ANNALY CAPITAL MANAGEMENT INC
Form 10-Q
November 06, 2012

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

FOR THE QUARTERLY PERIOD ENDED: SEPTEMBER 30, 2012

OR

[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

FOR THE TRANSITION PERIOD FROM _______________ TO _________________

COMMISSION FILE NUMBER: 1-13447

ANNALY CAPITAL MANAGEMENT, INC.
(Exact name of Registrant as specified in its Charter)

MARYLAND	22-3479661
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification No.)

1211 AVENUE OF THE AMERICAS, SUITE 2902
NEW YORK, NEW YORK
(Address of principal executive offices)

10036
(Zip Code)

(212) 696-0100
(Registrant's telephone number, including area code)

Indicate by check mark whether the Registrant (1) has filed all documents and reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days: Yes X No___

Indicate by check mark whether the Registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes X No __

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of “accelerated filer and large accelerated filer” in Rule 12b-2 of the Exchange Act.

Large accelerated filer þ	Accelerated filer o	Non-accelerated filer o	Smaller reporting company o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).
Yes __ No X

APPLICABLE ONLY TO CORPORATE ISSUERS:

Indicate the number of shares outstanding of each of the issuer’s classes of common stock, as of the last practicable date:

Class	Outstanding at November 6, 2012
Common Stock, $.01 par value	974,964,290

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PART I

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION
(dollars in thousands, except share and per share amounts)

ASSETS	September 30, 2012 (Unaudited)	December 31, 2011(1)
Cash and cash equivalents	$ 2,264,854	$ 994,198
Reverse repurchase agreements	1,612,384	860,866
Investments, at fair value:		
U.S. Treasury Securities (including pledged assets of $2,242,039 and $352,820, respectively)	2,242,039	928,547
Securities borrowed	1,602,692	928,732
Agency mortgage-backed securities (including pledged assets of $105,841,340 and $90,406,535, respectively)	129,597,714	104,251,055
Agency debentures (including pledged assets of $774,437 and $567,383, respectively)	2,935,538	889,580
Investments in affiliates	224,899	211,970
Equity securities	-	3,891
Corporate debt, held for investment	64,928	52,073
Receivable for investments sold	470,266	-
Accrued interest and dividends receivable	434,026	409,023
Receivable from Prime Broker	3,272	3,272
Receivable for advisory and service fees (including from affiliates of $16,451 and $16,245, respectively)	20,271	19,550
Intangible for customer relationships (net of accumulated amortization of $7,177 and $5,432, respectively)	9,146	10,807
Goodwill	55,417	42,030
Other derivative contracts, at fair value	559	113
Other assets	38,595	24,295
Total assets	$ 141,576,600	$ 109,630,002
LIABILITIES AND STOCKHOLDERS' EQUITY		
Liabilities:		
U.S. Treasury Securities sold, not yet purchased, at fair value	$ 1,418,750	$ 826,912
Repurchase agreements	101,033,146	84,097,885
Securities loaned, at fair value	1,248,968	804,901
Payable for investments purchased	16,107,038	4,315,796
Convertible Senior Notes	999,749	539,913
Accrued interest payable	181,502	138,965
Dividends payable	487,237	552,806
Interest rate swaps, at fair value	2,926,461	2,552,687
Accounts payable and other liabilities	83,086	7,223
Total liabilities	124,485,937	93,837,088

6.00% Series B Cumulative Convertible Preferred Stock:

4,600,000 shares authorized, 0 and 1,331,849 shares issued and outstanding, respectively		-		32,272
Stockholders' Equity:				
7.875% Series A Cumulative Redeemable Preferred Stock: 7,412,500 authorized, issued and outstanding		177,088		177,088
7.625% Series C Cumulative Redeemable Preferred Stock: 12,650,000 and 0 authorized, respectively, 12,000,000 and 0 issued and outstanding, respectively		290,514		-
7.50% Series D Cumulative Redeemable Preferred Stock: 18,400,000 and 0 authorized, issued and outstanding, respectively		445,457		-
Common stock, par value $0.01 per share, 1,956,937,500 and 1,987,987,500 authorized, respectively, 974,799,779 and 970,161,647 issued and outstanding, respectively		9,748		9,702
Additional paid-in capital		15,144,200		15,068,870
Accumulated other comprehensive income (loss)		4,069,607		3,008,988
Accumulated deficit		(3,045,951)		(2,504,006)
Total stockholders' equity		17,090,663		15,760,642
Total liabilities, Series B Cumulative Convertible Preferred Stock and stockholders' equity	$	141,576,600	$	109,630,002

(1) Derived from the audited consolidated financial statements at December 31, 2011.

See notes to consolidated financial statements.

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ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(dollars in thousands, except share and per share amounts)
(Unaudited)

	For the Quarter Ended September 30,		For the Nine Months Ended September 30,	
	2012	2011	2012	2011
Interest income:				
Investments	$754,096	$926,558	$2,481,284	$2,713,141
U.S. Treasury Securities	4,588	2,302	13,403	13,624
Securities loaned	2,581	1,942	7,797	5,153
Total interest income	761,265	930,802	2,502,484	2,731,918
Interest expense:				
Repurchase agreements	158,150	109,014	411,643	311,780
Convertible Senior Notes	18,026	8,798	51,718	22,465
U.S. Treasury Securities sold, not yet purchased	3,739	2,109	12,184	11,867
Securities borrowed	1,978	1,496	6,136	4,081
Total interest expense	181,893	121,417	481,681	350,193
Net interest income	579,372	809,385	2,020,803	2,381,725
Other income (loss):				
Investment advisory and other fee income	21,034	20,828	63,729	58,745
Net gains (losses) on disposition of investments	142,172	91,668	317,308	126,189
Net loss on extinguishment of Convertible Senior Notes	(87,328)	-	(87,328)	-
Dividend income from affiliates	7,097	8,706	21,239	23,233
Net gains (losses) on trading assets	1,368	1,942	7,729	15,042
Net unrealized gain (losses) on interest-only Agency mortgage-backed securities	(33,563)	(39,321)	(28,789)	(39,045)
Income from underwriting	-	2,772	-	5,599
Subtotal	50,780	86,595	293,888	189,763
Realized gains (losses) on interest rate swaps(1)	(224,272)	(231,849)	(665,614)	(654,757)
Realized gains (losses) on termination of interest rate swaps	-	-	(2,385)	-
Unrealized gains (losses) on interest rate swaps	(104,197)	(1,505,333)	(373,773)	(1,802,968)
Subtotal	(328,469)	(1,737,182)	(1,041,772)	(2,457,725)
Total other income (loss)	(277,689)	(1,650,587)	(747,884)	(2,267,962)
Expenses:				
Compensation expense	52,310	57,629	164,860	151,911
Other general and administrative expenses	10,694	7,565	30,615	22,339
Total expenses	63,004	65,194	195,475	174,250
Income (loss) before income taxes and income from equity method investment in affiliate	238,679	(906,396)	1,077,444	(60,487)

Income taxes	(13,921)	(15,417)	(42,039)	(41,754)
Income from equity method investment in affiliate	-	-	-	1,140
Net income (loss)	224,758	(921,813)	1,035,405	(101,101)
Dividends on preferred stock	9,367	4,172	19,813	12,706
Net income (loss) available (related) to common shareholders	$215,391	$(925,985)	$1,015,592	$(113,807)
Net income (loss) available (related) per share to common shareholders:				
Basic	$0.22	$(0.98)	$1.04	$(0.14)
Diluted	$0.22	$(0.98)	$1.00	$(0.14)
Weighted average number of common shares outstanding:				
Basic	974,729,078	948,545,975	973,674,586	841,912,810
Diluted	997,007,829	948,545,975	1,035,365,251	841,912,810

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Dividends Declared Per Share of Common Stock	$0.50	$0.60	$1.60	$1.87
Net income (loss)	$224,758	$(921,813)	$1,035,405	$(101,101)
Other comprehensive income (loss):				
Unrealized gains (losses) on available-for-sale securities	798,269	1,115,325	1,377,737	2,020,737
Unrealized losses on interest rate swaps	-	-	-	14,298
Reclassification adjustment for net (gains) losses included in net income (loss)	(141,982)	(91,668)	(317,118)	(126,189)
Other comprehensive income (loss)	656,287	1,023,657	1,060,619	1,908,846
Comprehensive income (loss)	$881,045	$101,844	$2,096,024	$1,807,745

(1) Interest expense related to the Company's interest rate swaps is recorded in Realized gains (losses) on interest rate swaps on the Consolidated Statements of Comprehensive Income.

See notes to consolidated financial statements.

ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
(dollars in thousands, except per share data)
(Unaudited)

	7.875% Series A Cumulative Redeemable Preferred Stock	7.625% Series C Cumulative Redeemable Preferred Stock	7.50% Series D Cumulative Redeemable Preferred Stock	Common Stock Par Value	Additional Paid-In Capital	Accumulated Other Comprehensive Income	Accumulated Deficit	Total
BALANCE, DECEMBER 31, 2010	$177,088	-	-	$6,316	$9,175,245	$1,164,642	$(658,391)	$9,864,900
Net income (loss)	-	-	-	-	-	-	(101,101)	(101,101)
Other comprehensive income (loss)	-	-	-	-	-	1,908,846	-	1,908,846
Exercise of stock options	-	-	-	6	7,858	-	-	7,864
Stock option expense and long-term compensation expense	-	-	-	4	3,858	-	-	3,862
Conversion of Series B cumulative preferred stock	-	-	-	7	6,361	-	-	6,368
Net proceeds from direct purchase and dividend reinvestment	-	-	-	261	455,445	-	-	455,706
Net proceeds from follow-on offering	-	-	-	3,105	5,348,741	-	-	5,351,846
Contingent beneficial conversion feature on Convertible Senior Notes	-	-	-	-	44,853	-	-	44,853
Preferred Series A dividends declared $1.477 per share	-	-	-	-	-	-	(10,945)	(10,945)
Preferred Series B dividends declared $1.125 per share	-	-	-	-	-	-	(1,761)	(1,761)

Common dividends declared, $1.87 per share	-	-	-	-	-	-	(1,620,416)	(1,620,416)
BALANCE, SEPTEMBER 30, 2011	$177,088	-	-	$9,699	$15,042,361	$3,073,488	$(2,392,614)	$15,910,022
BALANCE, DECEMBER 31, 2011	$177,088	-	-	$9,702	$15,068,870	$3,008,988	$(2,504,006)	$15,760,642
Net income (loss)	-	-	-	-	-	-	1,035,405	1,035,405
Other comprehensive income (loss)	-	-	-	-	-	1,060,619	-	1,060,619
Exercise of stock options	-	-	-	5	6,056	-	-	6,061
Stock option expense and long-term compensation expense	-	-	-	-	3,857	-	-	3,857
Conversion of Series B cumulative preferred stock	-	-	-	40	32,232	-	-	32,272
Net proceeds from direct purchase and dividend reinvestment	-	-	-	1	1,978	-	-	1,979
Contingent beneficial conversion feature on 4% Convertible Senior Notes	-	-	-	-	19,738	-	-	19,738
Equity component on 5% Convertible Senior Notes	-	-	-		11,717			11,717
Offering expenses	-	-	-	-	(248)	-	-	(248)
Net proceeds from 7.625% Series C Cumulative Redeemable Preferred Stock offering	-	290,514	-	-	-	-	-	290,514
Net proceeds from 7.50% Series D Cumulative	-	-	445,457	-	-	-	-	445,457

Redeemable Preferred Stock offering								
Extinguishment of convertible debt	-	-	-	-				
Preferred Series A dividends declared $1.477 per share	-	-	-	-	-	-	(10,945)	(10,945)
Preferred Series B dividends declared $0.375 per share	-	-	-	-	-	-	(289)	(289)
Preferred Series C dividends declared $0.715 per share	-	-	-	-	-	-	(8,579)	(8,579)
Common dividends declared, $1.60 per share	-	-	-	-	-	-	(1,557,537)	(1,557,537)
BALANCE, SEPTEMBER 30, 2012	$177,088	$290,514	$445,457	$9,748	$15,144,200	$4,069,607	$(3,045,951)	$17,090,663

See notes to consolidated financial statements.

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ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(dollars in thousands)
(Unaudited)

	For the Quarters Ended		For the Nine Months Ended	
	September 30, 2012	September 30, 2011	September 30, 2012	September 30, 2011
Cash flows from operating activities:				
Net income (loss)	$224,758	$(921,813)	$1,035,405	$(101,101)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:				
Amortization of investment premiums and discounts, net	455,493	200,942	1,038,598	502,186
Amortization of intangibles	634	676	1,858	1,511
Amortization of deferred expenses	2,189	900	4,927	2,700
Amortization of contingent beneficial conversion feature and equity component on convertible senior notes	1,438	1,898	15,498	1,898
Net (gains) losses on disposal of investments	(142,172)	(91,668)	(317,308)	(126,189)
Net loss on extinguishment of 4% Convertible Senior Notes	87,328	-	87,328	-
Stock option and long-term compensation expense	997	1,403	3,857	3,862
Unrealized (gains) losses on interest rate swaps	104,197	1,505,333	373,773	1,802,968
Net unrealized (gains) losses on interest-only Agency mortgage-backed securities	33,563	39,321	28,789	39,045
Net (gains) losses on trading assets	(1,368)	(1,942)	(5,344)	(15,042)
Gain on investment in affiliate, equity method	-	-	-	(98)
Unrealized (gains) losses on equity securities	-	63	-	63
Proceeds from repurchase agreements from RCap	168,905,024	157,069,300	509,943,940	720,578,286
Payments on repurchase agreements from RCap	(166,150,546)	(156,683,356)	(502,959,819)	(719,466,382)
Proceeds from reverse repurchase agreements to RCap	113,457,928	27,610,583	299,139,881	132,302,897
Payments on reverse repurchase agreements to RCap	(113,053,067)	(27,359,741)	(299,884,954)	(131,634,729)
Proceeds from reverse repurchase agreements to Shannon	185,640	58,848	409,380	65,893
Payments on reverse repurchase agreements to Shannon	(177,414)	(76,140)	(415,825)	(88,213)
Proceeds from securities borrowed	26,397,098	12,445,883	45,821,749	14,898,651
Payments on securities borrowed	(26,534,463)	(12,978,764)	(46,495,709)	(15,734,785)
Proceeds from securities loaned	59,324,108	12,398,720	125,183,976	14,902,887
Payments on securities loaned	(59,188,247)	(11,938,989)	(124,739,909)	(14,213,667)
Proceeds from U.S. Treasury Securities	13,085,890	(5,303,369)	44,183,569	(18,193,311)
Payments on U.S. Treasury Securities	(13,407,718)	5,716,809	(45,248,472)	18,514,722
Net payments on derivatives	(648)	(1,771)	(18,108)	(4,545)
Net change in:				

Other assets	(3,226)	(4,795)	(1,072)	(4,110)
Accrued interest and dividend receivable	(4,812)	(22,148)	(16,942)	(62,792)
Advisory and service fees receivable	472	10	(721)	(3,484)
Accrued interest payable	6,683	5,618	42,537	12,605
Accounts payable and other liabilities	(11,767)	(4,058)	75,863	65,916
Net cash provided by (used in) operating activities	3,597,992	1,667,753	7,286,745	4,047,642
Cash flows from investing activities:				
Payments on purchases of Agency mortgage-backed securities and debentures	(21,398,098)	(17,054,754)	(59,518,222)	(49,344,466)
Proceeds from sales of Agency mortgage-backed securities and debentures	7,810,451	3,568,718	17,725,948	9,001,949
Principal payments on Agency mortgage-backed securities	9,943,910	5,074,528	25,197,941	14,429,098
Proceeds from Agency debentures called	327,385	288,925	1,177,548	906,523
Payments on purchase of corporate debt	(23,520)	-	(33,420)	(7,425)
Proceeds from corporate debt called	19,165	-	19,165	-
Principal payments on corporate debt	565	-	2,025	1,155
Net gains (losses) on other derivative securities	-	-	-	11,518
Earn out payment	-	-	(13,387)	-
Purchase of investment in affiliate	-	-	-	(57,500)
Purchase of customer relationships	-	-	-	(3,555)
Proceeds from sales of equity securities	-	(3,990)	4,048	(3,990)
Net cash provided by (used in) investing activities	(3,320,142)	(8,126,573)	(15,438,354)	(25,066,693)
Cash flows from financing activities:				
Proceeds from repurchase agreements	91,857,968	72,790,611	258,994,965	200,627,105
Principal payments on repurchase agreements	(90,340,097)	(65,127,815)	(249,043,825)	(180,776,641)
Proceeds from exercise of stock options	670	1,752	6,061	7,864
Net proceeds from Series C Preferred offering	-	-	290,514	-
Net proceeds from Series D Preferred offering	445,457	-	445,457	-
Net proceeds from issuance of 5% Convertible Senior Notes offering	-	-	727,500	-

Statement continued on following page.

Statement continued from previous page

Net proceeds from direct purchases and dividend reinvestments	1,134	-	1,979	455,706
Net payment from extinguishment of 4% Convertible Senior Notes	(357,220)	-	(357,220)	-
Net (payment) proceeds from follow-on offerings	(17)	2,410,435	(248)	5,351,846
Dividends paid	(545,265)	(544,141)	(1,642,918)	(1,455,589)
Net cash provided by (used in) financing activities	1,062,630	9,530,842	9,422,265	24,210,291
Net (decrease) increase in cash and cash equivalents	1,340,480	3,072,022	1,270,656	3,191,240
Cash and cash equivalents, beginning of period	924,374	401,844	994,198	282,626
Cash and cash equivalents, end of period	$2,264,854	$3,473,866	$2,264,854	$3,473,866
Supplemental disclosure of cash flow information:				
Interest received	$1,203,598	$1,107,518	$3,514,893	$3,168,555
Dividends received	$6,621	$8,230	$22,425	$23,170
Fees received	$21,506	$20,838	$63,008	$55,261
Interest paid (excluding interest paid on interest rate swaps)	$173,889	$116,641	$423,752	$345,485
Net interest paid on interest rate swaps	$224,155	$229,109	$665,508	$644,962
Taxes paid	$17,374	$17,919	$46,541	$43,595
Noncash investing activities:				
Receivable for Investments sold	$470,266	$402,817	$470,266	$402,817
Payable for Investments purchased	$16,107,038	$5,852,986	$16,107,038	$5,852,986
Net change in unrealized loss on available-for-sale securities and interest rate swaps, net of reclassification adjustment	$656,287	$1,023,657	$1,060,619	$1,908,846
Noncash financing activities:				
Dividends declared, not yet paid	$487,237	$581,752	$487,237	$581,752
Conversion of Series B cumulative preferred stock	-	$6,295	$32,272	$6,368
Contingent beneficial conversion feature on 4% Convertible Senior Notes	$(26,603)	$44,853	$19,738	$44,853
Equity component of 5% Convertible Senior Notes	$11,717	-	$11,717	-

See notes to consolidated financial statements.

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ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

1. ORGANIZATION AND SIGNIFICANT ACCOUNTING POLICIES

Annaly Capital Management, Inc. ("Annaly" or the "Company") was incorporated in Maryland on November 25, 1996. The Company commenced its operations of purchasing and managing an investment portfolio of mortgage-backed securities on February 18, 1997, upon receipt of the net proceeds from the private placement of equity capital, and completed its initial public offering on October 14, 1997. The Company is a real estate investment trust ("REIT") under the Internal Revenue Code of 1986, as amended. On June 4, 2004, the Company acquired Fixed Income Discount Advisory Company ("FIDAC"). FIDAC is a registered investment advisor and is a wholly owned taxable REIT subsidiary of the Company. On June 27, 2006, the Company made a majority equity investment in an affiliated investment fund (the "Fund"), which is now wholly owned by the Company. During the third quarter of 2008, the Company formed RCap Securities, Inc. ("RCap"). RCap was granted membership in the Financial Industry Regulatory Authority ("FINRA") on January 26, 2009, and operates as a broker-dealer. RCap is a wholly owned taxable REIT subsidiary of the Company. On October 31, 2008, the Company acquired Merganser Capital Management, Inc. ("Merganser"). Merganser is a registered investment advisor and is a wholly owned taxable REIT subsidiary of the Company. In 2010, the Company established Shannon Funding LLC ("Shannon"), which provides warehouse financing to residential mortgage originators in the United States. In 2010, the Company also established Charlesfort Capital Management LLC ("Charlesfort"), which engages in corporate middle market lending transactions. In 2011, FIDAC established FIDAC Europe Limited ("FIDAC Europe"), which provides advice on commercial real estate transactions, including sale-leaseback and single tenant net leased properties across Europe. In 2011, the Company established FIDAC FSI LLC ("FIDAC FSI"), which invested in trading securities. FIDAC FSI was liquidated in August 2012.

A summary of the Company's significant accounting policies follows:

Basis of Accounting

The accompanying consolidated financial statements and related notes of the Company have been prepared in accordance with accounting principles generally accepted in the United States ("U.S. GAAP"). In the opinion of management, all adjustments considered necessary for a fair presentation of the Company's consolidated financial position, results of operations and cash flows have been included and are of a normal and recurring nature.

Principles of Consolidation

The consolidated financial statements include the accounts of the Company, FIDAC, FIDAC Europe, FIDAC FSI, Merganser, RCap, Shannon, Charlesfort and the Fund. All intercompany balances and transactions have been eliminated in consolidation.

Cash and Cash Equivalents - Cash and cash equivalents include cash on hand and cash held in money market funds on an overnight basis.

Reverse Repurchase Agreements – The Company through RCap enters into reverse repurchase agreements as part of the RCap's matched book trading activity. Reverse repurchase agreements are recorded on trade date at the contract amount and are collateralized by mortgage-backed or other securities. Margin calls are made by RCap as necessary based on the daily valuation of the underlying collateral as compared to the contract price. The Company generates income from the spread between what is earned on the reverse repurchase agreements and what is paid on the matched repurchase agreements. The Company's policy is to obtain possession of collateral with a market value in excess of the principal amount loaned under reverse repurchase agreements. To ensure that the market value of the underlying collateral remains sufficient, collateral is valued daily, and the Company will require counterparties to deposit additional collateral, when necessary. All reverse repurchase activities are transacted under master repurchase agreements that give the Company the right, in the event of default, to liquidate collateral held and to offset receivables and payables with the same counterparty.

Securities borrowed and loaned transactions – RCap records securities borrowed and loaned transactions at fair value. Securities borrowed transactions require RCap to provide the counterparty with collateral in the form of cash. RCap receives collateral in the form of cash for securities loaned transactions. For these transactions, the fees received or paid by RCap are recorded as interest income or expense, respectively. On a daily basis, market value changes of securities borrowed or loaned against the collateral value and RCap may require counterparties to deposit additional collateral or may require RCap to return collateral pledged, when appropriate.

U.S. Treasury Securities — RCap's trades in U.S. Treasury securities consist of long and short positions on U.S Treasury notes and bonds. U.S. Treasury securities are classified as trading investments and are recorded on the trade date at cost. Changes in fair value are reflected in the Company's Consolidated Statement of Comprehensive Income. Generally RCap does not hold the U.S. Treasury bills, notes and bonds to maturity and realizes gains and losses from trading those positions. Interest income or expense on U.S Treasury notes and bonds is accrued based on the outstanding principal amount of those investments and their stated terms.

Investment Securities –Agency mortgage-backed securities, Agency debentures, and corporate debt are referred to herein as "Investment Securities." Although the Company generally intends to hold most of its Investment Securities until maturity, it may, from time to time, sell any of its Investment Securities as part of its overall management of its portfolio. Investment Securities classified as available-for-sale are reported at fair values estimated by management that are compared to independent sources for reasonableness, with unrealized gains and losses reported as a component of stockholders' equity. Investment Securities transactions are recorded on the trade date. Realized gains and losses on sales of Investment Securities are determined using the average cost method.

On April 1, 2011, the Company elected the fair value option for Agency interest-only mortgage-backed securities acquired on or after such date. These Agency interest-only mortgage-backed securities represent the Company's right to receive a specified proportion of the contractual interest flows of specific Agency mortgage-backed securities. Agency interest-only mortgage-backed securities acquired on or after April 1, 2011 are measured at fair value through earnings in the Company's Consolidated Statements of Comprehensive Income. The interest-only securities are included in Agency mortgage-backed securities at fair value on the accompanying Consolidated Statements of Financial Condition.

Agency Mortgage-Backed Securities and Agency Debentures – The Company invests primarily in mortgage pass-through certificates, collateralized mortgage obligations and other mortgage-backed securities representing interests in or obligations backed by pools of mortgage loans, and certificates guaranteed by Ginnie Mae, Freddie Mac or Fannie Mae (collectively, "Agency mortgage-backed securities"). The Company also invests in Agency debentures issued by Federal Home Loan Bank ("FHLB"), Freddie Mac, and Fannie Mae.

Interest income from coupon payments is accrued based on the outstanding principal amount of the Investment Securities and their contractual terms. Premiums and discounts associated with the purchase of the Investment Securities are amortized into interest income over the projected lives of the securities using the interest method. The Company's policy for estimating prepayment speeds for calculating the effective yield is to evaluate historical performance, consensus prepayment speeds, and current market conditions. Adjustments are made for actual prepayment activity.

Equity Securities – The Company invests in equity securities that are classified as available-for-sale or trading. Equity securities classified as available-for-sale are reported at fair value, based on market quotes, with unrealized gains and losses reported as a component of stockholders' equity. Equity securities classified as trading are reported at fair value, based on market quotes, with unrealized gains and losses reported in the Consolidated Statement of Comprehensive Income. Dividends are recorded in earnings based on the declaration date.

Other-Than-Temporary Impairment – Management evaluates available-for-sale securities for other-than-temporary impairment at least quarterly, and more frequently when economic or market concerns warrant such evaluation. The Company determines if it (1) has the intent to sell the securities, (2) is more likely than not that it will be required to sell the securities before recovery, or (3) does not expect to recover the entire amortized cost basis of the securities. Further, the security is analyzed for credit loss (the difference between the present value of cash flows expected to be collected and the amortized cost basis). The credit loss, if any, will then be recognized in the Consolidated Statements of Comprehensive Income, while the balance of losses related to other factors will be recognized as a component of stockholders' equity. There was no other-than-temporary impairment for the quarters and nine months ended September 30, 2012 and 2011.

Derivative Instruments – The Company accounts for interest rate swaps at fair value as either assets or liabilities on the Consolidated Statements of Financial Condition. Changes in the fair value of interest rate swaps are recognized in earnings. The Company uses interest rate swaps to manage its exposure to changing interest rates on its repurchase agreements. Net payments on interest rate swaps are included in the Consolidated Statements of Cash Flows as a component of operating activities.

The Company elected to net, by counterparty, the fair value of interest rate swap contracts. These contracts contain legally enforceable provisions that allow for netting or setting off swap receivables and payables with each counterparty and, therefore, the fair value of those swap contracts are netted by counterparty. The credit support annex provisions of the Company's interest rate swap contracts allow the parties to mitigate their credit risk by requiring the party which is out of the money to post collateral. As the Company elected to net by counterparty the fair value of interest rate swap contracts, it also nets by counterparty any collateral exchanged as part of the interest rate swap contracts. Substantially all collateral is non-cash collateral under these contracts. In addition, the Company's agreements with certain of its counterparties with whom it has both interest rate swap contracts and master repurchase agreements contain legally enforceable provisions that allow for netting or setting off, on an aggregate basis, all receivables, payables and collateral postings required under both the interest rate swap contract and the master repurchase agreement with respect to each such counterparty.

RCap primarily enters into exchange traded U.S. interest rate, equity index, and FX futures and options contracts as well as German interest rate futures contracts for speculative or hedging purposes. RCap maintains a margin account which is settled daily with futures and options commission merchants. Changes in the unrealized gains or losses on the futures and options contracts are reflected in the Company's Consolidated Statements of Comprehensive Income. Unrealized gains (losses) are excluded from net income (loss) in arriving at cash flows from operating activities in the Consolidated Statements of Cash Flows.

Credit Risk – The Company has limited its exposure to credit losses on its portfolio of Agency mortgage-backed securities by only purchasing securities issued by Freddie Mac, Fannie Mae or Ginnie Mae and Agency debentures issued by the FHLB, Freddie Mac and Fannie Mae. The payment of principal and interest on the Freddie Mac and Fannie Mae Agency mortgage-backed securities are guaranteed by those respective agencies, and the payment of principal and interest on Ginnie Mae Agency mortgage-backed securities are backed by the full faith and credit of the U.S. government. Principal and interest on Agency debentures are guaranteed by the agency issuing the debenture. Substantially all of the Company's Investment Securities have an actual or implied "AAA" rating. The Company faces credit risk on the portions of its portfolio which are not Agency mortgage-backed securities and Agency debentures.

Market Risk - Weakness in the mortgage market may adversely affect the performance and market value of the Company's investments. This could negatively impact the Company's net book value. Furthermore, if many of the Company's lenders are unwilling or unable to provide additional financing, the Company could be forced to sell its Investment Securities at an inopportune time when prices are depressed. The Company does not anticipate having difficulty converting its assets to cash or extending financing terms due to the fact that its Agency mortgage-backed securities and Agency debentures have an actual or implied "AAA" rating and principal payment is guaranteed by Freddie Mac, Fannie Mae, or Ginnie Mae.

Repurchase Agreements - The Company finances the acquisition of a significant portion of its Agency mortgage-backed securities with repurchase agreements. None of the Company's repurchase agreements are accounted for as components of linked transactions. The Company examines each of the specified criteria in Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") 860, Transfers and Servicing, at the inception of each transaction and has determined that each of the financings meet the specified criteria in this guidance. As a result, the Company separately accounts for the financial assets and related repurchase financings in the accompanying consolidated financial statements.

Reverse repurchase agreements and repurchase agreements with the same counterparty and the same maturity are presented net in the Consolidated Statements of Financial Condition when the terms of the agreements permit netting. The Company reports cash flows on repurchase agreements as financing activities in the Consolidated Statements of Cash Flows. The Company reports cash flows on repurchase agreements entered into by RCap and Shannon as operating activities in the Consolidated Statements of Cash Flows.

Convertible Senior Notes – The Company records the 4% Convertible Senior Notes and 5% Convertible Senior Notes (collectively, the "Convertible Senior Notes") at their contractual amounts, adjusted by the effects of a beneficial conversion feature and a contingent beneficial conversion feature. This intrinsic value is included in "Additional paid-in capital" on the Company's Consolidated Statements of Financial Condition and reduces the liability associated with the Convertible Senior Notes.

The Convertible Senior Notes have a conversion price adjustment feature that is evaluated at the time of the conversion price adjustment. A contingent beneficial conversion feature may be recognized as a result of adjustments to the conversion price for dividends declared. The Company determined the intrinsic value of a contingent beneficial conversion feature.

Cumulative Convertible Preferred Stock - The Series B Cumulative Convertible Preferred Stock (the "Series B Preferred Stock") contains fundamental change provisions that allow the holder to redeem the Series B Preferred Stock for cash if certain events occur. As redemption under these provisions is not solely within the Company's control, for the periods that the Company had Series B Preferred Stock issued and outstanding, the Company classified the Series B Preferred Stock as temporary equity in the accompanying Consolidated Statements of Financial Condition. As of September 30, 2012, there were no shares outstanding of Series B Preferred Stock.

Income Taxes - The Company has elected to be taxed as a REIT and intends to comply with the provisions of the Internal Revenue Code of 1986, as amended (the "Code"), with respect thereto. Accordingly, the Company will not be subjected to federal income tax to the extent of its distributions to shareholders and as long as certain asset, income and stock ownership tests are met. The Company and its direct and indirect subsidiaries, FIDAC, FIDAC Europe, Merganser and RCap, have made separate joint elections to treat these subsidiaries as taxable REIT subsidiaries. As such, each of the taxable REIT subsidiaries are taxable as a domestic C corporation and subject to federal, state, and local income taxes based upon their taxable income. FIDAC Europe is located in Europe and is not currently required to pay United States income taxes.

The provisions of ASC 740, Income Taxes, clarify the accounting for uncertainty in income taxes recognized in financial statements and prescribe a recognition threshold and measurement attribute for tax positions taken or expected to be taken on a tax return. ASC 740 also requires that interest and penalties related to unrecognized tax benefits be recognized in the financial statements. The Company does not have any unrecognized tax benefits that would affect its financial position. Thus, no accruals for penalties and interest were necessary as of September 30, 2012.

Goodwill and Intangible Assets - The Company's acquisitions of FIDAC and Merganser and FIDAC Europe's acquisition of certain assets were accounted for using the acquisition method. Under the acquisition method, net assets and results of operations of acquired companies are included in the consolidated financial statements from the date of acquisition. The costs of FIDAC and Merganser were allocated to the assets acquired, including identifiable intangible assets, and the liabilities assumed based on their estimated fair values at the date of acquisition. The excess of purchase price over the fair value of the net assets acquired was recognized as goodwill. In addition, FIDAC Europe acquired a customer relationship after its formation. Goodwill and intangible assets are periodically (but not less frequently than annually) reviewed for potential impairment. Intangible assets with an estimated useful life are amortized over the expected life. During the quarters and nine months ended September 30, 2012 and 2011, there were no impairment losses recognized related to goodwill and intangible assets.

Stock-Based Compensation - The Company is required to measure and recognize in the consolidated financial statements the compensation cost relating to share-based payment transactions. The Company recognizes compensation expense on a straight-line basis over the requisite service period for the entire award.

Use of Estimates - The preparation of the consolidated financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. All assets classified as trading or available-for-sale and interest rate swaps are reported at their estimated fair value, based on market prices. The Company's policy is to obtain fair values from one or more independent sources to compare to internal prices for reasonableness. Actual results could differ from those estimates.

A Summary of Recent Accounting Pronouncements Follows:

Presentation

Balance Sheet (Topic 210)

On December 23, 2011, the FASB released Accounting Standards Update ("ASU") 2011-11, Balance Sheet (Topic 210): Disclosures about Offsetting Assets and Liabilities. Under this update, the Company will be required to disclose both gross information and net information about both instruments and transactions eligible for offset in the statement of financial position and transactions subject to an agreement similar to a master netting arrangement. The scope would include derivatives, sale and repurchase agreements and reverse sale and repurchase agreements and securities borrowing and securities lending arrangements. This disclosure is intended to enable financial statement users to understand the effect of such arrangements on the Company's financial position. The objective of this update is to support further convergence between U.S. GAAP and International Financial Reporting Standards ("IFRS"). This update is effective for annual reporting periods beginning on or after January 1, 2013. This update is expected to result in additional disclosure.

Comprehensive Income (Topic 220)

In June 2011, the FASB released ASU 2011-05 Comprehensive Income: Presentation of Comprehensive Income, which attempts to improve the comparability, consistency, and transparency of financial reporting and increase the prominence of items reported in other comprehensive income ("OCI"). ASU 2011-05 requires that all non-owner changes in stockholders' equity be presented either in a single continuous statement of net income and comprehensive income or two separate consecutive statements. Either presentation requires the presentation on the face of the financial statements any reclassification adjustments for items that are reclassified from OCI to net income in the statements. There is no change in what must be reported in OCI or when an item of OCI must be reclassified to net income. This update is effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. This update resulted in additional disclosure, but had no significant effect on the Company's consolidated financial statements.

On December 23, 2011, the FASB issued ASU 2011-12, Comprehensive Income: Deferral of Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income In ASU No. 2011-05, which defers those changes in ASU 2011-05 that relate to the presentation of reclassification adjustments out of accumulated OCI. This was done to allow the FASB time to re-deliberate the presentation on the face of the financial statements the effects of reclassifications out of accumulated OCI on the components of net income and OCI. No other requirements under ASU 2011-05 are affected by ASU 2011-12. FASB tentatively decided not to require presentation of reclassification adjustments out of accumulated other comprehensive income on the face of the financial statements and to propose new disclosures instead.

Assets

Intangibles – Goodwill and Other (Topic 350)

In September 2011, the FASB released ASU 2011-08, Intangibles-Goodwill and Other: Testing Goodwill for Impairment, which allows an entity to first assess qualitative factors to determine whether it is necessary to perform the two-step quantitative goodwill impairment test. The objective of the update is to simplify how entities test goodwill for impairment. Under this update, an entity is not required to calculate the fair value of a reporting unit unless the entity determines that it is more likely than not that its fair value is less than its carrying amount. This update is effective for annual and interim goodwill impairment tests performed for fiscal years beginning after

December 15, 2011. This update had no significant impact on the Company's consolidated financial statements.

Broad Transactions

Fair Value Measurements and Disclosures (Topic 820)

In May 2011, the FASB released ASU 2011-04 Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRS, further converging U.S. GAAP and IFRS by providing common fair value measurement and disclosure requirements. FASB made changes to the fair value measurement guidance, which include: 1) prohibiting the inclusion of block discounts in all fair value measurements, not just Level 1 measurements, 2) adding guidance on when to include other premiums and discounts in fair value measurements, 3) clarifying that the concepts of "highest and best use" and "valuation premise" apply only when measuring the fair value of non-financial assets and 4) adding an exception that allows the measurement of a group of financial assets and liabilities with offsetting risks (e.g., a portfolio of derivative contracts) at their net exposure to a particular risk if certain criteria are met. ASU 2011-04 also requires additional disclosure related to items categorized as Level 3 in the fair value hierarchy, including a description of the processes for valuing these assets, providing quantitative information about the significant unobservable inputs used to measure fair value, and in certain cases, explaining the sensitivity of the fair value measurements to changes in unobservable inputs. This guidance is effective for interim and annual reporting periods beginning after December 15, 2011. The Company does not hold any Level 3 assets and therefore, this update has no significant effect on the Company's consolidated financial statements.

Transfers and Servicing (Topic 860)

In April 2011, the FASB issued ASU 2011-03, Transfers and Servicing: Reconsideration of Effective Control for Repurchase Agreements. In a typical repurchase agreement transaction, an entity transfers financial assets to the counterparty in exchange for cash with an agreement for the counterparty to return the same or equivalent financial assets for a fixed price in the future. Previous to this update, one of the factors in determining whether sale treatment could be used was whether the transferor maintained effective control of the transferred assets and in order to do so, the transferor must have the ability to repurchase such assets. In connection with the issuance of ASU 2011-03, the FASB concluded that the assessment of effective control should focus on a transferor's contractual rights and obligations with respect to transferred financial assets, rather than whether the transferor has the practical ability to perform in accordance with those rights or obligations. ASU 2011-03 removes the transferor's ability criterion from consideration of effective control. This update is effective for the first interim or annual period beginning on or after December 15, 2011. As the Company records repurchase agreements as secured borrowings and not sales, this update has no significant effect on the Company's consolidated financial statements.

Financial Services – Investment Companies (Topic 946)

In October 2011, the FASB issued a proposed ASU 2011-20, Financial Services-Investment Companies: Amendments to the Scope, Measurement, and Disclosure Requirements, which would amend the criteria in Topic 946 for determining whether an entity qualifies as an investment company. As proposed, this ASU would affect the measurement, presentation and disclosure requirements for Investment Companies, as defined, amend the investment company definition in ASC 946, and remove the current exemption for Real Estate Investment Trusts from this topic. If promulgated in its current form, this proposal may result in a material modification to the presentation of the Company's consolidated financial statements. The Company is monitoring developments related to this proposal and is evaluating the effects it would have on the Company's consolidated financial statements.

2. AGENCY MORTGAGE-BACKED SECURITIES

The following tables present the Company's available-for-sale Agency mortgage-backed securities portfolio as of September 30, 2012 and December 31, 2011 which were carried at their fair value:

September 30, 2012	Freddie Mac	Fannie Mae	Ginnie Mae	Total Mortgage-Backed Securities
	(dollars in thousands)			
Agency mortgage-backed securities, par value	$ 45,694,153	$ 74,191,691	$ 296,707	$ 120,182,551
Unamortized discount	(9,552)	(14,615)	(391)	(24,558)
Unamortized premium	2,009,836	3,443,390	24,344	5,477,570
Amortized cost	47,694,437	77,620,466	320,660	125,635,563
Gross unrealized gains	1,535,949	2,546,506	21,808	4,104,263
Gross unrealized losses	(17,193)	(124,164)	(755)	(142,112)
Estimated fair value	$ 49,213,193	$ 80,042,808	$ 341,713	$ 129,597,714

	Amortized Cost	Gross Unrealized Gain	Gross Unrealized Loss	Estimated Fair Value
	(dollars in thousands)			
Adjustable rate	$ 6,671,582	$ 289,871	$ (4,450)	$ 6,957,003
Fixed rate	118,963,981	3,814,392	(137,662)	122,640,711
Total	$ 125,635,563	$ 4,104,263	$ (142,112)	$ 129,597,714

December 31, 2011	Freddie Mac	Fannie Mae	Ginnie Mae	Total Mortgage Backed Securities
	(dollars in thousands)			
Agency mortgage-backed securities, par value	$ 34,395,542	$ 63,066,372	$ 500,968	$ 97,962,882
Unamortized discount	(9,874)	(13,632)	(399)	(23,905)
Unamortized premium	1,139,881	2,205,138	15,949	3,360,968
Amortized cost	35,525,549	65,257,878	516,518	101,299,945
Gross unrealized gains	973,476	2,081,282	31,474	3,086,232
Gross unrealized losses	(15,243)	(118,871)	(1,008)	(135,122)
Estimated fair value	$ 36,483,782	$ 67,220,289	$ 546,984	$ 104,251,055

	Amortized Cost	Gross Unrealized Gain	Gross Unrealized Loss	Estimated Fair Value

	(dollars in thousands)			
Adjustable rate	$ 8,698,746	$ 345,642	$ (3,188)	$ 9,041,200
Fixed rate	92,601,199	2,740,590	(131,934)	95,209,855
Total	$ 101,299,945	$ 3,086,232	$ (135,122)	$ 104,251,055

Actual maturities of Agency mortgage-backed securities are generally shorter than stated contractual maturities because actual maturities of Agency mortgage-backed securities are affected by the contractual lives of the underlying mortgages, periodic payments and prepayments of principal. The following table summarizes the Company's Agency mortgage-backed securities as of September 30, 2012 and December 31, 2011, according to their estimated weighted-average life classifications:

	September 30, 2012		December 31, 2011	
Weighted-Average Life	Fair Value	Amortized Cost	Fair Value	Amortized Cost
	(dollars in thousands)			
Less than one year	$4,424,036	$4,379,206	$1,715,530	$1,697,101
Greater than one year through five years	124,868,825	120,967,061	97,344,791	94,534,782
Greater than five years through ten years	304,853	289,296	4,447,540	4,348,841
Greater than 10 years	-	-	743,194	719,221
Total	$129,597,714	$125,635,563	$104,251,055	$101,299,945

The weighted-average lives of the Agency mortgage-backed securities at September 30, 2012 and December 31, 2011 in the table above are based upon data provided through subscription-based financial information services, assuming constant principal prepayment rates to the reset date of each security. The prepayment model considers current yield, forward yield, steepness of the yield curve, current mortgage rates, mortgage rate of the outstanding loans, loan age, margin, volatility, and other factors. The actual weighted average lives of the Agency mortgage-backed securities could be longer or shorter than estimated.

The following table presents the gross unrealized losses and estimated fair value of the Company's Agency mortgage-backed securities by length of time that such securities have been in a continuous unrealized loss position at September 30, 2012 and December 31, 2011.

	Unrealized Loss Position For: (dollars in thousands)					
	Less than 12 Months		12 Months or More		Total	
	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses
September 30, 2012	$1,302,641	$(31,172)	$360,621	$(110,940)	$1,663,262	$(142,112)
December 31, 2011	$1,087,552	$(118,593)	$883,143	$(16,529)	$1,970,695	$(135,122)

The decline in value of these securities is solely due to market conditions and not the quality of the assets. Substantially all of the Company's Investment Securities are Agency mortgage-backed securities that are "AAA" rated or carry an implied "AAA" rating. The investments are not considered to be other-than-temporarily impaired because the Company currently has the ability and intent to hold the investments to maturity or for a period of time sufficient for a forecasted market price recovery up to or beyond the cost of the investments, and it is not more likely than not that the Company will be required to sell the investments before recovery of the amortized cost bases, which may be maturity. Also, the Company is guaranteed payment of the principal amount of the securities by the respective issuing government agency.

During the quarter and nine months ended September 30, 2012, the Company sold $7.0 billion and $17.9 billion of Agency mortgage-backed securities, respectively, resulting in a net realized gain of $142.0 million and $317.1 million, respectively. During the quarter and nine months ended September 30, 2011, the Company sold $3.6 billion and $8.5 billion of Agency mortgage-backed securities, respectively, resulting in a realized gain of $91.7 million and

$118.5 million, respectively. Average cost is used for calculating gains or losses on securities sold.

Agency interest-only mortgage-backed securities represent the right to receive a specified portion of the contractual interest flows of the underlying unamortized principal balance of specific Agency mortgage-backed securities. As of September 30, 2012, Agency interest-only mortgage-backed securities had net unrealized losses of $129.9 million and an amortized cost of $604.5 million.

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3. INVESTMENTS IN AFFILIATES, AVAILABLE FOR SALE EQUITY SECURITIES

Substantially all of the Company's available-for-sale equity securities are shares of Chimera Investment Corporation ("Chimera") and CreXus Investment Corp. ("CreXus") and are reported at fair value. The Company owned approximately 45.0 million shares of Chimera at September 30, 2012 and December 31, 2011 with a fair value of approximately $121.9 million and $112.9 million, respectively. At September 30, 2012 and December 31, 2011, the investment in Chimera had an unrealized loss of $16.9 million and $25.9 million, respectively. The Company owned approximately 9.5 million shares of CreXus at September 30, 2012 and December 31, 2011 with a fair value of approximately $103.0 million and $98.9 million, respectively. At September 30, 2012 and December 31, 2011, the investment in CreXus had an unrealized loss of $22.4 million and $26.5 million, respectively.

The Company has evaluated the near-term prospects of its investment in affiliates in relation to the severity and length of time of the impairment. Based on this evaluation, management has determined that its investment in affiliates is not considered to be other-than-temporarily impaired as of September 30, 2012 and December 31, 2011 as the Company has the intent and ability to retain its investments for a period of time sufficient to allow for any anticipated recovery in market value.

4. GOODWILL

Merganser's prior owners received an additional payment of $13.4 million during the first quarter of 2012 relating to earn-out provisions in the merger agreement. This amount was recorded as additional goodwill.

5. FAIR VALUE MEASUREMENTS

The Company follows fair value guidance in accordance with U.S. GAAP to account for its financial instruments. The Company categorizes its financial instruments, based on the priority of the inputs to the valuation technique, into a three-level fair value hierarchy. The fair value hierarchy gives the highest priority to quoted prices in active markets for identical assets or liabilities (Level 1) and the lowest priority to unobservable inputs (Level 3). If the inputs used to measure the financial instruments fall within different levels of the hierarchy, the categorization is based on the lowest level input that is significant to the fair value measurement of the instrument. Financial assets and liabilities recorded at fair value on the consolidated statements of financial condition or disclosed in the related notes are categorized based on the inputs to the valuation techniques as follows:

Level 1– inputs to the valuation methodology are quoted prices (unadjusted) for identical assets and liabilities in active markets.

Level 2 – inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument.

Level 3 – inputs to the valuation methodology are unobservable and significant to overall fair value.

Agency mortgage-backed securities, Agency debentures and interest rate swaps are valued using quoted prices, including dealer quotes, or internally estimated prices for similar assets. The Company incorporates common market pricing methods, including a spread measurement to the Treasury curve as well as underlying characteristics of the particular security including coupon, periodic and life caps, rate reset period and expected life of the security in its estimates of fair value. Management ensures that current market conditions are reflected in its estimates of fair value. Management compares internal prices to independent third party sources and dealer quotes for reasonableness.

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The fair value of U.S. Treasury securities, securities borrowed and loaned, investments in affiliates and equity investments are based on quoted prices in active markets.

	Level 1	Level 2	Level 3
At September 30, 2012	(dollars in thousands)		
Assets:			
U.S. Treasury Securities	$2,242,039	$-	$-
Securities borrowed	-	1,602,692	-
Agency mortgage-backed securities	-	129,597,714	-
Agency debentures	-	2,935,538	-
Investment in affiliates	224,899	-	-
Other derivative contracts	559	-	-
Liabilities:			
U.S. Treasury securities sold, not yet purchased	1,418,750	-	-
Interest rate swaps	-	2,926,461	-
Securities loaned	-	1,248,968	-

	Level 1	Level 2	Level 3
At December 31, 2011	(dollars in thousands)		
Assets:			
U.S. Treasury securities	$928,547	$-	$-
Securities borrowed	-	928,732	-
Agency mortgage-backed securities	-	104,251,055	-
Agency debentures	-	889,580	-
Investments in affiliates	211,970	-	-
Equity securities	3,891	-	-
Other derivative contracts	113	-	-
Liabilities:			
U.S. Treasury securities sold, not yet purchased	826,912	-	-
Interest rate swaps	-	2,552,687	-
Securities loaned	-	804,901	-

The following table summarizes the estimated fair value for all financial assets and liabilities as of September 30, 2012 and December 31, 2011.

	September 30, 2012		December 31, 2011	
	Carrying Value	Fair Value	Carrying Value	Fair Value
	(dollars in thousands)			
Financial assets:				
Cash and cash equivalents(1)	$2,264,854	$2,264,854	$994,198	$994,198
Reverse repurchase agreements(1)	1,612,384	1,612,384	860,866	860,866
U.S. Treasury Securities(2)	2,242,039	2,242,039	928,547	928,547
Securities borrowed(2)	1,602,692	1,602,692	928,732	928,732
Agency mortgage-backed securities	129,597,714	129,597,714	104,251,055	104,251,055
Agency debentures	2,935,538	2,935,538	889,580	889,580
Investment in affiliates(2)	224,899	224,899	211,970	211,970
Receivable from Prime Broker	3,272	3,272	3,272	3,272
Equity securities(2)	-	-	3,891	3,891
Corporate debt(3)	64,928	66,195	52,073	52,628
Other derivatives(2)	559	559	113	113
Financial liabilities:				
U.S. Treasury Securities sold, not yet purchased(2)	$1,418,750	$1,418,750	$826,912	$826,912
Repurchase agreements(1)(4)	101,033,146	101,634,836	84,097,885	84,369,817
Securities loaned(2)	1,248,968	1,248,968	804,901	804,901
Convertible Senior Notes(2)	999,749	1,180,525	539,913	685,500
Interest rate swaps	2,926,461	2,926,461	2,552,687	2,552,687

(1) The fair value of repurchase agreements with maturities less than one year approximates carrying value due to the short-term maturities of these items.

(2) Fair value is determined using end of day quoted prices in active markets.

(3) The carrying value of the corporate debt is based on amortized cost. Estimates of fair value of corporate debt require the use of significant judgments and inputs including, but not limited to, the enterprise value of the borrower (i.e., an estimate of the total fair value of the borrower's debt and equity), the nature and realizable value of any collateral, the borrower's ability to make payments when due and its earnings history. Management also considers factors that affect the macro and local economic markets in which the borrower operates.

(4) The fair value of repurchase agreements with maturities greater than one year are valued as pay fixed versus receive floating interest rate swaps.

6. REPURCHASE AGREEMENTS

The Company had outstanding $101.0 billion and $84.1 billion of repurchase agreements with weighted average borrowing rates of 1.52% and 1.59%, after giving effect to the Company's interest rate swaps, and weighted average remaining maturities of 213 days and 103 days as of September 30, 2012 and December 31, 2011, respectively. Investment Securities and U.S. Treasury Securities pledged as collateral under these repurchase agreements and interest rate swaps had an estimated fair value and accrued interest of $108.9 billion and $358.0 million at September 30, 2012, respectively, and $91.3 billion and $337.0 million at December 31, 2011, respectively.

At September 30, 2012 and December 31, 2011, the repurchase agreements had the following remaining maturities and weighted average rates:

	September 30, 2012		December 31, 2011	
	Repurchase Agreements	Weighted Average Rate	Repurchase Agreements	Weighted Average Rate
	(dollars in thousands)			
1 day	$ 3,585,234	0.28 %	$ 508,647	0.50 %
2 to 29 days	27,234,957	0.45 %	33,780,070	0.37 %
30 to 59 days	18,726,669	0.43 %	28,346,380	0.37 %
60 to 89 days	4,795,439	0.41 %	3,699,425	0.93 %
90 to 119 days	11,309,846	0.49 %	6,781,137	0.37 %
Over 120 days	35,381,001	0.93 %	10,982,226	1.39 %
Total	$ 101,033,146	0.61 %	$ 84,097,885	0.53 %

The Company did not have an amount at risk greater than 10% of the equity of the Company with any counterparty as of September 30, 2012 or December 31, 2011.

7. DERIVATIVE INSTRUMENTS

In connection with the Company's interest rate risk management strategy, the Company economically hedges a portion of its interest rate risk by entering into derivative financial instrument contracts. As of September 30, 2012, such instruments are comprised of interest rate swaps, which in effect modify the cash flows on repurchase agreements, or convert floating rate liabilities to fixed rates. The purpose of the swaps is to mitigate the risk of rising interest rates that affect the Company's cost of funds. The use of interest rate swaps creates exposure to credit risk relating to potential losses that could be recognized if the counterparties to these instruments fail to perform their obligations under the contracts. In the event of a default by the counterparty, the Company could have difficulty obtaining its Investment Securities pledged as collateral for swaps. The Company does not anticipate any defaults by its counterparties. The Company's interest rate swaps have not been designated as hedging instruments for accounting purposes.

The location and fair value of interest rate swaps reported in the Consolidated Statements of Financial Condition as of September 30, 2012 and December 31, 2011 are as follows:

	Location on Consolidated Statements of Financial Condition	Notional Amount	Net Estimated Fair Value
		(dollars in thousands)	
September 30, 2012	Assets: Interest rate swaps, at fair value	-	-
September 30, 2012	Liabilities: Interest rate swaps, at fair value	$46,746,710	$(2,926,461)
December 31, 2011	Assets: Interest rate swaps, at fair value	-	-
December 31, 2011	Liabilities: Interest rate swaps, at fair value	$40,109,880	$(2,552,687)

The effect of interest rate swaps on the Consolidated Statements of Comprehensive Income is as follows:

	Location on Consolidated Statements of Comprehensive Income		
	Realized Gains (Losses) on Interest Rate Swaps*	Gain (loss) on Termination of Interest Rate Swaps	Unrealized Gains (Losses) on Interest Rate Swaps
	(dollars in thousands)		
For the Quarter Ended September 30, 2012	$(224,272)	-	$(104,197)
For the Quarter Ended September 30, 2011	$(231,849)	-	$(1,505,333)
For the Nine Months Ended September 30, 2012	$(665,614)	$ (2,385)	$(373,773)
For the Nine Months Ended September 30, 2011	$(654,757)	-	$(1,802,968)

* Net interest payments on interest rate swaps is presented in the Company's Consolidated Statements of Comprehensive Income as realized gains (losses) on interest rate swaps.

The Company's interest rate swap weighted average pay rate at September 30, 2012 was 2.23% and the weighted average receive rate was 0.27%. The weighted average pay rate at December 31, 2011 was 2.55% and the weighted average receive rate was 0.33%. Without netting the market value of the swaps by dealer at September 30, 2012, the gross unrealized losses on interest rate swaps was $2.9 billion, with a notional amount of $46.2 billion and the gross unrealized gains on interest rate swaps was $10.5 million with a notional amount of $500.0 million. Without netting the market value of the swaps by dealer at December 31, 2011, the gross unrealized loss on interest rate swaps was $2.6 billion, with a notional amount of $40.1 billion.

Certain of the Company's derivative contracts are subject to International Swaps and Derivatives Association Master Agreements ("ISDA") which contain provisions that grant counterparties certain rights with respect to the applicable ISDA upon the occurrence of (i) negative performance that results in a decline in net assets in excess of specified thresholds or dollar amounts over set periods of time, (ii) the Company's failure to maintain its REIT status, (iii) the Company's failure to comply with limits on the amount of leverage, and (iv) the Company's stock being delisted from the New York Stock Exchange (NYSE). Upon the occurrence of items (i) through (iv), the counterparty to the applicable ISDA has a right to terminate the ISDA in accordance with its provisions. The aggregate fair value of all derivative instruments with credit-risk-related contingent features that are in a net liability position at September 30, 2012 is approximately $3.0 billion, including accrued interest, which represents the maximum amount the Company would be required to pay upon termination, which is fully collateralized.

In connection with RCap's proprietary trading activities, it has entered into exchange traded U.S. interest rate, equity index, and FX futures and options contracts as well as German interest rate futures contracts for speculative or hedging purposes. RCap invests in futures and options contracts for economic hedging purposes to reduce exposure to changes in yields of its U.S Treasury securities and for speculative purposes to achieve capital appreciation. The use of options contracts creates exposure to credit risk relating to potential losses that could be recognized if the counterparties to these instruments fail to perform their obligations under the contracts. RCap executes these trades through an independent futures and options broker.

8. CONVERTIBLE SENIOR NOTES

In 2010, the Company issued $600.0 million in aggregate principal amount of its 4% convertible senior notes due 2015 ("4% Convertible Senior Notes") for net proceeds of approximately $582.0 million. Interest on the 4% Convertible Senior Notes is paid semi-annually at a rate of 4% per year and the Convertible Senior Notes will mature on February 15, 2015 unless repurchased or converted earlier. The 4% Convertible Senior Notes are convertible into shares of Common Stock at a conversion rate for each $1,000 principal amount of 4% Convertible Senior Notes. The initial conversion rate was 46.6070, which was equivalent to an initial conversion price of approximately $21.4560 per share of Common Stock. The conversion rate at September 30, 2012 was 68.5105, which is equivalent to a conversion price of approximately $14.5963 per share of Common Stock. The conversion rate is subject to adjustment in certain circumstances.. There is no limit on the total number of shares of Common Stock that the Company would be required to issue upon a conversion.

The intrinsic value of the contingent beneficial conversion feature was $80.9 million and $67.6 million, respectively, at September 30, 2012 and December 31, 2011, which is reflected in Additional paid in capital on the Company's Consolidated Statements of Financial Condition, and serves to reduce the 4% Convertible Senior Notes liability. The discount to the principal amount of the 4% convertible Senior Notes at September 30, 2012 and December 31, 2011 of $59.3 million and $60.1 million, respectively, is recognized in interest expense over the remaining life of the notes.

During the quarter ended September 30, 2012, the Company repurchased approximately $280.7 million of the outstanding $600.0 million of our 4.00% Convertible Senior Notes for $357.2 million, resulting in a loss on extinguishment of debt of $87.3 million.

In May 2012, the Company issued $750.0 million in aggregate principal amount of its 5% convertible senior notes due 2015 ("5% Convertible Senior Notes") for net proceeds of approximately $727.5 million. Interest on the 5% Convertible Senior Notes is paid semi-annually at a rate of 5% per year and the 5% Convertible Senior Notes will mature on May 15, 2015 unless repurchased or converted earlier. The 5% Convertible Senior Notes are convertible into shares of Common Stock at a conversion rate for each $1,000 principal amount of 5% Convertible Senior Notes. The initial conversion rate and conversion rate at September 30, 2012 is 52.7969, which is equivalent to an initial conversion price of approximately $18.94 per share of Common Stock, subject to adjustment in certain circumstances. Upon conversion, the Company will pay or deliver, as the case may be, cash, shares of Common Stock or a combination of cash and shares of Common Stock, at the Company's sole discretion. There is no limit on the total number of shares of Common Stock that the Company would be required to issue upon a conversion.

At issuance, the Company determined that the 5% Convertible Senior Notes included a beneficial conversion feature of $11.7 million, which is reflected in Additional paid in capital on the Company's Consolidated Statements of Financial Condition, and serves to reduce the 5% Convertible Senior Notes liability. The $11.7 million discount to the principal amount of the Convertible Senior Notes is recognized in interest expense over the remaining life of the notes using the effective yield method. At September 30, 2012, $10.3 million of the discount had not been reflected in interest expense.

9. COMMON STOCK AND PREFERRED STOCK

(A) Common Stock

During the quarter and nine months ended September 30, 2012, 50,000 and 444,000 options were exercised for an aggregate amount of $669,000 and $6.1 million, respectively. During the quarter and nine months ended September 30, 2011, 134,000 options and 596,000 options were exercised for an aggregate exercise price of $1.8 million and $7.9 million, respectively.

During the nine months ended September 30, 2012, 1.3 million shares of Series B Preferred Stock were converted into 4.0 million shares of common stock. During the quarter and nine months ended September 30, 2011, 260,000 shares and 263,000 shares of Series B Preferred Stock were converted into 732,000 shares and 740,000 shares of common stock, respectively.

During the quarter and nine months ended September 30, 2012, the Company raised $1.1 million and $2.0 million, respectively, by issuing 65,000 and 117,000 shares through the Direct Purchase and Dividend Reinvestment Program. During the nine months ended September 30, 2011, the Company raised $455.7 million by issuing 26.2 million shares through the Direct Purchase and Dividend Reinvestment Program. The Company did not issue any shares through the program during the quarter and nine months ended September 30, 2011.

On March 19, 2012, the Company entered into six separate Distribution Agency Agreements (or Distribution Agency Agreements) with each of Merrill Lynch, Pierce, Fenner & Smith Incorporated, Credit Suisse Securities (USA) LLC, Goldman, Sachs & Co., J.P. Morgan Securities LLC, Morgan Stanley & Co. LLC and RCap Securities, Inc. (together, the "Agents"). Pursuant to the terms of the Distribution Agency Agreements, the Company may sell from time to time through the Agents, as its sales agents, up to 125,000,000 shares of the Company's common stock. The Company did not make any sales under the Distribution Agency Agreements during the quarter ended September 30, 2012.

On January 4, 2011, the Company entered into an agreement pursuant to which it sold 86,250,000 shares of its common stock for net proceeds of approximately $1.5 billion. This transaction settled on January 7, 2011.

On February 15, 2011, the Company entered into an agreement pursuant to which it sold 86,250,000 shares of its common stock for net proceeds of approximately $1.5 billion. This transaction settled on February 18, 2011.

On June 23, 2011, the Company amended its charter to increase the number of authorized shares of capital stock, par value $0.01 per share, from 1,000,000,000 shares to 2,000,000,000 shares, consisting of 1,987,987,500 shares classified as Common Stock, 7,412,500 shares classified as 7.875% Series A Cumulative Redeemable Preferred Stock, and 4,600,000 shares classified as 6.00% Series B Cumulative Convertible Preferred Stock.

On July 11, 2011 the Company entered into an agreement pursuant to which it sold 138,000,000 shares of its common stock for net proceeds following expenses of approximately $2.4 billion. This transaction settled on July 15, 2011.

On May 16, 2012, the Company amended its charter through the filing of articles supplementary to its charter to reclassify 12,650,000 shares of authorized shares of Common Stock as 7.625% Series C Cumulative Redeemable Preferred Stock.

On September 13, 2012, the Company amended its charter through the filing of articles supplementary to its charter to reclassify 18,400,000 shares of authorized shares of Common Stock as 7.50% Series C Cumulative Redeemable Preferred Stock. Following the effectiveness of the articles supplementary to its charter the Company's authorized shares of capital stock, par value of $0.01 per share, consists of 1,956,937,500 shares classified as Common Stock, 7,412,500 shares classified as 7.875% Series A Cumulative Redeemable Preferred Stock, 4,600,000 shares classified as 6.00% Series B Cumulative Convertible Preferred Stock, 12,650,000 shares classified as 7.625% Series C Cumulative Redeemable Preferred Stock and 18,400,000 shares classified as 7.50% Series D Cumulative Redeemable Preferred Stock.

(B) Preferred Stock

At September 30, 2012 and December 31, 2011, the Company had issued and outstanding 7,412,500 shares of Series A Cumulative Redeemable Preferred Stock ("Series A Preferred Stock"), with a par value of $0.01 per share and a liquidation preference of $25.00 per share plus accrued and unpaid dividends (whether or not declared). The Series A Preferred Stock is entitled to a dividend at a rate of 7.875% per year based on the $25.00 liquidation preference before the common stock is entitled to receive any dividends. The Series A Preferred Stock is redeemable at $25.00 per share plus accrued and unpaid dividends (whether or not declared) exclusively at the Company's option commencing on April 5, 2009 (subject to the Company's right under limited circumstances to redeem the Series A Preferred Stock earlier in order to preserve its qualification as a REIT). The Series A Preferred Stock is senior to the Company's common stock and is on parity with the Series C Preferred Stock and Series D Preferred Stock with respect to dividends and distributions, including distributions upon liquidation, dissolution or winding up. The Series A Preferred Stock generally does not have any voting rights, except if the Company fails to pay dividends on the Series A Preferred Stock for six or more quarterly periods (whether or not consecutive). Under such circumstances, the Series A Preferred Stock, together with the Series C Preferred Stock and Series D Preferred Stock, will be entitled to vote to elect two additional directors to the Board, until all unpaid dividends have been paid or declared and restricted for payment. In addition, certain material and adverse changes to the terms of the Series A Preferred Stock cannot be made without the affirmative vote of holders of at least two-thirds of the outstanding shares of Series A Preferred Stock, Series C Preferred Stock and Series D Preferred Stock. Through September 30, 2012, the Company had declared and paid all required quarterly dividends on the Series A Preferred Stock.

In May 2012, the Company issued 12,000,000 shares of Series C Cumulative Redeemable Preferred Stock ("Series C Preferred Stock"), with a par value of $0.01 per share and a liquidation preference of $25.00 per share plus accrued and unpaid dividends (whether or not declared). The Series C Preferred Stock is entitled to a dividend at a rate of 7.625% per year based on the $25.00 liquidation preference before the common stock is entitled to receive any dividends. The Series C Preferred Stock is redeemable at $25.00 per share plus accrued and unpaid dividends (whether or not declared) exclusively at the Company's option commencing on May 16, 2017 (subject to the Company's right under limited circumstances to redeem the Series C Preferred Stock earlier in order to preserve its qualification as a REIT or under limited circumstances related to a change of control of the Company). The Series C Preferred Stock is senior to the Company's common stock and is on parity with the Series A Preferred Stock and Series D Preferred Stock with respect to dividends and distributions, including distributions upon liquidation, dissolution or winding up. The Series C Preferred Stock generally does not have any voting rights, except if the Company fails to pay dividends on the Series C Preferred Stock for six or more quarterly periods (whether or not consecutive). Under such circumstances, the Series C Preferred Stock, together with the Series A Preferred Stock and Series D Preferred Stock, will be entitled to vote to elect two additional directors to the Board, until all unpaid dividends have been paid or declared and restricted for payment. In addition, certain material and adverse changes to the terms of the Series C Preferred Stock cannot be made without the affirmative vote of holders of at least two-thirds of the outstanding shares of Series C Preferred Stock and Series A Preferred Stock and Series D Preferred Stock. Through September 30, 2012, the Company had declared and paid all required quarterly dividends on the Series C Preferred Stock.

In September 2012, the Company issued 18,400,000 shares of Series D Cumulative Redeemable Preferred Stock ("Series D Preferred Stock"), with a par value of $0.01 per share and a liquidation preference of $25.00 per share plus accrued and unpaid dividends (whether or not declared). The Series D Preferred Stock is entitled to a dividend at a rate of 7.50% per year based on the $25.00 liquidation preference before the common stock is entitled to receive any dividends. The Series D Preferred Stock is redeemable at $25.00 per share plus accrued and unpaid dividends (whether or not declared) exclusively at the Company's option commencing on September 13, 2017 (subject to the Company's right under limited circumstances to redeem the Series D Preferred Stock earlier in order to preserve its qualification as a REIT or under limited circumstances related to a change of control of the Company). The Series D Preferred Stock is senior to the Company's common stock and is on parity with the Series A Preferred Stock and Series C Preferred Stock with respect to dividends and distributions, including distributions upon liquidation, dissolution or winding up. The Series D Preferred Stock generally does not have any voting rights, except if the Company fails to pay dividends on the Series D Preferred Stock for six or more quarterly periods (whether or not consecutive). Under such circumstances, the Series D Preferred Stock, together with the Series A Preferred Stock and Series C Preferred Stock, will be entitled to vote to elect two additional directors to the Board, until all unpaid dividends have been paid or declared and restricted for payment. In addition, certain material and adverse changes to the terms of the Series D Preferred Stock cannot be made without the affirmative vote of holders of at least two-thirds of the outstanding shares of Series D Preferred Stock.

At December 31, 2011, the Company had issued and outstanding 1,331,849 shares of Series B Preferred Stock, with a par value $0.01 per share and a liquidation preference of $25.00 per share plus accrued and unpaid dividends (whether or not declared). On March 27, 2012, the Company announced that it elected to convert all outstanding shares of Series B Preferred Stock into shares of common stock. In this conversion, the Company converted 772,000 shares of Series B Preferred Stock into 2.4 million shares of common stock and the Company had no shares of Series B Preferred Stock outstanding at September 30, 2012.

The Series B Preferred Stock was paid a dividend at a rate of 6% per year on the $25.00 liquidation preference before the common stock received any dividends. The Series B Preferred Stock was not redeemable. The Series B Preferred Stock was convertible into shares of common stock at a conversion rate that adjusted from time to time upon the occurrence of certain events, including when the Company distributed to its common shareholders in any calendar quarter cash dividends in excess of $0.11 per share. Initially, the conversion rate was 1.7730 shares of common shares per $25 liquidation preference, and the Series B Preferred Stock was converted into common stock at a conversion ratio of 3.0614 shares of common stock for each share of Series B Preferred Stock. The Series B Preferred Stock was also convertible into common shares at the option of the Series B preferred shareholder anytime at the then prevailing conversion rate. The Series B Preferred Stock was senior to the Company's common stock and on parity with the Series A Preferred Stock with respect to dividends and distributions, including distributions upon liquidation, dissolution or winding up. The Series B Preferred Stock generally did not have any voting rights, except if the Company failed to pay dividends on the Series B Preferred Stock for six or more quarterly periods (whether or not consecutive). Under such circumstances, the Series B Preferred Stock, together with the Series A Preferred Stock, would be entitled to vote to elect two additional directors to the Board, until all unpaid dividends have been paid or declared and restricted for payment. In addition, certain material and adverse changes to the terms of the Series B Preferred Stock could not be made without the affirmative vote of holders of at least two-thirds of the outstanding shares of Series B Preferred Stock and Series A Preferred Stock. Through March 31, 2012, the Company had declared and paid all required quarterly dividends on the Series B Preferred Stock. During the nine months ended September 30, 2012, 1.3 million shares of Series B Preferred Stock were converted into 4.0 million shares of common stock. During the quarter and nine months ended September 30, 2011, 260,000 and 263,000 shares of Series B Preferred Stock were converted into 732,000 and 740,000 shares of common stock, respectively.

(C) Distributions to Shareholders

During the quarter and nine months ended September 30, 2012, the Company declared dividends to common shareholders totaling $487.2 million or $0.50 per share, and $1.6 billion or $1.60 per share, respectively, of which $487.2 million was paid to shareholders on October 29, 2012. During the quarter and nine months ended September 30, 2012, the Company declared dividends to Series A Preferred shareholders totaling approximately $3.6 million or $0.492 per share and $10.9 million or $1.477 per share, respectively. During the quarter and nine months ended September 30, 2012, the Company declared dividends to Series B Preferred shareholders totaling approximately $0 or $0 per share and $289,000 or $0.375 per share, respectively. During the quarter and nine months ended September 30, 2012, the Company declared dividends to Series C Preferred shareholders totaling approximately $5.7 million or $0.477 per share and $8.6 million or $0.715, respectively.

During the quarter and nine months ended September 30, 2011, the Company declared dividends to common shareholders totaling $581.8 million or $0.60 per share and $1.6 billion or $1.87 per share, respectively, of which $581.8 million was paid to shareholders on October 27, 2011. During the quarter and nine months ended September 30, 2011, the Company declared dividends to Series A Preferred shareholders totaling approximately $3.6 million or $0.492 per share and $10.9 million or $1.477 per share, respectively. During the quarter and nine months ended September 30, 2011, the Company declared dividends to Series B Preferred shareholders totaling approximately $524 thousand or $0.375 per share and approximately $1.8 million or $1.125 per share, respectively.

10. NET INCOME PER COMMON SHARE

The following table presents a reconciliation of the net income and shares used in calculating basic and diluted earnings per share for the quarters and nine months ended September 30, 2012 and 2011.

	For the Quarter Ended		For the Nine Months Ended	
	September 30, 2012	September 30, 2011	September 30, 2012	September 30, 2011
	(dollars in thousands)			
Net income (loss)	$224,758	$(921,813)	$1,035,405	$(101,101)
Less: Preferred stock dividends	9,367	4,172	19,813	12,706
Net income (loss) available to common shareholders, prior to adjustment for dilutive potential common shares, if necessary	215,391	$(925,985)	1,015,592	$(113,807)
Add: Interest on Convertible Senior Notes, if dilutive	3,193	-	23,850	-
Net income (loss) available to common shareholders, as adjusted	$218,584	$(925,985)	$1,039,442	$(113,807)
Weighted average shares of common stock outstanding-basic	974,729	948,546	973,675	841,913
Add: Effect of dilutive stock options, Series B Preferred Stock and Convertible Senior Notes, if dilutive	22,279	-	61,690	-
Weighted average shares of common stock outstanding-diluted	997,008	948,546	1,035,365	841,913

Options to purchase 1.1 million and 1.8 million shares of common stock were outstanding and considered anti-dilutive as their exercise price exceeded the average stock price for the quarter and nine months ended September 30, 2012. Options to purchase 572,000 and 572,000 shares of common stock were outstanding and considered anti-dilutive as their exercise price exceeded the average stock price for the quarter and nine months ended September 30, 2011.

11. LONG-TERM STOCK INCENTIVE PLANS

The Company has adopted the 2010 Equity Incentive Plan, which authorizes the Compensation Committee of the board of directors to grant options, stock appreciation rights, dividend equivalent rights, or other share-based awards, including restricted shares up to an aggregate of 25,000,000 shares, subject to adjustments as provided in the 2010 Equity Incentive Plan. The Company had adopted a long term stock incentive plan for executive officers, key employees and non-employee directors (the Prior Plan). The Prior Plan authorized the Compensation Committee of the board of directors to grant awards, including non-qualified options as well as incentive stock options as defined under Section 422 of the Code. The Prior Plan authorized the granting of options or other awards for an aggregate of the greater of 500,000 shares or 9.5% of the diluted outstanding shares of the Company's common stock, up to a ceiling of 8,932,921 shares. No further awards will be made under the Prior Plan, although existing awards remain effective.

Stock options were issued at the market price on the date of grant, subject to an immediate or four year vesting in four equal installments with a contractual term of 5 or 10 years.

The Company has issued and outstanding the following stock options as of September 30, 2012 and 2011:

	For the Nine Months Ended			
	September 30, 2012		September 30, 2011	
	Number of Shares	Weighted Average Exercise Price	Number of Shares	Weighted Average Exercise Price
Options outstanding at the beginning of period	6,216,805	$15.57	6,891,975	$15.20
Granted	7,500	17.11	7,500	18.67
Exercised	(443,669)	13.65	(596,470)	13.18
Forfeited	(2,450)	16.15	-	-
Expired	-	-	(3,750)	12.15
Options outstanding at the end of period	5,778,186	$15.72	6,299,255	$15.54
Options exercisable at the end of the period	5,147,624	$16.02	4,534,143	$16.12

The weighted average remaining contractual term was approximately 4.6 years for stock options outstanding and approximately 4.3 years for stock options exercisable as of September 30, 2012. As of September 30, 2012, there was approximately $1.2 million of total unrecognized compensation cost related to nonvested share-based compensation awards. That cost is expected to be recognized over a weighted average period of seven months.

The weighted average remaining contractual term was approximately 5.7 years for stock options outstanding and approximately 5.1 years for stock options exercisable as of September 30, 2011. As of September 30, 2011, there was approximately $5.3 million of total unrecognized compensation cost related to nonvested share-based compensation awards. That cost is expected to be recognized over a weighted average period of 1.3 years.

12. INCOME TAXES

For the quarter and nine months ended September 30, 2012 the Company is qualified to be taxed as a REIT. As a REIT, the Company is not subject to federal income tax to the extent that it distributes its taxable income to its shareholders. To maintain qualification as a REIT, the Company must distribute at least 90% of its annual REIT taxable income to its shareholders and meet certain other requirements. It is generally the Company's policy to distribute to its shareholders all of the Company's taxable income except for the amount of taxable income attributable to certain employee remuneration deductions disallowed for tax purposes pursuant to Internal Revenue Code Section 162(m). Accordingly, in general, the Company is subject to federal, state and local income taxes on taxable income attributable to the Section 162(m) disallowance. It is assumed that the Company intends to retain its REIT status by complying with the REIT regulations and its distribution policy in the future. The state and city tax jurisdictions for which the Company is subject to tax filing obligations recognized the Company's status as a REIT.

During the quarter and nine months ended September 30, 2012, the Company recorded $10.6 million and $32.7 million of income tax expense for the portion of earnings retained based on Section 162(m) limitations. During the quarter and nine months ended September 30, 2011, the Company recorded $12.8 million and $32.4 million of income tax expense for the portion of earnings retained based on Section 162(m) limitations.

The Company's effective tax rate differs from its combined federal, state, and city corporate statutory tax rate primarily due to the deduction of dividend distributions and Sec 162(m) limitations.

During the quarter and nine months ended September 30, 2012, the Company's taxable REIT subsidiaries recorded $3.3 million and $9.3 million of income tax expense. During the quarter and nine months ended September 30, 2011, the Company's taxable REIT subsidiaries recorded $2.6 million and $9.4 million of income tax expense.

The Company's 2009, 2010 and 2011 federal and state tax returns remain open for examination.

13. LEASE COMMITMENTS AND CONTINGENCIES

Commitments

The Company has a non-cancelable lease for office space which commenced in May 2002 and expires in December 2015. Merganser has a non-cancelable lease for office space, which commenced on May 2003 and expires in May 2014. Merganser subleases a portion of its leased space to a subtenant. FIDAC has a lease for office space which commenced in October 2010 and expires in February 2016. The Company's aggregate net future minimum lease payments total approximately $6.4 million. The following table details the lease payments.

Year Ending December	Lease Commitment	Sublease Income	Net Amount
		(dollars in thousands)	
2012 (remaining)	$ 751	$ 45	$ 706
2013	3,004	60	2,944
2014	2,520	-	2,520
2015	159	-	159
2016	27	-	27
Thereafter	-	-	-
	$ 6,461	$ 105	$ 6,356

Contingencies

From time to time, the Company is involved in various claims and legal actions arising in the ordinary course of business. In the opinion of management, the ultimate disposition of these matters will not have a material effect on the Company's consolidated financial statements and therefore no accrual is required as of September 30, 2012 and December 31, 2011.

14. INTEREST RATE RISK

The primary market risk to the Company is interest rate risk. Interest rates are highly sensitive to many factors, including governmental monetary and tax policies, domestic and international economic and political considerations and other factors beyond the Company's control. Changes in the general level of interest rates can affect net interest income, which is the difference between the interest income earned on interest-earning assets and the interest expense incurred in connection with the interest-bearing liabilities, by affecting the spread between the interest-earning assets and interest-bearing liabilities. Changes in the level of interest rates also can affect the value of the Company's interest earning assets and the Company's ability to realize gains from the sale of these assets. A decline in the value of the interest earning assets pledged as collateral for borrowings under repurchase agreements could result in the counterparties demanding additional collateral pledges or liquidation of some of the existing collateral to reduce borrowing levels.

The Company seeks to manage the extent to which net income changes as a function of changes in interest rates by matching adjustable-rate assets with variable-rate borrowings. The Company may seek to mitigate the potential impact on net income of periodic and lifetime coupon adjustment restrictions in the portfolio of interest earning assets by entering into interest rate agreements such as interest rate caps and interest rate swaps. As of September 30, 2012 and December 31, 2011, the Company entered into interest rate swaps to pay a fixed rate and receive a floating rate of interest, with a total notional amount of $46.7 billion and $40.1 billion, respectively.

Changes in interest rates may also have an effect on the rate of mortgage principal prepayments and, as a result, prepayments on Agency mortgage-backed securities. The Company will seek to mitigate the effect of changes in the mortgage principal repayment rate by balancing assets purchased at a premium with assets purchased at a discount. To date, the aggregate premium exceeds the aggregate discount on the Agency mortgage-backed securities. As a result, prepayments, which result in the amortization of unamortized premium, will reduce net income compared to what net income would be absent such prepayments.

15. RCAP REGULATORY REQUIREMENTS

RCap is subject to regulations of the securities business that include but are not limited to trade practices, use and safekeeping of funds and securities, capital structure, recordkeeping, and conduct of directors, officers and employees.

As a self clearing, registered broker dealer, RCap is subject to the minimum net capital requirements of the FINRA. As of September 30, 2012 RCap had a minimum net capital requirement of $307,832 and would be required to notify FINRA if capital was to fall below the early warning threshold of $369,398. RCap consistently operates with capital significantly in excess of its regulatory capital requirements. RCap's regulatory net capital as defined by SEC Rule 15c3-1 as of September 30, 2012 was $353.4 million with excess net capital of $353.1 million.

16. RELATED PARTY TRANSACTIONS

For the quarter and nine months ended September 30, 2012, the Company recorded advisory fees from affiliates totaling $16.4 million and $50.3 million, respectively. For the quarter and nine months ended September 30, 2011, the Company recorded advisory fees from affiliates totaling $16.5 million and $46.5 million, respectively. At September 30, 2012 and December 31 2011, the Company had amounts receivable from affiliates of $16.5 million and $16.2 million, respectively.

17. SUBSEQUENT EVENTS

Subsequent to September 30, 2012, the Company repurchased approximately $166.4 million of the 4.00 % Convertible Senior Notes for $206.9 million.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Special Note Regarding Forward-Looking Statements

Certain statements contained in this quarterly report, and certain statements contained in our future filings with the Securities and Exchange Commission (the SEC or the Commission"), in our press releases or in our other public or shareholder communications may not be based on historical facts and are "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. Forward-looking statements, which are based on various assumptions, (some of which are beyond our control) may be identified by reference to a future period or periods, or by the use of forward-looking terminology, such as "may," "will," "believe," "expect," "anticipate," "continue," or similar terms or variations on those terms, or the negative of those terms. Actual results could differ materially from those set forth in forward-looking statements due to a variety of factors, including, but not limited to, changes in interest rates, changes in the yield curve, changes in prepayment rates, the availability of mortgage-backed securities and other securities for purchase, the availability of financing, and, if available, the terms of any financings, changes in the market value of our assets, changes in business conditions and the general economy, our ability to consummate any contemplated investment opportunities, changes in governmental regulations affecting our business, our ability to maintain our classification as a REIT for federal income tax purposes, our ability to maintain our exemption from registration under the Investment Company Act of 1940, and risks associated with the business of our subsidiaries, including the investment advisory businesses of our subsidiaries, including the removal by their clients of assets they manage, their regulatory requirements, and competition in the investment advisory business, and risks associated with the broker dealer business of our subsidiary. For a discussion of the risks and uncertainties which could cause actual results to differ from those contained in the forward-looking statements, see our most recent Annual Report on Form 10-K and any subsequent Quarterly Reports on Form 10-Q. We do not undertake and specifically disclaim any obligation, to publicly release the result of any revisions which may be made to any forward-looking statements to reflect the occurrence of anticipated or unanticipated events or circumstances after the date of such statements.

All references to "we," "us," or "our" mean Annaly Capital Management, Inc. and all entities owned by us, except where it is made clear that the term means only the parent company. The following defines certain of the commonly used terms in this quarterly report on Form 10-Q: Agency refers to a federally chartered corporation, such as Fannie Mae or Freddie Mac, or an agency of the U.S. Government, such as Ginnie Mae; Agency mortgage-backed securities refers to residential mortgage-backed securities that are issued or guaranteed by an Agency; Investment Securities refers to Agency mortgage-backed securities, Agency debentures and corporate debt securities; and Interest Earning Assets refers to Investment Securities, securities borrowed and U.S. Treasury Securities.

Overview

We own, manage, and finance a portfolio of real estate related investments, including mortgage pass-through certificates, collateralized mortgage obligations (or CMOs), Agency callable debentures, and other securities representing interests in or obligations backed by pools of mortgage loans. Our principal business objective is to generate net income for distribution to our stockholders from the spread between the interest income on our Interest-Earning Assets and the costs of borrowing to finance our acquisition of Interest-Earning Assets and from dividends we receive from our subsidiaries. Our wholly-owned subsidiaries offer diversified real estate, asset management and other financial services.

We are a Maryland corporation that commenced operations on February 18, 1997. We are self-advised and self-managed. We acquired Fixed Income Discount Advisory Company (or FIDAC) on June 4, 2004 and Merganser Capital Management, Inc. (or Merganser) on October 31, 2008. FIDAC and Merganser manage a number of investment vehicles and separate accounts for which they earn fee income. Our subsidiary, RCap Securities, Inc. (or RCap), operates as a broker-dealer, and was granted membership in the Financial Industry Regulatory Authority (or FINRA) in January 2009. In 2010, we established Shannon Funding LLC (or Shannon), which provides warehouse financing to residential mortgage originators in the United States. In 2010, we also established Charlesfort Capital Management LLC (or Charlesfort), which engages in corporate middle market lending transactions. In 2011, FIDAC established FIDAC Europe Limited (or FIDAC Europe), which provides advice on commercial real estate transactions, including sale-leaseback and single tenant net leased properties across Europe. In 2011, we established FIDAC FSI LLC (or FIDAC FSI), which invested in trading securities. FIDAC FSI was liquidated in August 2012. We also own an additional subsidiary which owns trading securities.

We have elected and believe that we are organized and have operated in a manner that qualifies us to be taxed as a real estate investment trust (or REIT) under the Internal Revenue Code of 1986, as amended (or the Code). If we qualify for taxation as a REIT, we generally will not be subject to federal income tax on our taxable income that is distributed to our stockholders. Therefore, substantially all of our assets, other than FIDAC, Merganser and RCap, which are our taxable REIT subsidiaries, consist of qualified REIT real estate assets (of the type described in Section 856(c)(5)(B) of the Code). We have financed our purchases of Agency mortgage-backed securities and Agency debentures with the net proceeds of equity offerings, convertible notes offerings and borrowings under repurchase agreements whose interest rates adjust based on changes in short-term market interest rates.

Capital Investment Policy

Under our capital investment policy, at least 75% of our total assets must be comprised of high-quality mortgage-backed securities and short-term investments. High quality securities means securities that (1) are rated within one of the two highest rating categories by at least one of the nationally recognized rating agencies, (2) are unrated but are guaranteed by the United States government or an agency of the United States government, or (3) are unrated but we determine them to be of comparable quality to high-quality rated mortgage-backed securities.

The remainder of our assets, comprising not more than 25% of our total assets, may consist of other qualified REIT real estate assets which are unrated or rated less than high quality, but which are at least “investment grade” (rated “BBB” or better by Standard & Poor’s Corporation (or S&P) or the equivalent by another nationally recognized rating agency) or, if not rated, we determine them to be of comparable credit quality to an investment which is rated “BBB” or better. In addition, we may directly or indirectly invest part of this remaining 25% of our assets in other types of securities, including without limitation, unrated debt, equity or derivative securities, to the extent consistent with our REIT qualification requirements. The derivative securities in which we invest may include securities representing the right to receive interest only or a disproportionately large amount of interest, as well as inverse floaters, which may have imbedded leverage as part of their structural characteristics.

We may acquire Agency mortgage-backed securities backed by single-family residential mortgage loans as well as securities backed by loans on multi-family, commercial or other real estate related properties. To date, substantially all of the Agency mortgage-backed securities that we have acquired have been backed by single-family residential mortgage loans.

The results of our operations are affected by various factors, many of which are beyond our control. Our results of operations primarily depend on, among other things, our net interest income, the market value of our assets and the supply of and demand for such assets. Our net interest income, which reflects the amortization of purchase premiums and accretion of discounts, varies primarily as a result of changes in interest rates, borrowing costs and prepayment speeds, the behavior of which involves various risks and uncertainties. Prepayment speeds, as reflected by the Constant Prepayment Rate, or CPR, and interest rates vary according to the type of investment, conditions in financial markets, competition and other factors, none of which can be predicted with any certainty. In general, as prepayment speeds on our Agency mortgage-backed securities portfolio increase, related purchase premium amortization increases, thereby reducing the net yield on such assets. The CPR on our Agency mortgage-backed securities portfolio averaged 20% and 22% for the quarters ended September 30, 2012 and December 31, 2011, respectively. Since changes in interest rates may significantly affect our activities, our operating results depend, in large part, upon our ability to effectively manage interest rate risks and prepayment risks while maintaining our status as a REIT. We continue to explore alternative business strategies, alternative investments and other strategic initiatives to complement our core business strategy of investing, on a leveraged basis, in high quality Investment Securities. No assurance, however, can be provided that any such strategic initiative will or will not be implemented in the future.

The table below provides quarterly and annual information regarding our average interest-earning assets, interest income, yield on average interest-earning assets, average interest-bearing liabilities, economic interest expense, average cost of interest-bearing liabilities, economic net interest income, and net interest rate spreads for the periods presented.

	Average Interest-Earning Assets(1)	Total Interest Income	Yield on Average Interest-Earning Assets	Average Interest-Bearing Liabilities	Economic Interest Expense (2)	Average Cost of Interest-Bearing Liabilities	Economic Net Interest Income(3)	Net Interest Rate Spread
	(ratios for the quarters have been annualized, dollars in thousands)							
Quarter Ended September 30, 2012	$119,880,120	$761,265	2.54 %	$106,973,056	$406,165	1.52 %	$355,100	1.02 %
Quarter Ended June 30, 2012	$116,458,864	$886,324	3.04 %	$103,668,465	$388,445	1.50 %	$497,879	1.54 %
Quarter Ended March 31, 2012	$105,706,554	$854,895	3.23 %	$92,552,175	$352,685	1.52 %	$502,210	1.71 %
Year Ended December 31, 2011	$96,675,016	$3,579,618	3.70 %	$84,595,933	$1,362,721	1.61 %	$2,216,897	2.09 %
Quarter Ended December 31, 2011	$102,339,797	$847,700	3.31 %	$89,488,111	$357,771	1.60 %	$489,929	1.71 %
Quarter Ended September 30,	$100,473,505	$930,802	3.71 %	$86,671,908	$353,266	1.63 %	$577,536	2.08 %

2011								
Quarter Ended June 30, 2011	$94,696,473	$957,068	4.04 %	$83,042,390	$330,080	1.59 %	$626,988	2.45 %
Quarter Ended March 31, 2011	$89,190,290	$						