

CFTC Letter No. 00-50

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 non-conforming residential adjustable-rate and fixed-rate single family 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 non-conforming residential adjustable-rate and fixed-rate single family mortgage securities and loans.

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Dear :

This is in response to your letter dated November 19, 1999, to the Division of Trading and Markets (the "Division") of the Commodity Futures Trading Commission (the "Commission"), as supplemented by your letter dated February 11, 2000, your facsimile transmission dated March 22, 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 not recommend that the Commission commence any enforcement action if: (1) the Company trades interest rate futures and options contracts as described below without registering as a commodity pool operator ("CPO") under Section 4m(1) of the Commodity Exchange Act (the "Act")<sup>1</sup>, or (2) the Manager provides commodity interest trading advice to the Company without registering as a commodity trading advisor ("CTA") under Section 4m(1) of the Act. 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")<sup>2</sup>, coupled with a request for CTA registration relief on behalf of the Manager.<sup>3</sup>

*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 non-conforming residential, adjustable-rate and fixed-rate, single family whole mortgage loans ("Mortgage Loans"). The Company was initially financed through a private equity funding from the Manager. It has elected to be taxed as a real estate investment trust ("REIT") under the Internal Revenue Code of 1986 (the "Code").

The Company acquires Mortgage Loans through bulk purchases in the capital markets, from other financial institutions and through purchases from originators. From time to time, the Company's investment portfolio may include mortgage securities issued or guaranteed by federal government-sponsored agencies. The Company's mortgage securities ("Mortgage Securities," and together with Mortgage Loans, "Mortgage Assets") are securitized interests in pools of adjustable-rate single family residential mortgage loans. The Company finances its acquisitions of Mortgage Assets with equity and secured borrowings.

The Manager manages the day-to-day operations of the Company pursuant to a Management Agreement. Under the Management Agreement, the Manager advises the Company's Board of Directors with respect to the formulation of investment criteria and preparation of policy guidelines.

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. Three of the Directors are also directors of the Manager.<sup>4</sup> In addition, each of the officers of the Company is also an officer of the Manager (with each person having the same title in each entity). Neither the Manager nor any of the Directors is subject to statutory disqualification under Section 8a(2) or 8a(3) of the Act<sup>5</sup>

As described in its Prospectus for its October 1997 initial public offering and its 1998 Annual Report on Form 10-K, the Company hedges against interest rate risk with interest rate caps and other instruments. The Company discloses in those documents that in the future it may hedge against interest rate changes by investing in financial futures contracts and options on these contracts, and by trading forward contracts, but that the Company will not engage in such a hedging strategy unless the Company and the Manager are exempt from the registration requirements of the Act or otherwise comply with the Act.

The Company seeks to open commodity interest trading accounts for the purpose of hedging the interest rate exposure it encounters as a result of its financing strategy, and it will use these trading accounts solely for *bona fide* hedging transactions and positions as defined in Commission Rule 1.3(z). Including commodity interests in its interest rate management strategy, however, would bring the Company within the "pool" definition in Rule 4.10(d).<sup>6</sup> 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. If granted the requested relief, the Company would utilize financial futures and options thereon, in addition to other hedging instruments, as a hedge against future interest rate changes.<sup>7</sup>

In support of your request, you represent that the Company will limit the amount of funds deposited as original margin or option premiums for commodity interest contracts to no more than 1 percent of the fair market value of its total assets.

As noted previously, the Company has elected to be subject to tax as a REIT under the Code. As a result of its REIT status, the Company generally will be subject to a 100 percent tax on any income derived from certain non-real estate related sources that exceeds 5 percent of the Company's gross income. Income from the interest rate futures contracts and options thereon that the Company will trade if the requested relief is granted would be of the type that would be taxed at 100 percent in the event that such income, together with certain other non-real estate related income, exceeded 5 percent of the Company's gross income. Consequently, a maximum of only 5 percent of the Company's gross income would be derived from such interest rate futures contracts and options thereon.

## *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."<sup>8</sup> 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."<sup>9</sup>

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."<sup>10</sup> 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."<sup>11</sup>

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 5 percent of the Company's gross income and the limitation on initial margin and option premiums to no more than 1 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 the principal executive officers of each of the Company and the Manager are the same individuals. You note that "H", Senior Vice President, Capital Markets of both the Company and the Manager, will be the individual who engages in hedging transactions, on the advice of the Manager, with respect to the use of interest rate futures and options contracts for the purpose of hedging the Company's interest rate exposure. "H" is not subject to a statutory disqualification under Section 8a(2) or 8a(3) of the Act. 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.<sup>12</sup>

### *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 The Directors are "A", "B", "C", "D", "E", "F" and "G".

3 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).

4 "A", "B" and "C" are also directors of the Manager.

5 7 U.S.C. § 12a(2) or § 12a(3).

6 You make the argument that the Company should not be considered a pool as defined in Rule 4.10(d), but the Division is unable to accept your argument because, as previously noted, there is no exclusion from the pool definition, either in the Act or in the Commission's regulations, based on a minimal or restricted level of commodity interest trading.

7 The Company would limit the commodity interest contracts it utilizes to Eurodollar, Fed Funds, Treasury bill and Treasury note futures and options thereon.

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."