

Investment Company Act of 1940- Section 3(c)(5)(C)
Capital Trust, Inc

May 24, 2007

RESPONSE OF THE OFFICE OF CHIEF COUNSEL
DIVISION OF INVESTMENT MANAGEMENT

Our Ref. No. 2006-1221
Capital Trust, Inc.
File No. 132-3

In your letter, dated May 16, 2007, you request that we concur with your view that certain mezzanine loans, described below, that are held by Capital Trust, Inc., a public company that has elected treatment as a real estate investment trust for federal tax law purposes (the "Company"), would be considered qualifying interests, as defined below, for purposes of complying with the exclusion in Section 3(c)(5)(C) of the Investment Company Act of 1940.

Facts

You state that the Company engages primarily in commercial real estate financing. Among other things, the Company invests in certain mezzanine loans made specifically and exclusively for the financing of real estate, which for purposes of this letter shall be referred to as "Tier 1 mezzanine loans." You explain that in a Tier 1 mezzanine loan arrangement, the Company lends money as mezzanine lender to a special purpose bankruptcy remote entity ("mezzanine borrower") whose sole purpose is to hold all of the ownership interests of another special purpose entity that owns the commercial real estate being financed and that is subject to a mortgage loan secured by the property ("property-owning entity").¹ You state that under the terms of their respective organizational documents and loan documents, the property-owning entity may not engage in any business other than owning and holding the underlying property and the mezzanine borrower may not engage in any business other than owning and holding the ownership interests in the property-owning entity. You state that the ownership interests held by the mezzanine borrower has no value apart from the underlying real property that is held by the property-owning entity other than incidental assets related to ownership of the property.²

You explain that the mezzanine borrower enters into an agreement with the Company as Tier 1 mezzanine lender pursuant to which it pledges its entire ownership interests in the property-owning entity to the Company as collateral for the mezzanine

¹ You state that mezzanine loans are junior to the senior position of the mortgage holder but senior to the equity position of the owner of the underlying real property. You state that while there may be multiple tiers of mezzanine loans made in connection with the financing of a property, your request for relief is limited to mezzanine loans that are granted to a mezzanine borrower that directly owns interests in the entity that owns the property being financed (*i.e.*, Tier 1 mezzanine loans).

² You note, for example, that the property-owning entity may also hold incidental assets, such as cash generated from rental payments and held for short periods of time pending distribution or disbursement to meet operating expenses.

loan.³ The Company obtains a first priority perfected security interest in the ownership interests in the property-owning entity.⁴ You state that if the mezzanine borrower were to default on the mezzanine loan, the Company has the right to foreclose on the collateral and, through its 100% ownership of the property-owning entity, become the owner of the underlying real estate.⁵

You further explain that the Company as Tier 1 mezzanine lender also enters into an intercreditor agreement with the mortgage lender in connection with the issuance of the Tier 1 mezzanine loan that sets forth the relative priority of rights between the two parties with respect to claims on the underlying property being financed. Among other things, you state that the Company obtains rights under the intercreditor agreement that allow it to readily cure defaults or purchase the mortgage loan in the event of a default on the mortgage loan. You state that the agreement also gives the Company as Tier 1 mezzanine lender various control rights over the management of the underlying property.

You state that in the commercial real estate financing industry second mortgages have effectively been replaced in part by Tier 1 mezzanine loans. You explain that second mortgages are rarely offered as a result of the increased practice of securitizing senior commercial mortgages. You state that the nationally recognized statistical rating organizations (“NRSROs”) have expressed an unwillingness to assign the highest ratings to securities issued by a trust holding a pool of senior commercial mortgages when the underlying properties associated with these mortgages are encumbered by second mortgages. You explain that the NRSROs are concerned that the presence of a second mortgage may negatively impact the trust’s remedies in the event that the senior mortgage should default, which in turn could impede payments made to the trust’s securities holders. You claim that such concerns are not found in the Tier 1 mezzanine loan arrangement because you explain that the absence of a second lien on the underlying property minimizes the likelihood that payments made to the trust’s securities holders might be affected in the event of a default of a senior mortgage in the pool.

³ You state that the aggregate principal balance of a mortgage loan and mezzanine loan at origination would be less than the value of the underlying property so that the mezzanine loan would be fully secured by the underlying real property.

⁴ You note that typically both the mezzanine borrower and the mezzanine lender are limited liability companies. You also state that in very rare cases the property-owning entity may be organized as a limited partnership. In such cases, the mezzanine borrower would own all of the limited partnership interests in the property-owning entity as well as all of the ownership interests in the general partner of the property-owning entity. The mezzanine borrower would pledge the ownership interests in both the property-owning entity and the general partnership as collateral for the mezzanine loan.

⁵ You note, moreover, that the process of foreclosing on the ownership interests in the property-owning entity is governed by the Uniform Commercial Code rather than the state laws that control the process of foreclosing on real estate. Consequently, you claim that a Tier 1 mezzanine lender could foreclose on the ownership interests in the property-owning entity more quickly than a mortgage lender can foreclose on the mortgage, because the equitable rights of redemption granted to mortgage borrowers under most state laws can cause the real estate foreclosure process to be drawn out over an extended period of time.

Analysis

Section 3(c)(5)(C) provides an exclusion from the definition of investment company for any issuer that is not engaged in the business of issuing redeemable securities, face-amount certificates of the installment type, or periodic payment plan certificates and who is “primarily engaged in . . . purchasing or otherwise acquiring mortgages and other liens on and interests in real estate.” We previously have taken the position that an issuer may not rely on the exclusion provided by Section 3(c)(5)(C) unless at least 55% of its assets consist of “mortgages and other liens on and interests in real estate” (called “qualifying interests”) and the remaining 45% of its assets consist primarily of real estate-type interests. To meet the 45% real estate-type interests test, an issuer must invest at least 25% of its total assets in real estate-type interests (subject to reduction to the extent that the issuer invests more than 55% of its total assets in qualifying interests) and may invest no more than 20% of its total assets in miscellaneous investments.⁶

You argue that the Tier 1 mezzanine loan that you describe in your letter should be considered a qualifying interest for purposes of Section 3(c)(5)(C) even though such a loan is not directly secured by real estate. You argue that, except for the lack of a mortgage loan against the property, such a mezzanine loan is the functional equivalent of, and provides its holder with the same economic experience as, a second mortgage.

Specifically, you argue that the Tier 1 mezzanine loans that the Company holds are the functional equivalent of second mortgages because, except for the lack of a mortgage lien on the property, all of the principal terms and features of a second mortgage loan are present. You explain that both are loans, made specifically and exclusively for the financing of real estate, that are junior to the first mortgage loan but senior to the equity position of the owner of the property. You also note that second mortgages and Tier 1 mezzanine loans are underwritten based on the same considerations and after the lender performs a hands-on analysis of the underlying commercial property, including, among other things, inspection of the property, review of revenue leases and property agreements, analyses of local commercial real estate market conditions, and review of the financial performance of the property. You state that, as is typically the case with a second mortgage lender, the Company exercises ongoing control rights over the management of the underlying property, such as rights relating to the approval of major leases, budget improvements, capital expenditures and the application of insurance proceeds or condemnation awards, as well as the right to replace the property manager in case of default on the loan. Finally, you state that the Company has rights under the intercreditor agreement to readily cure defaults or purchase the mortgage loan in the event of a default on the mortgage loan.

You also argue that the economic experience of the Company as a Tier 1 mezzanine lender is no different from the economic experience of a second mortgage

⁶ See, e.g., Citytrust, SEC Staff No-Action Letter (Dec. 19, 1990); Greenwich Capital Acceptance Inc., SEC Staff No-Action Letter (Aug. 8, 1991).

lender. Although the Company holds as collateral the ownership interests of the property-owning entity rather than the property itself, you argue that the value of the collateral is economically the same under both loan forms. In essence, you explain that the ownership interests in the property-owning entity have no economic value apart from the underlying real property (other than incidental assets related to the ownership of the property) because the property-owning entity in a Tier 1 mezzanine loan arrangement is not permitted to engage in any business except the ownership of the real property.⁷ Consequently, the Company as Tier 1 mezzanine lender, like the second mortgage lender, looks to the underlying real property as the true measure of the value of its collateral. You also note that despite the absence of a mortgage lien, the Company has the right to foreclose on the collateral and, through its ownership of the property-owning entity, become the owner of the underlying real estate.⁸

We generally take the position that a qualifying interest is an asset that represents an actual interest in real estate or is a loan or lien fully secured by real estate. Thus, for example, we have not objected if an issuer treats as qualifying interests, among other things, fee interests in real estate,⁹ mortgage loans fully secured by real property,¹⁰ second mortgages secured by real property¹¹ and leasehold interests secured solely by real property.¹² We also have provided no-action relief where an asset can be viewed as being the functional equivalent of,¹³ and the asset provides its holder with the same

⁷ See *supra* note 2 and accompanying text.

⁸ See *supra* note 5. You also argue that the economic experience under both a Tier 1 mezzanine loan and a second mortgage should be considered the same because, in your view, the ownership interests of the mezzanine borrower in the property-owning entity are unlikely to be considered “securities.” You explain that in such case, the collateral that the mezzanine lender is receiving is not a “security” that has a value independent of the underlying property held by the property-owning entity. We take no position whether under this arrangement the ownership interests are “securities.”

⁹ See, e.g., United Bankers, SEC Staff No-Action Letter (Mar. 23, 1988).

¹⁰ See, e.g., United States Property Investment N.V., SEC Staff No-Action Letter (May 1, 1989).

¹¹ See, e.g., Prudential Mortgage Bankers & Investment Corp., SEC Staff No-Action Letter (Dec. 4, 1977); The State Street Mortgage Co., SEC Staff No-Action Letter (July 17, 1986).

¹² See, e.g., Health Facility Credit Corp., SEC Staff No-Action Letter (Feb. 6, 1985).

In contrast, we generally take the position that an asset is not a qualifying interest if it is not fully secured by real estate. See, e.g., NAB Asset Corp., SEC Staff No-Action Letter (June 20, 1991) (loans that are not fully secured by real estate are not qualifying assets). We also take the position that an asset is not a qualifying interest if it is in the nature of a security interest in another person engaged in the real estate business. See, e.g., The Realex Capital, SEC Staff No-Action Letter (Mar. 19, 1984) (Section 3(c)(5)(C) not available to an issuer who invests solely in limited partnership interests in an underlying limited partnership that would own and operate a building).

¹³ See, e.g., Investors GMNA Trust, Inc., SEC Staff No-Action Letter (July 22, 1983) (counsel opined that that issuer’s ownership of GNMA Mortgage Pass-Through Securities representing 100% beneficial interests in mortgage pools constitutes an investment in mortgages within the meaning of Section 3(c)(5)(C) because ownership of these securities “is the functional equivalent of ownership of the underlying mortgage loans”); GEM Savings Association, SEC Staff No-Action Letter (Sept. 28, 1983) (counsel argued that issuer’s ownership of GNMA certificates is the “functional equivalent of ownership in an interest in real estate,” thereby permitting the issuer to rely on Section 3(c)(5)(C), because the certificates represent 100% beneficial interests in each underlying mortgage pool, the payment of principal and interest on the

economic experience as,¹⁴ a direct investment in real estate or in a loan or lien fully secured by real estate, albeit in a context different from the facts you present.

Based on the facts and representations in your letter and in particular your representations that: (1) a Tier 1 mezzanine loan is a subordinated loan made specifically and exclusively for the financing of real estate; (2) both second mortgages and Tier 1 mezzanine loans are underwritten based on the same considerations and after the lender performs a hands-on analysis of the property being financed; (3) the Company as Tier 1 mezzanine lender exercises ongoing control rights over the management of the underlying property; (4) the Company as Tier 1 mezzanine lender has the right to readily cure defaults or purchase the mortgage loan in the event of a default on the mortgage loan; (5) the true measure of the collateral securing the Tier 1 mezzanine loan is the property being financed and any incidental assets related to the ownership of the property; and (6) the Company as Tier 1 mezzanine lender has the right to foreclose on the collateral and through its ownership of the property-owning entity become the owner of the underlying property, we agree that the Tier 1 mezzanine loan which you describe in your letter can be viewed as being the functional equivalent of, and provide its holder with the same economic experience as, a second mortgage which is a qualifying interest

underlying mortgages is passed through to holders of GNMA certificates and the certificates are secured by the real estate associated with the underlying mortgages). *See also* NAB Asset Corp., SEC Staff No-Action Letter (June 20, 1991) (counsel stated that an issuer that has general partnership interests in partnerships that hold real estate and loans backed by real estate should be “functional equivalents of direct ownership in the real estate and loans held by the partnerships and not be ‘securities’ for securities law purposes”); United States Property Investments N.V., SEC Staff No-Action Letter (May 1, 1989) (counsel argued that issuer’s joint venture investments in real estate and mortgages are the “functional equivalents of direct ownership by the . . . [issuer], and would not constitute ‘securities’ under the ‘investment contract test’ used for securities law purposes”).

¹⁴ *See, e.g.*, Premier Mortgage Corp., SEC Staff No-Action Letter (Mar. 14, 1983) (holder of notes secured by a pool of whole mortgage loans “would have essentially the same investment experience that it would have were it directly investing in the mortgage loans.”). *See also* Protecting Investors: A Half Century of Investment Company Regulation 72 (1992) (we stated that qualifying interests include agency whole pool certificates because “the holder of these certificates generally has the same economic experience as the investor who purchases the underlying mortgages directly, including the receipt of both principal and interest payments and the risk of prepayment on the underlying mortgage loans, notwithstanding the guarantees provided by the agencies.”).

for purposes of complying with Section 3(c)(5)(C). Accordingly we concur with your view that the Tier 1 mezzanine loan described in your letter may be considered a qualifying interest for purposes of complying with the exclusion from the definition of investment company provided by Section 3(c)(5)(C).

Please note that our views are based upon the facts and representations contained in your letter and that any different facts or representations may require a different conclusion.

Rochelle Kauffman Plesset
Senior Counsel

Incoming Letter:

May 16, 2007

CONFIDENTIAL

Elizabeth Osterman, Assistant Chief Counsel
Division of Investment Management
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: Capital Trust, Inc.: No Action Request

Dear Ms. Osterman:

We are writing on behalf of Capital Trust, Inc. (the "Company"), a public company that has elected treatment as a real estate investment trust for federal tax law purposes. We are seeking the concurrence of the staff of the Division of Investment Management with our view that certain mezzanine loans which the Company invests in, as described below, would be considered Qualifying Assets (as defined below) for purposes of the exclusion in Section 3(c)(5)(C) of the Investment Company Act of 1940, as amended (the "Investment Company Act"). Alternatively, we seek the staff's concurrence that it will agree not to recommend enforcement action to the Securities and Exchange Commission ("Commission") if the Company were to treat these mezzanine loans as Qualifying Assets for purposes of Section 3(c)(5)(C) of the Investment Company Act.

I.
BACKGROUND

The Company is engaged primarily in the business of commercial real estate financing. It invests in, among other things, mezzanine loans as described below.¹⁵

In these mezzanine loan arrangements,¹⁶ the Company lends money to a special purpose bankruptcy remote entity, typically organized as a limited liability company (“mezzanine borrower”), whose sole purpose is to hold all of the ownership interests in another special purpose entity, also organized typically as a limited liability company, that owns commercial real property (“property-owning entity”) and is subject to a mortgage loan secured by the property.¹⁷ Under the terms of their respective organizational documents and loan documents, the property-owning entity and the mezzanine borrower may not engage in any other business. The ownership interests of the mezzanine borrower in the property-owning entity, therefore, have no value apart from the underlying real property that is held by the property-owning entity essentially as its only asset.¹⁸ The value of the underlying property in excess of the mortgage loan is the ultimate collateral that secures the mezzanine loan.

The mezzanine borrower pledges its entire ownership interests in the property-owning entity to the mezzanine lender as collateral for the mezzanine loan. The mezzanine lender obtains a first priority perfected security interest in this collateral. If the mezzanine borrower were to default on the mezzanine loan, the mezzanine lender has the right to foreclose on the collateral and, through its ownership of the property-owning entity, effectively become the owner and operator of the underlying real property.

The mezzanine loan is issued pursuant to the terms of a mezzanine loan agreement between the mezzanine borrower and the Company, as the mezzanine lender. In addition, the relative priority of rights of the Company as mezzanine lender and the mortgage lender, with respect to claims on the underlying commercial property, is set forth in an intercreditor agreement between these two parties. The intercreditor agreement provides for communication between the mortgage lender and the mezzanine lender and gives certain rights to the mezzanine lender, such as cure rights and purchase rights that allow it to readily cure defaults or purchase the mortgage loan in case of a default on the mortgage loan. The mezzanine lender may also obtain through negotiation various control rights over the management of the underlying property, such as the right to approve major leases, budgets, improvements, capital expenditures and the application of insurance proceeds or condemnation award and, in the case of default, the right to replace the property manager. Further, the mezzanine loan documents and the intercreditor agreement contain various

¹⁵ The loans described in this letter are considered “mezzanine” because they occupy a place in the relative priority of creditor and ownership interests in the underlying real property that is junior to the senior position of the mortgage holder but senior to the equity position of the owner of the underlying real property.

¹⁶ In accordance with the staff’s request, we are limiting our request for relief in this letter only to mezzanine loans that are granted to a mezzanine borrower that directly owns interests in a property-owning entity. We are not requesting relief in this letter for other levels of mezzanine loans.

¹⁷ In very rare cases, the property owning entity may also be organized as a limited partnership. In these cases, the mezzanine borrower would own all of the limited partnership interests in the property-owning entity, as well as all of the ownership interests in the general partner of the property-owning entity, and would pledge all of these ownership interests as collateral for the mezzanine loan.

¹⁸ The property-owning entity may also hold incidental assets related to ownership of the commercial property, such as cash generated from rental payments from tenants and held temporarily for short periods of time pending distribution or disbursement to meet operating expenses.

restrictions on the mortgage lender's ability to modify loan documents or grant material consents or waivers to the mezzanine borrower.

Like many of the Company's commercial real estate financing industry competitors, the Company rarely makes second mortgage loans. The second mortgage has been effectively replaced by the mezzanine loan. This change is due to the practice of senior mortgage lenders contributing first mortgages into securitized offerings of commercial mortgage-backed securities ("CMBS") and selling classes of securities collateralized by the mortgages and rated by the nationally recognized statistical rating organizations ("NRSROs"). The NRSROs have expressed an unwillingness to assign the highest ratings to CMBS when the underlying property for a mortgage loan included in a pool of underlying commercial mortgage loans is encumbered by a second mortgage loan.¹⁹

II. LEGAL ANALYSIS AND DISCUSSION

Section 3(c)(5)(C) of the Investment Company Act provides an exclusion from the definition of "investment company" for certain companies engaged primarily in the real estate business. Under this section, an issuer would be excluded from the definition of investment company if it does not issue "redeemable securities," as defined in Section 2(a)(32) of the Investment Company Act,²⁰ and is engaged primarily in the business of "purchasing or otherwise acquiring mortgages and other liens on and interests in real estate."

Through various no-action letters, the Commission staff has provided guidance on the circumstances under which it would regard a company as being engaged primarily in the business of "purchasing or otherwise acquiring mortgages and other liens on and interests in real estate" for purposes of Section 3(c)(5)(C) of the Investment Company Act. The staff has granted no-action assurance to permit an issuer to rely on Section 3(c)(5)(C) where (a) at least 55% of the value of the issuer's total assets consisted of real estate interests ("Qualifying Assets"), (b) at least an additional 25% of the value of the issuer's total assets consisted of real estate-type interests ("Real Estate-Related Assets"), reduced by any amount the issuer held in excess of the 55% minimum limit for Qualifying Assets, and (c) no more than 20% of the value of the issuer's total assets consisted of assets other than Qualifying Assets and Real Estate-Related Assets.²¹

¹⁹ The NRSROs are concerned that in a workout situation involving a defaulted mortgage loan included in a CMBS pool, the presence of a second mortgage loan may impact negatively the trust's exercise of remedies and ultimate realization on the underlying property because the second mortgagee, as a lienholder, may assert rights under state law. In addition, the second mortgagee's claims on the underlying real property might cause significant delays in a bankruptcy proceeding involving the property owning entity. By contrast, the absence of a lien on the underlying property in the mezzanine loan context minimizes the likelihood that payments to be made to CMBS holders might be affected during the workout of a defaulted mortgage loan.

²⁰ The term "redeemable security" is defined in Section 2(a)(32) of the Investment Company Act to mean any security (other than short-term paper) that gives its holder the right to receive, upon tender to the issuer or the issuer's agent, the holder's approximate share of the issuer's current net assets or the cash equivalent thereof.

²¹ See, e.g., *Citytrust* (pub. avail. Dec. 19, 1990); *Prudential-Bache Securities, Inc.* (pub. avail. Aug. 19, 1985); *Salomon Brothers, Inc.* (pub. avail. June 17, 1985).

The staff has indicated that Qualifying Assets include fee interests in real estate,²² whole mortgage loans,²³ and agency whole pool certificates (which represent the entire beneficial interest in the underlying pool of mortgage loans).²⁴ The Commission staff also has granted no-action assurance to permit pass-through notes secured by whole pools of conventional mortgage loans to be treated as Qualifying Assets.²⁵ Further, the staff has granted no-action assurance to permit an issuer that has a substantial holding of second mortgage loans to rely on Section 3(c)(5)(C) even though the holder of such a loan is generally required to obtain the consent of the mortgage holder before pursuing foreclosure on the underlying real property.²⁶

We believe, on the basis of the foregoing legal authorities, that a mezzanine loan should be treated as a Qualifying Asset for purposes of Section 3(c)(5)(C) of the Investment Company Act because, except for the lack of a mortgage lien against the property, a mezzanine loan is the functional equivalent of a second mortgage and provides the lender with the same economic experience as a second mortgage lender. We respectfully request the staff's concurrence with this view or, in the alternative, that the staff grant our request for no-action relief to permit mezzanine loans to be treated as Qualifying Assets.

A. A mezzanine loan is the functional equivalent of a second mortgage loan.

A mezzanine loan functions in a manner that is equivalent to the function of a second mortgage loan. Except for the mortgage lien against the property, all of the principal terms and features of the second mortgage loan are present in the mezzanine loan arrangement. Both loans are made specifically and exclusively for the financing of real estate, and occupy a structural position in the borrower's debt hierarchy that is junior to the first mortgage loan but senior to the borrower's equity in the property. Both are priced generally with higher interest rates that give effect to their subordinate position with respect to the priority accorded the mortgage loan lender.²⁷ In both cases, a filing is made with a public official with respect to the borrower's assets pledged as collateral for the loan – a Uniform Commercial Code filing to record a first priority security interest in the collateral, in the case of the mezzanine loan, and a filing made with the registrar of deeds or other similar county official, in the case of the second mortgage loan.

²² See, e.g., Investment Company Act Release No. 3140 (Nov. 18, 1960).

²³ *Id.* See also *Merrill, Lynch, Pierce, Fenner & Smith* (pub. avail. Nov. 4, 1981).

²⁴ See, e.g., *American Home Finance Corp.* (pub. avail. Apr. 9, 1991) (no-action relief granted to permit certificates representing the entire ownership interest in a particular pool of mortgage loans to be treated as Qualifying Assets). The staff has reasoned that holding the certificates with respect to a whole pool of mortgages is the functional equivalent of owning the mortgages and that the investor in such certificates would have the same economic or investment experience as if the investor held the underlying mortgages. See, e.g., *Security Mortgage Acceptance Corp. I* (pub. avail. Jan. 6, 1986); *Salomon Brothers Inc.* (pub. avail. Dec. 4, 1985).

²⁵ See, e.g., *Premier Mortgage Corp.* (pub. avail. Mar. 14, 1983).

²⁶ See *The State Street Mortgage Co.* (pub. avail. Jul. 17, 1986).

²⁷ Indeed, a second mortgage loan and a mezzanine loan involve substantially the same underwriting considerations which are examined through similar underwriting procedures. Before granting or acquiring a mezzanine loan, the Company, like a second mortgagee, undertakes a hands-on analysis of the underlying commercial property, including an analysis of local commercial real estate market conditions, the creditworthiness of tenants and the financial performance of the property. The Company, similar to a second mortgagee, also conducts on-site inspections of the property, revenue leases and property agreements.

Further, in connection with a mezzanine loan, the Company exercises ongoing control rights over the underlying property, such as rights relating to the approval of major leases, budgets, improvements, capital expenditures, and the application of insurance proceeds or condemnation awards, as well as the right to replace the property manager in case of a default on the loans, as is typically the case with a second mortgage loan. In addition, like a second mortgage lender, the Company has the rights under the terms of the intercreditor agreement to readily cure a default or to purchase a mortgage loan in case of a default on the mortgage loan.

B. Economically, the mezzanine loan provides the same rights to repayment as a second mortgage loan.

The economic experience of the Company, as mezzanine lender, is no different than the economic experience of a second mortgagee.

First, the form of ownership of the underlying commercial real property in the mezzanine loan arrangement has no practical significance given that the mezzanine borrower's ownership interests in the property-owning entity pledged as collateral to secure the mezzanine loan have no economic value apart from the underlying real property held as the only principal asset of the property-owning entity. Consequently, the mezzanine lender would have to look to the underlying real property as the true measure of the value of its collateral. The aggregate principal balance of a mortgage loan and mezzanine loan at origination would be less than the value of the underlying property, so that the mezzanine loan would be fully secured by the underlying real property.

Second, since the Company, as mezzanine lender, can readily realize on its collateral and succeed to ownership of the property-owning entity in case of default on the mezzanine loan, the Company does not view the absence of the mortgage lien as a material distinction between a mezzanine loan and a second mortgage loan. The Company considers the underlying collateral to be economically the same under both loan forms since the property-owning entity in a mezzanine loan arrangement is not permitted to engage in any business except the ownership of the real property. In fact, the Company's ability to more quickly foreclose on the collateral ownership interests under a mezzanine loan can provide it with a distinct advantage compared to a mortgage lender which is subject to more strict procedures when foreclosing on a second mortgage.²⁸

The view that the Company's economic experience under both a mezzanine loan and a second mortgage should be considered the same is supported by the conclusion that for purposes of the Investment Company Act, the ownership interests of the mezzanine borrower in the property-owning entity are unlikely to be considered "securities."²⁹ In such

²⁸ A mezzanine lender could foreclose more quickly on ownership interests in a mezzanine borrower because this form of security is governed by the Uniform Commercial Code and is not subject to state laws controlling the process of foreclosing on real estate, which (because of the equitable right of redemption granted to borrowers under most state laws) can cause the foreclosure process to be drawn out over an extended period of time.

²⁹ The mezzanine borrower's ownership interests in the property-owning entity should not be considered "securities" under the applicable *Howey* investment contract test because in the typical mezzanine loan arrangement, as discussed above, the mezzanine borrower owns all of the outstanding limited liability company interests in the property-owning entity and exercises such a degree of control over the operations and management of the entity that the "reliance solely on the efforts of others for profits"

case, the Company may properly consider the collateral it receives as mezzanine lender in connection with providing a mezzanine loan not as “securities” having a value independent of the underlying property held by the property-owning entity, but as the underlying property itself.³⁰ As noted, if there is a default on the mezzanine loan, followed by a subsequent foreclosure on the collateral, the Company readily becomes the sole owner of the property-owning entity.

As noted, the Commission staff has used the “same economic experience” rationale in the past in granting no-action relief to permit particular real estate investments to be treated as Qualifying Assets. The staff has used this rationale in granting relief to permit agency “whole pool certificates” to be treated as Qualifying Assets.³¹ Similarly, in *Premier Mortgage Corp.*,³² the staff granted no-action assurance to permit pass-through notes secured by whole pools of conventional mortgage loans to be treated as Qualifying Assets on the basis that the issuer would have essentially the “same investment experience” were it investing directly in the mortgage loans. Although there are differences in the mezzanine loan arrangement when compared with the circumstances under which the staff has granted relief in the whole pool context, the fundamental thrust of the underlying rationale is the same in both cases – *i.e.*, a mezzanine lender on the one hand, or the holder of all of the certificates issued with respect to a pool of mortgage loans on the other, would have essentially the same economic experience as if the mezzanine lender instead held a second mortgage loan or as if the certificate owner owned the underlying mortgages directly. It should be appropriate, therefore, to accord similar treatment in both cases, so that a mezzanine loan, like a second mortgage loan, may be classified as a Qualifying Asset for Section 3(c)(5)(C) purposes.

III. CONCLUSION

For the foregoing reasons, we respectfully request that the staff concur with our position that mezzanine loans of the type described in this letter should be considered Qualifying Assets for purposes of Section 3(c)(5)(C) of the Investment Company Act or, in the alternative, that the staff agree not to recommend enforcement action to the Commission if the Company were to treat these mezzanine loans as Qualifying Assets for purposes of Section 3(c)(5)(C).

We would be willing to respond to any questions the staff may have concerning this request or to supplement in any way the arguments made in this letter. Please call Michael R. Rosella

element of the *Howey* test would not be met. *See generally Williamson v. Tucker*, 645 F.2d 404 (5th Cir.), *cert. denied*, 454 U.S. 897 (1981); *Robinson v. Glynn*, 349 F.3d 166 (4th Cir. 2003) (applying the *Howey* investment contract test in analyzing membership interests in a limited liability company); *Great Lakes Chemical Corporation v. Monsanto Company*, 96 F. Supp.2d 376 (D. Del. 2000) (also applying the *Howey* investment contract test to analyze membership interests in a limited liability company). *See also Frazier v. Manson*, 484 F. Supp. 449, 450-53 (N.D. Tex. 1980), *aff'd*, 651 F.2d 1078 (5th Cir. 1981) (holding that limited partnership interests may not be securities if special factors showing involvement of limited partners in management are met).

³⁰ *Cf. NAB Asset Corporation* (pub. avail. June 20, 1991) (no-action assurance to permit a company to treat its general partnership interests in a partnership holding real estate and loans as the functional equivalent of direct ownership of the real estate and loans for Section 3(c)(5)(C) purposes and not be considered “securities” for securities law purposes).

³¹ *See supra* n. 10.

³² *See supra* n. 11.

at 212-318-6800, Michael L. Zuppone at 212-318-6906 or Wendell M. Faria at 202-551-1758 with any question.

In accordance with Securities Act Release No. 6269 (Dec. 5, 1980), we enclose seven additional copies of this letter and identify in the upper right hand corner of the first page of this letter the specific statutory provisions to which this letter pertains.

Sincerely,

Michael R. Rosella
of PAUL, HASTINGS, JANOFSKY & WALKER LLP

Michael L. Zuppone