February 15, 2012

Ms. Susan Cosper  
Technical Director  
File Reference No. 2011-200  
Financial Accounting Standards Board  
401 Merritt 7  
PO Box 5116  
Norwalk, Connecticut 06856-5116

Re: Financial Services – Investment Companies (Topic 946)

Dear Ms. Cosper:

Capstead Mortgage Corporation welcomes this opportunity to respond to the request for comments from the Financial Accounting Standards Board (the “Board”) on the Board’s Financial Services – Investment Companies (Topic 946) Proposed Accounting Standards Update (the “Proposed Update”).

Background

Since our inception in 1985, we have elected to be taxed as a Real Estate Investment Trust (a “REIT”) and have been listed continuously on the New York Stock Exchange under the trading symbol “CMO.” Throughout our history we have operated within the residential mortgage finance industry in a variety of ways, including as a mortgage loan conduit acquiring and securitizing non-agency-guaranteed residential mortgage loans originated by correspondent lenders; as an originator and servicer of agency-guaranteed mortgage loans; and since 2000 as a manager of a large portfolio of agency-guaranteed adjustable-rate mortgage (“ARM”) residential mortgage-backed securities (“MBS”). As such we hold the distinction of being the oldest publicly traded mortgage REIT. At December 31, 2011 we held $12.3 billion in ARM securities supported by long-term investment capital of $1.4 billion and borrowings under repurchase arrangements of $11.4 billion.

Throughout our history, we have relied on an exemption afforded companies that invest in real estate, including mortgages and other liens on and interests in real estate, to be excluded from regulation as an investment company under the Investment Company Act of 1940 (the “40 Act”). Without this exemption, our ability to use leverage to invest in agency-guaranteed MBS would be drastically limited.

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1 The term “agency” refers to Fannie Mae, Freddie Mac (together, the “GSEs”) and Ginnie Mae. Agency-guaranteed MBS are considered to have little, if any, credit risk because of federal government support for the GSEs and outright ownership of Ginnie Mae.
We and other mortgage REITs have played a significant role in residential mortgage finance over the years, and presently bring to bear over $40 billion in private investment capital in support of the housing markets, which after considering leverage, represents holdings of over a ¼ trillion dollars of mortgages and residential MBS. Like commercial banks that also hold large portfolios of both non-agency and agency-guaranteed MBS, the prudent use of leverage has been critical to earning equity returns. Our use of leverage is predicated on our lenders’ willingness to accept agency-guaranteed MBS as collateral as well as our exemption from regulation as an investment company under the 40 Act.

Thus it was with deep concern that we consider the Board’s preliminary conclusion in the Proposed Update to eliminate the exclusion from investment company accounting previously afforded REITs. We find the connotation that a mortgage REIT is an “investment company” very troubling, despite the reality that real estate companies, including mortgage REITs that invest in mortgages and other liens on real estate, have appropriately been excluded from regulation as such by the Securities and Exchange Commission (the “SEC”) since the 40 Act became law. This concern is heightened by a recent effort by the SEC to gather information on the use of the real estate exemption from regulation under the 40 Act, which could lead to future rule-making to codify and potentially modify existing SEC interpretations in this regard (see Concept Release No. IC-29778 issued August 31, 2011).

Further, should we be required to use investment company accounting as proposed, we are concerned that the utility of our GAAP financial statements and therefore their relevance to the investing public will be drastically diminished.

The rest of our letter will expand on these concerns and propose solutions that we believe will result in a more appropriate framework for implementing investment company accounting where appropriate. We also note that as a member of the National Association of Real Estate Investment Trusts’ Mortgage REIT Council, we participated in the formulation of their comment letter and endorse their recommendations.

Change Needed because of Confusion between Regulatory and Accounting Terminology

As noted above, we are concerned about the connotation that a mortgage REIT is an “investment company” as may occur if the Proposed Update is not sufficiently modified. Even if the Board does nothing else, we believe it is critical that the confusion inherent in using the same terminology for regulatory and accounting purposes that have different definitions be avoided. Therefore, we wholeheartedly endorse the recommendation of the Mortgage REIT Council to converge the terminology of the Proposed Update with the International Accounting Standards Board’s (“IASB”) Investment Entities exposure draft by replacing references to investment companies in the Proposed Update with investment entities in order to create a more obvious distinction between investment companies for regulatory purposes and investment entities for accounting purposes.
The Decline in Utility of GAAP Financial Statements Under the Proposed Update

If mortgage REITs are required to follow investment company accounting, these companies’ net income and earnings per share will largely come to represent the change in net asset value (“NAV”) for the period, at least to the extent of the asset side of the balance sheet (obviously, liabilities are not marked-to-market at this point, and dilution/accretion from capital transactions would be excluded). This may be relevant for a mutual fund subject to the leverage limitations of the 40 Act and issuing equity at daily NAV, but of virtually no use to investors in operating companies.

As a REIT, our investors are primarily interested in the cash flows we generate for distribution as dividends and we are generally required by the REIT provisions of the tax code to distribute our taxable income to our stockholders. Net income and earnings per share under our current accounting framework tracks these metrics closely. If we are required to record changes in unrealized gains (losses) of our mortgage investments and related derivatives held for hedging purposes through earnings, then our investors will no longer take much notice or interest in our operating results presented in accordance with GAAP.

Rather, we will be forced to adopt non-GAAP financial measures in order to try to convey meaningful information to our investors. Unfortunately, unlike equity REITs that already use a fairly universally defined “funds from operations” non-GAAP measure, the non-GAAP measures adopted by mortgage REITs will at least initially have no such uniformity, contributing to investor confusion.

Additionally, we do not believe a requirement to list individual MBS in a detailed Schedule of Investments provides useful information, particularly when appropriately aggregated portfolio disclosures already being provided present data in useful and digestible formats.

Clearly, for mortgage REITs, investment company accounting represents a huge step backward in terms of usefulness, clarity and disclosure overload.

The Best Solution – Retain the REIT Scope Exception

We strongly urge the Board to retain the current scope exception for REITs from investment company accounting. By doing so the Board would allow mortgage REITs to continue to provide their investors with useful GAAP earnings information in a manner comparable to other financial institutions (i.e., banks) that conduct similar activities.

Retaining the current scope exception for REITs would also avoid the confusion inherent in lumping together for accounting purposes businesses such as mortgage REITs that are far different from typical investment companies (i.e., mutual funds). We think it is instructive to point out that even in the 1930s, when Congress deliberated on the provisions of the 40 Act, real estate businesses, including businesses investing in
mortgages that were similar to modern mortgage REITs, were specifically excluded from
regulation as investment companies. This conclusion was reached despite incredible
turmoil experienced in the real estate markets during the Great Depression. In the late
1960s, Congress performed a review of the 40 Act and made no changes to the real estate
exemption, citing the clear distinction between the business activities of REITs and other
real estate businesses and those of investment companies:

Although the companies enumerated in [the Section 3(c)(5)(C) real estate
exemption] have portfolios of securities in the form of . . . mortgages and
other liens on and interests in real estate, they are excluded from the [40
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 issuers2 [Emphasis added].

By retaining the current scope exception for REITs from investment company
accounting, the Board will both promote the relevance of GAAP financial reporting and
lessen the inevitable confusion resulting from forcing mortgage REITs to use an
accounting framework that not only is ill-suited to presenting its results of operations, but
was largely developed for the mutual fund industry.

Should the REIT Scope Exception not be Retained, Modify the Qualifying Criteria

In reviewing the Proposed Update and discussing its qualifying criteria for identifying
what constitutes an investment company for GAAP accounting purposes with our peers
on the Mortgage REIT Council, we noted that the Fair Value Management criterion was
not well developed in the Proposed Update. This criterion states:

Fair value management – Substantially all of the investment company’s
investments are managed, and their performance evaluated, on a fair value basis.

We concur with the Council’s conclusion that the Board did not adequately define what is
intended by this criterion, which will likely lead to implementation issues. Further, we
endorse the Council’s recommendation that the Board adopt the IASB definition of fair
value management used in its Investment Entities exposure draft:

B17 All controlled investments of an investment entity must be managed,
and their performance evaluated, internally and externally, on a fair value
basis. This evaluation is based on how the investment entity manages and
evaluates performance, rather than on the nature of its investments. The
entity’s activities must demonstrate that fair value is the primary
measurement attribute used to make a decision about the financial
performance of those assets3 [Emphasis added].

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3 http://www.ifrs.org/NR/rdonlyres/2E8EF4421-3006-4E31-AB0C­
C86A27CD2EE9/0/IEDInvestmentEntities.pdf
In this regard, we believe that under the IASB definition of fair value management, mortgage REITs would be excluded from the scope of the Proposed Update. This conclusion is based on the reality that mortgage REITs are managed almost solely on a yield basis, generating net interest margin, or spread income, not unlike many other financial institutions. This spread income produces the cash flows that can be distributed as dividends to our stockholders. Not surprisingly, our investors also view mortgage REITs as primarily yield vehicles and our stocks typically trade in a relatively tight dividend yield range, adjusted for the underlying risk inherent in our investment strategies and past performance in executing these strategies, in light of current and anticipated market conditions. This risk-adjusted dividend yield emphasis results in market pricing of mortgage REIT shares that at times can be below reported book value per share, and at other times above book value per share.

Further, the buy low, sell high investment strategies prevalent in the mutual fund industry do not work in the REIT structure because of prohibitions on actively trading our investments contained in the REIT provisions of the tax code. Therefore, mortgage REITs are essentially buy and hold investors that may periodically sell securities, typically not to generate gains, but to realign investment portfolios based on changes in market conditions or changes in investment strategy. For instance, in the last five years we have sold securities on only two occasions (the fall of 2007 and the spring of 2008 for liquidity purposes at the onset of the Great Recession and the near collapse of the financial system).

Regardless of whether the Board adopts the IASB definition of fair value management, we recommend that the final standard include more discussion and/or examples that will provide clarity regarding what entities meet this criterion.

Additionally, we endorse the Mortgage REIT Council’s recommendation that the Board add a seventh scope criterion to the Proposed Update:

**Transactions priced at NAV** – The entity sells shares or units based on the entity’s current NAV as opposed to a share price on a quoted market exchange.

By adding this criterion, the Board would further distinguish mortgage REITs and other financial companies from investment companies. The fact that certain entities regulated under the 40 Act would fail this criterion, such as closed-end bond funds, is addressed by the Board’s conclusion that all 40 Act-regulated entities are investment companies subject to the provisions of the Proposed Update regardless of meeting all of the scope criteria.
Should the REIT Exception not be Retained and the Qualifying Criteria not Modified, Retain the Mortgage REITs’ Current Accounting Framework

The existing accounting framework and disclosure practices followed by mortgage REITs, wherein (a) MBS investments are typically recorded at fair value as available-for-sale MBS with unrealized gains (losses) included in other comprehensive income and therefore in stockholders’ equity, (b) derivatives held for hedging purposes are recorded at fair value with related unrealized gains (losses) largely recorded in other comprehensive income and therefore in stockholders’ equity, and (c) appropriately aggregated portfolio disclosures are provided, serves our investors well and is comparable to GAAP for other financial institutions.

If the Board is not willing to otherwise exclude REITs from the scope of the Proposed Update, we believe the investment company accounting framework should be modified as it applies to mortgage REITs to allow us to continue to account for changes in unrealized gains (losses) on available-for-sale MBS and derivatives designated as accounting hedges as components of other comprehensive income thereby preserving the functional utility of our statements of income and earnings per share disclosures. This would address many of the problems with the Proposed Update described above. Additionally, it would be beneficial to eliminate of the burden of presenting a Statement of Investments consisting of a detailed listing of securities held. Retaining this statement requirement would only contribute to disclosure overload, be of marginal utility, and from a comparability standpoint, be inconsistent with financial statements presented by other financial institutions.

We thank the Board for the opportunity to comment on the Proposed Update. If you would like to discuss our comments further, please feel free to contact Phillip A. Reinsch directly at (214) 874-2380 or preinsch@capstead.com.

Respectfully submitted,

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