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November 12, 1986

ICA-40 1940 Act/3(c)(5)(C)  
Section 3(c)(5)(C)

Thomas P. Lemke, Esq.  
Chief Counsel  
Division of Investment Management  
Securities and Exchange Commission  
450 Fifth Street, N.W.  
Washington, D.C. 20549

Rule  
Public

5/5/87

Re: M.D.C. Holdings, Inc.

Dear Mr. Lemke:

On behalf of our client, M.D.C. Holdings, Inc. ("M.D.C."), we respectfully request your confirmation that the Securities and Exchange Commission will take no action if the REIT (as defined below) invests in Qualified Residual Interests (as defined below). Based upon and subject to our analysis set forth herein and recognizing that there appears to be no controlling legal precedent on the issue, we believe that such Qualified Residual Interests should be treated as "mortgages and other liens on and interests in real estate" under Section 3(c)(5)(C) of the Investment Company Act of 1940, as amended (the "1940 Act").

I. The Real Estate Investment Trust

M.D.C. has formed a subsidiary corporation (the "REIT") which intends to offer substantially all of its common stock to investors in a registered public offering through one or more registered broker-dealers under the Securities Exchange Act of 1934, as amended, and to qualify as a real estate investment trust under Sections 856-860 of the Internal Revenue Code of 1986 (the "Code").

Thomas P. Lemke, Esq.  
November 12, 1986  
Page Two

The REIT expects to generate income principally by investment directly or through one or more of its subsidiaries in conventional or governmentally insured fixed rate mortgage loans secured by single-family residential properties (the "Mortgage Loans") and in other mortgage-related assets, including, but not limited to, "fully modified pass-through" mortgage-backed certificates guaranteed by the Government National Mortgage Association, Mortgage Participation Certificates issued by the Federal Home Loan Mortgage Corporation, Guaranteed Mortgage Pass-Through Certificates issued by the Federal National Mortgage Association or privately issued mortgage certificates (collectively, the "Mortgage Certificates"). The REIT may sell to third parties such Mortgage Loans or Mortgage Certificates directly or through one or more of its subsidiaries or pledge them directly or through such entities as collateral for the issuance of collateralized mortgage obligations (the "Bonds") which it intends to sell.

## II. The Proposed Transactions

The REIT also proposes to purchase participations ("Residual Interests") which evidence fractional undivided interests in certain entities organized by non-affiliates (the "Entities") which have issued Bonds secured by Mortgage Loans, Mortgage Certificates and certain other funds and accounts (the "Collateral"). Each such Entity will have been formed as either a trust or partnership under state law. Each such Entity, whether a trust or a partnership, will be exempt from registration under the 1940 Act, because either (a) it is "primarily engaged" in "purchasing or otherwise acquiring mortgages and other liens on and interests in real estate" and is not "in the business of issuing redeemable securities, face-amount certificates of the installment type or periodic payment plan certificates" under Section 3(c)(5) of the 1940 Act and, at the time that it issued its Bonds, it received an opinion of counsel to that effect, or (b) it, or another entity on its behalf, has received an order under Section 6(c) of the 1940 Act exempting it from all provisions of such act on the basis of certain representations made by it in an application for such order. In the former case, the assets of the Entity will consist of, under the requirements of present law, at

Thomas P. Lemke, Esq.  
November 12, 1986  
Page Three

least 55 percent Mortgage Loans or Mortgage Certificates which represent 100 percent of the fractional undivided interests in the mortgage loans which make up such certificates ("Whole Pool Mortgage Certificates"). In the latter, its assets will likely not consist of at least 55 percent Mortgage Loans or Whole Pool Mortgage Certificates. The REIT at all times intends to have more than 55 percent of its assets which must be countered under the asset test under Section 3(c)(5)(C) of the 1940 Act invested in Mortgage Loans, Whole Pool Mortgage Certificates or Qualified Residual Interests.

Each trust will have been formed pursuant to a trust agreement (the "Trust Agreement") entered into by a depositor and a trustee (the "Owner Trustee"), while each partnership will have been formed pursuant to a partnership agreement (the "Partnership Agreement") entered into between the partners. Hereinafter, the Trust Agreement and the Partnership Agreement are known collectively as "Entity Agreements."

#### A. Trust Entities

In the case of an Entity which is a trust under state law, the Trust Agreement will have established the trust and authorized the Owner Trustee to issue the Residual Interests and the Bonds, purchase or otherwise acquire the Collateral, pledge such Collateral to an indenture trustee (the "Indenture Trustee") and enter into or cause its designee to enter into an underwriting agreement to sell the Bonds. Generally, the Trust Agreement will have also provided that the Owner Trustee will pay to the holders of such Residual Interests their pro rata share of the excess of principal and interest income from the Collateral over the sum of principal and interest expense on the Bonds plus other expenses associated with the ongoing maintenance of the Bonds (the "Residual Income"). The Trust Agreement can provide that more than one series of Bonds may be issued by any one trust and that any such trust will be dissolved when all of the Bonds are paid.

Currently, the Trust Agreement also includes certain provisions which permit the Entity to be viewed as either a partnership or grantor trust under the Code,

Thomas P. Lemke, Esq.  
November 12, 1986  
Page Four

thus permitting it to forego federal income taxation on its Residual Income at the trust level. These provisions generally include the following. First, the Trust Agreement provides that Residual Interests may only be transferred to holders which meet certain minimum net worth requirements. Second, it provides that holders of Residual Interests are liable for all expenses of the Entity, except for debt service on the Bonds. Third, it provides that holders of Residual Interests representing some percentage greater than or equal to 50% of the fractional undivided interests in the Entity (the "Applicable Percentage") control all non-ministerial activities of the Entity. Included in these activities are, for example, the decision to effect any optional redemption of the Bonds and the decision to remove the Indenture Trustee. Fourth, it provides that the Entity will not terminate on the bankruptcy, death or incapacity of any holder of a Residual Interest. Finally, it provides that the Entity must meet certain equity requirements at the time that it issues the Bonds and continue to meet them on an ongoing basis. The Entity may meet the latter limitation by either creating a reserve fund when a substantial portion of the Residual Interests are sold or creating it over time from Residual Income which would otherwise have been paid to the holders of such Residual Interests.

#### B. Partnership Entities

In the case of an Entity which is a partnership under state law, the Partnership Agreement will generally be written to comply with the Uniform Limited Partnership Act of the state where the partnership is formed. The purposes of the partnership will likely be limited to acquiring Mortgage Loans or Mortgage Certificates and issuing and selling one or more series of Bonds secured thereby and any activity incidental thereto or connected therewith. Normally, the Partnership Agreement will designate one partner as the general partner of the partnership and the others as limited partners thereof. The limited partners will not be liable thereunder for the debts of the partnership though the general partner will be so liable. Certain provisions of the Partnership Agreement will establish the method by which credits and charges will be made to each of the partners' capital accounts. The Partnership Agreement will provide that

Thomas P. Lemke, Esq.  
November 12, 1986  
Page Five

management of the affairs of the partnership will be controlled exclusively by the general partner and that the general partner will have no authority to act in contravention of the limited purposes of the partnership stated in the Partnership Agreement. The Partnership Agreement will provide that an Applicable Percentage of the holders of Residual Interests in the partnership may remove the general partner and that the death, dissolution, bankruptcy or incapacity of any limited partner will not act to terminate the partnership. However, such acts of the general partner will so terminate it, except, in certain instances, during any period when the Bonds are still outstanding. The Partnership Agreement will place other limitations on the ability of any partner to transfer his Residual Interest.

Currently, the Partnership Agreement includes certain provisions which will permit the Entity to qualify as a partnership subject to taxation under Subchapter K of the Code. First, as has been stated, any Residual Interest of the partnership will be transferable only under certain circumstances. Second, the general partner will be required always to hold more than a de minimis Residual Interest in the partnership, probably greater than a 10 percent interest. And third, the general partner will be liable for debts of the partnership.

#### C. The Tax Reform Act of 1986

On October 22, 1986, the Tax Reform Act of 1986 (the "TRA of 1986") was enacted. The TRA of 1986 makes certain changes to the scheme of federal income taxation of Residual Interests. In general, the TRA of 1986 permits Entities which have been formed prior to December 31, 1991 to continue to forego federal income taxation at the Entity level. In addition, it permits Entities to elect under new Section 860D of the Code to be taxed as real estate mortgage investment conduits, or "REMICs." Generally speaking, a REMIC is also not treated as an entity subject to taxation under the Code. Moreover, the REMIC provisions explicitly grant real estate-related asset status to such interests under the Code as long as the assets which make up the entity represent real-estate related assets. Entities which elect REMIC status generally are not required to comply with the additional tax-

Thomas P. Lemke, Esq.  
November 12, 1986  
Page Six

related requirements outlined above which are necessary for them not to be viewed as an association taxable as a corporation under the Code, though some or all of these provisions may be included for other reasons in the Entity Agreements.

#### D. The REIT Purchases

The REIT only intends to purchase Residual Interests from Entities which have the characteristics specified above (such interests being referred to as "Qualified Residual Interests"). Qualified Residual Interests of Entities which have elected to qualify as REMICs are referred to hereinafter as "REMIC Qualified Residual Interests," while Qualified Residual Interests which have not so elected are referred to hereinafter as "Non-REMIC Qualified Residual Interests."

### III. Analysis

Based upon and subject to our analysis set forth herein and recognizing that there appears to be no controlling legal precedent on the issue, it is our opinion that REMIC Qualified and Non-REMIC Qualified Residual Interests should be treated as "mortgages and other liens on and interests in real estate" under Section 3(c)(5)(C) of the 1940 Act. As more fully discussed below, the TRA of 1986 and its legislative history undoubtedly indicate a Congressional policy to clarify the definition of a real estate-related asset under federal law. This crystallization in Congressional thinking should not be undermined by adopting a contrary position under the 1940 Act. Were such a position adopted, a real estate investment trust, such as the REIT, would be substantially inhibited from acquiring REMIC Qualified Residual Interests. Furthermore, there appears to be no substantial economic differences between REMIC Qualified Residual Interests and Non-REMIC Qualified Residual Interests. Both will produce the same after-tax net cash flow to a holder, and the entities in which they represent an

Thomas P. Lemke, Esq.  
November 12, 1986  
Page Seven

interest are considered, for the purposes of the Code, as pass-through entities, i.e., entities which are not subject to federal income taxes.\* Therefore, there should be no reasonable basis for distinguishing between the two for the purposes of Section 3(c)(5)(C) of the 1940 Act.

A. Qualified Residual Interests

Any Qualified Residual Interest should be considered a "mortgage and other liens on and interests in the real estate" as that term is defined under Section 3(c)(5)(C) of the 1940 Act because of the recent clarification of Congressional intent regarding the nature of residual interests as real estate-related assets under federal law evidenced in the TRA of 1986. In this regard, it is instructive first to look generally at the applicable provisions of the TRA of 1986. Section 671 of the TRA of 1986 defines a "residual interest" as any interest in a pool of real estate-related assets which has elected to be treated as a REMIC and which is not a "regular interest." The term "regular interest" means:

an interest in a REMIC the terms of which are fixed on the startup day, and which --

(A) unconditionally entitles the holder to receive a specified principal amount (or other similar amount) and

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\* There appears to be two limited exceptions to this rule. First, the Conference Agreement interpreting new Section 860E of the Code appears to indicate that if the value of the residual interest of a REMIC is less than two percent of the combined value of such interest and its regular interests, then a thrift institution with net operating losses may not offset those losses against its income from such REMIC residual interest. Second, for an entity subject to tax under Section 511 of the Code, which holds an interest in a real estate investment trust which, in turn, holds a REMIC residual interest, income from such interest is unrelated business taxable income.

Thomas P. Lemke, Esq.  
November 12, 1986  
Page Eight

(B) provides that interest payments (or other similar amounts), if any, at or before maturity are payable based on a fixed rate (or to the extent provided in regulations, at a variable rate).

An interest shall not fail to meet the requirements of subparagraph (A) merely because the timing (but not the amount) of the principal payments (or other similar amounts) may be contingent on the extent of prepayments on qualified mortgages and the amount of income from permitted investments.

A "REMIC" is any entity:

(1) to which an election to be treated as a REMIC applies for the taxable year and all prior taxable years,

(2) all of the interests in which are regular interests or residual interests,

(3) which has 1 (and only 1) class of residual interests (and all distributions, if any, with respect to such interests are pro rata),

(4) as of the close of the 4th month ending after the startup day and each quarter ending thereafter, substantially all of the assets of which consist of qualified mortgages and permitted investments, and

(5) which has a taxable year which is a calendar year.

REMIC status is governed by an election under new Section 860D(b) of the Code. The REMIC provisions apply to regular and residual interests issued after January 1, 1987. Assuming a proper election, Bonds issued after that time will clearly be regular interests under the Code and the REMIC Qualified Residual Interests associated therewith will clearly be residual interests.

B. REMIC Qualified Residual Interests

Clarification of the real estate-related asset status of residual interests under federal law and thereby REMIC Qualified Residual Interests occurs as the result of a change in Section 856(c)(6)(C) of the Code. Section 856(c)(6)(C) of the Code defines an "interest in real property" for the purposes of Part III, Subchapter M of the Code, regarding real estate investment trusts. To qualify as a real estate investment trust under the Code, an entity must at the close of each quarter of any taxable year have at least 75 percent of the value of its total assets represented by real estate assets (including interests in real property), cash and cash items (including receivables) or government securities. Subject to an exception not here relevant, Section 671(b)(1) of the TRA of 1986 modifies the definition of an interest in real property by inserting subparagraph (D) after said subparagraph (C). New subparagraph (D) states that:

A regular or residual interest in a REMIC shall be treated as an interest in real property, and any amount includible in gross income with respect to such an interest shall be treated as interest . . .

(Emphasis added.) The Conference Agreement for the TRA of 1986 confirms this characterization. It states that "[b]oth regular and residual interests are treated as real estate assets under section 856(c)(6). . . ." For the purposes of applying the asset test stated in Section 856(c)(5)(C) of the Code, the amount of the real estate investment trust's investment in the residual interest is the value allocable to such interest. In that regard, the Conference Agreement likewise states that: "[i]n the case of a residual interest, the fair market value of the residual interest, and not the fair market value of all of the REMIC's assets, is used in applying the asset test of Section 856(c)(5)."\*

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\* As the test under Section 3(c)(5)(C) of the 1940 Act is basically also an asset test, we believe that Qualified Residual Interests should be evaluated under such section on essentially the same basis.

(Footnote continued)

Thomas P. Lemke, Esq.  
November 12, 1986  
Page Ten

Thus, as a result of the changes effectuated by the TRA of 1986, the Code undoubtedly permits a real estate investment trust to invest solely in residual interests that have qualified as REMICs. We believe that this recent expression of Congressional policy permitting a real estate investment trust to invest in REMIC residual interests is not frustrated by other federal laws, including Section 3(c)(5)(C) of the 1940 Act. Were one to conclude that REMIC residual interests were not "mortgages and other liens on and interests in real estate" (emphasis added), a real estate investment trust would be substantially inhibited in its ability to acquire REMIC residual interests. In such a case, the enactment into law by Congress of this crystallization of its policy regarding real estate related assets would not have the intended effect of decreasing the uncertainty with respect to investment in such assets. For this reason, we believe that REMIC Qualified Residual Interests should clearly be treated as such "interests in real estate" under Section 3(c)(5)(C) of the 1940 Act.

In further support of this proposition, we note that Congress' intent is reflected in at least three other changes to the Code made in the TRA of 1986. Section 671(b)(2) states that REMIC residual interests shall be treated as a "qualifying real property loans" for the purposes of Section 593 of the Code. Section 593 of the Code defines the method by which any mutual savings bank, domestic building and loan association or cooperative bank without capital stock may calculate its reserves for bad debts. Such reserves are used to calculate its bad debt deductions under Section 166 of the Code. Section 671(b)(3) states that REMIC residual interests shall be

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(Footnote \* continued from previous page)

Since Entities are by their nature fairly highly leveraged, we believe that it would be unfair to credit the REIT with the value of the Mortgage Loans or Mortgage Certificates owned by them rather than the net value of the REIT's investment in them in determining whether the REIT is "principally engaged" in permitted activities under Section 3(c)(5)(C) thereof.

Thomas P. Lemke, Esq.  
November 12, 1986  
Page Eleven

treated as qualifying properties for the purposes of Section 7701(a)(19) of the Code, which defines a domestic building and loan association for the purposes of the Code. Finally, Section 671(b)(4) of the TRA of 1986 amends Section 582(c) of the Code by providing that REMIC residual interests shall be treated as an evidence of indebtedness thereunder. Section 582 of the Code defines certain special rules applicable to banks regarding their deductions for bad debt losses under Section 166 of the Code. Without question, Congress has seen fit to state clearly and emphatically that REMIC residual interests for all purposes of the Code, and by implication for all purposes of federal law, are real estate-related assets.

#### C. Non-REMIC Qualified Residual Interests

With respect to Non-REMIC Qualified Residual Interests, we believe that such interests should also be treated as "mortgages and other liens on and interests in real estate," because there is no substantial difference between them and REMIC Qualified Residual Interests. In both cases, the pre-tax cash flow of a holder of such interests will be determined on the basis of the differences between principal and interest receipts on the Collateral over the sum of principal and interest payments on the Bonds plus other administrative expenses of the Entities. In both cases, federal income taxes will not be imposed on the Entities so that, all other variables being equal, after-tax cash flows to such holders will not differ.\* Furthermore, in both cases, the Entities will be structured identically for state law purposes, although, in the case of Entities which issue Non-REMIC Qualified Residual Interests, certain provisions in their Entity Agreements which permit them to be treated as pass-through entities for federal income tax purposes need not be included in the Entity Agreements of Entities which issue REMIC Qualified Residual Interests. However, these provisions may be included for other reasons, such as for rating agency purposes or to insure prudent administration of the Entities by their "equity" holders. Lastly, in both cases, since the Entities only differ

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\* See footnote on page seven hereof.

Thomas P. Lemke, Esq.  
November 12, 1986  
Page Twelve

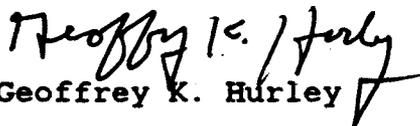
with respect to their election as to REMIC status under the federal income tax laws, the holders of interests in the Entities will have virtually identical rights in the Collateral held by the Entities and vis-a-vis holders of Bonds.

We believe that it would clearly contradict recent Congressional policy, which has been enacted into law, to conclude that Qualified Residual Interests, which are issued by Entities which have not elected or cannot elect to be REMICs, do not qualify as "mortgages and other liens on and interests in real estate." Quite to the contrary, it is clear that because Non-REMIC Qualified Residual Interests represent virtually the same economic interests as REMIC Qualified Residual Interests, Congress, looking to the substance of the relationship between the holders of such interests and the real estate assets held by the Entities which issued them, intended that such interests should also be treated as "mortgages and other liens on and interests in real estate" for the purposes of Section 3(c)(5)(C) of the 1940 Act.

#### IV. Conclusion

For the reasons stated above, we believe that the Qualified Residual Interests acquired by the REIT are qualified real estate-related assets under Section 3(c)(5)(C) of the 1940 Act. For your convenience, we have enclosed copies of the applicable provisions of the TRA of 1986 and the applicable sections of the Conference Agreement. If you have any questions concerning the foregoing, please do not hesitate to contact the undersigned at (212) 735-3840 or Richard F. Kadlick at (212) 735-2716, both of this office.

Sincerely,

  
Geoffrey K. Hurley

**PUBLIC**

JAN 05 1987

RESPONSE OF THE OFFICE OF CHIEF COUNSEL  
DIVISION OF INVESTMENT MANAGEMENT

Our Ref. No. 86-608-CC  
M.D.C. Holdings, Inc.  
File No. 132-3

In your letter of November 12, 1986, you request our assurance that we would not recommend any enforcement action to the Commission under the Investment Company Act of 1940 ("Act") if M.D.C. Holdings, Inc.'s subsidiary corporation (the "REIT") invests in various mortgage-related assets, including participations ("Residual Interests") in various partnerships and trusts ("Entities") which invest in real estate-related assets, and treats these Residual Interests as "mortgages and other liens on and interests in real estate" for purposes of Section 3(c)(5)(C).

You argue that, to the extent these Residual Interests comply with new Section 860D of the Internal Revenue Code ("Code"), they should be deemed to be "mortgages and other liens on and interests in real estate" under Section 3(c)(5)(C) of the Act. In addition, you assert that, in amending the Code, Congress did not intend companies investing in these Residual Interests to be subject to regulation under the Act.

We are unable to assure you that we would not recommend any enforcement action to the Commission if the REIT treats Residual Interests as "mortgages and other liens on and interests in real estate" for purposes of Section 3(c)(5)(C). Although the Entities may not be deemed to be investment companies by virtue of exemptive orders under Section 6(c) of the Act or in reliance on Section 3(c)(5)(C) of the Act, 1/ the staff has not viewed interests in similar entities to come within the phrase "mortgages and other liens on and interests in real estate" under Section 3(c)(5)(C). 2/

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1/ In the past, the staff has granted no-action requests where an issuer acquired whole-pool Government National Mortgage Association ("GNMA") certificates (i.e., certificates comprising an undivided interest in the entire pool of mortgages backing the certificates), whole-pool Federal National Mortgage Association ("FNMA") certificates, and whole-pool Federal Home Loan Mortgage Corporation ("FHLMC") certificates, to permit these certificates to be treated as "mortgages and other liens on and interests in real estate" for purposes of Section 3(c)(5)(C) of the Act. See, e.g., Landmark Funding Corp. (pub. avail. Sept. 20, 1984); American Home Finance Mortgage Corp. (pub. avail. May 11, 1981). However, the Division has declined to grant no-action with respect to issuers treating partial-pool GNMA, FNMA, or FHLMC certificates as "mortgages and other liens on and interests in real estate" for purposes of Section 3(c)(5)(C). See, e.g., Nottingham Realty Securities, Inc. (pub. avail. Apr. 19, 1984); Arlington Investment Company (pub. avail. Aug. 31, 1974).

2/ See, e.g., Realex Capital Corp. (pub. avail. Mar. 19, 1984) (holding that a limited partnership interest in a partnership relying on Section 3(c)(5)(C) does not come within the phrase); Urban Land Investments, Inc. (pub. avail. Nov. 4, 1971); see also Investment Company Act Rel. No. 3140 (Nov. 29, 1960) (stating that a trust investing to a substantial extent in other real estate investment trusts or in companies engaged in the real estate business might not qualify for the exception set forth in Section 3(c)(5)(C)).

In addition, although Congress amended the Code to provide pass-through tax treatment to entities electing to be taxed as real estate mortgage investment conduits ("REMICs"), neither the legislation nor the legislative history addresses the regulation of REMICs or similar entities under the Act. Thus, although the action of Congress may evidence an intent to facilitate the development of the market in mortgages and mortgage-related assets, we cannot conclude that Congress intended either REMICs to be excepted from the definition of an investment company under the Act or interests in REMICs to be deemed "mortgages and other liens on and interests in real estate" under Section 3(c)(5)(C).

Our position on this question is supported by other recent Congressional action regarding the market in mortgages and mortgage-related assets. In enacting the Secondary Mortgage Market Enhancement Act of 1984, 3/ Congress intended to broaden the market in mortgages and mortgage-related assets. 4/ However, the Senate Committee on Banking, Housing and Urban Affairs rejected a proposed amendment to exclude certain companies investing in real estate-related securities from the Act's coverage, stating that the Act "facilitates development of the private secondary mortgage market adequately" and "contains important protections for investors coming within the definition of the term 'investment company ....'" 5/ Moreover, the Committee believed that the Commission's power under Section 6(c) of the Act would "permit the Commission to deal with any problems that arise under the Investment Company Act in the area of mortgage-backed securities in a manner that assures adequate investor protection ...." 6/

Accordingly, we are unable to agree with your conclusion that interests in the Entities would constitute "mortgages and other liens on and interests in real estate" under Section 3(c)(5)(C) of the Act.

  
Gerald T. Lins  
Attorney

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3/ Pub. L. No. 98-440, 98 Stat. 1689 (1984).

4/ The report of the Senate Committee on Banking, Housing and Urban Affairs states that "[t]his bill is expressly designed to encourage this broadening of the market for mortgage-backed securities by encouraging more extensive involvement of the private sector in the formation of conduits for the flow of mortgage capital from investors to lenders and homebuyers." S. Rep. No. 293, 98th Cong., 1st Sess. 3 (1983).

5/ Id. at 9.

6/ Id.