

Commodity Futures Archive - Selected materials, CFTC Interpretative Letter No. 88-17. (Issuance and Offering of Debt Securities.), ¶24,320, Commodity Futures Trading Commission, (Sep. 6, 1988)

¶24,320. Commodity Futures Trading Commission. Off-Exchange Task Force. September 6, 1988. Correspondence in full text.

Interpretations: Enforcement Actions: Debentures: Issuance.—The Off-Exchange Task Force would not recommend that the CFTC take enforcement action under Section 4c of the Commodity Exchange Act if a corporation issues debentures that bear interest at an annual fixed rate and also provide for an additional payment on each semiannual interest payment date that is related to the increase in the price of natural gas over an established base price.

See ¶12,701, "Liabilities—Prohibitions" division, Volume 1.

By letters dated June 23, July 22, July 25 and August 3, 1988, you request on behalf of ***** ("Underwriter") and ***** ("Company") that the staff of the Commodity Futures Trading Commission ("Commission") confirm that it will not recommend to the Commission that any enforcement action be taken in connection with the proposed issuance and offering of debt securities by the Company.

In your letters, you represent that the Company plans to issue in an underwritten public offering registered under the Securities Act of 1933, as amended, approximately ***** million principal amount of Senior Subordinated Debentures. These debentures will be unsecured general obligations of the Company, will rank senior to all existing subordinated debt of the Company, will be subordinated in right of payment to the Company's bank indebtedness, and will be due in the year 2000. The debentures are proposed to be issued in integral multiples of \$1,000 face value and will bear interest at an annual rate of from 10 to 10 1/2 percent. The debentures further provide for an additional payment on each semiannual interest payment date which is related to the increase in the price of natural gas over an established base price. This additional payment will not exceed \$100 annually per \$1,000 principal amount of the debentures, equivalent therefore to no more than an annualized return of 10% per \$1,000 principal amount. When combined with a coupon interest rate of 10%, the overall return on the instruments should range from 10 to 20% of the debenture's principal amount per annum. The prices used to determine the additional payment will be an indicator of spot-market natural gas prices selected by the Company and Underwriter, or if no such reliable spot-market source of prices is available, the price will be a weighted average price of spot-market gas sales by the Company.

The Company is engaged in the business of oil and gas exploration and production. It had total natural gas sales of ***** MCF (millions of cubic feet of natural gas) in 1987 and estimated proven reserves of ***** MCF. The Company's consolidated stockholders' equity as of June 30, 1988, was approximately ***** and the Company is subject to the regular reporting requirements of the Securities and Exchange Act of 1934, as amended.

The Commission, in its Advance Notice of Proposed Rulemaking Relating to the Regulation of Certain Hybrid and Related Instruments ("Advance Notice"), 52 *Fed. Reg.* 47022 (December 11, 1987), sought comment on a proposed regulatory framework which would exempt from Commission regulation specified instruments having a commodity option-like component. In particular, the Commission proposed to establish an exemption for a class of hybrid instruments that are predominantly debt instruments and which possess only incidental commodity option elements. In view of the fact that the Advance Notice remains pending and that the Commission has not reached a final determination with respect to the proposals set forth therein, the staff believes that it is appropriate, in limited circumstances such as this, to address certain instruments on a case-by-case basis. In this regard, in your letter you compare the debentures and the Company with regard to each of the following criteria set forth in the Commission's Advance Notice.

(1) *Term to Maturity*

The debentures will have a twelve-year term to maturity, which is substantially in excess of the minimum three-year term proposed by the Commission.

(2) *Commodity-Based Return*

The Commission has proposed that any exemption based on incidental commodity-option elements be conditioned upon compliance with a requirement that the hybrid instrument have a minimum annual yield or return independent of its commodity-related component equal to at least 35% of the estimated annual yield at the time of issuance for a comparable pure debt or depository instrument and have no more than the maximum average potential return on its

commodity-related component of 20%, on an annualized basis, of the total principal or face amount of a hybrid instrument. You represent that the non-commodity based and commodity-related returns of the proposed debentures meet both of these tests. You represent that the Company's existing subordinated debentures presently trade at yields to maturity of approximately 14.3% and that a 10 percent non-indexed interest rate is therefore approximately 70 to 73% of the current market rate for the Company's pure debt securities. The additional, commodity-related payment on the debentures is limited to no more than 10% per annum.

(3) Line of Business

The Company is engaged in the business of oil and gas exploration, and its debentures are related to the price of natural gas. Hence, the commodity-based portion of the return is related to the Company's principal line of business.

(4) Otherwise Regulated

The debentures will be registered by the Company under the Securities Act of 1933, as amended, and the Company is subject to the regular reporting requirements of the Securities Exchange Act of 1934, as amended.

(5) Marketing and Disclosure

The Company and Underwriter, by your letter, agree not to market the debentures as having the beneficial characteristics of commodity options or futures contracts, except as may be necessary to disclose fully the operation and financial consequences of the instrument.

(6) Special Calls

You further represent in your letter, dated July 22, 1988, that the Company agrees to comply with special calls from the Commission for information relating to the issuance of these debentures, the matters addressed by the exemption request and compliance with the conditions upon which any no-action position is based.

(7) Net Worth and Cover

In the Commission's Advance Notice, the Commission proposed to condition any exemption on compliance with a requirement that the issuer have at least \$100 million of net worth. That notice also proposes a cover requirement to ensure performance of the issuer's commodity-related obligations undertaken by a qualifying hybrid instrument. You represent that the Company's stock-holders' equity as of June 30, 1988 was approximately ***** million. Additionally, the Company reported estimated proven reserves of natural gas in its financial statements as of December 31, 1987 of ***** MCF of gas. Of this amount, you represent that only ***** MCF of gas would be required to cover the issuer's commodity-related obligation for the twelve-year period that the debentures are outstanding. You further represent that the Company intends to maintain reserves sufficient to cover its obligations under the debentures through maturity. Taken together, these representations describe an issuer that is able to satisfy the obligations created by the instrument in question. *52 Fed. Reg.* at 47025.

(8) Minimum Unit Price

The Underwriter anticipates that initial sales of the debentures principally will be in large blocks "but it is possible that smaller sales may occur." In your letter of July 25, 1988, you suggest that a \$20,000 minimum trading unit, as required by the Advance Notice, would make it difficult to list the debentures on securities exchanges thereby limiting "an important mechanism to ensure liquidity ..." and, therefore, you intend to denominate the debentures in trading units of \$1,000. In addition, you have provided information concerning the listing requirements of several national securities exchanges. Based on this information, it appears that a trading unit of \$1,000 is the most common trading unit for exchange-traded debt instruments.

The Advance Notice proposed the \$20,000 minimum unit requirement as a means of protecting customers in an off-exchange environment. The listing and trading of such issues on national securities exchanges and the registration, reporting and underwriting requirements of the securities laws, as noted above, accomplish the purposes of customer protection in the circumstances of this offering. Thus, the staff is of the view that in the circumstances presented by this offering, an exception to the minimum unit size requirement proposed in the Advance Notice is warranted.

Accordingly, based upon the representations in your letters, the understanding that although denominated in units of \$1,000 the offer and sale of the debentures will be registered under the Securities Act of 1933 and initially offered pursuant to an underwriting under applicable law, and the significant reserves of natural gas owned by the Company, the staff has concluded that the proposed offering is not inconsistent with the general conditions for granting exemptive

relief articulated in the Advance Notice. Therefore, the staff will not recommend to the Commission any enforcement action under Section 4c of the Commodity Exchange Act based upon the issuance of the proposed instruments. This position does not excuse the Underwriter or the Company from complying with any otherwise applicable provisions of the Commodity Exchange Act nor does it address any other instrument or proposed instrument. Any different, omitted or changed facts or conditions might require a different conclusion. It should also be noted that this position is that of the staff and is not binding upon the Commission and that any subsequent determination by the Commission with regard to the rulemaking proceeding initiated by the Advance Notice of proposed rulemaking may require a reconsideration of this staff position.