

October 17, 2011

SEC Seeks Input on Investment Company Act Exclusion for Mortgage REITs and Other Mortgage-Related Pools

The Securities and Exchange Commission (the SEC) has issued a concept release (the Release) to request comments on Section 3(c)(5)(C) under the Investment Company Act of 1940, as amended (the 1940 Act). 76 Fed. Reg. 55300, Investment Company Act Rel. No. 29778 (Aug. 31, 2011). In announcing the concept release, Chairman Mary Shapiro noted “in some cases, certain REITs and potentially other mortgage-related pools relying on the [mortgage] exclusion can to some investors – particularly retail investors – look very much like traditional investment companies.” The Release seeks information regarding how the Section 3(c)(5)(C) exclusion has been interpreted by certain REITs. The Release was issued at the same time as a companion release on Rule 3a-7 under the 1940 Act, which provides an exclusion for certain asset-backed securities issuers. The Release appears to be a precursor to a staff study similar to the 1992 “Protecting Investors: A Half Century of Investment Company Regulation” study. Comments are due November 11, 2011.

Background

Section 3(c)(5)(C) generally excludes from the definition of “investment company” any 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, among other things, “purchasing or otherwise acquiring mortgages and other liens on and interests in real estate.” The Release observes that Section 3(c)(5)(C) was enacted in 1940 to exclude from regulation under the 1940 Act companies that “were engaged in the mortgage banking business and did not resemble, or were not considered to be, issuers that were in the investment company business.” However, since that time, as the mortgage markets have evolved and expanded, a “wide variety of companies, many of them unseen in 1940, have relied upon Section 3(c)(5)(C).” The Release notes that the statutory exclusion provided by Section 3(c)(5)(C) lacks an extensive legislative history and has not been comprehensively addressed by the SEC since 1960. Rather, Section 3(c)(5)(C) has been addressed on a case-by-case basis by SEC staff.

The Release explains the SEC’s concerns that mortgage-related pools potentially are making judgments about their status under the 1940 Act without sufficient guidance being developed by the SEC, and that certain interpretive positions regarding Section 3(c)(5)(C) may go beyond the intended scope of the exclusion and negatively impact investor protection. Further, the Release notes that the SEC has questioned whether some mortgage-related pools may raise the potential for the same types of abuses that the 1940 Act was meant to address, such as “deliberate misvaluation of the company’s holdings, extensive leveraging, and overreaching by insiders.” In doing so, the Release highlights a number of enforcement cases in which controlling persons of companies that hold mortgage-related assets used such companies’ assets to further their own interests to the detriment of shareholders.

In addition to its general purpose to gather additional information regarding mortgage-related pools, the SEC indicated that it had issued the Release in order: (i) to confirm consistency with the Congressional intent underlying the exclusion from regulation under the 1940 Act provided by Section 3(c)(5)(C); (ii) to ensure that the exclusion provided by Section 3(c)(5)(C) is administered in a manner that is consistent with the purposes and policies underlying the 1940 Act, the public

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interest, and the protection of investors, (iii) to provide greater clarity, consistency and regulatory certainty in this area, and (iv) to facilitate capital formation.

Request for Comments

The Release solicits comments in two areas – information about mortgage-related pools in general and information about the current interpretation of Section 3(c)(5)(C). The Release also asks for information about possible SEC action.

Request for Information About Mortgage-Related Pools In General

The request for information regarding mortgage-related pools in general relates to (i) the types of companies that rely on Section 3(c)(5)(C), including exchange-traded and non-exchange-traded REITs, privately placed REITs and similar companies, (ii) the apparent similarities between certain mortgage-related pools and traditional investment companies, and (iii) the types of potential abuses the 1940 Act was intended to prevent that might be associated with mortgage-related pools.

Request for Information on Current Interpretations of Section 3(c)(5)(C)

The request for information regarding the current interpretation of Section 3(c)(5)(C) is based on an SEC concern 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 Release states that the SEC is seeking comments:

- From mortgage-related pools and their counsel about any difficulties they may have encountered in determining the status of such companies under the 1940 Act;
- On whether there is uncertainty or differing views among companies concerning the availability of the Section 3(c)(5)(C) exclusion;
- On whether the current approach used by companies to determine whether they are primarily engaged in the business of purchasing or otherwise acquiring mortgages and other liens for purposes of Section 3(c)(5)(C) is appropriate. The SEC notes that based on staff guidance, 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 mortgages and other liens on and interest in real estate (qualifying interests) and the remaining 45% of the company’s assets consist primarily of real-estate type interests;
- On whether an asset that is a “lien on or interest in real estate” for purposes of Section 3(c)(5)(C) would be relevant in formulating guidance for current mortgage-related pools;
- On the appropriate SEC position under Section 3(c)(5)(C) with respect to agency whole pool certificates (*i.e.*, certificates issued by Fannie Mae, Freddie Mac, or Ginnie Mae); and
- On whether guidance is needed with respect to other mortgage-related instruments, such as certificates issued by pools that hold whole loans and participation interests in loans that are secured by commercial real estate (“CMBS”).

The SEC is also seeking comments on possible regulatory actions and the costs/benefits of those possible actions. The SEC stated that it welcomes statistical, empirical, and other data from

commenters that may support their views or refute the SEC's views set forth in the concept release.

Next Steps

Given the broad scope of the Release, any issuer that routinely relies upon the exclusion provided by Section 3(c)(5)(C) should consider submitting a comment letter in response to the issues the Release discusses. In particular, any tightening of the exclusion set forth in Section 3(c)(5)(C) could have a profound impact on the nature of mortgage-related investments that may be acquired by REITs, and could potentially lead to significant restrictions on both the use of leverage and the level of management and incentive fees for those REITs that the SEC may deem outside the intended scope of Section 3(c)(5)(C).



If you have any questions about this Legal Alert, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.

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