trillion market. Exhibit 11 shows the list of holders of Agency MBS. All large holders use leverage. The biggest unlevered holders are mutual funds that hold about 11%. The other four of the top five holders of MBS all use leverage and account for 60% of holdings of Agency MBS. We estimate that under 20% of Agency MBS is held by real money buyers. If one includes holdings of mortgages on bank and thrift balance sheets which use leverage, probably under 10% of mortgages in this country are held by real money investors.

Exhibit 11: MBS Holdings By Investor Type

$ in billions

	2010			Market	Change
Investor Type	Total	Agency	Non-Agency	Share	2Q-4Q10
Commercial Banks	1,231.2	1,070.9	160.3	18.7%	7.3%
US Treasury/NY Fed	1,147.8	1,147.8	0.0	17.4%	-11.7%
Foreign Investors	1,000.0	770.0	230.0	15.2%	5.5%
Mutual Funds	750.0	580.0	170.0	11.4%	1.4%
Fannie Mae/Freddie Mac	740.0	582.9	157.1	11.2%	-10.4%
Life Insurance Cos.	305.0	160.0	145.0	4.6%	-1.6%
Savings Institutions	200.1	171.4	28.7	3.0%	9.2%
FHL Banks	170.0	130.0	40.0	2.6%	12.7%
State/Local Governments	165.0	155.0	10.0	2.5%	1.9%
Public Pension Funds	160.0	125.0	35.0	2.4%	-11.1%
Private Pension Funds	157.0	110.0	47.0	2.4%	-12.8%
Securities Brokers & Dealers	115.0	80.0	35.0	1.7%	9.5%
Credit Unions	104.4	91.4	13.0	1.6%	9.9%
Property/Casualty Insurer	90.0	48.0	42.0	1.4%	-5.3%
REITs	75.0	70.0	5.0	1.1%	7.1%
Total Outstanding	**6,594.3**	**5,327.9**	**1,266.4**	**100.0%**	**-1.6%**

Source: Company reports, Federal Reserve and KBW Research.

This shows pretty clearly that real money investors cannot purchase the roughly $2 trillion of GSE MBS that is slated to move into the private markets over the next decade without meaningfully higher mortgage rates.

Given that leverage is essential to the mortgage market, the main question in our view is whether the SEC wants levered buyers to use the exemption under the Act and register as public companies in the U.S or whether levered investments in MBS should be done through unregistered or offshore vehicles (or through companies that are also engaged in mortgage origination activities). While this would make it harder for retail investors to get exposure to these companies, it would also have several negative impacts such as a

reduction in capital formation and a reduced level of SEC regulation. Also, systemic risk could increase as leveraged investors would become less regulated.

Importance of Permanent Capital

We believe that the mortgage REITS also play an important role by bringing permanent capital into the sector. If the MBS market is supported by levered investors who also invest in multiple asset classes this could create significant volatility in asset prices based on investor interest in the mortgage sector. Dedicated mortgage investors, such as the mortgage REITs, focus on relative value in the mortgage sector. They do not have the choice of exiting the sector if returns are unattractive.

Dodd-Frank Related Changes

Under Dodd-Frank, securitized mortgages that are not deemed qualifying residential mortgages (QRM) would require 5% risk retention by the securitizer. While there has been significant resistance to this proposal from many industry participants, mortgage REITs have been open to the idea. Regulators have not yet put out final rules on the definition of QRM. Regardless, it is clear that some portion of the mortgage market will require risk retention and mortgage REITs are ideal vehicles for holding long term mortgage credit risk.

Conclusion

During the mortgage crisis, the mortgage market was largely nationalized with the government providing funding for most new loans. As the mortgage market privatizes over time, we expect the role of the REITs to become increasingly more important. Also, while there clearly are risks in the business model, the performance of the mortgage REIT sector through the mortgage crisis demonstrated that this group managed risk far better than the other public companies in mortgage sector. As a result, we believe that this sector is positioned to be the one of the main ways in which the recapitalization of the mortgage industry will occur.

Sincerely,

Bose George

Senior Mortgage REIT Analyst

Frederick Cannon

Director of Research