

[CFTC Letter No. 00-49](#)

March 24, 2000

No-Action

Division of Trading and Markets

Re: Section 4m(1): -- Request for no-action position from CPO registration requirements for directors of a corporation that was formed to operate as a real estate investment trust by primarily investing in adjustable rate mortgage securities and loans and that intends to engage in commodity interest trading.

Section 4m(1): -- Request for no-action position from CTA registration requirements for a corporation formed to provide advice, including commodity interest trading advice, to a real estate investment trust formed to invest in adjustable rate mortgage securities and loans.

Dear :

This is in response to your letter dated October 26, 1999, to the Division of Trading and Markets (the "Division") of the Commodity Futures Trading Commission (the "Commission"), as supplemented by your letter dated March 24, 2000 and by telephone conversations with Division staff. By your correspondence, you request on behalf of your clients the "Company" and the "Manager", that the Division issue: (1) an interpretation that the Company is not a commodity pool if it begins limited use of interest rate futures and options contracts as described below, and (2) an interpretation that the Manager need not register under Section 4m(1) of the Commodity Exchange Act (the "Act")¹ as a commodity pool operator ("CPO") or as a commodity trading advisor ("CTA"), or in the alternative, a CTA registration no-action letter for the benefit of the Manager if the Manager restricts its commodity interest trading advice to the Company. After reviewing the representations made in your correspondence, the Division has determined to treat your correspondence as a request for CPO registration relief on behalf of the members of the Company's Board of Directors (the "Directors"), coupled with a request for CTA registration relief on behalf of the Manager.²

Facts

Based upon the representations made in your correspondence, we understand the facts to be as follows. The Company is a mortgage acquisition company that invests primarily in adjustable rate mortgage ("ARM") securities and ARM loans. It has elected to be taxed as a real estate investment trust ("REIT") under the Internal Revenue Code of 1986 (the "Code"). ARM securities represent interests in pools of ARM loans, which often include guarantees or other credit enhancements against losses for loan defaults. The Company leverages its equity capital using borrowed funds, and seeks to generate income based upon the difference between the yield on its ARM asset portfolio and the cost of its borrowings.

The Company is publicly held, and is currently listed on the New York Stock Exchange ("NYSE") and subject to the NYSE rules governing listed companies. It is a reporting company under Section 12(b) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). The Company is also subject to the periodic reporting requirements of the Exchange Act.³

The Manager is responsible for the day-to-day operations of the Company. The Manager is subject to the supervision of

the Company's Board of Directors and has only such functions and authority as the Directors may delegate to it. The Company's periodic reports filed with the Securities and Exchange Commission ("SEC") under the Exchange Act indicate that the same three individuals constitute the senior management of each of the Manager and the Company. "A" is Chairman of the Board of Directors and CEO of both the Company and the Manager. "B" is Chief Financial Officer and Treasurer of the Company, and a Managing Director of the Manager as well as its Chief Accounting Officer. "C" is President, a Director and the Chief Operating Officer of the Company, and he is a Managing Director of the Manager. Neither the Manager nor any of the Directors is subject to statutory disqualification under Section 8a(2) or 8a(3) of the Act.⁴

As described in its Exchange Act reports, the Company makes use of hedging transactions to mitigate the impact on its net interest income of certain adverse changes in interest rates.⁵ Currently, the Company hedges against interest rate risk primarily by purchasing interest rate cap agreements to prevent the Company's borrowing costs from exceeding the lifetime maximum interest rate on its ARM assets. The Company also enters into interest rate swap agreements to manage the average interest rate reset period on its borrowing. The Company pays a fixed rate of interest during the term of the agreements and receives a payment that varies monthly with the one-month LIBOR Index.

The Company seeks to begin trading commodity interests for the purpose of hedging interest rate risk exposure it encounters as a result of its financing strategy.⁶ Including commodity interests in its interest rate management strategy, however, would bring the Company within the "pool" definition in Rule 4.10(d). Absent relief, one or more of the Directors would be required to register as a CPO, and each person providing commodity interest trading advice to the Company would be required to register as a CTA.

In support of your request, you represent that the Company intends to restrict its trading to *bona fide* hedging transactions and positions as defined in Commission Rule 1.3(z) and that the Company will limit the amount of funds deposited as original margin or option premiums for commodity interest contracts to no more than 0.5 percent of the fair market value of its total assets.

The Company's Annual Report on Form 10-K states that it intends at all times to continue to comply with the requirements for qualification as a REIT under the Code, including the requirement that the Company ensure that 95% of its gross taxable income be derived from real property mortgage interest and certain other enumerated sources ("Qualified REIT Assets").⁷ The Company acknowledges that maintaining REIT status requires the Company to monitor all of its hedging strategies to avoid holding non-qualifying assets that generate excessive income in relation to total assets.

Analysis

CPO Registration

The term commodity "pool" is not defined in the Act. Rather, it was taken from the language of the term "commodity pool operator" in Section 1a(4) of the Act. In adding the CPO and CTA definitions to the Act, and the corresponding registration requirement in Section 4m(1) of the Act, Congress intended to establish the foundation for eliminating certain undesirable practices by unscrupulous operators and advisors who had "enticed unsuspecting traders into the markets with, far too often, substantial loss of funds."⁸ However, Congress vested discretion in the Commission "to exempt from registration those persons who would otherwise meet the criteria for registration . . . if, in the opinion of the Commission, there is no substantial public interest served by such registration."⁹

In light of this discretion, and in connection with its adoption of Rule 4.10(d), the Commission stated that "[w]hether a particular entity is operated 'for the purpose' of trading commodity interests, and thus is a pool within the scope of Rule

4.10(d), depends on an evaluation of all the facts relevant to the entity's operation."¹⁰ The Commission then recognized that in the past its staff had issued interpretations of the Part 4 rules and, consistent with that practice, the Commission invited interested persons "to seek such staff interpretations of Rule 4.10(d) and of all other Part 4 rules."¹¹

Based upon the representations in your correspondence, particularly the restriction of commodity interest trading by the Company to *bona fide* hedging transactions, the Company's REIT status, the limitation on income derived from interest rate futures and options to five percent of the Company's gross income and the limitation on initial margin and option premiums to no more than 0.5 percent of the fair market value of the Company's total assets, the Division will not recommend that the Commission commence any enforcement action against any of the Directors based solely upon his failure to register as a CPO under Section 4m(1) of the Act in connection with the operation of the Company.

CTA Registration

The Manager will be providing commodity interest trading advice to the Company. As such, the Manager will be a CTA. In reviewing the facts presented in your correspondence, however, the Division notes that the Manager has not provided commodity interest trading advisory services to any client other than the Company, and that the Manager is closely affiliated with the Company inasmuch as "A", "C" and "B" are the principal executive officers of each of the Company and the Manager. In view of the position taken with respect to the Company, the Division believes that a no-action position with respect to the Manager's failure to register as a CTA is appropriate. Accordingly, the Division will not recommend that the Commission commence any enforcement action against the Manager based solely upon the Manager's failure to register as a CTA under Section 4m(1) in connection with providing commodity interest trading advisory services to the Company. This position is subject to the condition that the Manager does not commence providing commodity interest trading advice to any client other than the Company without first obtaining the Division's written approval.¹²

Other Matters

This letter does not excuse the Directors or the Manager from compliance with any other applicable requirements contained in the Act or in the Commission's regulations issued thereunder. For example, each remains subject to all of the antifraud provisions of the Act and the Commission's regulations, to the reporting requirements for traders set forth in Parts 15, 18 and 19 of the Commission's regulations and to all otherwise applicable provisions of Part 4.

This letter, and the no-action positions taken herein, are based upon the representations you have made to us and are applicable to the Directors solely in their capacity as members of the board of directors of the Company, and to the Manager solely in its capacity as manager of the Company's interest rate futures and options trading. Any different, changed or omitted material facts or circumstances (such as a decision that the Company should no longer elect to be taxed as a REIT) might render these positions void. Also, the no-action position taken with respect to that Manager is subject to compliance with the condition stated above. In this connection, we request that you notify us immediately in the event that the operations or activities of the Directors, the Manager or the Company change in any material way from those represented to us. Further, the no-action positions taken herein are solely those of the Division and do not necessarily represent the views of the Commission or those of any other division or office of the Commission.

If you have any questions concerning this correspondence, please contact Chris Cummings, an attorney on my staff, at (202) 418-5445.

Very
truly
yours

John C.
Lawton
Acting
Director

1 7 U.S.C. § 6m(1) (1994).

2 Your letter alternatively asks the Division to take several actions that the Division believes to be either inappropriate under the circumstances or outside the Division's purview. Thus, the Division is declining to issue the interpretation you have requested that the Company is not a commodity pool because neither the Act nor the Commission's regulations provide an exclusion from the "pool" definition based upon the low level of a pooled investment vehicle's commodity interest trading. The Division also is declining to address your request for CPO registration relief for the Manager because the Division believes that, although the Manager performs some of the functions typically performed by a CPO, it does so pursuant to authority delegated to it *by the Company's Board of Directors*, and thus the Directors (for whom your correspondence does not expressly seek relief) are the CPOs of the Company. As for your reference to Rule 4.14(a) (5) as a basis for CTA registration relief for the Manager, the fact that the Manager is not the CPO of the Company renders that provision inapplicable. Commission rules referred to herein are found at 17 C.F.R. Ch. I (1999).

3 The Company's Quarterly Report on Form 10-Q for the quarterly period ended September 30, 1999 indicates that the Company began using the dba name "X" effective October 14, 1999, and that the Company will seek shareholder approval for a formal name change to "X" at its year 2000 annual meeting. This letter is applicable to the Company under either name.

4 7 U.S.C. § 12a(2) or § 12a(3).

5 We understand from your correspondence and the Company's Exchange Act periodic reports that the Company's interest rate risk arises generally from the fact that it finances the purchase of long-term debt instruments with short-term borrowings, as well as from the variable interest rates of the ARM Assets included in the Company's portfolio.

6 The Company will limit the commodity interest contracts it invests in to Eurodollar, Fed Funds, Treasury bill and Treasury note futures contracts and options on the same, and similar contracts.

7 For purposes of this letter we are assuming that income from interest rate futures and options thereon is not income derived from Qualified REIT Assets. We are taking the positions described herein based on restriction of any income from interest rate futures and options thereon to five percent of the Company's gross income.

8 H.R. Rep. No. 93-975, 93d Cong., 2d Sess. at 79 (1974).

9 *Id.* at 29.

10 46 Fed. Reg. 26004, 26006 (May 8, 1981). The Commission was responding to arguments that, for example, limited partnerships registered as broker-dealers would not be pools if they occasionally traded commodity interests, committed a limited amount of assets to such trading, and traded commodity interests for hedging as opposed to speculative purposes.

11 *Id.*

12 Because of the bases for the CTA registration no-action position taken herein, it has not been necessary for the Division to decide the question of whether the Manager can claim exemption from CTA registration under Section 4m(1)

of the Act. Section 4m(1) provides that a person is not required to register as a CTA if "during the course of the preceding twelve months, [the person] has not furnished commodity trading advice to more than fifteen persons and [the person] does not hold himself out generally to the public as a commodity trading advisor."