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Legal Update
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US Securities and Exchange Commission Issues Concept Release and Request for Comments Regarding Investment Company Exclusion under Section 3(c)(5)(C) of the Investment Company Act of 1940

Introduction. On August 31, 2011, the United States Securities and Exchange Commission (SEC), in Release No. IC-29778 (Release), provides a concept release and requests public comments regarding mortgage-related pools, including certain real estate investment trusts (REITs) and issuers of mortgage-backed securities,[1] that rely on the exclusion under Section 3(c)(5)(C) of the Investment Company Act of 1940 (ICA or 40 Act).

The SEC states that Section 3(c)(5)(C) was originally enacted, in 1940, without extensive legislative history,[2] to exclude from regulation mortgage-banking companies that were unlike, and were not considered to be, companies that were engaged in the investment company business. Since that time, the mortgage markets have changed dramatically, resulting in a variety of companies (many of them not in existence and otherwise unforeseen in 1940) relying on the exclusion today. And since enactment, the SEC has not comprehensively addressed Section 3(c)(5)(C).[3] Its staff has published a number of "no-action" letters, but these have been issued on a case-by-case basis.

The Release states that the SEC has concerns that Section 3(c)(5)(C) is not being interpreted consistently by companies that rely on this exclusion and that some no-action letters may have contained, or may have led to, interpretations beyond the intended scope of the exclusion and inconsistent with investment protection. The SEC believes that both investors and mortgage-related pools would benefit from a comprehensive review of the Section 3(c)(5)(C) exclusion.

In the Release, the SEC seeks data and other information regarding mortgage-related pools and solicits views regarding the application of Section 3(c)(5)(C) to mortgage-related pools in an effort to : (i) be consistent with the Congressional intent underlying the exclusion from regulation under the 40 Act provided by Section 3(c)(5)(C), (ii) 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 (iii) provide greater clarity, consistency and regulatory certainty in this area and (iv) facilitate capital formation. Comments are due on or before November 7, 2011.

Overview of Mortgage-Related Pools. In the Release, the SEC states that many different types of companies rely on the exclusion and that these companies engage in a variety of businesses. The Release provides examples of these companies: (i) companies that originate and hold mortgages and participations of mortgages that they originated; (ii) companies engaged in the business of acquiring mortgages, mortgage participations, mezzanine loans and mortgage-backed securities and other related instruments;

(iii) companies that invest in real estate, mortgages and mortgage-related instruments and (iv) companies that primarily invest in mortgage agency securities, as well as other mortgage-backed securities.

In the Release, the SEC makes several general observations about mortgage-related pools:

- 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.
- Although mortgage-related pools may utilize a variety of investment strategies, most mortgage-related pools use leverage to magnify their returns.
- 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.
- 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.

Similarities to Traditional Investment Companies. In the Release, the SEC describes certain similarities that it believes mortgage-related pools have with traditional investment companies:

- Both mortgage-related pools and traditional investment companies pool investor assets to purchase securities and provide investors with professional asset management.
- 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.
- Like investment advisers to traditional investment companies, investment advisers to mortgage-related pools typically are compensated with an asset-based fee.
- Some mortgage-related pools invest in the same types of assets as registered investment companies and private investment funds.
- 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.

The SEC states that it is concerned that some mortgage-related pools, as pooled investment vehicles, may raise the potential for abuses similar to those related to traditional investment companies, e.g., deliberate misvaluation of assets, excessive use of leverage and overreaching by insiders.[4]

Request for Comment. Within this context of regulatory concern, the SEC stated that it is interested in learning more about mortgage-

related pools. Specifically, the SEC requests comment and information on a number of matters, including:

- Information about companies (whether public or private) that rely on Section 3(c)(5)(C), including, among other things: the types of companies, how they are operated (including their strategies for asset acquisition and management), the types of investors that invest in such companies and the roles of such companies in the mortgage markets
- 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 similarities and differences between certain mortgage-related pools and traditional investment companies, including any key operational or structural characteristics of mortgage-related pools that distinguish them from traditional investment companies
- The types of potential abuses that the ICA was intended to prevent and that might be associated with mortgage-related pools
- Any existing safeguards in the structure and operations of mortgage-related pools that may address concerns similar to those addressed by the ICA
- Whether certain concerns addressed by the ICA are or are not relevant to mortgage-related pools and why
- Whether, and to what extent, such concerns are addressed by any industry practices or other regulatory schemes applicable to mortgage-related pools.

Overview of SEC Staff No-Action Letters. Over the years, the SEC staff has provided guidance on Section 3(c)(5)(C) by publishing various "no-action" letters on a case-by-case basis. The Release provides an overview of the staff's guidance in these letters, explaining that, as a general matter, the staff has said that whether an issuer can rely on the exclusion depends upon whether at least 55 percent of the issuer's assets will consist of mortgages and other liens on and interests in real estate ("qualifying interests") and whether the remaining 45 percent of the issuer's assets will consist primarily of real estate-type interests. The Release describes the types of assets that the staff has viewed as qualifying interests:

- Actual interests in real estate, and loans or liens fully secured by real estate (e.g., 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).
- Assets that are 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. For example, 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.

The Release states that 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 the exclusion and that, as a result, 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. The Release, however, describes two exceptions, where the staff expressed the view that certain interests in another person engaged in the real estate business may be regarded as qualifying interests:

- “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.
- 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.

Finally, the Release explains that 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 (e.g., loans in which at least 55 percent of the fair market value of each loan was secured by real estate at the time the issuer acquired the loan, and agency partial pool certificates).

Mortgage Pools’ Treatment of Other Assets. In the Release, the SEC describes other assets that certain mortgage-related pools treat as qualifying assets or real estate-type interests:

- Bridge, construction and rehabilitation loans, wrap-around mortgages and distressed debt, if the loans are fully secured by real estate.
- Portions of convertible mortgages (i.e., a mortgage with an option to purchase the underlying real estate). The pool treats the mortgage loan as a qualifying interest provided that it is fully secured by real estate and treats the option to purchase real estate (which is assigned an independent value) as a real estate-type interest.
- Certificates issued by pools that hold whole loans and participation interests in loans that are secured by commercial real estate (CMBS). Some pools treat CMBS as real estate-type interests, whereas others treat them as qualifying interests.

The SEC is concerned that there is confusion in the industry about how to treat certain assets under the staff’s guidance, i.e., as qualifying interests or real estate-type interests. The SEC also is concerned that the staff no-action letters may have contained, or led to, interpretations that are beyond the intended scope of the exclusion and inconsistent with investor protection. In addition, the SEC is concerned that certain types of companies today appear to resemble in many respects management investment companies that are registered under the ICA and may not be the kinds of companies that were intended to be excluded from regulation by Section 3(c)(5)(C).

Request for Comment. Within this context of regulatory concern, the SEC requests information and comment on a number of matters, including:

- The current state of guidance and interpretation concerning Section 3(c)(5)(C)
- Any difficulties encountered in determining the status of mortgage-related pools companies under the ICA
- Whether there are uncertainty or differing views among companies as to the availability of the Section 3(c)(5)(C) exclusion
- Whether the exclusion is generally being used consistent with the purposes and policies underlying that provision and investor protection
- Whether certain companies may be giving too broad an interpretation to this statutory exclusion and if so, whether such broad interpretation results in companies that resemble traditional investment companies avoiding regulation under the ICA
- Whether certain companies may be giving too narrow an interpretation to this statutory exclusion

- Whether the 55 percent/45 percent approach described above is appropriate for determining an issuer's primary engagement for purposes of Section 3(c)(5)(C) or, if not appropriate, whether it is too difficult, broad or narrow.

Possible SEC Action. The SEC also 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 ICA. The Release explains that the SEC could issue rules (such as a safe harbor or definitional rule), issue an interpretive release, provide exemptive relief or take no action at this time. In the Release, the SEC further requested comment on specific guidance, tests, definitions and factors that are or could be used in determining whether a company can rely on the exclusion.

Endnotes

[1] The SEC also issued a companion release that may be relevant to such issuers, regarding Rule 3a-7 under the ICA for certain asset-backed issuers. [insert link]

[2] Section 3(c)(5) was amended In 1970 to prohibit an issuer relying on the exclusion from issuing redeemable securities. The Release states that, 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. The Release further states that, because the exclusion was not intended to cover companies that fell within the generally understood concept of a traditional investment company, these amendments were designed to ensure that a company that structured itself like a traditional investment company would be regulated like one.

[3] In 1960, the SEC published a release addressing Section explains that the 1960 release stated that a REIT may fall within the definition of investment company under the ICA but, depending on the characteristics of its assets and the nature of the securities it issues, the REIT may be able to rely on Section 3(c)(5)(C). In the 1960 release, the SEC explained that a REIT might not qualify for the exclusion if it invested to a substantial extent in other REITS or in real estate companies or other securities. The SEC has not specifically addressed the scope of Section 3(c)(5)(C) since the 1960 release.

[4] The SEC has brought a number of enforcement cases in which controlling persons of mortgage-related companies used company assets to further their own interests.

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