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VIA E-Mail (rule-comments@sec.gov)

Ms. Elizabeth M. Murphy
Secretary
U.S. Securities and Exchange Commission
100 F Street NE
Washington, D.C. 20549-1090

Re: *Concept Release: Companies Engaged in the Business of Acquiring Mortgages and Mortgage-Related Instruments (Release No. S7-34-11)*

Dear Ms. Murphy:

Two Harbors Investment Corp. ("Two Harbors"), a real estate investment trust ("REIT") whose common stock is listed on the New York Stock Exchange under the symbol "TWO," welcomes the opportunity to submit this letter in response to the request of the Securities and Exchange Commission (the "Commission") for comments concerning the various matters raised in the above-captioned concept release (the "Concept Release").

Two Harbors supports the Commission's efforts to review and understand the application of Section 3(c)(5)(C) under the Investment Company Act of 1940 (the "1940 Act") to mortgage-related pools and its goals (i) to be consistent 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 is administered in a manner that is consistent with the purposes and policies underlying the 1940 Act, the public interest, and the protection of investors; (iii) to provide greater clarity, consistency and regulatory certainty in this area; and (iv) to facilitate capital formation. Given the importance of this matter to Two Harbors, we would like to offer our perspective on certain aspects of the Concept Release and respond to a number of the questions posed by the Commission in the Concept Release.

It is fair to say that, when Congress established the exemption set forth in Section 3(c)(5)(C), and when the Commission issued the 1960 Release[1] on the subject, no one could have foreseen the growth and changes in the mortgage markets that were to come. In the intervening years, the Commission's no-action letters have provided some guidance; however, as the Commission notes, in the absence of more comprehensive guidance, much has been left open to interpretation and judgment. As a result, the Mortgage REIT industry has evolved within a regulatory framework that, in many respects, lacks consistency and definition. Herein we make recommendations to eliminate these ambiguities and strengthen the regulatory framework for the benefit of the industry and investors.

The Concept Release has generated considerable uncertainty in the market. We urge the Commission to affirm, at the earliest opportunity, the continuing exemption of Mortgage REITs, such as Two Harbors, from the 1940 Act. For all of the reasons stated in this letter, we strongly believe that subjecting Mortgage REITs to regulation under the 1940 Act would be unnecessary, unreasonable and inconsistent with the intent of Section 3(c)(5)(C).

[1] Securities and Exchange Commission. Real Estate Investment Trusts, Concept Release No. IC-3140 (November 18, 1960).

Executive Summary

Our letter is organized into three parts: Part I provides an overview of Mortgage REITs (defined below) and the beneficial role they play in the housing market and the U.S. economy; Part II provides an overview of the current regulatory regime under which Mortgage REITs operate and how, under this regime, Mortgage REITs address the three primary investor protection concerns cited by the Commission in the Concept Release; and Part III suggests ways in which the Commission's interpretation of Section 3(c)(5)(C) exemption can be improved to provide regulatory clarity to the Mortgage REIT industry going forward.

For purposes of this letter, we limit our discussion to Mortgage REITs similar to Two Harbors (i) that are public companies, in that they have one or more classes of securities listed on a national securities exchange and are subject to the reporting requirements of the Securities Exchange Act of 1934, and (ii) whose assets consist primarily of residential mortgage-backed securities ("RMBS"), residential mortgage loans and other related financial assets. Throughout this letter, we refer to this category of REITs as "Mortgage REITs."

I. Mortgage REITs and Their Role in the Housing Market and U.S. Economy

A. *Overview of Mortgage REITs*

1) REITs Have Evolved to Keep Pace with the Housing and Mortgage Markets.

REITs were established in 1960 to give individual investors access to investments in income-producing real estate and mortgages. REITs were primarily established as a tax vehicle to avoid double taxation of investments in real property and mortgages. REITs have significant restrictions on their ability to invest, must pay out 90% of their income to investors, and are required to be widely held. Although most REITs are created to invest primarily in real estate, REITs have also been permitted to invest in mortgages and mortgage-related assets.

Since the 1960s, the residential housing markets have seen unprecedented growth, due in large part to various federal programs designed to make home ownership a reality for a large cross-section of the American public. To keep pace with demand, the mortgage markets have also evolved in order to ensure adequate liquidity is available to fund mortgages.

The federal government has spurred the development and evolution of the mortgage industry for decades, starting in the 1930s with the creation of the Federal National Mortgage Association ("Fannie Mae"), and followed by the creation of the Government National Mortgage Association ("Ginnie Mae") in 1968 and the Federal Home Loan Mortgage Corporation ("Freddie Mac") in 1970. Beginning in the early 1970s, Fannie Mae and Freddie Mac (the so-called "government-sponsored enterprises" or "GSEs") began packaging and securitizing mortgage loans as a way to transform relatively illiquid, individual financial assets (mortgage loans) into liquid and tradable instruments (pass-through certificates and RMBS). In fact, the GSEs were specifically created to establish and stabilize a secondary market for mortgage loans, enabling originators to replenish their funds so they are able to lend to other homeowners.[2] The creation of RMBS, therefore, was critical to the ability of the GSEs to carry out the federal government's mandate with respect to the mortgage market.

[2] Fannie Mae Company Overview (available at http://www.fanniemae.com/portal/about-us/company-overview/about-fm.html). Federal Home Loan Mortgage Corporation Act, Public Law No. 91-351, 84 State. 450 (July 24, 1970) .

Mortgage REITs play an active and important role in the residential mortgage markets. Mortgage REITs engage in various activities directly linked to today's residential mortgage and finance industry, including originating or directly financing mortgage loans; purchasing or otherwise acquiring mortgage loans in the secondary market; creating, purchasing interests in and managing mortgage-related securitization vehicles; and acquiring and holding RMBS. As of June 30, 2011, Mortgage REITs held approximately $227 billion of RMBS, representing over 3% of the aggregate $6.5 trillion of RMBS which currently exist in the market.[3]

The securities of Mortgage REITs are widely held by both institutional and retail investors and, consistent with Congress's intent when it created REITs, provide the investing public access to a class of securities which, in the absence of publicly traded REITs, would likely be available to only large institutional investors. Mortgage REITs allow investors to diversify their investment portfolios with real estate and mortgage-related assets that, generally, are less volatile and less correlated to wide-ranging external market forces than typical stocks and bonds of corporate issuers.[4] As a result, Mortgage REITs enhance the breadth, depth and diversity of the financial markets for investors.

2) Mortgage REITs are Different From Traditional Investment Companies and Should Not be Regulated Under the 1940 Act.

In the Concept Release, the Commission notes that certain mortgage-related pools appear to resemble traditional investment companies that are registered under the 1940 Act. The Commission goes on to suggest that, as a result, these mortgage-related pools may not be the kind of companies that were intended to be excluded from regulation under Section 3(c)(5)(C) of the 1940 Act. For example, the Commission observes that both mortgage-related pools and traditional investment companies (i) pool investor assets to purchase securities and provide investors with professional asset management; (ii) may be internally or externally managed; (iii) if externally managed, pay an asset-based fee for the external manager's service; and (iv) offer their securities to both retail and institutional investors. The Commission also observes that some mortgage-related pools might invest in some of the same types of assets as traditional investment companies.

The similarities noted by the Commission are, however, somewhat superficial. In fact, some of the similarities noted by the Commission could also be said to apply to companies that are neither Mortgage REITs nor traditional investment companies. For example, virtually all public companies offer their equity securities to both institutional and retail investors. All public companies also pool the money they raise from sales of their securities to invest in assets designed to generate a profit for shareholders. The types of assets and operations might vary widely, but the business principal is the same: shareholders collectively invest in a common enterprise with the expectation of receiving profits in return.

The fact that there are similarities between Mortgage REITs and traditional investment companies has never been in dispute. Congress recognized that, in some respects, REITs and investment companies resemble one another. If they did not, there would have been no need to exempt REITs from the 1940 Act. When Congress enacted the Real Estate Investment Trust Act of 1960, it acknowledged the similarities shared between REITs and traditional investment companies. Congress specifically pointed out that its intent was to provide tax benefits to REITs similar to those already enjoyed by regulated investment companies, "since in both cases the methods of investment constitute pooling arrangements whereby small investors can secure advantages normally available only to those with larger resources." [5]

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[3] Mortgage REIT Quarterly Reports on Form 10-Q for the quarter ended June 30, 2011 as filed with the Commission.

[4] For example, from December 31, 1988 to March 31, 2011, there has been virtually no correlation (i.e., slightly negative, at 0.047) between the S&P 500 Index and the Barclays Fixed Rate RMBS Index. Source: Bloomberg.com.

[5] Real Estate Investment Trusts, House Report 86-2020 (June 28, 1960), at 3-4.

It did not, however, go so far as to say that REITs and investment companies were one and the same.[6] Ten years later, in 1970, when Congress adopted amendments to the 1940 Act, it again observed that "[a]lthough the companies enumerated in [Section 3(c)(5)(C)] have portfolios of securities in the form of . . . mortgages and other liens on and interests in real estate, they are excluded from the [1940 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"* (emphasis added).[7]

Beneath the similarities, there are several key operational and structural characteristics that distinguish Mortgage REITs from traditional investment companies:

a) Asset Selection. Mortgage REITs, by virtue of their structure as REITs under the Internal Revenue Code, are limited as to what type of assets they can hold.[8] Traditional investment companies, on the other hand, have broad latitude as to the types of instruments in which they can invest. So, while traditional investment companies can invest in the same asset classes as Mortgage REITs (e.g., RMBS), Mortgage REITs cannot invest in all of the types of assets classes in which traditional investment companies typically invest. This is an important difference. One of the "similarities" noted by the Commission in the Concept Release is that Mortgage REITs and traditional investment companies invest in some of the same types of assets, but any similarity with respect to asset selection results from the flexible investment strategy of traditional investment companies, not of Mortgage REITS.

b) Portfolio Turnover and Investment Horizon. In order to obtain the tax benefits associated with REIT status, Mortgage REITs are required to purchase and hold their assets, which results in very low turnover in their portfolios;[9] traditional investment companies are not restricted in this regard and, thus, tend to have a higher turnover rate in their portfolios. As a result, it is more likely that a Mortgage REIT will select assets conservatively – showing a marked preference for those it can hedge and preserve the value of over time – in order to deliver stable returns to investors and to comply with REIT requirements. A traditional investment company, on the other hand, is free to select riskier assets and to trade them more frequently.

c) Use of Leverage. Mortgage REITs employ leverage in their business models, with the amount of leverage directly linked to the value of the underlying assets that serve as collateral for the financing. Typically, Mortgage REITs enter into short-term repurchase agreements with lenders to finance their RMBS portfolios. RMBS are valuable collateral because they are liquid instruments that generate revenue streams (i.e., principal and interest). The corporate bonds and common stocks in which investment companies typically invest, on the other hand, often represent unsecured claims on the issuer's assets and are not generally backed by specific revenue streams. As a result, the volatility of these instruments can be

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6 In making the distinction between REITs and regulated investment companies, Congress noted in 1960 that despite the fact that both kinds of companies pool their investor funds, investment companies invest "in stocks and securities of operating companies" whereas REITs specialize "in investments in real estate equities and mortgages." Id at 3.

7 Investment Company Act Amendments of 1970, House Report 91-1382 (Aug. 7, 1970), at 17. In amending the 1940 Act to prohibit REITs from issuing redeemable securities, Congress acknowledged that while a REIT may share characteristics with registered funds, they are distinct entities, and continued to permit them to be regulated as such.

8 *See infra* at Part II, Section A(2)(a).

9 *See infra* at Part II, Section A(2)(a). For example, since commencing operations in October 2009, Two Harbors' portfolio has had an average turnover rate of 5.3% per quarter. Excluding the third quarter of 2011, which saw extreme volatility in the capital markets and resulted in Two Harbors making several adjustments to its portfolio to preserve shareholder value, Two Harbor's average turnover rate per quarter from fourth quarter 2009 to second quarter 2011 was 3.4%.

substantially higher, and thus unsuitable for the level of leverage associated with assets with a defined stream of cash flows. It is for this reason that leverage is typically very limited, if it is available at all. Further, the principal and interest payments under RMBS that are issued by the GSEs and held by the Mortgage REITs enjoy the express or implied backing of the U.S. government. As a result, the repurchase market for these "Agency" RMBS is liquid and transparent.

d) Mitigating Interest Rate Risk. Because Mortgage REITs generally hold mortgage assets and/or securities as long-term investments, they are subject to the interest rate risk associated with such assets. Mortgage REITs, therefore, may seek to protect against the interest rate risk associated with their holdings, using interest rate swaps, caps, swaptions and other tools that mitigate interest rate risk and, thusly, reduce book value volatility. Traditional investment companies do not typically guard against the interest rate risk of their holdings; as a result, their investors realize the returns generated by the underlying assets held, which could include large capital gains or losses as interest rates change.

As illustrated above, Mortgage REITs and traditional investment companies are conceptually distinct and have been recognized as such for more than 50 years. The limitations placed upon Mortgage REITs by the Internal Revenue Code result in key operational and structural characteristics that are very different from traditional investment companies. Accordingly, it would be inappropriate for the Commission, on the basis of a few similarities, to regulate Mortgage REITs as investment companies under the 1940 Act.

B. The Role of Mortgage REITs in the Housing Market and U.S. Economy

1) Mortgage REITs Provide Much-Needed Liquidity to the Mortgage Markets.

Mortgage REITs play a significant role in the U.S. housing market by providing much-needed liquidity through the acquisition and financing of mortgages and mortgage-related instruments.

While Mortgage REITs have long been active participants in the mortgage markets, they have been a particularly important source of capital in the wake of the 2008 financial crisis. While other sources of private capital have been reluctant to participate in the mortgage markets, since 2006 Mortgage REITs have raised more than $30 billion from the public markets to invest in mortgages and mortgage-related instruments, including RMBS.[10] Mortgage REITs increased their RMBS holdings from approximately $78 billion at the end of 2007 to nearly $227 billion at June 30, 2011.[11] In contrast, the mutual fund industry has reduced its holdings.[12]

There has been broad bi-partisan recognition of and support for the need for private capital in the recovery of the housing and mortgage markets. For example, the Public-Private Investment Program ("PPIP"), which was established by the federal government in 2009, was specifically designed to encourage private capital to acquire distressed mortgage assets. It was hoped that the PPIP program would revive the market for unpackaged loans and mortgage securities not backed by Fannie Mae, Freddie Mac and other government-supported institutions. Through September 30, 2011, the PPIP program has provided approximately $25 billion in capital to the mortgage market.

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[10] Industry Capital Offerings Summary. NAREIT® (2011).

[11] Source: Credit Suisse Securities (USA) LLC (October 2011).

[12] In 2009 and 2010, the Mortgage REIT industry added approximately $140 billion in RMBS holdings, while the mutual fund industry is estimated to have reduced its RMBS holdings during the same period by approximately $165 billion. Source: Inside Mortgage Finance and J.P. Morgan Securities.

Traditional holders of mortgages (e.g., the Federal Reserve, Treasury Department and GSEs), which previously had the capacity to hold trillions of dollars in mortgage assets on their books, are expected to reduce or eliminate their holdings as the U.S. government seeks to substantially reduce the government's role in the housing and mortgage markets.[13] Since December 31, 2010, the U.S. Treasury has sold over $95 billion, or nearly two-thirds, of its Agency RMBS holdings.[14] Under the Obama Administration's plan, Fannie Mae and Freddie Mac, which collectively hold approximately $1.5 trillion in Agency RMBS, are mandated to wind down their portfolios at an annual rate of no less than 10 percent.[15] And the Federal Reserve, which as of June 30, 2011 held over $900 billion of Agency RMBS, is ultimately expected to begin to sell off its portfolio.[16] As a result, a projected $2 trillion or more in Agency securities are expected to be placed into the market over time.

The need for private capital in the mortgage markets is expected to increase. Capital is needed not only to absorb the government's sell-off of its RMBS holdings, but also to provide a greater share of the financing going forward. According to the U.S. Department of Housing and Urban Development, in the wake of the financial crisis, private capital essentially stopped providing funding for new mortgages and has not yet returned to the market in any meaningful way, leaving the government to guarantee more than nine out of every ten new mortgages.[17] The Obama Administration believes that under normal market conditions the private sector should be the primary source of mortgage credit and bear the burden for losses.[18] Mortgage REITs are one of the likeliest sources of this capital.

2) Mortgage REITs are Positioned to be Major Contributors to the Eventual Resurgence of the Securitization Markets.

Securitization is the process of financing a pool of financial assets (such as residential mortgage loans) by issuing securities representing claims against the cash flow and other economic benefits generated by the pool of assets. The securitization industry has been a critically important source of financing and liquidity for the residential real estate markets. By providing an efficient funding mechanism for the residential mortgage loan industry, securitizations allow financial institutions, the GSEs and other entities to manage credit and other risks associated with mortgage lending.[19]

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[13] On February 11, 2011, the U.S. Treasury Department and U.S. Department of Housing and Urban Development released the Obama Administration's white paper on housing finance reform, "Reforming America's Housing Finance Market: A Report To Congress." The white paper discusses the plan to wind down Fannie Mae and Freddie Mac, shrink the government's current footprint in housing finance, and the need to "help bring private capital back to the market." *See also* Fannie Mae, Freddie Mac, and the Federal Role in the Secondary Mortgage Market. Congressional Budget Office, Pub. No. 4021 (December 2010). According to the Congressional Budget Office, in 2009, Fannie and Freddie alone owned or guaranteed roughly half of all outstanding mortgages in the United States (including a significant share of subprime mortgages), and they financed three-quarters of new mortgages originated that year. Including the 20 percent of home loans insured by federal agencies, such as the Federal Housing Administration (FHA), more than 90 percent of new mortgages made in 2009 carried a federal guarantee.

[14] U.S Treasury Department. February 2011: Current Face of the Portfolio at the End of the Month (available at http://www.treasury.gov/resource-center/data-chart- enter/Documents/February%202011%20Portfolio%20by%20month.pdf) and October 2011: Current Face of the Portfolio at the End of the Month (available at http://www.treasury.gov/resource-center/data-chart-center/Documents/October%202011%20Portfolio%20by%20month.pdf).

[15] Press Release, U.S. Department of Housing and Urban Development. Obama Administration Plan Provides Path Forward for Reforming America's Housing Finance Market, Winding Down Fannie Mae and Freddie Mac. (February 11, 2011).

[16] The Federal Reserve, Factors Affecting Reserve Balances of Depository Institutions and Condition Statement of Federal Reserve Banks, Statistical Release H.4.1(June 30, 2011) (available at http://www.federalreserve.gov/releases/h41/20110630/).

[17] U.S. Department of Housing and Urban Development, supra note 15.

[18] Id.

[19] The Role of Securitization and the Secondary Market. American Securitization Forum (2011).

As of June 30, 2011, the size of the U.S. mortgage market was estimated to be $10.4 trillion.[20] Nearly two-thirds (approximately $6.5 trillion) of all U.S. mortgage debt is held in securitization vehicles.[21] Historically, the majority of RMBS issued through securitizations have been held by the GSEs, depository institutions, mutual funds and foreign investors. However, as noted above, the GSEs and the federal government are expected to play a smaller role in the mortgage markets in the future.

As the government deliberates over the future of the mortgage market, various proposals continue to recognize the role of the private sector in the secondary market for mortgage loans. For example, one proposal of the Congressional Budget Office involves a public/private model, which specifically contemplates the role of private capital in securitizing federally back mortgages.[22] Additionally, changes to a number of rules, including capital requirements and risk retention requirements will force banks to further limit their participation in the securitization markets going forward, particularly as it relates to holding the credit risk associated with new securitizations. Furthermore, banks typically hold RMBS and U.S. Treasury securities when loan demand is low and reduce holdings of these assets when loan demand is robust.[23] It will be particularly important to have vehicles that can house mortgage credit risk for long holding periods in order to facilitate the development of private finance for the housing market. Mortgage REITs are logical vehicles to step into the gap, given their structure, permanent capital and ability to analyze and hedge mortgage risk.

C. Potential Adverse Effects of Requiring Mortgage REITs to Register as Investment Companies Under the 1940 Act

In the Concept Release, the Commission identified a number of actions it might consider with respect to Mortgage REITs, including imposing limitations on leverage, restricting the ability of Mortgage REITs to treat a variety of mortgage-related instruments (such as agency whole pool certificates) as qualifying interests, and even eliminating altogether the ability of Mortgage REITs to rely on Section 3(c)(5)(C). Any of these actions would have a crippling effect on the Mortgage REIT industry and adverse consequences for the recovery of the housing market and the U.S. economy.

1) Impact on Mortgage REITs.

As discussed below in Part II, the use of leverage is critical to the Mortgage REIT business model. If the Commission were to limit the amount of leverage a Mortgage REIT could use or change what is commonly understood today to constitute a "qualifying interest" under Section 3(c)(5)(C), it would drastically change the Mortgage REIT business model and, as a result, the attractiveness and viability of Mortgage REITs as an investment vehicle would be substantially reduced.

2) Impact on Mortgage REIT Investors.

As discussed above, Mortgage REITs provide the investing public access to a class of securities which, in the absence of publicly traded REITs, would only be available to large institutional investors. Institutional and retail investors alike invest in Mortgage REITs because Mortgage REITs provide a dividend income stream and offer an opportunity to invest in the future recovery of the mortgage market in a regulated and liquid capital market. Investors understand the Mortgage REIT business model and make informed choices about whether to invest based on their own investment objectives.

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[20] Outlook and Opportunities in the US RMBS Market. Amherst Securities Group LP (September 2011).

[21] Id.

[22] Congressional Budget Office, supra note 13, at 16.

[23] Securitized Products Weekly. Nomura Securities International Inc. (November 4, 2011).

The Commission's actions have already taken a significant toll on Mortgage REIT investors. On September 1, 2011, the first trading day following the issuance of the Concept Release, Mortgage REIT shareholders saw the value of their investments plummet, with shares trading down approximately 3.7% (or approximately $1.5 billion in market value) in the aggregate, across the Mortgage REIT sector.[24] At least one analyst downgraded certain of the Mortgage REITs it covered from a "buy" to "neutral" rating based on the Commission's Concept Release[25] and, since then, nearly all analyst reports covering the Mortgage REIT sector have referenced the Concept Release and included some degree of cautionary language concerning the impact of potential Commission actions suggested in the Concept Release.

If the Commission were to make significant changes to or eliminate the Section 3(c)(5)(C) exemption for Mortgage REITs, it would threaten the viability of Mortgage REITs as an industry. Not only would the loss of Mortgage REITs limit the ability of investors to diversify their investment portfolios to include REITs, but the capital of hundreds of thousands of public retail and institutional shareholders who, in the aggregate, own approximately $38.5 billion in Mortgage REIT equity, would be at risk of suffering significant losses.[26]

3) Impact on Mortgage Markets and U.S. Economy.

Historically, the U.S. government has played a significant role in financing the mortgage market, and since the financial crisis, the role of the government has expanded greatly. As the involvement of the federal government and the GSEs in the U.S. mortgage market is reduced, the role of private capital must necessarily increase. The markets are already seeing the departure of Fannie Mae and Freddie Mac from the RMBS market. Investors have embraced the role of Mortgage REITs as a key player in the future of housing finance by investing substantial amounts of new capital into Mortgage REITs in the past few years. This capital is essential to the revival of the mortgage and housing markets. Given regulatory and capital constraints, banks are not in a position to provide additional capital in any meaningful way. Similarly, as discussed above, traditional investment companies (such as mutual funds) have been reducing their RMBS holdings since the financial crisis.

The loss of the Mortgage REIT industry would be injurious not only to the Mortgage REITs and their investors, but also to the securitization and RMBS markets and to the underlying U.S. housing market which depends upon the securitization and RMBS markets to provide liquidity. As discussed above, the private capital provided by Mortgage REITs is expected to be a critical component of the recovery of the housing market and the U.S. economy. Eliminating this source of private capital could add to the instability of the mortgage and housing markets, upon which the recovery of the U.S. economy is dependent.

[24] Represents the aggregate difference between closing price of Mortgage REIT shares on August 31, 2011 and September 1, 2011, using the closing share price on those dates. Source: Bloomberg.com.

[25] In September 2, 2011 report, Bank of America Merrill Lynch analysts downgraded six of the twelve Mortgage REITs it covered, using captions in its report such as "SEC Serves Up a Big Bowl of Uncertainty" and "Major Fly-in-the-Ointment for mortgage REITs."

[26] Represents aggregate market value of public float across Mortgage REIT sector at close of market on November 1, 2011, as reported on Bloomberg.com. According to public filings made with the Commission, more than 900 institutional investors report holding Mortgage REIT securities and, while specific numbers cannot be ascertained, it is estimated that hundreds of thousands of retail investors hold Mortgage REIT securities.

II. Existing Regulation and Investor Protection

A. Lack of Regulation Under the Investment Company Act Does Not Mean That Investor Protection is Lacking

1) Mortgage REITs are Subject to a Comprehensive Regulatory Regime That Focuses on Investor Protection.

Public Mortgage REITs, such as Two Harbors, are subject to a comprehensive regulatory regime which requires extensive disclosure of key information to the investing public, including information about their business, financial condition and result of operations, securities, related party transactions and more. The regulatory regime applicable to Mortgage REITs includes regulation and oversight by:

a) The Securities and Exchange Commission

1. The Securities Act of 1933 ("1933 Act"), which regulates the offer and sale of securities. The 1933 Act is based on the premise that investors are capable of evaluating the merits of a securities offering and making an informed investment decisions if they are provided complete and accurate information regarding all material facts concerning the issuer, its securities and the terms of the offering.

2. The Securities Exchange Act of 1934 ("1934 Act"), which is the principal source of reporting and disclosure obligations for public companies and also regulates the trading of securities on securities exchanges. Among other things, under the 1934 Act, Mortgage REITs are required to file annual, quarterly and current reports on Forms 10-K, 10-Q and 8-K, respectively, as well as reports related to securities ownership of insiders under Section 16.

3. The Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley"), which was enacted to enhance corporate responsibility and financial disclosures as well as prevent corporate and accounting fraud. Among other things, Sarbanes-Oxley requires the CEO and CFO to certify as to the accuracy and completeness of a company's 1934 Act reports, prohibits certain insider transactions, requires an assessment of a company's internal control procedures for financial reporting, requires certain independence standards for board and audit committees, and creates reporting obligations for attorneys in the event of material violations of securities laws.

b) State Corporate and Securities Laws

Every state in the United States has its own unique set of corporate and securities laws that, among other things, regulate fiduciary duties of officers and directors, corporate governance matters, shareholders rights, and the offer and sale of securities in both registered and unregistered offerings. These laws must be adhered to in addition to the federal securities laws.

c) Self Regulatory Organizations

National stock exchanges, such as the New York Stock Exchange (NYSE) and NASDAQ, require their listed companies to comply with certain rules and regulations that are in addition to or complimentary with federal and state laws. For example, the NYSE has established rules related to board independence, financial literacy of audit committee members, disclosure of material corporate events, shareholder voting, corporate governance, and codes of business conduct and ethics.

2) Mortgage REITs are Subject to Additional Regulation and Scrutiny to Which Traditional Investment Companies are Not Subject.

a) Internal Revenue Code

An entity intending to qualify as a REIT must satisfy, on a continuing basis, various rules set forth under the Internal Revenue Code of 1986, as amended (the "Code"). Among others, the Code includes rules that (i) limit what types of assets a REIT can own, (ii) limit the kind of income a REIT can receive from its assets, and (iii) restrict how a REIT holds its assets.

For example, at least 75% of the value of a REIT's total assets must be represented by real estate assets, cash and cash items, and government securities.[27] REITs are also limited in how they derive their income. Specifically, they must derive at least 75% of their income from the qualifying assets such as those noted above.[28] Additionally, REITs must meet certain holding periods with respect to their assets or risk the imposition of onerous tax penalties (e.g., "prohibited transaction" tax). The result of this is that a REIT must generally purchase assets to hold, rather than trade, and thus portfolio turnover is typically very low.

By imposing these rules as well as onerous penalties for failure to follow the rules, the Code seeks to protect investors to ensure that REITs operate consistent with the purpose for which the Real Estate Investment Trust Act of 1960 was enacted: to provide small investors with access to income-producing investments related to real estate and mortgages, and give those investors the same tax benefits as already enjoyed by investors in traditional investment companies.

b) Financing Counterparties

Mortgage REITs that use leverage are generally subject to strict financial covenants and reporting requirements in connection with repurchase agreements and other debt instruments that they use to finance their assets. In many cases, the financial covenants and reporting requirements are more onerous and restrictive than those imposed by governmental agencies and regulatory bodies. For example, most lenders impose monthly reporting requirements with respect to certain financial metrics, allowing the lender to closely monitor the financial health of the Mortgage REIT. Many lenders also impose liquidity and net worth requirements, which must be maintained in order for the Mortgage REIT to preserve its borrowing ability.

Although lenders establish these financial covenants and reporting requirements to protect their lending operations, investors are an additional beneficiary of the oversight and scrutiny exercised by lenders in this context.

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[27] The so-called "75% Asset Test." Under this test, the term "real estate assets" includes interests in mortgages on real property, such as RMBS and agency pass-through certificates.

[28] The so-called "75% Gross Income Test." Additionally, REITs must derive at least 95% of their gross income from the qualifying assets noted above or from or from dividends, interest or gains from the sale or disposition of stock or other securities that are not "dealer property."

B. The Regulatory Regime in Which Mortgage REITs Operate Greatly Mitigates the Risk for Abuses Similar to Those the Commission Cites as Having Occurred in Traditional Investment Companies

In the Concept Release, the Commission states that it is concerned that some mortgage-related pools may raise the potential for abuses similar to those experienced by some traditional investment companies, and identified certain specific areas of particular concern (discussed below). However, we believe that the existing regulatory framework for publicly-listed Mortgage REITs provides ample protection for investors and fully covers the concerns raised by the Commission. Additional regulatory constraints are unlikely to improve matters, and may only serve to increase the regulatory burden on Mortgage REITs without any salutary effect.

Specifically, the Commission cites as examples of such abuses the deliberate misvaluation of assets, the use of excessive amounts of leverage and overreaching and self-dealing by insiders. For the reasons discussed below, we believe that the Commission's concerns are unfounded as they pertain to the Mortgage REIT industry and, therefore, should not be used as a basis for imposing additional regulation on Mortgage REITs under the 1940 Act.

1) Valuation of Assets.

The Financial Accounting Standards Board ("FASB") requires reporting companies to disclose the fair value of their assets and liabilities. The purpose of requiring companies to report the value of assets as "marked to market" is to provide investors with a clear picture of the current value of the assets held by the companies they own.

Two Harbors understands the inherent conflict of interest that can exist in assessing fair value and, as a result, has instituted a number of safeguards designed to ensure a robust valuation process. These include:

- a Valuation Policy designed to ensure that the assets, securities, trading positions, financial instruments and investments held by Two Harbors and its subsidiaries are valued in a timely, accurate and objective manner, in accordance with applicable laws and regulations;

- appointment of a Pricing Officer, who is independent of the trading and investment functions of Two Harbors, and who is responsible for the day-to-day implementation of the Valuation Policy;

- appointment of a Valuation Committee, a majority of whose members are not involved in trading and investment decisions, which meets at least twice each month and is responsible for overseeing the valuation process;

- the extensive solicitation and use of broker quotes and independent third party valuation services to value assets and investment positions;

- the valuation of assets at the "bid" side of the bid/ask spread, rather than the midpoint between the bid and ask, so that assets reflect their liquidation value;

- the regular back-testing of the fair value measurements provided by the pricing providers it uses against actual performance, and monitoring the market for recent trades, market surveys or other market information that may be used to benchmark pricing provider inputs; and

- engaging its independent certified public accountant firm to perform an annual independent valuation of 100% of its portfolio to act as a check on the risk of inflated or inaccurate investment values, the results of which are reported directly to the independent Audit Committee of Two Harbors' Board of Directors.

Additionally, Two Harbors discloses in its quarterly reports on Form 10-Q and annual reports on Form 10-K the results of its valuations, including what percentage of its assets are assessed as Level 1, Level 2 or Level 3 assets.[29]

In light of the existing safeguards and robust policies and procedures discussed above, it is highly unlikely that any additional regulatory oversight that might be provided under the 1940 Act would strengthen investor protection as it pertains to ensuring fair and accurate asset valuations.

2) Use of Leverage.

Nominal "leverage" is a hollow metric. Leverage is used in a variety of ways and can have different applications and different risk profiles. Therefore, a company's "leverage ratio" only provides a small part of the story. To accurately assess levels of leverage, therefore, one must understand what is being leveraged and how the leverage is structured.

Mortgage REITs typically finance their assets through short-term borrowings structured as repurchase agreements. The amount of leverage applied depends on the nature of the asset being used to collateralize the borrowings. For example, Agency RMBS, given their liquidity and guarantees by the GSEs or Ginnie Mae, are typically eligible for higher levels of leverage, while non-Agency RMBS or mortgage loans, with less liquidity and more exposure to credit risk, are typically eligible for lower levels of leverage. Because leverage has risk priced into the borrowing amount and the cost of borrowing, when prudently employed it does not expose the company to unjustified risk.

The average range of leverage employed by the Mortgage REITs sector since December 31, 2001 has ranged from approximately 5.2:1 to 9.8:1; since the financial crisis in 2008, leverage has averaged approximately 6.1:1 and was at approximately 6.7:1 as of September 30, 2011.[30] Since its inception in late 2009, Two Harbors' RMBS target leverage, as defined by its debt-to-equity ratio[31], has ranged from 3.5:1 to 5.0:1. As of September 30, 2011, Two Harbors' RMBS debt-to-equity ratio was 4.4:1.

Two Harbors provides detailed disclosures regarding debt and use of leverage in its quarterly reports on Form 10-Q and annual reports on Form 10-K. Many Mortgage REITs also provide guidance in quarterly earnings conference calls concerning future expectations with respect to leverage.

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[29] FASB Accounting Standards Codification 820: "Fair Value Measurements and Disclosures," as amended by the Accounting Standard Update entitled "Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements." (January 21, 2010).

[30] Based on Quarterly Reports on Form 10-Q filed with the Commission since the year ended December 31, 2001.

[31] Debt-to-equity ratio is defined as total borrowings to fund RMBS securities and Agency inverse interest-only derivatives divided by total equity. Two Harbors also finances its U.S. Treasuries trading portfolio, which it holds for the purpose of hedging funding costs. Due to the highly liquid nature of U.S. Treasuries, the company believes the debt-to-equity ratio funding its RMBS and Agency derivatives is the most meaningful leverage measure. Two Harbors' targeted debt-to-equity ratio for Agency RMBS and derivatives is generally 6.0:1.0 to 7.0:1.0 given their liquidity and high credit quality. Targeted debt-to-equity ratio for non-Agency RMBS is generally 1.0:1.0 to 1.5:1.0 due to less liquidity and exposure to credit risk.

Two Harbors utilizes many tools to manage its leverage. These include:

- adopting a Risk Management Policy to ensure that effective risk management is exercised and promoted within the company;
- appointing a Chief Risk Officer, who is charged with the responsibility for implementing risk management policies and developing risk management systems, including with respect to risks associated with financing and leverage, and who makes regular reports to the Board of Directors;
- establishing a Risk Management Committee, a majority of whose members do not have trading authorization, which sets risk management limits, monitors compliance with the risk management limits, and oversees the Chief Risk Officer;
- maintaining a diversity of financing counterparties in order to reduce concentration of risk with any one counterparty (as of the date of this letter, Two Harbors has established relationships with 20 different counterparties);
- varying the duration of funding periods under repurchase agreements so that financings mature at staggered intervals; and
- in addition to short-term repurchase agreements, utilizing longer duration repurchase facilities to finance RMBS at committed funding terms (e.g., rate, haircut) for the duration of the facility (e.g., up to 364 days).

It is not appropriate to compare the amount of leverage used by investment companies registered under the 1940 Act to the amount of leverage used by Mortgage REITs. Investment companies typically own a wide variety of securities, many with leverage inherent in the underlying capital structure (e.g., common and preferred equity and high yield bonds), and it would, therefore, be imprudent to apply a high amount of leverage on assets that themselves are already levered. Moreover, the leverage limitations in the 1940 Act were created in response to a concern that investment companies were using excessive leverage at the corporate level, through unsecured debt and preferred stock issuances. By contrast, Mortgage REITs typically employ leverage at the asset level, through repurchase facilities that are secured by specific assets.[32]

To the extent the Commission is concerned about the use of leverage by Mortgage REITs, the solution is not greater regulation, but greater disclosure. As noted above, Two Harbors provides extensive disclosures to its investors regarding leverage in its quarterly filings with the Commission and through other investor communications. We are always looking for ways to improve those disclosures, not because of regulatory constraints, but because of our desire to help our investors understand our business. We would support the Commission's use of the Concept Release process as a forum for developing more consistent disclosures regarding leverage in the Mortgage REIT industry. However, we urge the Commission not to impose 1940 Act leverage limitations on Mortgage REITs. Doing so would have an immediate and adverse impact on the industry, and especially on those Mortgage REITs that

[32] Similarly, there is no reason for the Commission to compare the use of leverage by Mortgage REITs to the use of leverage by Carlyle Capital – a closed-end fund neither domiciled in the U.S. nor listed on a U.S. securities exchange – simply because it invested in mortgage securities.

focus on investments in Agency securities. This, in turn, would reduce the ability of Mortgage REITs to contribute to the revival and restructuring of the U.S. mortgage markets.[33]

3) Transactions Involving Insiders.

As discussed above in Part II, Mortgage REITs are subject to a comprehensive regulatory regime that is highly focused on investor protection, including imposing restrictions on the relationships an entity can have with affiliates (e.g., independent board and audit committee) and extensive disclosure requirements concerning transactions with related parties.

Additionally, many Mortgage REITs, such as Two Harbors, seek to align the interests of its management team with the interests of shareholders through significant purchases of stock in the company by officers and directors.

Without a doubt, history tells countless stories of insider abuses in public companies, replete with egregious acts of self-dealing and widespread fraud. Those companies, too, were subject to comprehensive regulatory regimes. Nonetheless, there are bad actors in every industry and those bad actors will look for opportunities to circumvent the regulatory regime to which they are subject. Mortgage REITs are not any more susceptible, nor are they any less susceptible, to these sorts of abuses than any other public company.

While regulation under the 1940 Act may subject Mortgage REITs to additional rules, we believe that the existing regulatory framework applicable to Mortgage REITs is sufficient to protect the interests of investors. Additional regulation under the 1940 Act is not warranted.

III. The Commission Should Use the Concept Release to Affirm and Strengthen the Regulatory Framework of the Mortgage REIT Industry

As a matter of first importance, we urge the Commission to affirm the application of the Section 3(c)(5)(C) exemption to Mortgage REITs and to the investment practices that are standard in the industry. The Concept Release, which suggests that the Commission may be questioning this bedrock assumption, has created unnecessary uncertainty for Mortgage REITs and has slowed capital formation.

Two Harbors firmly believes that the Commission has provided appropriate interpretation and guidance regarding the Section 3(c)(5)(C) exemption, through past no-action letters. There is no need to question this long-standing practice and precedent. Further, we believe the Commission has acted within the scope of its statutory authority on these matters, not only under the Section 3(c)(5)(C) exemption but also under the extensive authority that Congress granted to the Commission elsewhere in the 1940 Act to fashion exemptions that are "consistent with the protection of investors and the purposes fairly intended by the policy and provisions of [the 1940 Act]."[34] Thus, at the earliest opportunity, the Commission should send a signal to the markets that it will leave the overall regulatory framework of Section 3(c)(5)(C) intact.

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[33] The U.S. government clearly understands the importance that leverage plays in financing mortgage assets. In designing the PPIP, the government recognized that participants in the program would need to use leverage, and as a result, the federal government offered to provide financing for the asset purchases under the PPIP.

[34] Section 6(c) of the 1940 Act, 11 U.S.C. § 80a-6(c): "The Commission, by rules and regulations upon its own motion, or by order upon application, may conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of this subchapter or of any rule or regulation thereunder, if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this subchapter."

That said, the SEC has an opportunity to use the process initiated by the Concept Release to strengthen and clarify certain matters under the exemption. In general, we support the approach taken by others who have recommended that the Commission articulate overall guidelines and principles for the interpretation of the Section 3(c)(5)(C) exemption. This would assist Mortgage REITs in assessing new securities, investments and situations as and when they arise, including new developments based on the possible elimination of the GSEs, the potential sale of credit risk on Agency mortgage pools in the private market, and the likely participation of Mortgage REITs in the reincarnation of the private label securitization market.

In addition to articulating general guidelines and principles regarding the interpretation of Section 3(c)(5)(C), we encourage the Commission to provide greater clarity regarding certain aspects of the exemption on which the Mortgage REIT industry currently relies, including in the areas discussed below.

A. *Qualifying Assets*

1) 55% Whole Pool Test.

Mortgage REITs have interpreted the Salomon Brothers Inc. no-action letter[35] as stating that an entity may qualify for the Section 3(c)(5)(C) exemption as long as at least 55% of its assets consist of whole mortgage pools (the "55% Whole Pool Test"). We encourage the Commission to consider whether 55% is necessary as a minimum threshold and whether it places an artificial constraint around investment in qualifying assets, particularly in light of the historical innovation in mortgage and mortgage-related assets. Furthermore, the Commission should consider the impact on Mortgage REITs of any amendment to the 55% threshold and grant an acceptable transition period during which companies that rely on this threshold may adjust their portfolios.

2) Agency Partial Pool Certificates.

It is our view that the partial ownership of an Agency mortgage pool is the functional equivalent, from an investment perspective, of the ownership of the entire pool, and we ask the Commission to consider extending the 55% Whole Pool Test to partial ownerships in pools. We recognize that the Commission Staff has previously addressed this question in the Nottingham Realty Securities no-action letter[36], and at that time declined to take the action that we propose. Nonetheless, we invite the Commission to reconsider this position. Whole or partial interests in an Agency mortgage pool have the same economics, the same risk of prepayment and the same cash flows through the receipt of principal and interest on the underlying mortgage loans. Treating partial pool interests in the same way as whole pool interests would expand the universe of available investments for Mortgage REITs without changing the underlying characteristics of the investments. Moreover, such a determination would permit a Mortgage REIT to reduce its risks by diversifying its holdings over a broader portfolio of partial pool investments, rather than concentrating its holdings in larger but fewer whole pools.

3) Private Whole or Partial Pool Certificates.

Furthermore, we encourage the Commission to make a determination that a private whole or partial pool certificate is a qualifying asset for purposes of Section 3(c)(5)(C). Although not guaranteed by the federal government, certain levels of private label mortgage-backed securities, such as mezzanine and subordinate classes, have essentially the same structural characteristics as Agency securities. Due to

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[35] Securities and Exchange Commission. Salomon Brothers Inc., No-Action Letter (June 17, 1985).

[36] Securities and Exchange Commission. Nottingham Realty Securities, Inc., No-Action Letter (April 19. 1984).

the anticipated reduction of GSE involvement in the mortgage market and the likely increase in private label issuances, this question will take on increasing urgency.

4) Beneficial Ownership Interest and Foreclosure Rights.

As discussed above, Mortgage REITs are poised to become major contributors in the resurgence of the securitization markets, a necessary component of the recovery of the U.S. housing market. For Mortgage REITs to participate in the securitization market without concern for their compliance with the 1940 Act, there must be greater clarity around the beneficial ownership interest concept and the treatment of foreclosure rights.

Currently, Dodd-Frank and other regulatory initiatives contemplate requiring sponsors to increase their on-going exposure to the mortgage-backed securities they create. Conversely, there is a trend toward investors and servicers requiring sponsors to reduce their control of the servicer and/or loss mitigation activities (such as through the appointment of an independent credit risk manager). If "foreclosure rights" are viewed as only the direct, unconditional ability to foreclose on a real property, the majority of future consolidated trust structures may not be viewed as "qualifying Assets." This interpretation would limit the role of Mortgage REITs in the securitization market. Therefore, we encourage the Commission to establish broad principles addressing beneficial ownership interests and foreclosure, based on the underlying economic, contractual and legal rights of the holders of the securities, for example, by broadening foreclosure rights to include conditional and unconditional rights to foreclose as well as the right to direct another party's foreclosure rights.

B. Treatment of TBA Mortgage-Backed Securities

Pass-through securities issued by the GSEs are eligible to be sold or traded on the "to-be-announced" market, which is a forward or delayed delivery market that allows mortgage originators and lenders to sell mortgage loans, without having to hedge interest rates, before they have funded or closed the loans. The contracts to purchase and sell Agency RMBS issued and traded in the "to-be-announced" market, referred to as "TBA MBS," provide mortgage originators with certainty as to the secondary market for the loans they originate and, therefore, play an essential role in providing liquidity to the mortgage markets.

There is, however, significant uncertainty among Mortgage REITs concerning the treatment of TBA MBS. For example, it is unclear as to whether TBA MBS represent a "good" asset under the 55% Whole Pool Test, and as a result, out of an abundance of caution some Mortgage REITs exclude TBA MBS when calculating this ratio. We encourage the Commission to clarify the treatment of TBA MBS under the 55% Whole Pool Test.

C. Treatment of Cash

We urge the Commission to clarify the treatment of cash assets under the 55% Whole Pool Test. As the rules are currently interpreted, in calculating the total value of assets, both assets and cash are included in the denominator, but only qualifying assets are included in the numerator. As a result, cash can skew the results and actually has the effect of being a "bad" asset for the purposes of the 55% Whole Pool Test. We believe this is an unintended result of the current interpretation of the 55% Whole Pool Test. Accordingly, we propose that the Commission consider making the following clarifications:

- In calculating the value of total assets for purposes of the 55% Whole Pool Test, allow for all cash items (except for Qualifying Cash, as defined below) to be excluded from the calculation (e.g., included in neither the numerator or denominator); and

- Define a "qualifying interest" for purposes of the 55% Whole Pool Test to include the concept of "Qualifying Cash." The term Qualifying Cash would be defined as the net cash proceeds received on sale of an asset that is a qualifying interest and which cash proceeds are held, pending distribution or reinvestment in other qualifying assets. The definition could include a finite period of time during which a cash asset could be considered Qualifying Cash, for example, for a maximum period of one year after the date of sale of the qualifying asset. After the expiration of such time period, the cash asset would no longer be deemed Qualifying Cash and could be excluded from the total asset calculation.

V. <u>Conclusion</u>

For all of the reasons stated in this letter, we strongly believe that subjecting Mortgage REITs to regulation under the 1940 Act would be unnecessary, unreasonable and inconsistent with the intent of the Section 3(c)(5)(C) exemption. We therefore urge the Commission to affirm the continuing application of Section 3(c)(5)(C) to Mortgage REITs such as Two Harbors.

We do, however, support action by the Commission to strengthen the exemption. Bringing clarity and certainty to Section 3(c)(5)(C) by articulating principles for assessing whether securities and transactions fall within the exemption, and providing guidance on the specific areas identified above, would serve the Commission's goals (i) to be consistent 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 is administered in a manner that is consistent with the purposes and policies underlying the 1940 Act, the public interest, and the protection of investors; (iii) to provide greater clarity, consistency and regulatory certainty in this area; and (iv) to facilitate capital formation.

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We appreciate the opportunity to provide the foregoing comments in response to the Concept Release and would be pleased to participate, as a member of the Mortgage REIT industry, in further deliberations with the Commission in this regard. Should you have any questions or desire any clarification concerning the matters addressed in this letter, please do not hesitate to contact me via telephone at (612) 629-2500 or via email at thomas.siering@twoharborsinvestment.com.

Sincerely,

Thomas E. Siering
President and Chief Executive Officer