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SEC Raises Questions Regarding Mortgage REIT Exemption Under Investment Company Act

Recent releases from the Securities and Exchange Commission (the "SEC") regarding exclusions under the Investment Company Act of 1940, as amended (the "Investment Company Act"), provide the mortgage REIT and securitization industry the opportunity to help shape clear, concise best practices for companies that invest in mortgages and mortgage-backed securities.

On August 31, 2011, the SEC issued three releases soliciting comments under the Investment Company Act. One of these releases, a concept release relating to the exclusion from registration as an investment company provided to mortgage companies by Section 3(c)(5)(C) of the Investment Company Act, appears at first blush to signal impending regulatory burdens for mortgage REITs and to put a chill on the prospect of a restart of non-agency mortgage securitization. The SEC has not made any specific proposals and is seeking input and information from interested parties. As a result, the concept release provides a concrete opportunity for the mortgage industry to obtain greater clarity about the mortgage exclusion, which has never been comprehensively addressed by the SEC. Application of the mortgage exclusion is understood only by reference to no-action letters, many of which are decades old, and SEC staff comments received during the registration process. It is imperative that the industry assist the SEC with this regulatory reform so that what results is a clear and comprehensive set of best practices consistent with industry needs.

A second release, relating to Rule 3a-7 under the Investment Company Act, an exclusion from regulation for securitizations, initially appears benign, but contains two concepts that could be problematic for the mortgage industry and complicate securitizations: a suggestion that securitization vehicles should not be permitted to rely on Section 3(c)(5)(C) and a suggestion that investments in securitization vehicles should be considered investment securities. Again the industry must help the SEC understand the implications of these potential changes.

We already are in contact with the SEC staff about these releases and intend to participate actively in the comment process. We invite our clients and others to join us in responding to the SEC's questions. It is important that the industry's views be conveyed clearly to the SEC staff so that the impact of any potential new rules on the mortgage REIT industry and non-agency mortgage securitizations are clearly understood and taken into account.

Section 3(c)(5)(C) excludes from the definition of "investment company" any company that is "… primarily engaged in the business of purchasing or otherwise acquiring mortgages and other liens on and interests in real estate." Mortgage REITs and other entities that invest in mortgage loans and mortgage-backed securities typically rely on the Section 3(c)(5)(C) exclusion either directly or through one or more subsidiaries. The SEC indicates in this release that it is concerned that some mortgage companies may be subject to the kinds of abuses that the Investment Company Act was intended to address, including the following:

- misvaluation of the company's holdings
- excessive leveraging
- overreaching by insiders

Within this context, the SEC asks whether the exclusion should be narrowed or changed in such a way that these potential abuses can be curtailed. The SEC also asks whether there are existing safeguards in the structure and operations of REITs and other mortgage companies that would address these or similar concerns. A copy of the release on Section 3(c)(5)(C) may be found here.

The release relating to Rule 3a-7, an exclusion for certain securitization vehicles from registration as investment companies under the Investment Company Act, appears to focus primarily on whether the exclusion should continue to be tied to credit ratings, but it also contains two provisions that could be troublesome to the mortgage market:

- It asks whether asset-backed issuers should be permitted to rely on Section 3(c)(5)(C) or if they should be required to rely solely on Rule 3a-7.
- It asks whether equity securities issued by a Rule 3a-7 entity should be considered investment securities for purposes of its parent company's Investment Company Act exemption.

This first question suggests the SEC is considering yet another narrowing of the use of the Section 3(c)(5)(C) exclusion. This change could make it more difficult to securitize distressed mortgage loans, which would eliminate one tool in managing the country's mortgage default and foreclosure problems. The second question would be problematic for many mortgage REITs and other companies that rely on a "holding company" exemption, with one or more subsidiaries relying on the Section 3(c)(5)(C) exclusion. Many of these companies consider their securitization subsidiaries to be "good assets" for their own exemption from regulation. Changing the classification of these subsidiaries could be detrimental to these parent companies, particularly given the risk retention requirements proposed under the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") and by the SEC. Ironically, new regulations could require risk to be retained and simultaneously cause the company retaining the risk to have to register under the Investment Company Act.

Questions about the use of credit ratings under Rule 3a-7 are not surprising given the mandate in the Dodd-Frank Act to eliminate references to credit ratings in SEC regulations. The release notes that the inclusion of credit ratings was intended to assure that a deal included structural safeguards for investor protection, but that ratings may be unreliable in light of the flaws in rating agency methodology that contributed to the recent financial crisis. The SEC asks for comment on whether additional conditions should be added to the rule, including a possible requirement for a sponsor certification or an independent review regarding whether an issuer's assets provide sufficient cash flow to meet expected payments, a requirement limiting the structure and operations of an asset-backed issuer in order to eliminate possible conflicts of interest of a sponsor, and a requirement ensuring the preservation of assets and cash flow. A copy of the release on Rule 3a-7 may be found here.

The third release is a concept release related to Investment Company Act issues raised by the use of derivatives by investment companies. In response to investment companies' increased use of derivatives, the SEC is reassessing its ad hoc approach in this area. The SEC is asking for comments, for example, on pricing and liquidity determinations of derivatives in connection with the provisions that require an investment company to meet certain asset coverage tests with respect to the issuance of debt, that limit the percentage of assets an investment company can invest in a single issuer or single industry, and that limit investments in securities-related issuers such as broker-dealers. A copy of this release may be found here.

The SEC's reassessment of the Investment Company Act, in particular the exclusions noted above, provides an opportunity for the industry to participate in the rulemaking process. We welcome your input and invite you to contact us with any questions regarding these crucial matters.

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