CLIFFORD

CHANCE

Client Memorandum
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SEC Issues 3(c)(5)(C) Concept Release: Clifford Chance Does Not Anticipate Material Changes to Mortgage REIT Exemptions

Overview

On August 31, 2011, the U.S. Securities and Exchange Commission (the "Commission") issued a concept release (the "Concept Release") 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, such as real estate investment trusts ("REITs"), 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."

The Concept Release has generated some (but not universal) negative reaction due to the inclusion in the release of a handful of questions and commentary which can be read to suggest that the Commission is considering changes in the existing Section 3(c)(5)(C) guidance that could materially limit the manner in which mortgage REITs conduct their businesses. However, for the reasons developed below, we do not expect the Commission's review of the 3(c)(5)(C) exemption will result in this outcome.

Key Features of the Concept Release

The Concept Release clarifies and brings together the current state of guidance issued by the Staff of the Commission (the "SEC Staff") under Section 3(c)(5)(C). Under this guidance, which was first adopted by the SEC Staff in a No-Action Letter issued to Salomon Brothers, Inc. (publicly available on June 17, 1985), at least 55% of the total assets of a company relying on this exemption must be comprised of what the SEC Staff classifies as "qualifying assets" and at least another 25% of such company's total assets must be comprised of qualifying assets or what the SEC Staff classifies as "real estate-related assets." The remaining 20% of the company's assets are not required to fit into any specific category. The Commission in the Concept Release clarifies that "qualifying assets" for purposes of these tests include:

- Fee interests in real estate;
- First and second mortgages or other loans or liens fully secured by real estate;
- Installment land contracts and leasehold interests secured solely by real property;
- Certain real estate mezzanine loans and subordinate participations in commercial real estate first mortgage loans, or B-Notes; and
- Assets that can be viewed as being the functional equivalent of, and provide their holder with the same economic experience as, an actual interest in real estate or a loan or lien fully secured by real estate,

If you would like to know more about the subjects covered in this publication or our services, please contact:

Jay Bernstein +1 212 878 8527
Andrew Epstein +1 212 878 8332
Larry Medvinsky +1 212 878 8149
Kathleen Werner +1 212 878 8526
Jonathan Zonis +1 212 878 3250
Jason Myers +1 212 878 8324
Per Chilstrom +1 212 878 3079
Clifford Cone +1 212 878 3180
Ari Kahn +1 212 878 8023

To email one of the above, please use firstname.lastname@cliffordchance.com

Clifford Chance, 31 West 52nd Street, New York, NY 10019-6131, USA
www.cliffordchance.com

including "whole pool certificates" that are issued or guaranteed by Fannie Mae, Freddie Mac or Ginnie Mae ("Agency RMBS").

Other portions of the Concept Release request data and other information about what the Concept Release classifies as "mortgage-related pools" and the application of Section 3(c)(5)(C) to these pools. In particular, the Concept Release requests commentators to provide information on the various types of companies relying on the Section 3(c)(5)(C) exemption and how such companies are operated, including their strategies for the acquisition and management of their holdings; the types of investors that invest in such companies; and the roles of such companies in the mortgage markets. The Concept Release also asks that commentators describe the key operational or structural characteristics of mortgage-related pools that serve to distinguish them from traditional investment companies under the 1940 Act.

The Concept Release has generated some (but not universal) negative reaction due to the inclusion in the release of a handful of questions and commentary which can be read to suggest that the Commission is considering significant changes in the existing Section 3(c)(5)(C) guidance that could materially limit the manner in which mortgage REITs conduct their businesses. For example, the Concept Release asks:

- Whether the SEC Staff's 55%/25% asset test approach is appropriate for determining a company's primary engagement for purposes of Section 3(c)(5)(C)?
- Whether the Commission should revisit the SEC Staff's view that agency whole pool certificates may be treated as interests in real estate and whether the Commission should view a company whose primary business consists of investing in agency whole pool certificates – or other mortgage-backed securities – as the type of entity that Congress intended to be encompassed by the exclusion provided by Section 3(c)(5)(C)?
- Whether in light of the reference to "mortgages" in Section 3(c)(5)(C), the term "liens on and interests in real estate" should also be defined to include only those assets that are directly related to real estate, rather than include, for example, interests in a mortgage or in a pool or other entity that holds real estate?
- Whether there are grounds and authority to differentiate between companies that are primarily engaged in the real estate and "mortgage banking business" from other companies that rely on Section 3(c)(5)(C) but may resemble traditional investment companies, according to the Commission?

The Commission also raises a number of concerns in the Concept Release relating to investor protection issues, pointing out that some mortgage-related pools may raise the potential for the types of abuses that the 1940 Act seeks to regulate, such as deliberate misvaluation of company holdings, inappropriate leveraging and overreaching by insiders. The Concept Release asks about the use of leverage by mortgage REITs, noting that NAREIT reported in September 2010 that the debt-to-equity ratio of publicly traded mortgage REITs averaged 83.5%, or nearly five to one, while in contrast, as of June 30, 2010, the debt-to-equity ratio of registered closed-end investment companies that use borrowings was generally less than one quarter to one.

Notwithstanding the broad questions and commentary raised in the Concept Release, for the reasons developed below, we do not anticipate major adverse changes in the way mortgage REITs are excluded from registration under the 1940 Act as a result of the Commission's review of the Section3(c)(5)(C) exemption.

Continuation of two-year dialogue

While not mentioned in the Concept Release, practitioners who work in the mortgage REIT area are well aware that for more than two years selected members of the SEC Staff have been engaged in what we would describe as an industry wide dialogue relating to the issues covered in the Concept Release. The driver behind this dialogue according to SEC Staff members was a desire to improve the process through which regulatory policy in the mortgage REIT area is developed. These SEC Staff members have expressed concern that, with the exception of a handful of no-action letters issued over the last several decades, most of the legal developments involving mortgage REITS and their treatment under the 1940 Act have come through SEC Staff review of, and comments provided on, registration statements for mortgage REIT IPOs. We think the SEC Staff has felt for some time that the registration statement review process is not necessarily the most appropriate forum for the development of regulatory policy in this area, especially because many of the issues at stake have major national policy implications that go to the heart of private capital formation for the mortgage industry. In an effort to move beyond this process, the SEC Staff initiated this industry wide dialogue. Our impression of the way this dialogue has been conducted is that the while the SEC Staff is interested in considering new policies around the Section 3(c)(5)(C) exemption, the process is not aimed at preventing mortgage REITs from relying on Section 3(c)(5)(C) or materially restricting the types of assets mortgage REITs can acquire or the manner in which they finance their businesses. We view the Concept Release as a continuation of the industry wide dialogue rather than a signal that significant regulatory changes are being pushed by the SEC Staff or that such changes are at this time being contemplated by the Commission.

The Commission chose the Concept Release approach

We believe that it is significant that the Commission chose to issue a concept release in this area rather than making any specific rulemaking proposals. By way of background, in the normal course of events, the first step in the creation of new rules under the 1940 Act is for the Commission to issue for public comment a release which contains both a discussion of the issue at hand and a detailed formal rule proposal. After the comment period for the proposed rule has ended, the Commission considers what it has learned from the public notice and comments on the proposed rule, and seeks to agree on the specifics of a final rule. If a final measure is then adopted by a vote of the Commissioners, it becomes an official rule. Here, however, instead of taking this approach, the Commission chose to issue a "concept release" which did not involve any new rule proposals. Typically, the concept release approach is taken when the appropriate regulatory response to an issue is genuinely uncertain and the Commission needs input from the public to determine whether any further action is warranted and if so what that action should be.

It seems clear at this stage in the process and from the language in the Concept Release that the Commission is interested in finding out more about companies that rely on the Section 3(c)(5)(C) exemption and has not made any determination as to whether to move forward with any formal rulemaking. Consequently, we view the Concept Release as presenting an opportunity for the mortgage industry to be heard by the Commission on the topics raised in the Concept Release and this process should hopefully result in helpful clarifications and additional guidance from the Commission that will be of value to companies relying on the Section 3(c)(5)(C) exemption.

Other questions raised in the Concept Release signal possible expansion of existing guidance

While the Concept Release includes a handful of questions and commentary which can be read to suggest that the Commission is considering narrowing the existing Section 3(c)(5)(C) guidance, other language in the release also points to a possible expansion of the exemption. For example, the Concept Release asks in one place "should certain mortgage participations [which are not considered qualifying assets under existing SEC guidance] be treated as interests in real estate and, if so, what types of participations and why? Is a company whose primary business activity consists of holding mortgage participations, the type of entity that should be excluded from the definition of investment company?" Additional language in the Concept Release also points to possible expansion of existing guidance, such as where the release seems to worry in four different places whether companies are interpreting the existing Section 3(c)(5)(C) guidance "too narrowly."

Existing mortgage REIT structures address many of the concerns raised in the Concept Release

The Concept Release asks a number of questions centered on investor protection concerns relating to self-dealing and inflated valuations and other conflicts of interest between the company relying on Section 3(c)(5)(C) and its sponsors or external advisors. But 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, the Dodd-Frank Act's expanded investment adviser registration requirements could allow the Commission to address many of the concerns raised about externally managed companies in the Concept Release.

Given the existing investor protections and tools the Commission already employs, we question whether the Commission will determine that companies relying on Section 3(c)(5)(C) need additional significant regulations or that the Commission needs new tools to further regulate these companies.

Significant legal constraints on Commission rulemaking authority under the 1940 Act

We believe that the Commission is limited in its authority to make significant changes to the existing statute and rules without further action from Congress. Because the exemption provided in Section 3(c)(5)(C) is set out in the 1940 Act itself, the Commission cannot amend the 1940 Act or revoke this exemption. The Commission could try to limit the exemption through the rulemaking process or by providing new interpretive guidance, but REITs that primarily hold mortgages or equity interests in real estate cannot, in our view, be part of this limitation because of the specific reference to mortgages in the language of the Section 3(c)(5)(C) exemption.

The Commission could look to limit the applicability of the Section 3(c)(5)(C) exemption for REITs that primarily hold non-mortgage securities; however, for the reasons discussed below, we believe that there would be substantial hurdles for the Commission to overcome in taking this approach.

Section 38(a) standards

The 1940 Act grants the Commission certain limited rulemaking powers in Section 38(a) 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 [the 1940 Act], including rules and regulations defining accounting, technical, and trade terms used in [the 1940 Act], and prescribing the form or forms in which information required in registration statements, applications, and reports to the Commission shall be set forth…"

So the Commission can only properly make, amend or rescind a rule where the Commission (i) is providing an interpretation of terms used in the 1940 Act or (ii) where Congress specifically granted the Commission authority to adopt rules under the 1940 Act. And while Section 6(c) of the 1940 Act grants the Commission authority to expand the exemptions enumerated in the 1940 Act, and to make those expanded exemptions conditional if desired, there is no authority granted to limit or place conditions on the exemptions specified in the 1940 Act itself.

The Chevron Test

The U.S. Supreme Court in *Chevron, U.S.A., Inc. v. NRDC*, 467 U.S. 837 (1984), determined that "[i]f the intent of Congress is clear, that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress."

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." This section does not specifically grant to the Commission the authority to adopt rules or to impose conditions on the availability of the Section 3(c)(5)(C) exemption. Without this grant of authority, the Commission's rulemaking authority is limited to adopting rules that define terms used in the exemption. In this regard, the Concept Release is very careful to couch possible action by the Commission as an "interpretation" of the terms used in the exemption such as "other liens and interests in real estate." The industry's concern is that the Commission might seek to define "other liens on and interests in real estate" narrowly so as to exclude certain asset types that are currently understood to be included in that phrase, like Agency MBS.

However, any regulatory action by the Commission cannot undermine Congressional intent as expressed in the language of Section 3(c)(5)(C) and we believe that it will be difficult for the Commission to take the position now that SEC Staff interpretations that have been in place for more than 30 years are somehow inconsistent with the original intent of Congress as expressed in Section 3(c)(5)(C).

The Concept Release reveals that the Commission fully appreciates this challenge. In discussing the legislative history under Section 3(c)(5)(C), the Concept Release suggests that, notwithstanding the broad language of the exemption, it was actually intended by Congress to be limited to businesses engaged in "mortgage banking." However, we believe that this reference to mortgage banking is not a valid expression of legislative intent, especially since the legislative "history" cited in the Concept Release on this point is from a 1970 House Report which was published 30 years ***after*** the Section 3(c)(5)(C) exemption was enacted. In fact, the language of the House Report quoted by the Concept Release never refers to "mortgage banking" at all, instead explaining that Congress excluded companies investing in mortgages and other liens on and interests in real estate from the [1940 Act]'s coverage "because they do not come within the generally understood concept of a conventional investment company investing in stocks and bonds of corporate issuers."[1]

Section 2(c) factors

The 1940 Act itself imposes additional burdens on rulemaking in Section 2(c), requiring 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

[1] *See FN 38 of the Concept Release quoting,* H.R. Rep. No. 1382, 91st Cong., 2d Sess. 17 (1970) *and also quoting*, SEC, Report on the Public Policy Implications of Investment Company Growth, H.R. Rep. No. 2337, 89th Cong. 2d Sess. 328 (1966) *stating that the exemption now found in Section 3(c)(5)(C):*

> "provides for an exclusion from the definition of investment company for companies primarily engaged in the . . . real estate businesses. Although these companies are engaged in acquiring . . . mortgages and other interests in real estate – thus acquiring investment securities, such activities are generally understood not to be within the concept of a conventional investment company which invests in stocks and bonds of corporate issuers."

public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition and capital formation. Indeed, the Concept Release on this point states that one of the goals of the Commission's efforts in this area is to "facilitate capital formation."

The Application of the Administrative Procedures Act

The Commission is further constrained in its rulemaking by the Administrative Procedures Act (the "APA") which prohibits the Commission from creating any rule that is "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law."

Together, the APA and 1940 Act create a heavy burden on Commission rulemaking. They require the Commission to examine relevant data and articulate a satisfactory explanation for its actions in creating or amending rules, including a rational connection between the facts found and the choice made. In addition, because in several recent cases, the D.C. Circuit Court of Appeals has found 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 or amendments.

For example, as noted above, 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). To justify any rulemaking action that would exclude Agency MBS as qualifying assets under Section 3(c)(5)(C), the Commission would have to first explain why investor protection is enhanced by limiting investments in these securities that are at least nominally safer than the underlying mortgages because of the Agency guarantee if the mortgages do not perform. Assuming they could articulate a justification, the Commission would still then have to factor in the costs to efficiency and capital formation of reversing an interpretation that had been used by the market for more than 30 years. And while the Concept Release includes a curious discussion that goes out of its way to minimize what no-action letters mean by noting in an early footnote that its discussion of SEC Staff statements is provided solely for background and is in no way intended to suggest that the Commission has adopted the analysis, conclusions or any other portion of the SEC Staff statements discussed here, we believe that in a case challenging a new interpretation, the Commission would bear a heavy burden under the law to simply say the Commission reads this differently than the SEC Staff has for the past 30 years.

We have seen how heavy this burden can be in a number of recent D.C. Circuit cases vacating Commission rules under the APA's arbitrary and capricious standard, including the latest case involving the Commission's "Proxy Access" rules. In *Business Roundtable and Chamber of Commerce v. Securities and Exchange Commission*, No. 10-1305 (D.C. Cir. filed July 22, 2011), the court found that the Commission acted,

> "arbitrarily and capriciously for having failed *once again*… adequately to assess the economic effects of a new rule. Here the Commission inconsistently and opportunistically framed the costs and benefits of the rule; failed adequately to quantify the certain costs or to explain why those costs could not be quantified; neglected to support its predictive judgments; contradicted itself; and failed to respond to substantial problems raised by commentators." (emphasis added)

The "once again" in the passage above refers to a 2010 case, *American Equity Investment Life Insurance Company v. Commission*, 613 F.3d 166, (D.C. Cir. 2010) (where the D.C. circuit vacated a Commission rule excluding "Fixed Index Annuities" from the definition of annuity contract under the Securities Act of 1933 under the APA's arbitrary and capricious standard), and before that to a pair of cases vacating a 1940 Act rule requiring independent board chairs for investment companies also under the APA's arbitrary and capricious standard, this time, in conjunction with the 1940 Act requirements of Section 2(c) to consider promoting efficiency, competition and capital formation in *Chamber of Commerce v Commission*, 412 F.3d 133 (D.C. Cir. 2005) and 443 F.3d 890 (D.C. Cir. 2006).

After being rebuffed in rulemaking four times in the past six years, our view is that the Commission would probably need to feel rock-solid in its economic analysis that any rules or amendments adopted (even where it has authority to act) would promote efficiency, competition and capital formation. As part of this analysis, the Commission would need to consider significant empirical evidence demonstrating that the proposed rule or amendment would solve whatever issues the Commission determines warrant additional regulation and would need to measure and justify the costs of the conditions it was imposing in light of their impact on efficiency, competition and capital formation.

Current national policy imperatives to bring private capital into the mortgage market run counter to rules that would significantly impact mortgage REIT flexibility or capital formation

Add to all of the considerations above an emerging national policy consensus 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 addition, the exclusion of mortgage REITs from the 1940 Act exempts them from the strict borrowing limitations imposed on registered investment companies. If the Commission adopts rules to narrow significantly the Section 3(c)(5)(C) exemption, 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 and a sharp deleveraging of REITs is inconsistent with the government's long-term goal of increasing private capital participation in the mortgage market.

These considerations add to the view that the Commission is not likely to take drastic measures with respect to its interpretation of Section 3(c)(5)(C). When the current administration has a policy of encouraging more private capital to enter mortgage markets, it is difficult for the Commission to create limiting rules and conditions that clearly run counter to this goal.

Where do we end up?

If significant changes are to be made to Section 3(c)(5)(C), we believe Congress would be the appropriate source for these changes because of its wider lens that could focus on the broad effects of any change. We do not see any appetite in Congress for restricting capital flow to the mortgage market.

Without significant Congressional changes to the 1940 Act exemption for mortgage related businesses, the Commission will, in our view, likely be constrained in its rulemaking on Section 3(c)(5)(C). It would need to implement rules that provide new definitions for terms included in a 70 year-old statute and in doing so, must engage in an exhaustive cost benefit analysis that ensures not only that the new rule or amendment actually addresses investor protection issues established by empirical evidence, but that the rules do so while not imposing undue costs on mortgage markets or impeding efficiency, competition and capital formation.

While it is possible that the SEC Staff could modify its own historical interpretive guidance as a result of the ongoing review process without any formal rulemaking, in our experience, it remains rare for the SEC Staff to change interpretations in a way that makes exemptions materially more restrictive. We also do not see the Commission sweeping aside in place SEC Staff interpretations that have served well for an extended period of time, especially at this time given the national policy imperative to bring more private capital into mortgage markets.

In our view, we are most likely to see a continuing dialogue between industry participants, the investing public and the Commission that may provide more depth to existing guidance. . We do not, however, expect that such guidance will prevent mortgage REITs from relying on Section 3(c)(5)(C) or otherwise materially restrict their businesses.[2]

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[2] At the same meeting approving the issuance of the Concept Release, the Commission approved an advance notice of proposed rulemaking (the "Advance Notice"), on possible amendments to Rule 3a-7 under the 1940 Act. Rule 3a-7 excludes certain ABS issuers that would otherwise fall under the 1940 Act definition of "investment company" from that definition and therefore effectively exempts these issuers from 1940 Act regulation if certain conditions are met. One of these conditions requires the securities issued by a Rule 3a-7 entity to be rated by a nationally recognized statistical ratings organization (NRSRO).The main purpose of the Advance Notice is to request public comment on the possibility of removing the rating condition for retail sales and replacing it with new conditions to conform with the policy goals of the Dodd Frank Act which tries to eliminate rating requirements from SEC rules.

The Advance Notice also calls for comments on issues similar to those in the Concept Release including:

- whether Section 3(c)(5) should be amended to limit the ability of ABS issuers to rely on Section 3(c)(5); and
- whether the Commission should engage in any rulemaking, consistent with Section 3(c)(5), that would define terms used in that section so as to limit its availability to those companies that the Commission claims were not intended by Congress to be encompassed by the statutory exclusion

As discussed above, we believe that the Commission cannot amend or revoke the exemption provided by statute, and it would require Congressional action to limit the exemption for ABS issuers holding mortgages. The Commission would face the same limits on their

Comments on the Concept Release are due on or before November 7, 2011.

The full Concept Release can be found at the following link:

http://sec.gov/rules/concept/2011/ic-29778.pdf

rulemaking authority and must factor the costs to efficiency and capital formation for any rules they would adopt. We do not believe that this process would result in rules limiting the applicability of the exemption to ABS issuers who primarily own mortgages in reliance on Section 3(c)(5)(C).