SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 270

[Release No. IC–29778; File No. S7–34–11]

RIN 3235–AL21

Companies Engaged in the Business of Acquiring Mortgages and Mortgage-Related Instruments

AGENCY: Securities and Exchange Commission.

ACTION: Concept release; request for comments.

SUMMARY: The Securities and Exchange Commission (''Commission'') and its staff (''Commission staff'' or ''staff'') are reviewing interpretive issues under the Investment Company Act of 1940 (''Investment Company Act'' or ''Act'') relating to the status under the Act of companies that are engaged in the business of acquiring mortgages and mortgage-related instruments and that rely on the exclusion from the definition of investment company in Section 3(c)(5)(C) of the Act (together, ''mortgage-related pools''). This review is focusing, among others, on certain real estate investment trusts (''REITs''). To help facilitate this review, the Commission requests information about these companies and how Section 3(c)(5)(C) of the Act is interpreted by, and affects investors in, these companies. The Commission solicits commenters' views about the application of the Investment Company Act to mortgage-related pools, including suggestions on the steps that the Commission should take to provide greater clarity, consistency or regulatory certainty with respect to Section 3(c)(5)(C).

DATES: Comments should be received on or before November 7, 2011.

ADDRESSES: Comments may be submitted by any of the following methods:

Electronic Comments

Use the Commission's Internet comment form *http://www.sec.gov/rules/concept.shtml*); or send an e-mail to *rule-comments@sec.gov*. Please include File No. S7–34–11 on the subject line; or use the Federal eRulemaking Portal (*http://www.regulations.gov*). Follow the instructions for submitting comments.

Paper Comments

Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549–1090.

All submissions should refer to File No. S7–34–11. This file number should be included on the subject line if e-mail is used. To help process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (*http://www.sec.gov/rules/concept.shtml*). Comments are also available for public inspection and copying in the Commission's Public Reference Room, 100 F Street, NE., Washington, DC 20549 on official business days between the hours of 10 a.m. and 3 p.m. All comments received will be posted without charge; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

FOR FURTHER INFORMATION CONTACT: Rochelle Kauffman Plesset, Senior Counsel, at (202) 551–6840, or Nadya Roytblat, Assistant Chief Counsel, at (202) 551–6825, Division of Investment Management, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549.

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I. Introduction and Executive Summary

The Commission and staff are reviewing interpretive issues relating to the status of mortgage-related pools under the Investment Company Act.[1] Companies that are engaged in the business of acquiring mortgages and mortgage-related instruments, and that issue securities, generally hold assets that are securities under the Investment Company Act and typically meet the definition of investment company under the Act.[2] While some such companies register as investment companies under the Act,[3] many seek to rely on Section 3(c)(5)(C) of the Act, which generally excludes from the definition of investment company any person who is primarily engaged in, among other things, ''purchasing or otherwise acquiring mortgages and other liens on and interests in real estate.'' [4] The

[1] Certain companies that are engaged in the business of acquiring mortgages and mortgage-related instruments are issuers of mortgage-backed securities that may rely on Section 3(c)(5)(C). Such issuers are not included in the term ''mortgage-related pools'' as it is used in this release. *See infra* note 5 and accompanying text.

[2] Section 3(a)(1)(A) of the Investment Company Act defines an investment company as any issuer which ''is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities.'' 15 U.S.C. 80a–3(a)(1)(A). Section 3(a)(1)(C) defines an investment company as any issuer which ''is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities [as that term is defined in the Act] having a value exceeding 40 per centum of the value of such issuer's total assets (exclusive of Government securities and cash items) on a unconsolidated basis.'' 15 U.S.C. 80a–3(a)(1)(C). A company that issues securities and is primarily engaged in investing in, owning, or holding mortgages and mortgage-related instruments typically meets one, if not both, of these definitions. *See, e.g.,* SEC, Report on the Public Policy Implications of Investment Company Growth, H.R. Rep. No. 2337, 89th Cong. 2d Sess. 328 (1966) (''PPI Report'') (stating that mortgages and other interests in real estate are investment securities for purposes of the Act).

Section 2(a)(36) of the Investment Company Act broadly defines ''security'' as ''any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security (including a certificate of deposit) or on any group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a 'security', or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.''

[3] According to industry statistics derived from Lipper's LANA Database, as of June 30, 2011, there were 23 series of registered open-end investment companies with total assets of $70.6 billion that invested ''at least 65% of their assets in Government National Mortgage Association securities.'' In addition, as of that date, there were 34 series of registered open-end investment companies with total assets of $26.6 billion, and 11 registered closed-end investment companies with total assets of $1.8 billion, that invested ''at least 65% of their assets in mortgages/securities issued or guaranteed as to principal and interest by the U.S. government and certain Federal agencies.''

[4] 15 U.S.C. 80a–3(c)(5)(C). Section 3(c)(5) excludes from the definition of investment company ''[a]ny person who is not engaged in the business of issuing redeemable securities, face-amount certificates of the installment type or periodic payment plan certificates, and who is primarily engaged in one or more of the following businesses: (A) Purchasing or otherwise acquiring notes, drafts, acceptances, open accounts

exclusion provided by Section 3(c)(5)(C) sometimes also is used by issuers of mortgage-backed securities, whose reliance on this statutory provision is discussed in a companion release.[5]

Section 3(c)(5)(C) of the Act was enacted in 1940 to exclude from regulation under the Investment Company Act companies that were engaged in the mortgage banking business and that did not resemble, or were not considered to be, issuers that were in the investment company business.[6] Since that time, as the mortgage markets have evolved and expanded, a wide variety of companies, many of them unforeseen in 1940, have relied upon Section 3(c)(5)(C).[7] The statutory exclusion from the definition of investment company provided by Section 3(c)(5)(C) does not have an extensive legislative history and has not been comprehensively addressed by the Commission. Section 3(c)(5)(C) has been addressed in staff no-action letters on a case-by-case basis.[8]

In light of the evolution of mortgage-related pools and the development of new and complex mortgage-related instruments, the Commission is reviewing interpretive issues relating to the status of mortgage-related pools under the Investment Company Act and whether mortgage-related pools potentially are making judgments about their status under the Act without sufficient Commission guidance. It appears that some types of mortgage-related pools might interpret the statutory exclusion provided by Section 3(c)(5)(C) in a broad manner, while others might interpret the exclusion too narrowly, suggesting that there may be confusion among some mortgage-related pools about when the exclusion applies. The Commission also is concerned that the staff no-action letters that have addressed the statutory exclusion in Section 3(c)(5)(C) may have contained, or led to, interpretations that are beyond the intended scope of the exclusion and inconsistent with investor protection. The Commission is concerned that certain types of mortgage-related pools today appear to resemble in many respects investment companies such as closed-end funds and may not be the kinds of companies that were intended to be excluded from regulation under the Act by Section 3(c)(5)(C). Therefore, the Commission believes that both investors and mortgage-related pools may benefit from the Commission's comprehensive review of the status of mortgage-related pools under the Investment Company Act and from any resulting guidance.

Accordingly, the Commission is requesting data and other information from the public about mortgage-related pools and soliciting views about the application of Section 3(c)(5)(C) of the Investment Company Act to mortgage-related pools, including steps that the Commission might take in this area. The Commission's goals in this effort are to: (1) be consistent with the Congressional intent underlying the exclusion from regulation under the Act provided by Section 3(c)(5)(C); (2) ensure that the exclusion is administered in a manner that is consistent with the purposes and policies underlying the Act, the public interest, and the protection of investors; (3) provide greater clarity, consistency and regulatory certainty in this area; and (4) facilitate capital formation.

II. Companies That Rely on Section 3(c)(5)(C)

A. Overview

By its terms, Section 3(c)(5)(C),[9] excludes from the definition of investment company ''[a]ny person who is not engaged in the business of issuing redeemable securities, face-amount certificates of the installment type or periodic payment plan certificates, and who is primarily engaged * * * [in the business of] purchasing or otherwise acquiring mortgages and other liens on and interests in real estate.'' Many different types of companies that engage in a variety of businesses rely on this exclusion.[10] Such companies include: Those that originate and hold mortgages and participations of mortgages that they originated; companies engaged in the business of acquiring from affiliates or third parties mortgages and mortgage-related instruments (such as mortgage participations, mezzanine loans and mortgage-backed securities); companies that invest in real estate, mortgages and mortgage-related instruments; and companies whose primary business is to invest in so-called agency securities[11] and other mortgage-backed securities.[12]

Companies that rely on the exclusion in Section 3(c)(5)(C) are structured and operated in various ways. Nevertheless, it appears that several general

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receivable, and other obligations representing part or all of the sales price of merchandise, insurance, and services; (B) making loans to manufacturers, wholesalers, and retailers of, and to prospective purchasers of, specified merchandise, insurance, and services; and (C) purchasing or otherwise acquiring mortgages and other liens on and interest in real estate.''

[5] *Treatment of Asset-Backed Issuers under the Investment Company Act,* Investment Company Act Release No. 29779 (Aug. 31, 2011) (''3a–7 Companion Release'').

[6] *See infra* note 38 and accompanying text.

[7] Some companies that privately place their securities may instead rely on the private investment company exclusions set forth in Sections 3(c)(1) and 3(c)(7) of the Act. Section 3(c)(1) of the Investment Company Act excludes from the definition of investment company any issuer whose outstanding securities (other than short-term paper) are beneficially owned by not more than 100 investors and which is not making and does not presently propose to make a public offering of its securities. 15 U.S.C. 80a–3(c)(1). Section 3(c)(7) of the Investment Company Act excludes from the definition of investment company any issuer whose outstanding securities are owned exclusively by persons who, at the time of acquisition of such securities, are ''qualified purchasers'' as defined in the Act and which is not making and does not at that time propose to make a public offering of its securities. 15 U.S.C. 80a–3(c)(7).

[8] This release includes extensive discussion of staff no-action letters; accordingly the Commission notes that its discussion of staff statements is provided solely for background and to facilitate comment on issues that the Commission might address. The discussion is in no way intended to suggest that the Commission has adopted the analysis, conclusions or any other portion of the staff statements discussed here. Staff no-action letters are issued by the Commission staff in response to written requests regarding the application of the Federal securities laws to proposed transactions. Many of the staff no-action letters are ''enforcement-only'' letters, in which the staff states whether it will recommend enforcement action to the Commission if the proposed transaction proceeds in accordance with the facts, circumstances and representations set forth in the requester's letter. Other staff no-action letters provide the staff's interpretation of a specific statute, rule or regulation in the context of a specific situation. *See Informal Guidance Program for Small Entities,* Investment Company Act Release No. 22587 (Mar. 27, 1997).

[9] Section 3(c)(5) was initially enacted in 1940 as Section 3(c)(6). Congress redesignated the provision as Section 3(c)(5) in 1970. Investment Company Amendments Act of 1970, Public Law 91–547, 84 Stat. 1413 (1970) (codified as amended 15 U.S.C. 80a–3(c)(5)).

[10] *See infra* note 13.

[11] Agency securities are mortgage-backed securities issued by the government-sponsored enterprises, Government National Mortgage Association (Ginnie Mae), Federal National Mortgage Association (Fannie Mae) and Federal Home Loan Mortgage Corporation (Freddie Mac).

[12] A summary review by the staff of filings under the Securities Exchange Act of 1934 (''Exchange Act'') of issuers identifying themselves as REITs suggests that, as of April 2011, there were approximately 49 REITs that had disclosed that they were primarily engaged in the business of holding mortgages and/or mortgage-related instruments, with most indicating that they or their subsidiaries were relying on Section 3(c)(5)(C). Of these companies, 15 stated that they were primarily engaged in the business of acquiring agency securities and other types of mortgage-backed securities. The staff's review also identified 57 companies that had disclosed in their Exchange Act filings that they were investing in both (i) real estate, and (ii) mortgages and mortgage-related instruments, with 28 of such companies suggesting that they or their subsidiaries may be relying on Section 3(c)(5)(C). This review did not include those companies that have not elected to be treated as REITs under the Internal Revenue Code but may nevertheless be relying on the Section 3(c)(5)(C) exclusion.

observations about mortgage-related pools can be made.[13]

Many, if not most, mortgage-related pools are corporations or business trusts that have elected to be treated as REITs for purposes of their tax status under the Internal Revenue Code.[14] Special tax provisions for REITs were created by Congress in 1960 as a means to make available to retail investors opportunities to invest in income-producing real estate and real estate-related assets.[15] In a REIT structure, investor assets are pooled together to acquire, or provide financing for, various types of income-producing real estate interests that are selected and managed by professional asset managers. Like most registered investment companies, companies that qualify for REIT status typically seek pass-through tax treatment. To achieve this tax benefit, a company electing REIT status must comply with restrictions and limitations set forth in the Internal Revenue Code.[16]

Although mortgage-related pools may utilize a variety of investment strategies, most mortgage-related pools use leverage to magnify their returns.[17] For example, some mortgage-related pools that primarily hold agency securities and other mortgage-backed securities operate using a business model that depends on the use of leverage, with their profits, if any, generated by the spread between the cost of borrowing and the return on holdings purchased with the proceeds from such borrowing.[18] According to data provided by the National Association of Real Estate Investment Trusts (''NAREIT''), as of September 30, 2010, the debt ratio of publicly traded Mortgage REITs averaged 83.5%, a debt-to-equity ratio of nearly five to one.[19] 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.[20]

B. Management Style and Corporate Governance

Some mortgage-related pools are internally managed and have their own employees to carry out the administrative, investment and other activities necessary to operate the companies. Other mortgage-related pools have few, if any, employees and instead rely on separate advisory entities for the day-to-day operations of the companies. These advisory entities often are the mortgage-related pool's sponsor (typically, a real estate investment firm, an investment management firm, a private equity manager or other similar company that sponsors REITs, hedge funds and/or private equity funds) or an affiliate of the sponsor. An adviser of an externally managed mortgage-related pool is compensated by the company through a variety of different compensation schemes, which may include a performance or incentive fee. Regardless of whether they are internally or externally managed, most mortgage-related pools have boards of directors or trustees to oversee the companies' management.

Many mortgage-related pools list and trade their securities on a national securities exchange and, like other public companies listed on a national securities exchange, must comply with the exchange's listing and maintenance requirements, including corporate governance rules. Such rules require, among other things, that a majority of the members of the company's board of directors or trustees be independent of its management.[21] Other mortgage-related pools do not list and trade their securities on a national securities exchange and may not be subject to any such corporate governance rules. Many non-exchange traded REITs, however, are structured in accordance with the NASAA Guidelines, as well as any applicable regulations of the states in which they sell their shares.[22] Among other things, the NASAA Guidelines provide for a REIT to have a board of

[13] The Commission's information about mortgage-related pools discussed in this release is derived primarily from the staff's review of registration statements filed under the Securities Act of 1933 (''Securities Act'') and periodic reports filed under the Exchange Act, to the extent that these filings discuss whether a company is relying on Section 3(c)(5)(C). Information available to the Commission is further limited by the fact that companies that rely on Section 3(c)(5)(C) also include companies that privately place their securities without registering under the Securities Act and companies that may not be subject to the periodic reporting requirements under the Exchange Act. The description of mortgage-related pools provided in this section of the release relates primarily to companies that make filings with the Commission under the Securities Act and the Exchange Act, and is based on these filings.

[14] The REIT provisions are set forth in Sections 856 through 859 of the Internal Revenue Code. 26 U.S.C. 856–859.

[15] *See, e.g.* Real Estate Investment Trusts, H.R. Rep. No. 2020, 86th Cong. 2nd Sess. 3–4 (1960). REITs may be classified into one of three categories. The National Association of Real Estate Investment Trusts (''NAREIT'') generally defines equity REITS to be companies that own and operate income-producing real estate, and mortgage REITs to be companies that lend money directly to real estate owners and their operators, or indirectly through the acquisition of loans or mortgage-backed securities. *See* NAREIT, *The REIT Story: and Introduction to the Benefits of Investing in Real Estate Stocks,* REIT.com (Feb. 2011). Hybrid REITs generally are companies that use the investment strategies of both Equity REITs and Mortgage REITs. As noted above, mortgage REITs and some Hybrid REITs typically seek to rely on Section 3(c)(5)(C). *See supra* note 12. Equity REITs that hold fee interests directly typically do not invest in securities to such an extent as to fall within the definition of investment company under the Investment Company Act. *See supra* note 2.

[16] These requirements generally provide that: (1) the company distribute at least 90% of its taxable income in dividends to its shareholders annually; (2) at least 75% of the company's total assets on the last day of each quarter of the company's taxable year consist of real estate assets (including interests in real property, interests in mortgages on real property and shares of other REITs), cash and cash items, and government securities; and (3) the company derive at least 75% of its gross income during the past year from, among other things, rents from real property, interest on obligations secured by mortgages on real property or on interests in real property, and 95% of its gross income from the same assets that qualify for the 75% test or from dividends or interest from any source. In addition to the asset and income tests and the 90% dividend distribution requirements, the Internal Revenue Code requires a company that elects REIT status to: be a corporation, trust, or association; be managed by one or more trustees or directors; have transferable shares; have a minimum of 100 shareholders; have no more than 50% of its shares held by five or fewer individuals; and not engage in certain prohibited transactions. *See supra* note 14.

[17] *See, e.g.,* Peter C. Beller, *Bet Against the Fed, Buy Mortgage REITs,* Forbes.com, Jan. 25, 2010; *Anthracite Capital Files Chapter 7,* REITwrecks.com (Mar. 15, 2010).

[18] *See, e.g.,* Vivian Marino, *Some REITS Have a Contrarian Flavor,* NY Times.com, Mar. 29, 2009.

[19] NAREIT REITWatch: A Monthly Statistical Report on the Real Estate Investment Trust Industry (Apr. 2011). NAREIT calculates the debt ratio by dividing the total debt outstanding in a REIT sector by that REIT sector's total market capitalization. Total capitalization equals the sum of total debt plus implied market capitalization.

[20] *See* Thomas J. Herzfeld, Survey of Closed-End Fund Leverage, Investor's Guide to Closed-End Funds (Oct. 2010). We compared REITs to registered closed-end investment companies because, as discussed below, certain mortgage-related pools have characteristics similar to such registered companies. *See infra* section II.C.

We note that certain REITs follow the North American Securities Administrators Association's Statement of Policy Regarding Real Estate Investment Trusts (''NASAA Guidelines''), which generally state that the maximum level of borrowings (in relation to the company's net asset value) should not exceed 300% without ''a satisfactory showing that a higher level of borrowing is appropriate'' and that any borrowing in excess of that level must be approved by a majority of the company's independent trustees and disclosed to shareholders. NASAA Guidelines at V.J. *See infra* note 22. We understand from filings made by mortgage-related pools under the Securities Act and the Exchange Act that other mortgage-related pools may specify in their organizational documents the level of leverage that they may use, although that level often may be increased with the approval of a majority of the company's board of directors or trustees, and still others may use leverage up to any level deemed appropriate by their investment advisers.

[21] *See, e.g.,* Section 303A of the New York Stock Exchange Listed Company Manual.

[22] Most states require non-exchange traded REITs to comply with the provisions of the NASAA Guidelines, although certain states have adopted their own guidelines. *See supra* note 20. *See, e.g.,* Foss, *et al., Real Estate Investment Trusts Handbook,* § 4:1 (2009–2010 ed).

trustees that has a majority of independent members.[23]

C. Similarities to Traditional Investment Companies

Some mortgage-related pools today have characteristics similar to, and may operate like, traditional investment companies. For example, both mortgage-related pools and traditional investment companies pool investor assets to purchase securities and provide investors with professional asset management.[24] Like traditional investment companies, mortgage-related pools may be internally or externally managed, with externally managed mortgage-related pools typically having few, if any, employees, and instead relying on their investment advisers, which may be their sponsors or the sponsors' affiliates, to operate the companies.[25] Like investment advisers to traditional investment companies, investment advisers to mortgage-related pools typically are compensated with an asset-based fee.[26] Some mortgage-related pools invest in the same types of assets as registered investment companies and private investment funds.[27] Finally, some mortgage-related pools are perceived by investors and the media as being investment vehicles and not as companies that are engaged in the mortgage banking business.[28]

With respect to investment companies, the Investment Company Act [29] seeks to prevent such companies from, among other things, (i) Employing unsound or misleading methods, or not receiving adequate independent scrutiny, when computing the asset value of their investments or their outstanding securities; [30] (ii) engaging in excessive borrowing and issuing excessive amounts of senior securities; [31] and (iii) being organized, operated, managed, or having their portfolio securities selected, in the interests of company insiders.[32] In addition, the Investment Company Act seeks to protect the assets of investment companies, including imposing custody controls and preventing controlling persons of an investment company from commingling the investment company's assets with their own and misappropriating them.[33]

We are concerned that some mortgage-related pools, as pooled investment vehicles, may raise the potential for the same types of abuses, such as deliberate misvaluation of the company's holdings,[34] extensive leveraging,[35] and overreaching by insiders.[36] The Commission also has

[23] NASAA Guidelines at III.B. The NASAA Guidelines also address: A REIT's issuing certain securities, including redeemable securities; minimum suitability requirements; leverage concerns; potential conflicts of interests (such as providing for a majority of a REIT's board of trustees, including a majority of its independent trustees, to approve transactions between the REIT and its affiliates); and annual reports to shareholders. NASAA Guidelines at III., V.,VI.

[24] Like registered investment companies, many mortgage-related pools publicly offer their securities to both retail and institutional investors.

[25] In addition, as discussed previously, both registered investment companies that seek to avoid corporate taxation and mortgage-related pools that elect REIT status must distribute at least 90% of their income to investors annually so as to avoid corporate taxation. *See supra* note 16 and accompanying text.

[26] Investment advisers to mortgage-related pools also may receive incentive-based fees of a type that is prohibited for investment advisers to registered investment companies under the Investment Advisers Act of 1940 (''Advisers Act''), but typically charged by investment advisers to hedge funds and certain other private investment companies. *See* Section 205 of the Advisers Act. 15 U.S.C. 80b–5. An investment adviser to a mortgage-related pool may be required to register under the Advisers Act. *See generally* Section 203 of the Advisers Act and Commission rules thereunder.

[27] For example, many mortgage-related pools and registered investment companies, including money market funds, invest in agency securities. According to the Federal Reserve, as of March 31, 2011, registered investment companies (not including money market funds) held $800.8 billion (or 10.5%), and money market funds held $373.4 billion (or 4.9%), of outstanding ''agency- and GSE-backed securities,'' defined as issues of Federal budget agencies (such as those for TVA), issues of government-sponsored enterprises (such as Fannie Mae and FHLB) and agency- and GSE-backed mortgage pool securities issued by Ginnie Mae, Fannie Mae, Freddie Mac and the Farmers Home Administration. In contrast, REITs held $191.1 billion (or 2.5%) of such securities. Federal Reserve Statistical Release, *Flow of Funds Accounts of the United States: Flows and Outstandings First Quarter 2011* (June 9, 2011). As noted previously, certain registered investment companies focus their investments on the same types of assets as mortgage-related pools that primarily hold agency securities and other mortgage-backed securities. *See supra* note 3. In addition, in recent years, some hedge funds and offshore funds have been investing in the same types of assets as some mortgage-related pools. *See, e.g., Hedge Funds Investing in Delinquent Mortgages,* MSNBC.com (July 30, 2008).

[28] For example, a number of mortgage REITs appear to have been formed with the intent of targeting retail investors who may be unable to make the high minimum investments often required of large bond funds. *See A.D. Pruitt, Mortgage REITs on a Tear as High Yields Fuel Demand,* Wall St. J. (Apr. 13, 2011). Press reports have also characterized some such companies as investment vehicles. *See, e.g.,* Jonathan Weil, *Hedge Fund Instant IPO Tests the New Complacency,* Bloomberg.net (Jun. 18, 2009) (''PennyMac is a hedge fund dressed up as a real estate investment trust''). *See also* Nathan Vardi, *High-Profile Investor Sues Carlyle Group,* Forbes.com (July 13, 2009) (''Michael Huffington, the wealthy former Republican congressman from California, is suing the Carlyle Group and its co-founder, David Rubenstein, over misrepresentations and deceptions Huffington claims they made regarding his $20 million investment loss in Carlyle Corp., Carlyle's failed * * * mortgage fund.'').

[29] *See, e.g.,* Section 1(b) of the Investment Company Act (setting forth findings and declaration of policy). 15 U.S.C. 80a–1(b).

[30] The Investment Company Act places significant emphasis on the manner in which a registered investment company must value its portfolio. *See, e.g.,* Section 2(a)(41) of the Act. 15 U.S.C. 80(a)–2(a)(41) (defining ''value,'' with respect to securities held by a registered investment company, to be (a) Market value for securities for which market quotations are readily available or (b) for other securities or assets, fair value as determined in good faith by the company's board of directors).

[31] Prior to 1940, some investment companies were highly leveraged through the issuance of ''senior securities'' in the form of debt or preferred stock, which often resulted in the companies being unable to meet their obligations to the holders of their senior securities. *See generally Investment Trusts and Investment Companies: Report of the Securities and Exchange Commission* (1940) (''Investment Trusts Study''). Excessive leverage also greatly increased the speculative nature of the common stock of the companies. *Id.* Section 18 of the Investment Company Act limits the ability of registered investment companies to engage in borrowing and to issue senior securities. 15 U.S.C. 80a–18.

[32] A study conducted prior to the adoption of the Act documented numerous instances in which investment companies were managed for the benefit of their sponsors and affiliates to the detriment of investors. *See* Investment Trusts Study, *supra* note 31. Section 17 of the Investment Company Act prohibits certain transactions involving investment companies and their affiliates. 15 U.S.C. 80a–17(a). Other provisions of the Investment Company Act also effectively limit opportunities for overreaching by investment company sponsors and affiliates. *See, e.g.,* Section 10(f) of the Investment Company, which generally prohibits a registered investment company from knowingly purchasing, during the existence of any underwriting or selling syndicate, any security a principal underwriter of which is an affiliated person of the investment company. 15 U.S.C. 80a–10(f).

[33] *See, e.g.,* Investment Trusts Study, *supra* note 31. Prior to 1940, investment company assets were not adequately protected from misuse by investment company insiders. *Id.* In many cases, controlling persons of investment companies commingled the investment companies' assets with the investment advisers' assets and then proceeded to misuse the assets themselves. *Id.* Section 17(f) of the Investment Company Act and the rules thereunder set forth requirements with respect to the custody of investment company assets. 15 U.S.C. 80a–17(f). *See, e.g.,* Rule 17f–2 under the Investment Company Act governing custody of investments by a registered investment company. 17 CFR 270.17f–2.

[34] For example, the Commission has brought an enforcement action against the management of a company that had, among other things, improperly recorded mortgages that had decreased in value at cost rather than at market value in order to avoid writing down certain mortgages held for resale, thereby adversely affecting the company's income and equity. *See SEC* v. *Patrick Quinlan,* 2008 Fed. Sec. L. Rep. (CCH) ¶ 95,005 (E.D. Mich. Nov. 7, 2008), *aff'd,* 373 Fed. Appx. 581 (6th Cir. 2010).

[35] For example, an offshore fund that held mortgage-backed securities reportedly had a 32:1 leverage ratio (borrowing against the security of the mortgage-backed securities), so that when the mortgage-backed securities lost value, the fund could not service its debts, resulting in lenders seizing the fund's assets. *See, e.g.,* Nathan Vardi, *High-Profile Investor Sues Carlyle Group, Forbes.com* (July 13, 2009).

[36] For example, the Commission brought a settled administrative proceeding against a former chief executive officer of both a publicly held REIT and its manager (which owned approximately 52% of the REIT) who had used his significant influence on the advisory services provided by the REIT manager to cause the REIT, its manager and other related

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brought a number of enforcement cases, for example, in which controlling persons of companies that hold mortgage-related assets used such companies' assets to further their own interests.[37]

D. Request for Comment

The Commission is interested in learning more about mortgage-related pools. Accordingly, commenters are requested to provide information about companies that rely on Section 3(c)(5)(C) of the Act, including, among other things, the various types of such companies; 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. We ask commenters to discuss the differences, if any, between companies that originate mortgages and then continue to hold all or portions of those mortgages, and companies that only invest in mortgages and mortgage-related instruments. The Commission also invites commenters to provide the same type of information about any similar companies that do not rely on Section 3(c)(5)(C) and to explain whether they are registered under the Act or rely on another exclusion or exemption and, if so, which exclusion or exemption. The Commission is interested in obtaining information about both public (exchange-traded and non-exchange traded) and privately offered mortgage-related pools and similar companies. The Commission also requests that commenters provide any other information about mortgage-related pools they believe is relevant to the Commission's review of the status of such companies under the Investment Company Act.

We also ask commenters for their views on the apparent similarities between certain mortgage-related pools and traditional investment companies. We ask commenters to describe any key operational or structural characteristics of mortgage-related pools that serve to distinguish them from traditional investment companies regulated under the Investment Company Act. The Commission requests that commenters provide any other information that may be relevant to evaluating the similarities and differences between mortgage-related pools and investment companies.

Finally, we request comment on the types of potential abuses that the Investment Company Act was intended to prevent that might be associated with mortgage-related pools. We also are interested in learning about any existing safeguards in the structure and operations of mortgage-related pools that may address concerns similar to those addressed by the Investment Company Act. Commenters also are invited to comment on whether certain concerns addressed by the Investment Company Act may not be relevant to mortgage-related pools and the reasons why. Commenters also should discuss whether, and to what extent, such potential abuses are addressed by any industry practices or other regulatory schemes that may be applicable to mortgage-related pools.

III. The Exclusion Provided by Section 3(c)(5)(C)

A. Legislative and Administrative Background

Section 3(c)(5) originally was intended to exclude from the definition of investment company, among other things, companies that did not resemble, or were not considered to be, issuers that were in the investment company business.[38] In 1970, Congress amended Section 3(c)(5) to prohibit any issuer relying on the exclusion from issuing redeemable securities. According to the legislative history, certain companies that had been relying on Section 3(c)(5) sought to capitalize on the popularity of mutual funds by issuing redeemable securities.[39] Because Section 3(c)(5) was not intended to cover those companies that fell within the generally understood concept of a traditional investment company,[40] the 1970 amendment sought to ensure that companies that structured themselves like mutual funds would be subject to regulation under the Investment Company Act, regardless of the types of securities that they held.[41]

In 1960, the Commission addressed Section 3(c)(5)(C) in a release that discussed the applicability of the Federal securities laws to REITs.[42] In the 1960 Release, the Commission, among other things, stated that a REIT may fall within the definition of investment company under the Investment Company Act but, depending on the characteristics of its

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parties together to purchase over a million shares of a publicly traded company over a 13-month period, representing 16.1% of the total shares of that company. These purchases accounted for approximately 54% of the total trading volume in the company's stock during that period, and on some days these parties purchased all of the company's stock that traded that day. Although no entity itself purchased more than 5% of the company's securities, the Commission determined that given the interrelationships that existed, the REIT and others constituted a ''group'' for purposes of Section 13(d), and that a Schedule 13D should have been filed. *See In the Matter of Basic Capital Management Inc., et al.,* Exchange Act Release No. 46538 (Sept. 24, 2002). This case illustrates how a mortgage-related pool insider has the potential to influence the management of the company's assets for the insider's benefit.

[37] *See, e.g., SEC* v. *Pittsford Capital Income Partners LLC, et al.,* No. 06–6353 (W.D.N.Y. Aug. 23, 2007), *aff'd,* 305 Fed. Appx. 694 (2d. Cir. 2008) (persons that controlled certain real estate investment companies sold to senior citizens engaged in a fraudulent scheme involving, among other things, transfers of large amounts of money from the companies to entities in which the controlling persons had significant personal interests); *SEC* v. *Global Express Capital Real Estate Investment Fund I et al.,* No. 03–1514 (Nev. Mar. 28, 2006), *aff'd in part, rev'd and remanded in part,* 289 Fed. Appx. 183 (9th Cir. 2008) (a Ponzi-like scheme which purported to pool investor funds to purchase interests in mortgage loans and trust deeds); *SEC* v. *LandOak Securities, LLC, et al.,* No. 3:08–209 (E.D. Tenn., Mar. 29, 2011) (persons that controlled a mortgage company misappropriated funds due to the company's investors).

[38] *See, e.g.,* H.R. Rep. No. 2639, 76th Cong., 3d Sess. 12(1940) (''Subsection (c) specifically excludes * * * companies dealing in mortgages. * * * ''); H.R. Rep. No. 1382, 91st Cong., 2d Sess. 17 (1970) (''Although the companies enumerated * * * have portfolios of securities in the form of * * * mortgages and other liens on and interests in real estate, they are excluded from the 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'') (''1970 House Report''). *See also* PPI Report, *supra* note 2 at 328 (''Section 3(c)(6) 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''); *Exclusion from the Definition of Investment Company for Certain Structured Financings,* Investment Company Act Release No. 18736 (May 29, 1992) (''Proposing Release to Rule 3a–7'') at text following n.5 (''section 3(c)(5)] * * * originally was intended to exclude issuers engaged in the commercial finance and mortgage banking industries.'').

As initially enacted by Congress in 1940, Section 3(c)(5) was limited to companies that did not issue face-amount certificates of the installment type or periodic payment plan certificates, in response to the abuses found prior to 1940 in the sale of these types of securities by certain companies, including those of the type that would have otherwise been excluded by this provision. *See generally Investment Trusts and Investment Companies: Hearings Before a Subcomm. of the Senate Comm. on Banking and Currency on S. 3580,* 76th Cong., 3d. at 182 (1940) (statement of David Schenker). The prohibition on issuing face-amount certificates also may have been added to ensure that Investors Syndicate, a face-amount certificate company that held real estate and mortgage interests, would not be able to rely on Section 3(c)(5)(C) and instead be required to register under the Investment Company Act, as detailed in the Investment Trusts Study, *supra* note 31, at Ch. II of Companies Issuing Face Amount Installment Contracts (1940).

[39] *See, e.g.,* 1970 House Report, *supra* note 38 at 17; PPI Report, *supra* note 2 at 328–329.

[40] *See supra* note 38.

[41] *See, e.g.,* 1970 House Report, *supra* note 38.

[42] *Real Estate Investment Trusts,* Investment Company Act Release No. 3140 (Nov. 18, 1960) (''1960 Release'') (discussing Section 3(c)(6)(C), which was subsequently redesignated as Section 3(c)(5)(C)). *See supra* note 9.

assets and the nature of the securities it issues, the REIT may be able to rely on Section 3(c)(5)(C).[43] In the 1960 Release, the Commission also generally stated that the applicability of the Section 3(c)(5)(C) exclusion could be determined only on the basis of the facts and circumstances of the particular REIT. The Commission further stated, however, that any REIT that invested ''exclusively in fee interests in real estate or mortgages or liens secured by real estate'' could rely on the Section 3(c)(5)(C) exclusion, provided that the REIT also met the exclusion's other criteria with respect to the nature of the securities it issued.[44] The Commission explained that a REIT might not qualify for the exclusion if it ''invested to a substantial extent in other real estate investment trusts * * * or in companies engaged in the real estate business or in other securities.'' [45] The Commission has not specifically addressed the scope of Section 3(c)(5)(C) since the 1960 Release.[46]

B. Commission Staff No-Action Letters and Other Interpretations

As noted above, Section 3(c)(5)(C) generally excludes from the definition of investment company any person who is primarily engaged in, among other things, ''purchasing or otherwise acquiring mortgages and other liens on and interests in real estate.'' The staff, in providing guidance on this exclusion, generally has focused on whether at least 55% of the issuer's assets will consist of mortgages and other liens on and interests in real estate (called ''qualifying interests'') [47] and the remaining 45% of the issuer's assets will consist primarily of real estate-type interests.[48] The staff generally has viewed the following types of assets as qualifying interests:

- Assets that represent an *actual* interest in real estate or are loans or liens fully secured by real estate. Thus, the staff generally took the position that an issuer may treat as qualifying interests such assets as mortgage loans fully secured by real estate, fee interests in real estate, second mortgages secured by real property, deeds of trust on real property, installment land contracts and leasehold interests secured solely by real property.[49]
- 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. Thus, the staff took the position that a Tier 1 real estate mezzanine loan, under certain conditions, may be considered a qualifying interest if the loan may be viewed as being the functional equivalent of, and provide its holder with the same economic experience as, a second mortgage.[50]

Consistent with the view the Commission expressed in the 1960 Release, the staff has taken the position that an issuer that is primarily engaged in the business of holding interests in the nature of a security in another person engaged in the real estate business, generally may not rely on Section 3(c)(5)(C).[51] Thus, securities issued by REITs, limited partnerships, or other entities that invest in real estate, mortgages or mortgage-related instruments, or that are engaged in the real estate business, generally are not considered by the staff to be qualifying interests. In two particular circumstances, however, the staff expressed the view that certain interests in another person engaged in the real estate business may be regarded as qualifying interests:

- The staff has expressed the view that ''whole pool certificates'' that are issued or guaranteed by Fannie Mae, Freddie Mac or Ginnie Mae (''agency whole pool certificates'') provide the holder with the same economic experience as an investor who purchases the underlying mortgages directly, and therefore would be qualifying interests; [52] and
- The staff has expressed the view that certain subordinate participations in commercial real estate first mortgage loans, called B–Notes, have a number of attributes that, when taken together, may allow them to be classified as an interest in real estate rather than an interest in the nature of a security issued by a person that is engaged in the real estate business.[53]

[43] *Id.*

[44] *Id.*

[45] *Id.*

[46] The Commission testified before Congress in 1983 and 1984 concerning the applicability of the Investment Company Act to issuers of some mortgage-related securities in connection with legislation that became the Secondary Mortgage Market Enhancement Act of 1984. Statement of the Securities and Exchange Commission Submitted to the Subcommittee on Housing and Urban Affairs, U.S. Senate, on S. 1821 (Sep. 27, 1983) (''The Commission believes that the Investment Company Act offers important protections to investors in entities coming within the definition of the term 'investment company' that should not be sacrificed lightly, even in the name of an objective as worthwhile as enhancing the private secondary mortgage market'').

In the Proposing Release to Rule 3a–7, issued in 1992, the Commission discussed the reliance on Section 3(c)(5) by certain private sector issuers of asset-backed securities, including mortgage-backed securities. *See* Proposing Release to Rule 3a–7, *supra* note 38. In that release, the Commission requested comment on whether Section 3(c)(5) should be amended to prevent such issuers from continuing to rely on this exclusion, because such issuers could instead rely on Rule 3a-7. In response to commenters' arguments, including that it would be inappropriate to narrow the scope of Section 3(c)(5) until both the market and the Commission gained experience with Rule 3a–7, the Commission decided not to pursue any legislative changes with respect to Section 3(c)(5) at that time. *See Exclusion from the Definition of Investment Company for Structured Financings,* Investment Company Act Release No. 19105 (Nov. 19, 1992) [57 FR 56248 (Nov. 27, 1992)] (''Adopting Release to Rule 3a–7''). In the 3a–7 Companion Release, the Commission once again is seeking comment on whether Section 3(c)(5) should be amended to limit the ability of asset-backed issuers to rely on this exclusion. 3a–7 Companion Release, *supra* note 5.

[47] *See, e.g.,* Salomon Brothers, Inc., SEC Staff No-Action Letter (June 17, 1985).

[48] *See, e.g.,* Citytrust, SEC Staff No-Action Letter (Dec. 19, 1990); Greenwich Capital Acceptance Inc., SEC Staff No-Action Letter (Aug. 8, 1991) (issuer represented its intention to invest at least 25% of its total assets in real estate-type interests (subject to reduction to the extent that the issuer invested more than 55% of its total assets in qualifying interests) and no more than 20% of its total assets in miscellaneous investments).

[49] *See, e.g.,* United States Property Investment N.V., SEC Staff No-Action Letter (May 1, 1989) (mortgage loan secured exclusively by real estate in which the value of the real estate was equal or greater than the note evidencing the loan); Division of Investment Management, SEC, *The Treatment of Structured Finance Under the Investment Company Act,* Protecting Investors: A Half Century of Investment Company Regulation (1992) Ch. 1 (''Protecting Investors Report'') at n. 345 and accompanying text (mortgage loan in which 100% of the principal amount of each loan was fully secured by real estate at the time of origination and 100% of the market value of the loan was fully secured by real estate at the time of acquisition); United Bankers, SEC Staff No-Action Letter (Mar. 23, 1988) (fee interests in real estate); The State Street Mortgage Co., SEC Staff No-Action Letter (July 17, 1986) (second mortgages); First National Bank of Fremont, SEC Staff No-Action Letter (Nov. 18, 1985) (deeds of trust on real property); American Housing Trust I, SEC Staff No-Action Letter (May 21, 1988) (installment land contracts); Health Facility Credit Corp., SEC Staff No-Action Letter (Feb. 6, 1985) (leasehold interests).

[50] *See* Capital Trust Inc., SEC Staff No-Action Letter (May 24, 2007).

[51] *See* 1960 Release, *supra* note 42. *See also* Urban Land Investments Inc., SEC Staff No-Action Letter (Nov. 4, 1971); The Realex Capital, SEC Staff No-Action Letter (Mar. 19, 1984); M.D.C. Holdings, SEC Staff No-Action Letter (May 5, 1987). The staff also has stated its view that an issuer that is engaged primarily in purchasing or otherwise acquiring participations or fractionalized interests in individual or pooled mortgages or deeds of trust would not qualify to rely on Section 3(c)(5)(C) because such participations and interests are in the nature of a security in another person engaged in the real estate business. MGIC Mortgage Corp., SEC Staff No-Action Letter (Oct. 6, 1972 and Aug. 1, 1974); M.D.C Holdings, SEC Staff No-Action Letter (May 5, 1987).

[52] *See* Protecting Investors Report, *supra* note 49 at n. 267. A whole pool certificate is a security that represents the entire ownership interest in a particular pool of mortgage loans. *Id. See also* American Home Finance Corp. (pub. avail. Apr. 9, 1981).

[53] Capital Trust Letter, SEC Staff No-Action Letter (Feb. 3, 2009) (''Capital Trust B-Note Letter''). The Capital Trust B-Note Letter was intended to clarify the staff's earlier statements with respect to mortgage participations as qualifying interests. In

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Finally, the staff has expressed the view that certain mortgage-related instruments that were not treated as qualifying interests may be treated as real estate-type interests. In the staff's view, such instruments would include loans in which at least 55% of the fair market value of each loan was secured by real estate at the time the issuer acquired the loan,[54] and agency partial pool certificates.[55]

Some mortgage-related pools have determined that certain other assets constitute qualifying assets for purposes of that exclusion. For example, we understand that mortgage-related pools generally treat bridge loans, certain construction and rehabilitation loans, wrap-around mortgage loans and investments in distressed debt as qualifying interests, provided that the loans are fully secured by real estate. We also understand that some mortgage-related pools have determined to treat a convertible mortgage (which is a mortgage plus an option to purchase the underlying real estate) as two assets—a mortgage loan (treated as a qualifying interest provided that it is fully secured by real estate) and an option to purchase real estate (which is assigned an independent value and treated as a real estate-type interest).

With respect to certain other mortgage-related instruments, there appears to be a degree of uncertainty or differing views among mortgage-related pools as to the availability of the Section 3(c)(5)(C) exclusion. For example, it appears that some mortgage-related pools that invest in certificates issued by pools that hold whole loans and participation interests in loans that are secured by commercial real estate (''CMBS'') limit the amount of CMBS that they hold, treating such assets as real estate-type interests under Section 3(c)(5)(C), whereas others treat certain CMBS as qualifying interests.

C. Request for Comment on the Current Interpretation of Section 3(c)(5)(C)

As the discussion above indicates, the exclusion from the definition of investment company provided by Section 3(c)(5)(C) does not have an extensive legislative history, has not been comprehensively addressed by the Commission, and generally has been addressed in staff no-action letters only on a case-by-case basis. The evolution of mortgage-related pools and the development of new and complex mortgage-related instruments have led us to be concerned that mortgage-related pools are making judgments about their status under the Investment Company Act without sufficient Commission guidance.[56] It appears that some types of mortgage-related pools might interpret the statutory exclusion provided by Section 3(c)(5)(C) in a broad manner, while others might interpret the exclusion too narrowly. The Commission also is concerned that the staff no-action letters that have addressed the statutory exclusion in Section 3(c)(5)(C) may have contained, or led to, interpretations that are beyond the intended scope of the exclusion and inconsistent with investor protection. The Commission is concerned that certain types of companies today appear to resemble in many respects management investment companies that are registered under the Act and may not be the kinds of companies that were intended to be excluded from regulation under the Act by Section 3(c)(5)(C).

The Commission requests comment from mortgage-related pools, investors, and the public on the current state of guidance and interpretation concerning Section 3(c)(5)(C). The Commission is interested in learning from mortgage-related pools and their legal counsel about any difficulties they may have encountered in determining the status of such companies under the Investment Company Act. Are we correct that there is uncertainty or differing views among companies as to the availability of the Section 3(c)(5)(C) exclusion? If so, please explain and provide specific examples. Do commenters believe that the exclusion provided by Section 3(c)(5)(C) is generally being used consistent with the purposes and policies underlying that provision and investor protection? Do commenters believe that certain mortgage-related pools may be giving too broad an interpretation to this statutory exclusion? If so, does such broad interpretation result in companies that resemble traditional investment companies avoiding regulation under the Act and, if so, is it inconsistent with the purposes and policies underlying that provision and investor protection? Do commenters believe that certain companies may be giving too narrow an interpretation to this statutory exclusion? Commenters are requested to provide detailed explanations of their views, including specific examples, if appropriate.

We noted above that companies generally determine whether they are primarily engaged in the business of purchasing or otherwise acquiring mortgages and other liens on and interests in real estate, based on whether at least 55% of the company's assets consist of qualifying interests and the remaining 45% of the company's assets consist primarily of real estate-type interests. Is this an appropriate approach to determining an issuer's primary engagement for purposes of Section 3(c)(5)(C)? Is it a difficult determination to make? Is the approach too broad or, conversely, too narrow in terms of identifying the types of companies that are able to rely on the exclusion, consistent with legislative intent? Does this approach lead certain companies to invest their assets in a different manner than they otherwise would in accordance with their business model, in order to have the certainty of being able to rely on Section 3(c)(5)(C)? Are there companies that have concluded that they do not qualify for the exclusion in Section 3(c)(5)(C)? If so, how did such companies address their status under the Investment Company Act? Commenters are requested to comment on their experiences in this

prior letters, the staff had expressed the view that a trust that held certain participation interests in construction period mortgage loans acquired from mortgage lenders may rely on Section 3(c)(5)(C), concluding that each mortgage participation interest held by the trust was an interest in real estate because the participation interest was in a mortgage loan that was fully secured by real property and the trustee had the right by itself to foreclose on the mortgage securing the loan in the event of default. *See, e.g.* Northwestern Ohio Building and Construction Trades Foundation, SEC Staff No-Action Letter (Apr. 20, 1984); Baton Rouge Building and Construction Industry Foundation, SEC Staff No-Action Letter (Aug. 31, 1984). Although the Capital Trust B-Note Letter specifically did not withdraw the prior staff no-action letters, it noted the staff's view that, while the right to foreclose is an important attribute to consider when determining whether an asset should be considered a qualifying interest, other attributes of the asset also need to be considered when making such a determination.

[54] NAB Asset Corp., SEC Staff No-Action Letter (June 20, 1991).

[55] The staff has expressed the view that, while an agency partial pool certificate (which is a certificate that represents less than the entire ownership interest in a mortgage pool) is not a qualifying interest because it is more akin to being an investment in the securities of an issuer holding mortgages rather than an investment directly in the underlying mortgages, such asset may be treated as a real estate-type interest for purposes of determining whether an issuer may rely on Section 3(c)(5)(C). *See, e.g.,* Nottingham Realty Securities, SEC Staff No-Action Letter (Apr. 19, 1984); Protecting Investors Report, *supra* note 49 at n. 268 and accompanying text.

[56] In this regard we note that most mortgage-related pools, when publicly offering their securities, disclose in their registration statements that their determinations whether they may rely on the Section 3(c)(5)(C) exclusion will be based on staff no-action letters and Commission guidance and, where such guidance does not exist, on their own judgments. Such companies also state that there can be no assurance that the Commission staff will concur with their views, or that the laws governing the Investment Company Act status of mortgage-related pools, or the guidance provided by the Commission or its staff, will not change in a manner that would not adversely affect their operations.

area, including the economic impact of this approach.

With respect to the staff no-action letters, we ask for comment on whether any of the staff's analysis relating to the determination of whether an asset is a ''lien on or interest in real estate'' for purposes of Section 3(c)(5)(C) would be relevant in formulating Commission guidance for today's mortgage-related pools. Commenters should identify any such staff position and explain its relevance. For example, should certain mortgage participations 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? Why or why not, and does it matter what type(s) of participations the company holds? If participations are to be treated as interests in real estate, what features should be considered in making a determination about such assets? For example, should the right to foreclose be considered an important attribute, even though such right only exists if the underlying mortgage defaults? [57] Commenters are encouraged to discuss the costs and benefits of their recommendations.

We also request comment on the view that the Commission should take concerning agency whole pool certificates under Section 3(c)(5)(C). Should the Commission revisit the staff's view that agency whole pool certificates may be treated as interests in real estate? [58] Should we 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) or not? What would be the economic impact of the Commission adopting a position that would not treat agency whole pool certificates as interests in real estate? Commenters should explain how such companies are similar to, or differ from, traditional investment companies that invest in similar assets, and how any such similarities or differences should affect the status of such companies under the Investment Company Act.

Finally, we ask for comment generally on whether guidance is needed with respect to other mortgage-related instruments. If so, which instruments and what should that guidance provide? We note in particular the differing approaches taken by certain mortgage-related pools as to the appropriate treatment of certain types of CMBS for purposes of determining a company's ability to rely on Section 3(c)(5)(C). Should the Commission provide guidance with respect to these mortgage-related instruments, what should that guidance address, and what would be the potential economic impact of this guidance? We also request comment on whether a company whose primary business consists of investing in CMBS, or any other type of mortgage-backed security, is the type of entity that Congress intended to be encompassed by the exclusion provided by Section 3(c)(5)(C).

IV. Request for Comment on Possible Commission Action

The Commission requests comment on what steps, if any, it should take to provide greater clarity, consistency or regulatory certainty regarding the status of mortgage-related pools under the Investment Company Act. The Commission potentially could engage in rulemaking (such as a safe harbor or definitional rule), issue an interpretive release, and/or provide exemptive relief to address mortgage-related pools and the scope of Section 3(c)(5)(C), or take no further action at this time. Commenters are encouraged to discuss the benefits and costs of each such option.

Commenters are asked to address whether a test could be devised that would differentiate companies that are primarily engaged in the real estate and mortgage banking business from those companies that resemble traditional investment companies. If commenters believe that such a test is appropriate, the Commission is interested in commenters' views as to the factors that would be suitable in such a test, the benefits and costs associated with any suggested test, and the effect that any suggested test may have on investor protection, competition, efficiency and capital formation.

Section 3(c)(5)(C) suggests that one factor that must be considered when determining whether a company is primarily engaged in the business set forth in Section 3(c)(5)(C) is the composition of the company's assets. Would it be helpful for the Commission to define the term ''liens on and other interests in real estate'' for purposes of Section 3(c)(5)(C)? If so, how should the Commission define that term? For example, in light of the reference to ''mortgages'' in Section 3(c)(5)(C), should the term ''liens on and interests in real estate'' 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? The Commission requests comment on the advantages and disadvantages of defining the term ''liens on and interests in real estate'' in this manner. If commenters believe that a broader definition of the term ''liens on and interests in real estate'' is more appropriate, the Commission requests comment on the principles or concepts that could be used to craft such a definition. Commenters are encouraged to discuss the benefits and costs of alternative definitions.

In addition to the composition of a company's assets, other factors may help to differentiate companies that are primarily engaged in the real estate and mortgage banking business from those companies that resemble traditional investment companies. What are such other factors? Should a company also look to its sources of income in determining its ''primary business'' under Section 3(c)(5)(C)? [59] Should factors such as the company's historical development, the activities of its officers, directors and employees, and its public representations also be considered in determining the company's primary business under Section 3(c)(5)(C)? Are there factors that may be potentially indicative of a company's non-investment company business? For example, are there any types of business activities or types of business expenses that differentiate such a company from an investment company? [60] Commenters are urged to be specific in their responses.

[57] *See supra* note 53.

[58] The Commission issued a similar request for comment in 1992. *See* Proposing Release to Rule 3a-7, *supra* note 38 at n.103 and accompanying text. That request for comment stemmed from the Protecting Investors Report, issued in 1992, in which the staff discussed whether it should reconsider its position with respect to agency whole pool certificates, noting that an agency whole pool certificate holder does not have the same economic experience as an investor who holds the underlying mortgages because of the agency guarantee, which increases the certificates' liquidity. Protecting Investors Report, *supra* note 49 at text following n.346. Commenters strongly urged the staff not to withdraw its position, arguing that agency whole pool certificates are interests in real estate because certificate holders receive payment streams that reflect payments on the underlying mortgages. Commenters also argued that withdrawal of the position could result in some REITs and mortgage bankers that held these instruments becoming subject to the Investment Company Act. In response to commenters' concerns at that time, the staff ultimately decided not to withdraw its position. Adopting Release to Rule 3a–7, *supra* note 46 at nn. 90–92 and accompanying text.

[59] *See, e.g.,* Section 3(c)(6) of the Investment Company Act. 15 U.S.C. 80a–3(c)(6). We note that the Internal Revenue Code's REIT provisions contain an asset and income test. *See supra* note 16.

[60] *See e.g.,* Rule 3a–8 under the Investment Company Act (addressing the status under the Act

Continued

IV. General Request for Comment

In addition to the issues raised or mentioned in this release, the Commission requests and encourages all interested persons, including investors in mortgage-related pools, to submit their views on any other issues relating to the status of such companies under the Investment Company Act. The Commission particularly welcomes statistical, empirical, and other data from commenters that may support their views and/or support or refute the views or issues raised in this release.

Dated: August 31, 2011.

By the Commission.

Elizabeth M. Murphy,

Secretary.

[FR Doc. 2011–22771 Filed 9–6–11; 8:45 am]

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of certain research and development companies based on, among other things, their research and development expenses, the activities of their officers, directors and employees, their public representations of policies, and their historical development). 17 CFR 270.3a–8.

SECURITIES AND EXCHANGE COMMISSION

[Release No. IC–29779; File Nos. S7–35–11]

17 CFR Part 270

RIN 3235–AL03

Treatment of Asset-Backed Issuers Under the Investment Company Act

AGENCY: Securities and Exchange Commission.

ACTION: Advance notice of proposed rulemaking; withdrawal.

SUMMARY: The Commission is considering proposing amendments to Rule 3a–7 under the Investment Company Act of 1940 (''Investment Company Act'' or ''Act''), the rule that provides certain asset-backed issuers with a conditional exclusion from the definition of investment company. Amendments to Rule 3a–7 that the Commission may consider could reflect market developments since 1992, when Rule 3a–7 was adopted, and recent developments affecting asset-backed issuers, including the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the ''Dodd-Frank Act'') and the Commission's recent rulemakings regarding the asset-backed securities markets. The Commission is withdrawing its 2008 proposal to amend Rule 3a–7, which was published July 11, 2008.

DATES: Comments should be received on or before November 7, 2011.

ADDRESSES: Comments may be submitted by any of the following methods:

Electronic Comments

- Use the Commission's Internet comment form (*http://www.sec.gov/rules/concept.shtml*); or
- Send an e-mail to *rule-comments@sec.gov.* Please include File Number S7–35–11 on the subject line; or
- Use the Federal eRulemaking Portal (*http://www.regulations.gov*). Follow the instructions for submitting comments.

Paper Comments

- Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549–1090.

All submissions should refer to File Number S7–35–11. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Web site (*http://www.sec.gov/rules/concept.shtml*). Comments also are available for Web site viewing and printing in the Commission's Public Reference Room, 100 F Street, NE., Washington, DC 20549, on official business days between the hours of 10 a.m. and 3 p.m. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make publicly available.

FOR FURTHER INFORMATION CONTACT: Rochelle Kauffman Plesset, Senior Counsel, at (202) 551–6840 or Nadya Roytblat, Assistant Chief Counsel, at (202) 551–6825, Office of the Chief Counsel, Division of Investment Management, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549.

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I. Introduction and Executive Summary

Asset-backed issuers [1] typically meet the definition of investment company under the Investment Company Act, but generally cannot operate under certain of the Act's requirements and restrictions.[2] In 1992, the Commission adopted Rule 3a–7 under the Investment Company Act specifically to exclude from the definition of investment company certain asset-backed issuers that meet the rule's conditions.[3] These conditions were designed to incorporate then-existing practices in the asset-backed securities market that we believed served to distinguish asset-backed issuers from registered investment companies and addressed investor protection under the Investment Company Act.[4]

Rule 3a–7 includes several conditions that refer to credit ratings by nationally recognized statistical rating organizations (''NRSROs'' or ''rating agencies''). One such condition is that certain of the asset-backed issuer's fixed-income securities receive certain credit ratings by at least one rating agency. These conditions were included in Rule 3a–7 not principally as standards of credit-worthiness, but, because we believed that rating agencies, when providing a rating assessing the credit risk of an asset-

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[1] We use the term ''asset-backed issuer'' in this release to refer generally to any issuer of fixed-income securities the payments on which depend primarily on the cash flows generated by a specified pool of underlying financial assets. *See also infra* section III.A.2.d.ii for a discussion of the definition of ''asset-backed securities'' under other Federal securities laws.

[2] *See infra* note 29.

[3] 17 CFR 270.3a–7.

[4] The conditions also were intended to accommodate future innovations in the securitization market, consistent with investor protection. *See Exclusion from the Definition of Investment Company for Structured Financings,* Investment Company Act Release No. 19105 (Nov. 19, 1992) [57 FR 56248 (Nov. 27, 1992)] (''Adopting Release'') at text accompanying n.8. Rule 3a–7 effectuated the recommendation made by the Division of Investment Management's staff in its report, *Protecting Investors: A Half Century of Investment Company Regulation,* The Treatment of Structured Finance under the Investment Company Act 1–101 (May 1992) (''Protecting Investors Report''). The Protecting Investors Report contains a discussion of the issues raised by asset-backed issuers under the Investment Company Act and the state of the asset-backed securities market prior to the Rule's adoption.