



The SEC Seeks Comment Related to the Status Under the Investment Company Act of REITs and Other Companies Engaged in the Business of Acquiring Mortgages and Mortgage Related Instruments

On August 31, 2011, the U.S. Securities and Exchange Commission (the “SEC” or “Commission”) issued a release relating to the treatment of companies engaged in the business of acquiring mortgages and mortgage related instruments under the Investment Company Act of 1940 (the “1940 Act”).¹ The Release provides an overview of mortgage-related pools, including mortgage REITs, and requests data and comment on their management styles, corporate governance, and similarities to traditional investment companies.² It also discusses the legislative, administrative and interpretive background of Section 3(c)(5)(C) of the 1940 Act, the statutory exclusion for such entities.

As indicated in the Release, due to the evolution of mortgage-related pools and the development of new and complex mortgage-related instruments over the last seventy plus years, the Commission believes that it is appropriate to review the status of such pools under the 1940 Act to provide greater clarity, consistency and regulatory certainty with respect to the application of Section 3(c)(5)(C). Specifically, the Commission asserts in the Release that it appears that some types of mortgage-related companies have interpreted the statutory exclusion provided by Section 3(c)(5)(C) in a broad manner, while others have interpreted the exclusion too narrowly, thus suggesting that there may be some confusion about when, exactly, the exclusion applies.

Background to Section 3(c)(5)(C) and Legislative History

As indicated in the Release, 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 1940 Act and typically meet the definition of investment company. The Commission points out, however, that while some such companies register as investment companies under the 1940 Act, many seek to rely on Section 3(c)(5)(C), 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.”

¹ *Companies Engaged in the Business of Acquiring Mortgages and Mortgage-Related Instruments*, Investment Company Act Release No. 29778, (Aug. 31, 2011), available at <http://sec.gov/rules/concept/2011/ic-29778.pdf>. (the “Release”)

² SEC Seeks Public Comment on Asset Backed Issuers and Mortgage-Related Pools Under the Investment Company Act, (Aug. 31, 2011), available at <http://www.sec.gov/news/press/2011/2011-176.htm>.

According to the Commission, since the adoption of the 1940 Act, a wide variety of companies, many of them unforeseen in 1940, have relied upon Section 3(c)(5)(C) to avoid registering as investment companies. (In a companion release the Commission discussed the use of Section 3(c)(5)(C) rather than Rule 3a-7 by certain asset-backed issuers).³

Unfortunately, as the Commission points out in the Release, 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 in several years, thus leaving many mortgage-related pools without proper guidance in this area. This point is well reflected in the offering documents of many mortgage-related pools, as they often point out that there are no assurances that the Commission staff will concur with their determinations, of such things, as what constitutes “qualifying real estate assets” or “real estate related assets” under Section 3(c)(5)(C).

Furthermore, while the SEC has addressed the application of Section 3(c)(5)(C) in staff no-action letters on a case-by-case basis, the Commission is concerned that such guidance “may have contained, or led to, interpretations that are beyond the intended scope of the exclusion and are inconsistent with investor protection.” This statement signals the possibility that action taken by the Commission may retreat from previous staff interpretations that have been relied upon by industry participants. The release does not specify which interpretations the Commission is concerned about. However, we note that among the Commission’s many requests for comment contained in the release, it specifically asks about the treatment of agency whole pool certificates and certain mortgage participations.

Interpretive Issues/Concerns Highlighted by the Commission

The Release also indicates that the Commission is concerned that certain types of mortgage-related pools today appear to resemble in many respects investment companies that are registered under the 1940 Act, and may not be the kinds of companies that were intended to be excluded by Section 3(c)(5)(C). For example, the Commission points out, that mortgage-related pools, like traditional investment companies, can 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. Additionally, the release highlights the fact that, like traditional investment companies, investment advisers of mortgage-related pools are typically compensated with an asset-based fee.

Finally, the Commission points out that some mortgage-related pools invest in the same types of assets as registered investment companies. This point is made clear by the Commission when it addresses the position it has previously taken, pursuant to its 1960 Release, with respect to “issuers that are primarily engaged in the business of holding interests in another person engaged in the real estate business,” rather than owning interests in real estate themselves.

Due to these similarities, the Commission stated that it will need to consider whether it may be appropriate to require certain mortgage-related pools to register as investment companies under the 1940 Act.

Issues Raised by Registration Under the 1940 Act

The implications of registration under the 1940 Act could potentially have significant effects on the business of certain mortgage-related pools. Specifically, registration would, among other things, require compliance with each of the rules listed below:

- **Leverage/Capital Structure:** under Section 18 of the 1940 Act, registered investment companies are generally limited in their issuance of any class of senior securities. A registered closed-end investment company may, however, issue senior debt securities if it maintains a 300% asset coverage ratio, or issue senior stock if it maintains a 200% asset coverage ratio.

³ *Treatment of Asset-backed Issuers under the Investment Company Act*, Investment Company Act Release No. 29779, (Aug. 31, 2011), available at <http://sec.gov/rules/concept/2011/ic-29779.pdf>.

- **Interested Party Transactions:** under Section 17 of the 1940 Act, affiliated persons are prohibited from engaging in transactions with registered investment companies. Notwithstanding the approval by non-interested members of the board, many transactions are prohibited under the 1940 Act absent an exemption granted by the Commission.
- **Restrictions on Advisory Fees:** registered investment companies generally may not pay advisory fees based on capital gains. Under Section 36(b) of the 1940 Act, investment advisers have a fiduciary duty with respect to their receipt of fees charged to registered investment companies and their investors. Thus, advisory fees must be within the range of what would have been negotiated in an arm's length transaction. This duty has been the subject of litigation for registered investment companies.
- **Duration of Investment Advisory Agreements:** under Section 15 of the 1940 Act, advisory contracts are subject to annual approval, and are terminable at any time by the investment company's board of directors without penalty.
- **Valuation of Assets:** under Section 2(a)(41) of the 1940 Act, the "value" of securities held by registered investment companies is to be determined by (1) the market value at the end of the last preceding fiscal quarter for which market quotations are readily available, (2) fair value as determined by the board of directors with respect to other assets and property owned at the end of the last preceding fiscal quarter and (3) at cost with respect to assets acquired after the end of the last preceding fiscal quarter.
- **Custody of Assets:** under Section 17(f) and Rule 17f-2 of the 1940 Act, registered investment companies must place and maintain their securities and similar investments in the custody of (1) a bank, (2) a company which is a member of a national securities exchange or (3) the investment company itself if in accordance with Rule 17f-2.
- **Compliance Policies and Procedures:** under Rule 38a-1 of the 1940 Act, a registered investment company must adopt written policies and procedures reasonably designed to prevent violations of the Federal Securities Laws. In addition, a registered investment company must designate a Chief Compliance Officer, who is responsible for administering the fund's policies and procedures and whose compensation is subject to approval by the independent members of the board of the registered investment company.

The Commission's Request for Comments

The Release indicates that 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 1940 Act, and from any resulting guidance with respect to Section 3(c)(5)(C). To this end, the Commission poses numerous questions and requests comment on various issues in the release. Among its requests for comment, the Commission specifically asks mortgage-related pools and their counsel to comment on the following issues:

- any difficulties they may have encountered in determining their status under the 1940 Act;
- any key operational or structural characteristics of mortgage-related pools that distinguish them from traditional registered funds;
- whether the Section 3(c)(5)(C) exclusion is generally being used consistent with the purposes and policies underlying the provision and investor protection; and
- whether a test could be devised that could differentiate mortgage-related pools that are primarily engaged in the real estate and mortgage banking business from those mortgage-related pools that resemble traditional investment companies, and what factors might be included in such a test.

The Commission has indicated that it could potentially 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). The deadline for submitting comments to the SEC is October 30, 2011.

If you have any questions regarding this update, please contact the Sidley lawyer with whom you usually work.

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