CAPSTEAD MORTGAGE CORP
Form 424B5
February 23, 2012
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Filed Pursuant to Rule 424(b)(5)

Registration No. 333-179607

CALCULATION OF REGISTRATION FEE

Title of each class of securities to be registered	Amount to be registered	Proposed maximum offering price per unit	Proposed maximum aggregate offering price	Amount of registration fee(2)
Series B Preferred Stock	$1,495,548	$14.80[(1)]	$22,134,110	$2,537

(1) Calculated, pursuant to Rule 457(c), as the average of the high and low prices reported on the NYSE on February 22, 2012.

(2) The filing fee of $2,537 is calculated in accordance with Rule 457(r) under the Securities Act of 1933, as amended. Payment of the registration fee at the time of filing of the registrant s registration statement on Form S-3ASR filed with the Securities and Exchange Commission on February 21, 2012 (File No. 333-179607) was deferred pursuant to Rules 456(b) and 457(r) of the Securities Act. This Calculation of Registration Fee table shall be deemed to update the Calculation of Registration Fee table in the registration statement referenced herein.

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Prospectus Supplement

(To prospectus dated February 23, 2012)

Capstead Mortgage Corporation

1,495,548 Shares

$1.26 Cumulative Convertible Preferred Stock, Series B

Through this prospectus supplement, Capstead Mortgage Corporation may offer and sell from time to time up to 1,495,548 shares of our $1.26 Cumulative Convertible Preferred Stock, Series B, or Series B Preferred Stock. Our Series B Preferred Stock is listed on the New York Stock Exchange under the symbol CMOPRB.

We may sell all or a portion of the shares of stock offered pursuant to this prospectus supplement through agents, to or through underwriters or dealers. We are a party to a sales agreement with Brinson Patrick Securities Corporation as sales manager, relating to the sale of shares offered pursuant to this prospectus supplement. The sales manager is not required to sell any specific number or dollar amount of shares, but will use its best efforts to sell the shares offered by this prospectus supplement, subject to direction from us as to amount and timing. Such sales will be at market prices prevailing at the time of the sale. On February 22, 2012, the last reported sales price on the New York Stock Exchange of our Series B Preferred Stock was $14.80 per share. The compensation to the sales manager for sales of Series B Preferred Stock pursuant to this prospectus supplement will be at maximum commission rates ranging from 1.0% to 3.0% of the gross sales price per share, depending upon the aggregate sales proceeds raised by the sales manager under the sales agreement and the timing of such sales. The sales manager will be deemed to be an underwriter, within the meaning of the Securities Act, in connection with any sales of Preferred Stock on our behalf. See Description of Sales Agreement and Plan of Distribution.

Investing in these securities involves various risks. Risks associated with an investment in these securities are described in the accompanying prospectus under Risk Factors beginning on page 1 and in certain of our filings with the Securities and Exchange Commission.

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities, or determined if this prospectus supplement or the accompanying prospectus is truthful or complete. Any representation to the contrary is a criminal offense.

The date of this prospectus supplement is February 23, 2012.

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IMPORTANT NOTICE ABOUT INFORMATION IN THIS PROSPECTUS SUPPLEMENT

This document is in two parts. The first part is the prospectus supplement, which describes the specific terms of this offering and also adds to and updates information contained in the accompanying base prospectus and the documents incorporated by reference into this prospectus supplement and the base prospectus. The second part, the base prospectus, gives more general information about securities we may offer from time to time, some of which does not apply to this offering. Generally, when we refer only to the prospectus, we are referring to both parts combined, and when we refer to the accompanying prospectus, we are referring to the base prospectus.

If the description of this offering varies between this prospectus supplement and the accompanying prospectus, you should rely on the information in this prospectus supplement.

You should rely only on the information contained in or incorporated by reference in this prospectus supplement and the accompanying prospectus. We have not authorized anyone to provide you with information that is different. If anyone provides you with different or inconsistent information, you should not rely on it. We are offering to sell, and seeking offers to buy, shares of our Series B Preferred Stock only in jurisdictions where offers and sales are permitted. The information contained in or incorporated by reference in this document is accurate only as of the date such information was issued, regardless of the time of delivery of this prospectus supplement or any sale of our Series B Preferred Stock.

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OUR COMPANY

We are a self-managed real estate investment trust, or REIT, formed in 1985 and based in Dallas, Texas. We earn income from investing in a leveraged portfolio of residential mortgage pass-through securities consisting almost exclusively of adjustable-rate mortgage (ARM) securities issued and guaranteed by government-sponsored enterprises, either Fannie Mae or Freddie Mac (together, the GSEs), or by an agency of the federal government, Ginnie Mae. Residential mortgage pass-through securities guaranteed by the GSEs or Ginnie Mae are referred to as agency-guaranteed securities and are considered to have limited, if any, credit risk, particularly in light of the conservatorship of the GSEs by the federal government.

Our investment strategy is to manage a conservatively leveraged portfolio of agency-guaranteed ARM securities that can produce attractive risk-adjusted returns over the long term, while reducing, but not eliminating, sensitivity to changes in interest rates. This strategy differentiates us from our peers because ARM securities reset to more current interest rates within a relatively short period of time allowing for the recovery of financing spreads diminished during periods of rising interest rates and smaller fluctuations in portfolio values from changes in interest rates compared to portfolios that contain a significant amount of fixed-rate mortgage securities. From a credit-risk perspective, the credit quality of agency-guaranteed mortgage securities helps ensure that fluctuations in value due to credit risk should be limited and financing at reasonable rates and terms should remain available under stressed market conditions.

THE OFFERING

Issuer	Capstead Mortgage Corporation.
Series B Preferred Stock offered by us	Up to 1,495,548 shares.
Series B Preferred Stock to be outstanding after this offering	Up to 17,819,263 shares.
Manner of offering	Best efforts, at-the-market offering that may be made from time to time through Brinson Patrick Securities Corporation, as sales manager, subject to direction from us as to amount and timing. See Plan of Distribution on page S-3.
NYSE symbol	CMOPRB
Use of proceeds	We intend to use the net proceeds from this offering for general corporate purposes, including, without limitation, repayment of maturing obligations, financing future acquisitions, capital expenditures and working capital. Pending any such uses, we may invest the net proceeds from the sale of any stock offered pursuant to this prospectus supplement in short-term investments, or may use the proceeds to reduce short-term indebtedness.
Risk factors	An investment in our Series B Preferred Stock involves various risks. Risks associated with an investment in these securities are described under the heading Risk Factors beginning on page 1 of the accompanying prospectus and beginning on page S-2 of this prospectus supplement.

Unless otherwise indicated, all offering information in this prospectus supplement is based on the number of shares of Series B Preferred Stock outstanding as of February 22, 2012.

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RECENT DEVELOPMENTS

Subsequent to our fiscal year-end and through the date of this filing, we sold 1,924,554 shares of our common stock and 139,582 shares of our Series B Preferred Stock, including 647,280 shares of common stock and 12,376 shares of Series B Preferred Stock sold during the four-day period ended February 16, 2012, pursuant to our at-the-market program. These shares were offered and sold under our prior registration statement, which expired on February 12, 2012. If shares sold subsequent to February 12, 2012 were held to be issued without registration in violation of the Securities Act of 1933, as amended, we could potentially be required to repurchase some or all of these shares, at the original purchase price ($8.8 million, in aggregate), plus statutory interest, less dividends paid on the shares, subject to the statutory limitations period. We believe any such repurchase obligation would not be material to our liquidity, earnings or financial condition. A new registration statement was filed with the SEC on February 21, 2012 to facilitate the resumption of sales made under our program. Regardless of when sold, all shares issued pursuant to our program are validly issued under the Maryland General Corporation Law and our charter documents and are issued and outstanding for all purposes with all rights (such as voting, dividend and liquidation rights) as all other issued and outstanding shares of our common stock or Series B Preferred Stock, as applicable.

USE OF PROCEEDS

The net proceeds from the stock offered by us will be available for general corporate purposes, including, without limitation, repayment of maturing obligations, financing future acquisitions, capital expenditures and working capital. Pending any such uses, we may invest the net proceeds from the sale of any stock offered pursuant to this prospectus supplement or related prospectus in short-term investments, or may use the proceeds to reduce short-term indebtedness.

DESCRIPTION OF SALES AGREEMENT

We may sell our Series B Preferred Stock from time to time (1) through arrangements with underwriters or dealers, (2) directly to one or more purchasers, or (3) through agents. We have entered into a sales agreement with Brinson Patrick Securities Corporation with respect to sales of shares of our common stock and our Series B Preferred Stock, and we may enter into other sales agreements with other sales agents or underwriters in the future. Under the terms of the Brinson Patrick sales agreement, we may issue and sell shares of our Series B Preferred Stock from time to time through Brinson Patrick, as our sales agent. Brinson Patrick is not required to arrange for the purchase or sale of any specific number of shares or dollar amount of Series B Preferred Stock. We have agreed to provide indemnification and contribution to Brinson Patrick against certain liabilities, including liabilities under the Securities Act.

All sales made pursuant to the Brinson Patrick sales agreement will be reported in our Securities Exchange Act of 1934 reports.

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Certain Terms of the Sales Agency Agreement

Subject to direction from the company as to the amount and timing of sales, sales pursuant to the Brinson Patrick sales agreement may be effected on a daily basis. The compensation to Brinson Patrick for sales of our stock under the Brinson Patrick sales agreement, including both common stock and Series B Preferred Stock, shall be at the following commission rates:

3.0% of the gross sales price per share (sales proceeds) for the first $8 million of aggregate sales proceeds raised under the sales agreement in each sales period;

2.5% of sales proceeds for the next $4 million of aggregate sales proceeds raised in each sales period;

2.0% of sales proceeds for the next $88 million of aggregate sales proceeds raised in each sales period; and

1.0% of sales proceeds for any additional aggregate sales proceeds raised in each sales period.

Notwithstanding the commission structure described above, we and Brinson Patrick can mutually agree in writing to modify the commission rates, but such modified rates cannot exceed the rates described above at each applicable level. For purposes of determining the appropriate commission rates, the initial sales period began on March 10, 2008 and will end on December 31, 2014, and each subsequent sales period shall be for a two year period, commencing on January 1 and ending on December 31 of the following calendar year. The remaining proceeds, after further deduction for any transaction fees imposed by any governmental or self-regulatory organization in respect to such sale shall constitute the net proceeds to us for such shares of stock. The commission rate is currently set at a maximum of 1.0% of sales proceeds.

The offering of Series B Preferred Stock pursuant to the Brinson Patrick sales agreement will terminate upon the termination of the Brinson Patrick sales agreement. The Brinson Patrick sales agreement may be terminated by us or by Brinson Patrick upon written notice and in certain other circumstances specified therein.

PLAN OF DISTRIBUTION

In connection with the sale of the Series B Preferred Stock on our behalf under the Brinson Patrick sales agreement, Brinson Patrick will be deemed to be an underwriter within the meaning of the Securities Act of 1933, as amended (the Securities Act), and the compensation payable to Brinson Patrick under the Brinson Patrick sales agreement will be deemed to be an underwriting commission or discount; however, Brinson Patrick is not purchasing or selling any Series B Preferred Stock nor is it required to arrange for the purchase or sale of any specific number of shares or dollar amount of Series B Preferred stock. We have separately agreed to provide indemnification and contribution to Brinson Patrick against certain civil liabilities, including liabilities under the Securities Act. Brinson Patrick may engage in transactions with, or perform services for, us in the ordinary course of business.

We will maintain a trading account at the clearing agent designated by Brinson Patrick to facilitate the transactions contemplated by the Brinson Patrick sales agreement. The net proceeds from the sale of the Series B Preferred Stock under the Brinson Patrick sales agreement will be available in the trading account on the third business day (or such other day as is industry practice for regular-way trading) following each sale of Series B Preferred Stock (each, a Settlement Date). We will effect the delivery of the applicable number of shares of Series B Preferred Stock to an account designated by Brinson Patrick at The Depository Trust Company on or before the settlement date of each sale hereunder. Brinson Patrick s compensation will be withheld from the sales proceeds on each settlement date and will be paid to Brinson Patrick.

The offering of Series B Preferred Stock pursuant to the Brinson Patrick sales agreement will terminate upon the termination of the Brinson Patrick sales agreement. The Brinson Patrick sales agreement may be terminated by us or by Brinson Patrick upon written notice and in certain other circumstances specified therein.

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Commissions

The following tables show the public offering prices, underwriting commissions and proceeds, before expenses, to us, assuming all 1,495,548 shares of Series B Preferred Stock are sold at $14.80 per share, the last reported sales price of our Series B Preferred Stock on the New York Stock Exchange on February 22, 2012.

Series B Preferred Stock

	Per Share*	Total**
Public offering Price	$ 14.8000	$ 22,134,110
Underwriting commissions	$ 0.1480	$ 221,341
Proceeds, before expenses, to us	$ 14.6520	$ 21,912,769

* This is an offering that will be made, if at all, from time to time at the then-prevailing market prices. Therefore, there can be no assurances that the public offering prices, underwriting commissions, and proceeds, before expenses, will be as set forth above. The commissions are computed based upon the current maximum rate under the Brinson Patrick sales agreement.

** Based upon the maximum commission rate for aggregate proceeds in excess of $100 million, which is the commission rate applicable as of the date of this prospectus supplement through December 31, 2014.

The expenses of the offering, not including underwriting commissions, are estimated at less than $50,000 and are payable by us.

LEGAL MATTERS

Certain legal matters in connection with this offering will be passed upon for us by Andrews Kurth LLP, Dallas, Texas. Certain Maryland law matters in connection with this offering will be passed upon for us by Hogan Lovells US LLP (US). Andrews Kurth LLP will rely on the opinion of Hogan Lovells US LLP (US) as to all matters of Maryland law.

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PROSPECTUS

COMMON STOCK

PREFERRED STOCK

DEBT SECURITIES

WARRANTS

Capstead Mortgage Corporation intends to offer and sell from time to time the securities described in this prospectus.

We will provide the specific terms of any securities we may offer in a supplement to this prospectus. You should carefully read this prospectus and any applicable prospectus supplement before deciding to invest in these securities.

The securities may be offered directly, through agents designated by us from time to time, or through underwriters or dealers, on a continuous or delayed basis. We may make any sales of our common shares under this prospectus, if any, on or through the facilities of the New York Stock Exchange, to or through a market maker, or to or through an electronic communications network, at market prices prevailing at the time of sale, or in any other manner permitted by law (including, without limitation, privately negotiated transactions).

Our common stock is listed on the New York Stock Exchange under the symbol CMO. On February 17, 2012, the last reported sale price of our common stock as reported was $13.55 per share.

Investing in our securities involves risks. See Risk Factors beginning on page 1 of this prospectus for information regarding risks associated with an investment in our securities.

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or determined if this prospectus is truthful or complete. Any representation to the contrary is a criminal offense.

The date of this prospectus is February 23, 2012.

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You should rely only on the information contained or incorporated by reference in this prospectus. We have not authorized anyone else to provide you with different information. If anyone provides you with different or inconsistent information, you should not rely on it. An offer to sell these securities will not be made in any jurisdiction where the offer and sale is not permitted. You should assume that the information appearing in this prospectus, as well as information we previously filed with the Securities and Exchange Commission and incorporated by reference, is accurate as of the date on the front cover of this prospectus only. Our business, financial condition, results of operations and prospects may have changed since that date.

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ABOUT THIS PROSPECTUS

This prospectus is part of a shelf registration statement. We may sell, from time to time, in one or more offerings, any combinations of the securities described in this prospectus. This prospectus only provides you with a general description of the securities we may offer. Each time we sell securities under this prospectus, we will provide a prospectus supplement that contains specific information about the terms of the securities. The prospectus supplement may also add, update or change information contained in this prospectus. You should read both this prospectus and any prospectus supplement together with the additional information described under the heading Where You Can Find More Information.

WHERE YOU CAN FIND MORE INFORMATION

We file annual, quarterly and current reports, proxy statements and other documents with the Securities and Exchange Commission under the Securities Exchange Act of 1934. You may read and copy any materials that we file with the SEC without charge at the public reference room of the Securities and Exchange Commission, 450 Fifth Street, N.W., Room 1024, Washington, DC 20549. Information about the operation of the public reference room may be obtained by calling the Securities and Exchange Commission at 1-800-SEC-0330. Also, the SEC maintains an internet website that contains reports, proxy and information statements, and other information regarding issuers, including Capstead, that file electronically with the SEC. The public can obtain any documents that we file with the SEC at www.sec.gov.

We also make available free of charge on or through our internet website (www.capstead.com) our Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, and, if applicable, amendments to those reports filed or furnished pursuant to Section 13(a) of the Exchange Act as soon as reasonably practicable after we electronically file such material with, or furnish it to, the SEC.

This prospectus is part of a registration statement on Form S-3 that we filed with the Securities and Exchange Commission. This prospectus does not contain all of the information set forth in the registration statement and exhibits and schedules to the registration statement. For further information with respect to our company and our securities, reference is made to the registration statement, including the exhibits and schedules to the registration statement. Statements contained in this prospectus as to the contents of any contract or other document referred to in this prospectus are not necessarily complete and, where that contract is an exhibit to the registration statement, each statement is qualified in all respects by reference to the exhibit to which the reference relates.

INCORPORATION OF INFORMATION BY REFERENCE

The SEC allows us to incorporate by reference the information we file with them, which means that we can disclose important information to you by referring you to other documents that we file with the SEC. These incorporated documents contain important business and financial information about us that is not included in or delivered with this prospectus. The information incorporated by reference is considered to be part of this prospectus, and later information filed with the SEC will update and supersede this information.

We incorporate by reference the documents listed below and any future filings we make with the SEC under Section 13(a), 13(c), 14 or 15(d) of the Securities Exchange Act of 1934 until the offering of securities covered by this prospectus is complete:

- our Annual Report on Form 10-K for the year ended December 31, 2010;
- our Quarterly Reports on Form 10-Q for the quarters ended March 31, 2011, June 30, 2011 (as amended by our Quarterly Report on Form 10-Q/A, as filed with the SEC on August 25, 2011) and September 30, 2011; and
- our Current Reports on Form 8-K filed with the SEC on April 5, 2011, May 5, 2011 (except Item 2.02 and Exhibit 99.2 thereto which were furnished and not filed), June 2, 2011 and June 24, 2011.

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You may obtain copies of these documents at no cost by writing or telephoning us at the following address:

Investor Relations

Capstead Mortgage Corporation

8401 N. Central Expressway, Suite 800

Dallas, Texas 75225

(214) 874-2323

A WARNING ABOUT FORWARD-LOOKING STATEMENTS

This prospectus contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements include, without limitation, any statement that may predict, forecast, indicate or imply future results, performance or achievements, and may contain the words believe, anticipate, expect, estimate, intend, will be, will likely continue, will likely result, phrases of similar meaning. Forward-looking statements are based largely on the expectations of management and, as discussed in our filings with the Securities and Exchange Commission (the SEC), are subject to a number of risks and uncertainties including, but not limited to, the following:

- changes in general economic conditions;
- fluctuations in interest rates and levels of mortgage prepayments;
- the effectiveness of risk management strategies;
- the impact of differing levels of leverage employed;
- liquidity of secondary markets and credit markets;
- the availability of financing at reasonable levels and terms to support investing on a leveraged basis;
- the availability of new investment capital;
- the availability of suitable qualifying investments from both an investment return and regulatory perspective;
- changes in legislation or regulation affecting exemptions for mortgage REITs from regulation under the Investment Company Act of 1940;

- changes in legislation or regulation affecting Fannie Mae, Freddie Mac and similar federal government agencies and related guarantees;

- deterioration in credit quality and ratings of existing or future issuances of Fannie Mae, Freddie Mac or Ginnie Mae securities; and

- increases in costs and other general competitive factors.

In addition to the above considerations, actual results and liquidity are affected by other risks and uncertainties which could cause actual results to be significantly different from those expressed or implied by any forward-looking statements included herein. It is not possible to identify all of the risks, uncertainties and other factors that may affect future results. In light of these risks and uncertainties, the forward-looking events and circumstances discussed herein may not occur and actual results could differ materially from those anticipated or implied in the forward-looking statements. Forward-looking statements speak only as of the date the statement is made, and we undertake no obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise. Accordingly, readers of this document are cautioned not to place undue reliance on any forward-looking statements included herein.

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OUR COMPANY

We are a self-managed real estate investment trust, or REIT, formed in 1985 and based in Dallas, Texas. We earn income from investing in a leveraged portfolio of residential mortgage pass through securities consisting almost exclusively of adjustable-rate mortgage, or ARM, securities issued and guaranteed by government-sponsored enterprises, either Fannie Mae or Freddie Mac, together the GSEs, or by an agency of the federal government, Ginnie Mae. Residential mortgage pass-through securities guaranteed by the GSEs or Ginnie Mae are referred to as Agency Securities and are considered to have limited, if any, credit risk, particularly in light of the conservatorship of the GSEs by the federal government.

Our investment strategy is to manage a conservatively leveraged portfolio of ARM Agency securities that can produce attractive risk-adjusted returns over the long term, while reducing, but not eliminating, sensitivity to changes in interest rates. This strategy differentiates us from our peers because ARM securities reset to more current interest rates within a relatively short period of time allowing for the recovery of financing spreads diminished during periods of rising interest rates and smaller fluctuations in portfolio values from changes in interest rates compared to portfolios that contain a significant amount of fixed-rate mortgage securities. From a credit-risk perspective, the credit quality of Agency Securities helps ensure that fluctuations in value due to credit risk should be limited and financing at reasonable rates and terms should remain available under stressed market conditions.

We and our qualified REIT subsidiaries have elected to be taxed as a REIT under the Internal Revenue Code of 1986, as amended (the Code), and intend to continue to do so. As a result of this election, we and our qualified REIT subsidiaries are not taxed at the corporate level on taxable income distributed to stockholders, provided that certain REIT qualification tests are met. Certain of our affiliates, which may be consolidated with us for financial reporting purposes, may not be consolidated for federal income tax purposes because such entities may elect taxable REIT subsidiary tax status. All taxable income of any such taxable REIT subsidiaries would be subject to federal and state income taxes, where applicable.

Our principal executive offices are located at 8401 N. Central Expressway, Suite 800, Dallas, Texas 75225. Our telephone number is (214) 874-2323. Our website is http://www.capstead.com. The contents of our website are not a part of this prospectus. Our shares of common stock are traded on the New York Stock Exchange, or the NYSE, under the symbol CMO.

RISK FACTORS

An investment in our securities involves various risks. You should carefully consider the following risk factors in conjunction with the other information contained in this prospectus before purchasing our securities. The risks discussed herein can adversely affect our business, liquidity, operating results, financial condition and future prospects, causing the market price of our securities to decline, which could cause an investor to lose all or part of his/her investment. The risk factors described below are not the only risks that may affect us. Additional risks and uncertainties not presently known to us also may adversely affect our business, liquidity, operating results, prospects and financial condition.

Risks Related to Our Business

Potential changes in the relationship between the federal government and the GSEs could negatively affect our liquidity, financial condition and earnings. Agency Securities are considered to have limited, if any, credit risk because the timely payment of principal and interest on these securities are guaranteed by the GSEs, or by an agency of the federal government, Ginnie Mae. Only the guarantee by Ginnie Mae is explicitly backed by the full faith and credit of the federal government. The high actual or perceived credit quality of Agency Securities allows us to finance our portfolio using repurchase arrangements with relatively low interest rate terms and margin requirements that otherwise would not be available. As a result of deteriorating housing market conditions that began in 2007, the GSEs have incurred substantial losses due to high levels of mortgagor defaults, which are ongoing. In 2008, the Federal Housing Finance Agency placed the GSEs into conservatorship, allowing it to operate the GSEs without forcing them to liquidate. Additionally, the federal government, through the U.S. Treasury and the Federal Reserve, undertook other actions to provide financial support to these entities and the housing market including committing to ensure the GSEs maintain a positive net worth through 2012 through the purchase of preferred stock, the acquisition by early 2010 of $1.25 trillion in Agency Securities and the subsequent reinvestment of related runoff into additional holdings of Agency Securities. These and other steps taken by the federal government were designed to support market stability and mortgage availability at favorable rates by providing additional confidence to investors in Agency Securities. There can be no assurance that the federal government s support for the GSEs and the market for Agency Securities will continue to be adequate to achieve these goals.

It is anticipated that over the next several years U.S. policy makers will address what the long-term role of the federal government in general, and the GSEs in particular, will play in the housing markets. The actual or perceived credit quality of Agency Securities could be negatively affected by market uncertainty over any legislative or regulatory initiatives that impact the relationship between the GSEs and the federal government. A significantly reduced role by the federal government or other changes in the guarantees provided by Ginnie Mae, the GSEs or their successors could negatively affect the credit profile and pricing of existing holdings and/or future issuances of Agency Securities and whether our strategy of holding a leveraged portfolio of Agency Securities remains viable, which could negatively affect earnings and book value per common share. In addition, the timing of any sales of Agency Securities held by the Federal Reserve or the GSEs could create volatility in the market pricing of these investments, which could negatively affect book value per common share.

Failure of the federal government to reduce future federal budget deficits could negatively impact our liquidity, financial condition and earnings. Federal budget deficit concerns have increased the possibility of a decrease in the market s perception of the creditworthiness of debt securities issued by or guaranteed by the federal government and of further credit rating agency actions to downgrade the federal government s credit rating. Because the GSEs are relying on federal government support, the perception of credit risk associated with Agency Securities and, therefore, the value of our holdings of Agency Securities could be negatively affected. In addition, these circumstances could create broader financial turmoil and uncertainty, which may weigh heavily on the global banking system and limit the availability of borrowings under repurchase arrangements at reasonable terms which could negatively impact our liquidity, financial condition and earnings.

Legislative and regulatory actions by the federal government could negatively affect the availability or terms of financing under standard repurchase arrangements. In July 2010 the U.S. Congress enacted the Dodd Frank Wall Street Reform and Consumer Protection Act (Dodd Frank) in order to restrict certain business practices of systemically significant participants in the financial markets, which include most of our lending counterparties. Additionally, Dodd Frank places restrictions on residential mortgage loan originations and reforms the asset-backed securitization markets most notably by imposing credit risk retention requirements. It remains unclear how significant of an impact Dodd Frank will have on the financial markets in general and on our strategy of holding a leveraged portfolio of Agency Securities. However, it is possible that the availability or terms of financing using repurchase arrangements could be negatively affected which could negatively impact our liquidity, financial condition and earnings.

Government-supported mortgagor relief programs could negatively affect our earnings and book value per common share. U.S. policy makers have established programs designed to provide qualified homeowners with assistance in avoiding foreclosure or in qualifying for the refinancing of their existing mortgages, which typically entails the pay off of existing mortgages with any losses absorbed by the GSEs. One of these programs, the Home Affordable Refinance Program (HARP), has been revised with the intent of increasing its availability to homeowners who are current on their mortgage payments but whose homes have lost significant value making it difficult to qualify for a new mortgage. A significant expansion of these mortgagor relief programs, as well as any future legislative or regulatory actions, could significantly reduce the expected life of our residential mortgage investments; therefore, actual yields we realize on these investments could be lower due to faster amortization of investment premiums. A significant expansion of these programs also could adversely impact book value per common share because of the elimination of any unrealized gains on that portion of the portfolio that prepays. Additionally, heightened prepayment exposure due to the real or perceived potential for government intervention could adversely impact pricing for Agency Securities and, as a result, book value could be adversely affected due to declines in the fair value of our portfolio.

An increase in prepayments may adversely affect our earnings and book value per common share. When short- and long-term interest rates are at nearly the same levels (i.e., a flat yield curve environment), or when long-term interest rates decrease, the rate of principal prepayments on mortgage loans underlying mortgage securities generally increases. Prolonged periods of high mortgage prepayments can significantly reduce the expected life of our investments; therefore, actual yields we realize can be lower due to faster amortization of investment premiums, which could adversely affect earnings. Additionally, periods of high prepayments can adversely affect pricing for Agency Securities and, as a result, book value per common share can be adversely affected due to declines in the fair value of our portfolio and the elimination of any unrealized gains on that portion of the portfolio that prepays.

Changes in interest rates, whether increases or decreases, may adversely affect our earnings. Our earnings currently depend primarily on the difference between the interest received on our residential mortgage investments and the interest paid on our related borrowings, net of the effect of derivatives held for hedging purposes. We typically finance our investments at 30- to 90-day interest rates. Coupon interest rates on only a portion of the ARM loans underlying our securities reset each month and the terms of these ARM loans generally limit the amount of any increases during any single interest rate adjustment period and over the life of a loan. Consequently, interest rates on related borrowings not hedged through the use of interest rate swap agreements can rise to levels that may exceed yields on these securities in a rising short-term interest rate environment. This can contribute to lower, or in more

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extreme circumstances, negative financing spreads and adversely affect earnings. At other times, during periods of relatively low short-term interest rates, declines in the indices used to determine coupon interest rate resets for ARM loans may negatively affect yields on our ARM securities as the underlying ARM loans reset at lower rates. If declines in these indices exceed declines in our borrowing rates, earnings would be adversely affected.

The lack of availability of suitable investments at attractive pricing may adversely affect our earnings. Pricing of investments is determined by a number of factors including interest rate levels and expectations, market liquidity conditions, and competition among investors for these investments, many of whom have greater financial resources and lower return requirements than we do. Additionally, in recent years the federal government, primarily through the Federal Reserve, has been an active buyer of Agency Securities which has had the effect of supporting, if not increasing, pricing for these securities. To the extent the proceeds from prepayments on our mortgage investments are not reinvested or cannot be reinvested at rates of return at least equal to the rates previously earned on those investments, our earnings may be adversely affected. Similarly, if proceeds from capital raising activities are not deployed or cannot be deployed at rates of return being earned on existing capital, earnings may be adversely affected. We cannot assure investors that we will be able to acquire suitable investments at attractive pricing and in a timely manner to replace portfolio runoff as it occurs or to deploy new capital as it is raised. Neither can we assure investors that we will maintain the current composition of investments, consisting primarily of ARM Agency Securities.

Periods of illiquidity in the mortgage markets may reduce amounts available to be borrowed under our repurchase arrangements due to declines in the perceived value of related collateral, which could negatively impact our financial condition and earnings. We generally finance our investments in mortgage securities by pledging them as collateral under uncommitted repurchase arrangements, the terms and conditions of which are negotiated on a transaction-by-transaction basis. The amount borrowed under a repurchase arrangement is limited to a percentage of the estimated market value of the pledged collateral and is specified at the inception of the transaction. The portion of the pledged collateral held by the lender that is not advanced under the repurchase arrangement is referred to as margin collateral and the resulting margin percentage is required to be maintained throughout the term of the borrowing. If the market value of the pledged collateral as determined by our lenders declines, we may be subject to margin calls wherein the lender requires us to pledge additional collateral to reestablish the agreed-upon margin percentage. Because market illiquidity tends to put downward pressure on asset prices, we may be presented with substantial margin calls during such periods. If we are unable or unwilling to pledge additional collateral, our lenders can liquidate our collateral, potentially under adverse market conditions, resulting in losses. At such times, we may determine that it is prudent to sell assets to improve our ability to pledge sufficient collateral to support our remaining borrowings, which could result in losses.

Periods of illiquidity in the mortgage markets may reduce the number of counterparties willing to lend to us or the amounts individual counterparties are willing to lend via repurchase arrangements. We will generally pledge our residential mortgage investments as collateral under uncommitted repurchase arrangements with numerous commercial banks and other financial institutions, both foreign and domestic, routinely with maturities of 30 to 90 days. Our ability to achieve our investment objectives depends on our ability to re-establish or roll maturing borrowings on a continuous basis. If a counterparty chooses not to roll a maturing borrowing, we must pay off the borrowing, generally with cash available from another repurchase arrangement entered into with another counterparty. For instance, a contraction in market liquidity is possible should Europe s sovereign debt problems deteriorate in a disorderly fashion, putting further financial pressures on large European banks, many of which are lending counterparties. If we determine that we do not have sufficient borrowing capacity with our counterparties, we could be forced to reduce our portfolio leverage by selling assets under potentially adverse market conditions, resulting in losses. This risk is increased if we rely significantly on any single counterparty for a significant portion of our repurchase arrangements. Under these conditions, we may determine that it is prudent to sell assets to improve our ability to pledge sufficient collateral to support our remaining borrowings, which could result in losses.

Periods of rising interest rates may reduce amounts available to be borrowed under our repurchase arrangements due to declines in the perceived fair value of related collateral, which could negatively impact our financial condition and earnings. Because rising interest rates tend to put downward pressure on financial asset prices, we may be presented with substantial margin calls during such periods. Additionally, lenders typically determine what fair value is assigned to collateral for margin call purposes, which can diverge from our perspective of fair value during stressed market conditions. If we are unable or unwilling to pledge additional collateral, our lenders can liquidate our collateral, potentially under adverse market conditions, resulting in losses. At such times we may determine that it is prudent to sell assets to improve our ability to pledge sufficient collateral to support our remaining borrowings, which could result in losses.

If we are unable to negotiate favorable terms and conditions on future repurchase arrangements with one or more of our counterparties, our liquidity, financial condition and earnings could be negatively impacted. The terms and conditions of

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each repurchase arrangement are negotiated on a transaction-by-transaction basis, and these borrowings generally are re-established, or rolled, at maturity. Key terms and conditions of each transaction include interest rates, maturity dates, asset pricing procedures and margin requirements. We cannot assure investors that we will be able to continue to negotiate favorable terms and conditions on our future repurchase arrangements. For instance, during periods of market illiquidity or due to perceived credit deterioration of the collateral pledged or the company itself, a lender may require that less favorable asset pricing procedures be employed, margin requirements be increased and/or may choose to limit or completely curtail lending to us. Under these conditions, we may determine it is prudent to sell assets to improve our ability to pledge sufficient collateral to support our remaining borrowings, which could result in losses.

Our use of repurchase arrangements to finance our investments may expose us to losses if a lending counterparty seeks bankruptcy protection, or otherwise defaults on its obligation to deliver pledged collateral back to us. Repurchase arrangements involve the sale and transfer of pledged collateral to the lending counterparty and a simultaneous agreement to repurchase the transferred assets at a future date. This may make it difficult for us to recover our pledged assets if a lender files for bankruptcy or otherwise fails to deliver pledged collateral back to us and subject us to losses to the extent of any margin amounts (pledged assets in excess of amounts borrowed) held by the lending counterparty.

Our use of repurchase arrangements to finance our investments may give our lending counterparties greater rights if we seek bankruptcy protection, exposing us to losses. Borrowings made under repurchase arrangements may qualify for special treatment under the U.S. Bankruptcy Code. If we filed for bankruptcy, our lending counterparties could avoid the automatic stay provisions of the U.S. Bankruptcy Code and liquidate pledged collateral without delay, which could result in losses.

We may sell assets for various reasons, including a change in our investment focus, which could increase earnings volatility. We may periodically sell assets to enhance our liquidity during periods of market illiquidity or rising interest rates or we may change our investment focus requiring us to sell some portion of our existing investments. Gains or losses resulting from any such asset sales, or from terminating any related longer-dated repurchase arrangements or interest rate swap agreements, will likely increase our earnings volatility.

We may invest in derivative financial instruments such as interest rate swap agreements to mitigate or hedge our interest rate risk, which may negatively affect our liquidity, financial condition or earnings. We may invest in such instruments from time to time with the goal of achieving more stable borrowing costs over an extended period. However, these activities may not have the desired beneficial impact on our liquidity, financial condition or earnings. For instance, the pricing of ARM securities and the pricing of related derivatives may deteriorate at the same time leading to margin calls by counterparties to both the borrowings supporting investments in ARM securities and the derivatives, negatively impacting our liquidity and financial condition. In addition, counterparties could fail to honor their commitments under the terms of the derivatives or have their credit quality downgraded impairing the value of the derivatives. In the event of any defaults by counterparties, we may have difficulty recovering our cash collateral receivable from our counterparties and may not receive payments provided for under the terms of the derivatives. Should we be required to sell our derivatives under such circumstances, we may incur losses. No such hedging activity can completely insulate us from the risks associated with changes in interest rates and prepayment rates.

Derivative financial instruments held may fail to qualify for hedge accounting introducing potential volatility to our earnings. We typically qualify derivative financial instruments held as cash flow hedges for accounting purposes in order to record the effective portion of the change in fair value of derivatives as a component of stockholders equity rather than in earnings. If the hedging relationship for any derivative held ceases to qualify for hedge accounting treatment for any reason, including failing to meet documentation and ongoing hedge effectiveness requirements, we would be required to record in earnings the total change in fair value of any such derivative. In addition, we could elect to no longer avail ourselves of cash flow hedge accounting for our derivative positions. Such a change could introduce a potentially significant amount of volatility to earnings reported by us.

We are dependent on our executives and employees and the loss of one or more of our executive officers could harm our business and prospects. As a self-managed REIT with 15 employees, we are dependent on the efforts of our key officers and employees, most of whom have significant experience in the mortgage industry. Although our named executive officers and many of our other employees are parties to severance agreements, our key officers and employees are not subject to employment agreements with non-compete clauses, nor have we acquired key man life insurance policies on any of these individuals. The loss of any of their services could have an adverse effect on our operations.

Risks Related to Our Status as a REIT and Other Tax Matters

If we do not qualify as a REIT, we will be subject to tax as a regular corporation and face substantial tax liability. We have elected to be taxed as a REIT for federal income tax purposes and intend to continue to so qualify. Qualification as a REIT involves the application of highly technical and complex Internal Revenue Code provisions for which only a limited number of judicial or administrative interpretations exist. Even a technical or inadvertent mistake could jeopardize our REIT status. Furthermore, new tax legislation, administrative guidance or court decisions, in each instance potentially with retroactive effect, could make it more difficult or impossible for us to qualify as a REIT.

If we fail to qualify as a REIT in any tax year, then:

- We would be taxed as a regular domestic corporation, which, among other things, means that we would be unable to deduct dividends paid to our stockholders in computing taxable income and would be subject to federal income tax on our taxable income at regular corporate rates;
- Any resulting tax liability could be substantial and would reduce the amount of cash available for distribution to stockholders, and we would not be required to make income distributions; and
- Unless we were entitled to relief under applicable statutory provisions, we would be disqualified from treatment as a REIT for the subsequent four taxable years and, as a result, our cash available for distribution to stockholders would be reduced during these years.

Even if we remain qualified as a REIT, we may face other tax liabilities that reduce our earnings. Even if we remain qualified for taxation as a REIT, we may be subject to certain federal, state and local taxes on our income and assets. For example, we:

- will be required to pay tax on any undistributed REIT taxable income,
- may be subject to the alternative minimum tax on any tax preference items, and
- may operate taxable REIT subsidiaries subject to tax on any taxable income earned.

Complying with REIT requirements may limit our ability to hedge effectively. The REIT provisions of the Code may limit our ability to hedge mortgage securities and related borrowings by requiring us to limit our income in each year from nonqualified hedges, together with any other income not generated from qualified real estate assets, to no more than 25% of gross income. In addition, we must limit our aggregate income from nonqualified hedging transactions, from providing certain services, and from other non-qualifying sources to not more than 5% of annual gross income. As a result, we may have to limit our use of advantageous hedging techniques. This could result in greater risks associated with changes in interest rates than we would otherwise incur. If we were to violate the 25% or 5% limitations, we may have to pay a penalty tax equal to the amount of gross income in excess of those limitations, multiplied by a fraction intended to reflect our profitability. If we fail to satisfy the REIT gross income tests we could lose our REIT status for federal income tax purposes unless the failure was due to reasonable cause and not due to willful neglect.

Complying with REIT requirements may cause us to forego otherwise attractive opportunities. To qualify as a REIT for federal income tax purposes, we must continually satisfy tests concerning, among other things, the sources of our income, the nature and diversification of our assets, the amounts that we distribute to our stockholders, and the ownership of our stock. We may be required to make distributions to stockholders at disadvantageous times or when we do not have funds readily available for distribution. As a result, compliance with the REIT requirements may hinder our ability to operate solely on the basis of maximizing profits.

Complying with REIT requirements may force us to liquidate otherwise attractive investments. To qualify as a REIT, we must also ensure that at the end of each calendar quarter at least 75% of the value of our assets consists of cash, cash items, United States government securities and qualified REIT real estate assets. The remainder of our investments in securities (other than government securities and qualified real estate assets) generally cannot include more than 10% of the outstanding voting securities of any one issuer or more than 10% of the total value of the outstanding securities of any one issuer. In addition, in general, no more than 5% of the value of our assets (other than government securities and qualified real estate assets) can consist of the securities of any one issuer, and no more than 25% of the value of our total securities can be represented by securities of one or more taxable REIT subsidiaries. If we fail to comply with these requirements at the end of any calendar quarter, we must correct such failure within 30 days after the end of the calendar quarter to avoid losing our REIT status and suffering adverse tax consequences. As a result, we may be required to liquidate otherwise attractive investments.

Complying with REIT requirements may force us to borrow to make distributions to stockholders. As a REIT, we must distribute at least 90% of our annual taxable income (subject to certain adjustments) to our stockholders. To the extent that we satisfy the distribution requirement, but distribute less than 100% of our taxable income, we will be subject to federal corporate income tax on our undistributed taxable income. In addition, we will be subject to a 4% nondeductible excise tax if the actual amount that we pay out to our stockholders in a calendar year is less than a minimum amount specified under the federal tax laws. From time to time, we may generate taxable income greater than our net income for financial reporting purposes or our taxable income may be greater than our cash flow available for distribution to stockholders. If we do not have other funds available in these situations, we could be required to borrow funds, sell investments at disadvantageous prices or find another alternative source of funds to make distributions sufficient to enable us to pay out enough of our taxable income to satisfy the distribution requirement and to avoid corporate income tax or the 4% excise tax in a particular year. These alternatives could increase our costs or reduce our long-term investment capital.

We may be subject to adverse legislative or regulatory tax changes that could reduce the market price of our securities. At any time, the federal income tax laws governing REITs or the administrative interpretations of those laws may change. Any such changes in laws or interpretations thereof may apply retroactively and could adversely affect us or our stockholders. We cannot predict any impact on the value of our securities from adverse legislative or regulatory tax changes.

An investment in our securities has various federal, state and local income tax risks that could affect the value of your investment. We strongly urge you to consult your own tax advisor concerning the effects of federal, state and local income tax law on an investment in our securities, because of the complex nature of the tax rules applicable to REITs and their stockholders.

Risk Factors Related to Our Corporate Structure

There are no assurances of our ability to pay dividends in the future. We intend to continue paying quarterly dividends and to make distributions to our stockholders in amounts such that all or substantially all of our taxable income in each year, subject to certain adjustments, is distributed. This, along with other factors, should enable us to qualify for the tax benefits accorded to a REIT under the Internal Revenue Code. However, our ability to pay dividends may be adversely affected by the risk factors described in this filing. All distributions will be made at the discretion of our board of directors and will depend upon our earnings, our financial condition, maintenance of our REIT status and such other factors as the board may deem relevant from time to time. There are no assurances of our ability to pay dividends in the future.

Failure to maintain an exemption from the Investment Company Act of 1940 would adversely affect our results of operations. The Investment Company Act of 1940 (the 40 Act) exempts from regulation as an investment company any entity that is primarily engaged in the business of purchasing or otherwise acquiring mortgages and other liens on, and interests in, real estate. We believe that we conduct our business in a manner that allows us to avoid registration as an investment company under the 40 Act. For over 30 years, the staff of the SEC has interpreted the provisions of the 40 Act to require, among other things, a REIT to maintain at least 55% of its assets directly in qualifying real estate interests and at least 80% of its assets in real estate-related assets in order to be exempt from regulation as an investment company. Critical to our exemption from regulation as an investment company is the long-standing staff interpretation that so called whole loan mortgage securities, in which an investor holds all issued certificates with respect to an underlying pool of mortgage loans, constitutes a qualifying real estate interest for purposes of the staff s 55% qualifying real estate interest requirement. Conversely, so called partial pool mortgage securities presently do not qualify for purposes of meeting the 55% requirement, although they are considered by the staff to be real estate-related assets for purposes of meeting the staff s 80% real estate-related asset requirement.

In August 2011, the staff issued a request for information (Concept Release No. IC-29778) from industry participants and investors regarding, among other things, its past interpretations of the 40 Act real estate exemption, including the interpretations described above, raising concerns that the SEC may issue a proposal for rulemaking that could overturn some of its past interpretations regarding the real estate exemption. If the SEC or its staff adopts contrary interpretations of the 40 Act and we become subject to regulation as an investment company, we would be unable to conduct business as described in this filing because our ability to use leverage would be substantially reduced. Absent a restructuring of our business operations to avoid such regulation, this could require the sale of most of our portfolio of Agency Securities under potentially adverse market conditions resulting in losses.

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Pursuant to our charter, our board of directors has the ability to limit ownership of our capital stock, to the extent necessary to preserve our REIT qualification. For the purpose of preserving our REIT qualification, our charter gives the board the ability to repurchase outstanding shares of our capital stock from existing stockholders if the directors determine in good faith that the concentration of ownership by such individuals, directly or indirectly, would cause us to fail to qualify or be disqualified as a REIT. Constructive ownership rules are complex and may cause the outstanding stock owned by a group of related individuals or entities to be deemed to be constructively owned by one individual or entity. As a result, the acquisition of outstanding stock by an individual or entity could cause that individual or entity to own constructively a greater concentration of our outstanding stock than is acceptable for REIT purposes, thereby giving the board the ability to repurchase any excess shares.

Because provisions contained in Maryland law and our charter may have an anti-takeover effect, investors may be prevented from receiving a control premium for their shares. Provisions contained in our charter and Maryland general corporation law can delay, defer or prevent a takeover attempt, which may prevent stockholders from receiving a control premium for their shares. For example, these provisions may defer or prevent tender offers for our common stock or purchases of large blocks of our common stock, thereby limiting the opportunities for our stockholders to receive a premium over then-prevailing market prices. These provisions include the following:

Repurchase Rights: Repurchase rights granted to our board in our charter limit related investors, including, among other things, any voting group, from owning common stock if the concentration owned would jeopardize our REIT status.

Classification of Preferred Stock: Our charter authorizes the board to issue preferred stock and establish the preferences and rights of any class of preferred stock issued. These actions can be taken without soliciting stockholder approval and could have the effect of delaying or preventing someone from taking control of us.

Statutory Provisions: We are subject to provisions of the Maryland statute restricting business combinations with interested stockholders and restricting voting rights of certain shares acquired in control share acquisitions. Our board has not taken any action to exempt us from these provisions.

Maryland statutory law provides that an act of a director relating to or affecting an acquisition or a potential acquisition of control of a corporation may not be subject to a higher duty or greater scrutiny than is applied to any other act of a director. Hence, directors of Maryland corporations may not be required to act in takeover situations under the same standards as apply in Delaware and certain other corporate jurisdictions.

There are risks associated with ownership of our Series A and B Preferred Stock. Risks associated with ownership of our preferred shares include:

Redemption Rights: Our preferred shares are redeemable by us, in whole or in part, at any time at cash redemption prices ($16.40 and $12.50 per share, respectively, for the Series A and B preferred shares) plus all accrued and unpaid dividends to the date of redemption, which may be less than prevailing market prices for these securities.

Limited Conversion Rights: Holders of our existing preferred stock may convert into shares of our common stock at any time; however, it may not be advantageous to do so given existing conversion ratios and current trading levels of our common stock.

Subordination: Our preferred stock is subordinate to all of our existing and future debt. None of the provisions relating to our existing preferred stock limit our ability to incur future debt. Future debt may include restrictions on our ability to pay dividends on, redeem or pay the liquidation preference on the existing shares of preferred stock.

Dilution through Issuance of Additional Preferred Stock: Our charter currently authorizes the issuance of up to 100 million shares of preferred stock in one or more series. The issuance of additional preferred stock on parity with or senior to existing shares of preferred stock would dilute the interests of the existing preferred stockholders, and could affect our ability to pay dividends on, redeem or pay the liquidation preference on the existing preferred stock. None of the provisions relating to existing preferred stock limit our ability to issue additional preferred stock on parity with existing shares of preferred stock.

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Limited Voting Rights: Voting rights as a holder of existing preferred stock are limited. Our common stock is currently the only class of stock carrying full voting rights. Voting rights for holders of existing preferred stock exist primarily with respect to (i) adverse changes in the terms of the existing preferred stock, (ii) the creation of additional classes or series of preferred stock that are senior to the existing preferred stock, (iii) any failure to pa