

CFTC Letter No. 00-53**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 single-family, non-conforming mortgage securities and loans and that intends to engage in commodity interest trading.

Dear :

This is in response to your letter dated November 11, 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 client, the "Company" that the Division confirm that it will not recommend that the Commission commence any enforcement action if the Company engages in limited commodity interest trading for *bona fide* hedging purposes (as defined in Commission Rule 1.3(z)¹) without registration as a commodity pool operator ("CPO") under Section 4m(1) of the Commodity Exchange Act (the "Act")². 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").³

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 single family residential, non-conforming mortgage loans ("Mortgage Loans"). 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 its assets from two sources: (1) wholesale origination of mortgage loans, primarily originated in the mortgage lending operation of its affiliate "R"; and (2) purchase of Mortgage Loans and mortgage securities ("Mortgage Securities," and together with Mortgage Loans, "Mortgage Assets") in the secondary mortgage market. The Company finances its acquisition of Mortgage Assets using warehouse facilities, including repurchase agreements, and by issuing collateralized debt obligations.

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. None of the Directors is subject to statutory disqualification under Section 8a(2) or 8a(3) of the Act.⁴

As described in its Prospectus for its October 1997 initial public offering and in its April 14, 1999 Prospectus, the Company hedges against interest rate risk with interest rate caps, and from time to time, interest rate swaps, interest-only REMIC⁵ regular interests and other instruments. The Company discloses in its Prospectuses 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 is in

compliance with the REIT gross income tests and applicable law (including the registration requirements and other provisions of 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).⁶ 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 commodity trading advisor ("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.⁷

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 elects 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."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 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

It is anticipated that "A" (Chairman of the Company's Board of Directors and its CEO) and "F" (the Company's Senior Vice President and Chief Investment Officer) will be the persons advising the Company with respect to the use of interest rate futures and options thereon for the purpose of hedging the Company's interest rate exposure. Like "A", "F" is not subject to a statutory disqualification under the Act, and neither provides commodity interest trading advice to any other person, or holds himself out as a CTA. Accordingly, the Division will not recommend that the Commission commence any enforcement action against either "A" or "F" based solely upon the failure of either or both 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 neither "A" nor "F" commences 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, "A" or "F" 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 each of "A" and "F" in their capacity as advisors determining 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 "A" and "F" 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, "A", "F" 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 Commission rules referred to herein are found at 17 C.F.R. Ch. I (1999).

² 7 U.S.C. § 6m(1) (1994).

³ Your letter asks the Division to take several actions that the Division believes to be inappropriate under the circumstances. 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 a no-action position with respect to the requirement of Rule 4.20(a)(1) to operate a pool as a cognizable legal entity separate from that of the pool operator, because we believe that it is reasonably clear from the representations in your correspondence that the Company itself is not the CPO. *See* 46 Fed. Reg. 26004, 26012-13 (May 8, 1981).

4 7 U.S.C. § 12a(2) or § 12a(3). The Directors are: "A", Chairman, "B", "C", "D", and "E".

5 Real estate mortgage investment conduit, as defined under Section 856 of the Code (26 U.S.C. § 860D (1994)).

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. at 26006. 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 *See* Rule 4.14(a)(5), which provides that a person is not required to register as a CTA if it is exempt from registration as a CPO and its commodity trading advice "is directed solely to, and for the sole use of, the pool or pools for which it is so exempt."

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 either "A" or "F" 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."