Commodity Futures Archive - Selected materials, CFTC Interpretative Letter No. 88-16. (Federally Chartered Stockholder-Owned Corporation Issuing Notes Which Afford a Specified Real Rate of Return.), ¶24,312, Commodity Futures Trading Commission, (Aug. 26, 1988)

¶24,312. Commodity Futures Trading Commission. Off-Exchange Task Force. August 26, 1988. Correspondence in full text.

Interpretations: Notes: Issuance: Reevaluation..– The Commission should not take enforcement action under Section 4c of the Commodity Exchange Act if a federally chartered stockholder-owned corporation issues notes that afford a specified real rate of return by means of a reevaluation mechanism that reflects a nationally disseminated measure of inflation published by a U.S. government agency. The staff believes that the no-action position is not inconsistent with the basic framework of analysis contained in an advance notice and that the instruments may be viewed as analogous to hybrid instruments with *de minimus* option characteristics.

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

This is in response to your letter of July 11, 1988, in which, on behalf of [the underwriter] you have requested that the staff of the Commodity Futures Trading Commission issue a no-action position with respect to an offering of notes (Notes) by [the issuer]. Based upon the representations contained in your letter, as supplemented by [the underwriter's] draft offering circular dated July 19, 1988 (Offering Circular), a schedule of terms prepared by [the underwriter] and conservations with the staff, and subject to the conditions set forth below, the staff has determined that it will not recommend enforcement action against [the underwriter] or [the issuer] due to their participation in the offering.

Based upon the information you have provided to us, we understand that the facts relevant to the offering include the following. [The issuer] is a federally chartered and stockholder-owned corporation [ ]. All stock and other securities of [the issuer] are deemed to be exempt securities under the laws administered by the Securities and Exchange Commission to the same extent as obligations of the United States. [ ].

The Notes will be general unsecured obligations of [the issuer] and will not limit other indebtedness or securities that may be incurred or issued by [the issuer]. The Notes will bear interest at a fixed rate of [ ] percent, payable quarterly in arrears on a principal amount that is revalued at quarterly intervals based upon application of an "inflation factor." The "inflation factor" will reflect an annualized inflation rate measured as: twice the percentage change (but not less than zero) in the United States Consumer Price Index all items and All Urban Consumers (CPI-U), U.S. city average for 1982-84 equals 100, as published by the Bureau of Labor Statistics of the U.S. Department of Labor, without seasonal adjustment, between the most recent month for which the CPI-U has been published and the same calendar month six months earlier. Interest on the Notes will be payable on October 20, 1988, January 20, 1989 and April 20, 1989, and on July 24, 1989, the stated maturity date.

The principal of the Notes will be revalued on each interest payment date and the stated maturity dated based upon the following formula: (i) the inflation factor applicable to the interest period then ended multiplied by a fraction, the numerator of which is the number of days in such period (computed on the basis of a 360-day year of twelve 30-day months) and the denominator of which is 360, multiplied by the original principal amount (in the case of the revaluation on the first interest payment date) or the revalued principal on the immediately preceding interest payment date; plus (ii) the original principal amount or prior revalued principal used in clause (i). As stated in your letter of July 11, 1988, the inflation factor for the first interest period of the Notes is [ ] percent per annum. Revaluation of the Notes' principal based upon the inflation factor, when added to the stated interest rate of [ ] percent per annum, results in an effective interest rate for the first three months following issuance of the Notes of early [ ] percent per annum.

Based upon the foregoing, the representations contained in your letter of July 11, 1988, and the additional documentation you have provided us, it appears that the only commodity-related component of the Notes is the quarterly inflation-based revaluation of principal based upon the CPI-U. The CPI-U is an index of inflation commonly used in commercial and other contracts to adjust the amount of an obligation or return to compensate for the impact of inflation. As a result of this inflation indexation future, the Notes provide a return based on a one-to-one indexing of the principal to increases in the inflation rate added to a fixed coupon rate of interest. The Notes provide a return that increases in the same proportion as declines in value resulting from inflation. The principal revaluation feature of the Notes, however, does not impose upon the investor any risk of loss of the nominal principal. Additionally, notwithstanding the indexing revaluation feature, interest continues to accrue and be paid quarterly at the specified coupon rate. As the only commodity-related return on the Notes is strictly limited to the inflation rate, the Notes can be viewed as instruments designed to afford the investor the fixed coupon rate plus an adjustment to principal in the case of inflation, the latter measured by a nationally disseminated inflation measure published by a U.S. government agency.

In an advance notice of proposed rulemaking relating to the regulation of certain hybrid and related instruments (Advance Notice), 52 FR 47022 (Dec. 11, 1987) the Commission requested public comment on, among other matters, a proposed exclusion from Commission jurisdiction for instruments with commodity components of such an ancillary and limited nature as to be insufficient to warrant regulation under the Commodity Exchange Act of a transaction otherwise unrelated to commodity futures or option contracts. In the Advance Notice, the Commission proposed to include within this category, among other things, adjustable rate mortgages, employment agreements, leases or other similar contracts "in which the interest payment or other contractual obligation is measured by reference to an economic index published by an agency of the United States, a published interest rate or index of rates such as the London Interbank Offered Rate (LIBOR), or other economic indicator in general commercial use, such as certain indices published by the Commodity Research Bureau, provided that the commodity-indexed component of the transaction is not severable from an underlying contractual obligation that serves an independent commercial purpose and is entered into other than for speculative, hedging or investment purposes." 52 FR 477024. These agreements are designed to provide for anticipated costs or returns in real rather than nominal terms.

Although the Notes do not appear to serve a commercial purpose that is independent of an investment purpose, they nonetheless resemble the instruments referred to in the Advance Notice whose value is structured to correlate with an inflation measure. The Notes are debt instruments affording a specified real rate of return based upon an inflation measure published by a U.S. government agency which is widely used commercially as a cost-of-living adjustment factor. The option-like characteristics of the Notes are not the sole source of their return, nor are these characteristics severable from the underlying obligation. Thus, the instruments may be viewed as analogous to hybrid instruments with *de minimis* option characteristics set forth in the Advance Notice.

Based upon the foregoing, the staff has determined that it will not recommend to the Commission that enforcement action be instituted under Section 4c based upon the issuance of the Notes. This position does not address any other offering or proposed offering by [the issuer] or [the underwriter]. This position is based upon the facts and representations contained in the materials supplied by you and [the underwriter], as supplemented by conversations with the staff. Any different, omitted or changed facts or conditions might require a different conclusion. In addition, it should 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 respect to the Advance Notice may require a reconsideration of this position for subsequent offerings.