



COMMODITY FUTURES TRADING COMMISSION

2033 K Street, NW, Washington, DC 20581

(202) 254 - 8955

(202) 254 - 8010 Facsimile

DIVISION OF
TRADING AND MARKETS

RECEIVED
PUBLIC RECORD
10 10 AM '95
95-27

February 16, 1995

Re: Section 4m(1): Request for Exemption from CPO and
CTA Registration

Dear :

This is in response to your letter dated December 15, 1994, to the Division of Trading and Markets ("Division") of the Commodity Futures Trading Commission ("Commission"), as supplemented by letter dated February 1, 1995, and telephone conversations with Division staff. By your letter you request on behalf of ("Company"), a Maryland corporation, that the Division grant the Company relief from registration as a commodity pool operator ("CPO") in connection with certain commodity interest trading activities in which the Company intends to engage, as described more fully below.^{1/}

Based upon the representations made in your letter, as supplemented, we understand that the facts are as follows. The Company was incorporated in April of 1994 for the purpose of acquiring, holding and managing first lien mortgage loans originated by others on single-family, multifamily and commercial real estate properties throughout the United States and securities backed by such mortgage loans. The Company will elect to be subject to tax as a real estate investment trust ("REIT") under the Internal Revenue Code of 1986, as amended, and has marketed itself as a REIT in its private placement memorandum ("Private Placement Memorandum").

The Company recently completed an offering of "Units," each Unit consisting of one share of convertible preferred stock and one stock purchase warrant, in a private offering (the "Private Placement") exempt from registration under the Securities Act of 1933 ("1933 Act"), pursuant to Section 4(2) of the 1933 Act and Regulation D promulgated thereunder. The Units were offered and

^{1/} Although not specifically requested, based upon telephone conversations with Division staff, this letter also addresses the applicability of commodity trading advisor registration requirements in connection with the Company's activities.

sold solely to accredited investors as defined in Rule 501 of Regulation D. The Company raised approximately \$22.5 million in capital in the Private Placement after deduction of placement agent fees and offering expenses.

In connection with the Private Placement, the Company entered into a "Registration Rights Agreement" with Unit Holders pursuant to which the Company is obligated to file a "Shelf Registration Statement" under the 1933 Act by May 22, 1995, and cause the Shelf Registration Statement to become effective by July 22, 1995. The purpose of the Shelf Registration Statement is to allow current holders of Units ("Unit Holders") to sell their preferred stock, common stock issuable upon conversion of preferred stock, warrants and any equity stock acquired upon exercise of the warrants on the open market from time to time, should the Unit Holders decide to do so. Concurrently with the shelf registration process, the Company will register its preferred stock, common stock and warrants under Section 12(g) of the Securities and Exchange Act of 1934 (the "1934 Act") and will attempt to have the preferred stock and warrants listed on a national stock exchange or have the stock and warrants approved for quotation on the NASDAQ National Market System. Upon effectiveness of the Shelf Registration Statement, the Company will be subject to the periodic reporting requirements under the 1934 Act and all of the liabilities, obligations and restrictions imposed upon the Company and its directors and officers under the 1933 Act and the 1934 Act to the same extent as would be imposed upon the Company, its directors and officers had the Company made an initial public offering of its equity securities. In addition, the Company, its directors and officers will be subject to the rules of any exchange on which the Company's preferred stock and warrants are listed or approved for quotation.

The Company's Private Placement Memorandum specifically authorizes the Company to engage in interest rate hedging transactions in order to reduce the Company's exposure to unfavorable interest rate fluctuations. Specifically, the Private Placement Memorandum states that the Company may "purchase interest rate caps, interest rate swaps and similar instruments to attempt to limit, fix or partially offset changes in interest rates on its borrowings and effectively extend the maturities of such borrowings." To this end, the Company seeks to open commodity interest trading accounts for the purpose of hedging the interest rate risk exposure it will encounter as a result of its financing strategy for bona fide hedging transactions and positions as defined in Commission Rule 1.3(z)(1).^{2/}

^{2/} Commission rules referred to herein are found at 17 C.F.R. Ch. I (1994).

The Company intends to limit the commodity interest contracts in which it invests to Eurodollar Time Deposit Rates, Federal Funds Rate, U.S. Treasury Bills and Notes, and options on the foregoing (collectively, the "Interest Rate Futures and Options Contracts"). You represent that the "cost of the Company's liabilities resulting from its financing strategy has a close correlation to the LIBOR and U.S. Treasury bill markets and, consequently, such [Interest Rate Futures and Options Contracts] are an effective hedge against the interest rate risks arising therefrom." You further represent that the aggregate amount of funds that the Company will deposit as original margin or option premiums for such Interest Rate Futures and Options Contracts will be limited to no more than one percent of the fair market value of the Company's total assets, after taking into account unrealized profits and unrealized losses on any such contracts it has entered into.

You also state that under the Internal Revenue Code of 1986, the Company's REIT status subjects the Company to a one-hundred percent income tax on any income derived from certain non-real estate related sources that exceed five percent of the Company's gross income. Any income derived from the Interest Rate Futures and Options Contracts would be included for purposes of calculating this five percent amount, together with certain other non-real estate related income. Consequently, you state that from a business perspective, the one-hundred percent income tax penalty imposed upon REITs deters the Company from earning income from non-real estate related sources, including commodity interest related activities, in excess of five percent of the Company's gross income.

In further support of the requested relief, you claim that the Company is not intended to be a commodity pool and that the opening of commodity interest accounts on Interest Rate Futures and Options Contracts is incidental to the Company's business of investing in mortgage loans and the acquisition of securities backed by such mortgage loans. You ask the Division to grant the Company relief from CPO registration requirements, either by finding that the Company is not a "pool" within the meaning of Rule 4.10(d), or by providing the Company with a "no-action" position such that the Company need not register as a CPO, notwithstanding its transactions involving Interest Rate Futures and Options Contracts.

Section 4m(1) of the Commodity Exchange Act ("Act")^{3/} requires all CPOs to be registered as such. Section 1a(4) of the Act^{4/} defines the term CPO as "any person engaged in a business

^{3/} 7 U.S.C. § 6(m) (1988 & Supp. IV 1992).

^{4/} 7 U.S.C. § 1 (Supp. IV 1992).

which is in the nature of an investment trust, syndicate, or similar form of enterprise and who, in connection therewith, solicits, accepts, or receives from others . . . property for the purpose of trading in [commodity interests].^{5/} Thus, absent an applicable exemption or other relief, the Company would need to register as a CPO.

The Division believes your request has merit in light of your representations, among others, that: (1) the Company was formed for the purpose of acquiring, holding and managing first lien mortgage loans originated by others on certain real estate properties throughout the United States and securities backed by such mortgage loans; (2) upon effectiveness of the Shelf Registration Statement, the Company will be subject to the periodic reporting requirements under the 1934 Act and all of the liabilities, obligations and restrictions imposed upon the Company and its directors and officers under the 1933 Act and 1934 Act; (3) the Company will engage in trading Interest Rate Futures and Options Contracts solely for bona fide hedging purposes, as defined in Rule 1.3(z)(1); (4) the Company will limit the commodity interest contracts it invests in to Interest Rate Futures and Options Contracts as defined herein; (5) the aggregate amount of funds that the Company will deposit as original margin or option premiums for such Interest Rate Futures and Options Contracts will be limited to no more than one percent of the fair market value of the Company's total assets, after taking into account unrealized profits and unrealized losses on any such Interest Rate Futures and Options Contract; and (6) the Company's Private Placement Memorandum discloses the purpose of and limitations on the Company's commodity interest trading to investors. Accordingly, the Division will not recommend that the Commission take any enforcement action against the Company for failure to register as a CPO in connection with its operations as described herein.

It is anticipated that three persons will be advising the Company with respect to the use of Interest Rate Futures and Options Contracts for the purpose of hedging the Company's interest rate exposure: "A", "B" and "C" (collectively the "Advisors").^{6/} You represent that none of the Advisors is subject to

^{5/} 7 U.S.C. § 1 (Supp. IV 1992).

^{6/} "A" was elected to serve as Chairman of the Board and Chief Executive Officer of the Company and also is the President of "A", "X", an investment adviser registered with the Securities and Exchange Commission under the Investment Advisers Act of 1940. "X" assists banks, insurance companies and savings and loans in managing portfolios of securitized and unsecuritized mortgage
(continued...)

a statutory disqualification under Section 8a(2) or 8a(3) of the Act.^{7/} You also represent that none of the Advisors otherwise provides commodity interest trading advice to other persons nor holds himself out generally to the public as a commodity trading advisor ("CTA"). Nonetheless, it appears that the Advisors may come within the definition of the term "commodity trading advisor" in Section 1a(5) of the Act^{8/} in connection with providing commodity interest trading advice to the Company. Based upon the foregoing representations, however, including the aforesaid limitations upon the Company's commodity interest trading activities, the Division will not recommend that the Commission take any enforcement action against any of the Advisors for failure to register as a CTA in connection with providing commodity interest trading advice to the Company as described herein.^{9/}

You should be aware that the positions taken in this letter do not excuse the Company or the Advisors from compliance with any otherwise applicable requirements contained in the Act^{10/} or in the Commission's regulations issued thereunder. For example, each remains subject to the antifraud provisions of Section 4o of the Act,^{11/} to the reporting requirements for traders set forth in Parts 15, 18, and 19 of the Commission's regulations, and to the operational provisions of Rules 4.20 for CPOs and 4.30 for CTAs and the advertising requirement of Rule 4.41 for both CPOs and CTAs.

This letter is based upon the representations provided to us and is strictly limited to those representations. Any different,

^{6/} (...continued)

loans, in arranging collateralized borrowings, in hedging balance sheet risks, and with other types of capital markets transactions. "B" was elected to serve as President, Chief Financial officer and a director of the Company and is a principal of "X". "C" was elected to serve as Vice Chairman of the Board and Secretary of the Company and also is a principal of "X".

^{7/} 7 U.S.C. § 12a(2) or 12a(3) (1988 & Supp. IV 1992).

^{8/} 7 U.S.C. § 1 (Supp. IV 1992).

^{9/} Cf. Rule 4.14(a)(5), which provides that a person is not required to register as a CTA where it is exempt from registration as a CPO and where "the person's commodity trading advice is directed solely to, and for the sole use of, the pool or pools for which it is so exempt."

^{10/} 7 U.S.C. § 1 et seq. (1988 & Supp. IV. 1992).

^{11/} 7 U.S.C. § 6o (1988).

changed or omitted facts or circumstances might require us to reach a different conclusion. In this connection, we request that you notify us immediately in the event the operations of the Company, including the restrictions on the use of Interest Rate Futures and Options Contracts as described herein, change in any way from those as represented.

The views expressed herein are those of the Division only and do not necessarily represent the views of the Commission or of any other office or division of the Commission. If you have any questions concerning this correspondence, please contact me or Tina Paraskevas Shea, an attorney on my staff, at (202) 254-8955.

Very truly yours,

Susan C. Ervin
Chief Counsel