

**Item 1 – Cover Page**

**Form ADV, Part 2: Brochure**



ARMOUR Residential Management LLC

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July 23, 2012

This Form ADV, Part 2 (the "Brochure") provides information about the qualifications and business practices of ARMOUR Residential Management LLC ("we," "us," or "ARRM"). If you have any questions about the contents of this Brochure, please contact us by telephone at (772) 617-4340 and/or by email at [sju@armourllc.com](mailto:sju@armourllc.com). The information in this Brochure has not been approved or verified by the United States Securities and Exchange Commission (the "SEC") or by any state securities authority.

From time to time, ARRM refers to itself as a "registered investment advisor" or describes itself as "registered." Registration does not include or imply a certain level of skill or training. Neither the SEC, the securities regulatory authority of any state, nor the securities regulatory authority of any other jurisdiction has approved or disapproved ARRM's regulatory status, or passed upon the adequacy or accuracy of this Brochure.

Additional information about ARRM is also available on the SEC's website at [www.advisorinfo.sec.gov](http://www.advisorinfo.sec.gov).

## **Item 2 – Material Changes**

As this Brochure is our initial Brochure, we are not yet amending this Brochure for our annual or for any interim update. Therefore, this Item 2 is not applicable to us until such time as we are required to amend the Brochure for our annual or for any interim update.

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#### **Item 4 – Advisory Business**

ARRM is a Delaware limited liability company that commenced its management business on November 6, 2009. ARRM's managing members are Scott J. Ulm and Jeffrey J. Zimmer.

ARRM manages the business affairs of ARMOUR Residential REIT, Inc. ("ARMOUR"), a publicly-traded real estate investment trust ("REIT") (NYSE: ARR) that invests primarily in hybrid adjustable rate, adjustable rate and fixed rate residential mortgage backed securities issued or guaranteed by a U.S. Government-sponsored entity ("GSE"), such as the Federal National Mortgage Association (more commonly known as Fannie Mae) and the Federal Home Loan Mortgage Corporation (more commonly known as Freddie Mac), or guaranteed by the Government National Mortgage Administration, a U.S. Government corporation (more commonly known as Ginnie Mae) (collectively, "Agency Securities"), pursuant to a management agreement entered into between ARRM and ARMOUR on November 6, 2009 (as amended and restated from time to time, the "Management Agreement"). Mr. Ulm is the Co-Chief Executive Officer, Chief Investment Officer, Co-Vice Chairman and Head of Risk Management of ARMOUR. Mr. Zimmer is the Co-Chief Executive Officer, Chief Financial Officer, President and Co-Vice Chairman of ARMOUR.

Under the Management Agreement, ARRM is responsible for (i) advising ARMOUR with respect to, arranging for, and managing the acquisition, financing, management and disposition of, its investments, (ii) evaluating the duration risk and prepayment risk of its investments and arranging borrowing and interest rate risk mitigation strategies, and (iii) coordinating its capital raising activities. In conducting these activities, ARRM also advises ARMOUR on formulating and implementing its operating strategies and policies, arranging for its acquisition of assets, monitoring the performance of its assets, arranging for various types of financing and interest rate risk mitigation strategies, and providing administrative and managerial services in connection with its day-to-day operations, as may be required from time to time for its management and its assets.

We manage the business affairs of ARMOUR in conformity with certain restrictions, including contractual restrictions, investment guidelines and any other material operating policies adopted by ARMOUR. Our role as the manager of ARMOUR is subject to the direction and oversight of ARMOUR's board of directors. Under the Management Agreement, ARMOUR, in its discretion, is able to limit our management, services, and other activities performed by us pursuant to the Management Agreement. Additionally, under the Management Agreement, ARMOUR has the right to limit our duties, in ARMOUR's discretion, to "mortgage assets." Pursuant to the Management Agreement, "mortgage assets" means the following assets types of ARMOUR, which ARMOUR may determine from time to time shall be solely managed by us:

- mortgage securities (or interests therein), including (a) adjustable-rate, hybrid adjustable-rate and pass-through certificates (including GNMA certificates, FNMA certificates and FHLMC certificates), (b) collateralized mortgage obligations, (c) securities representing interests in, or secured by, agency wrapped mortgages on real property other than pass-through certificates and CMOs, (d) agency mortgage

derivative securities and other agency mortgage-backed and mortgage collateralized obligations, and (e) mortgage derivative securities;

- U.S. government issued bills, notes and bonds including general obligations of the agencies of the U.S. government (including, but not limited to GNMA, FNMA and FHLMC); and
- short-term investments, including short-term bank certificates of deposit, short-term U.S. Treasury securities, short-term U.S. government agency securities, commercial paper, repurchase agreements, short-term CMOs, short-term asset backed securities and other similar types of short-term investment instruments, all of which will have maturities or average lives of less than one (1) year.

Under the Management Agreement, ARMOUR's board of directors is able to direct us to perform similar management and services for any of ARMOUR's subsidiaries; provided, however, that we neither have the right nor the obligation to supervise any other manager, or to manage or otherwise participate in any way in any securitization transaction undertaken by ARMOUR or any joint venture formed by ARMOUR.

As of July 13, 2012, we managed approximately \$13,941,700,000 in assets, consisting primarily of Agency Securities.

## **Item 5 – Fees and Compensation**

### ***Base Management Fee***

For the services we render under the Management Agreement, ARMOUR pays us each month in arrears compensation equal to 1/12th of the sum of (a) 1.5% of the "Gross Equity Raised" up to \$1 billion plus (b) 0.75% of the "Gross Equity Raised" in excess of \$1.0 billion (the "Base Management Fee") within one (1) Business Day after the end of such month. Pursuant to the Management Agreement, the Base Management Fee shall not ever be less than 1/12th of the "Annual Minimum Fee," defined as \$900,000 for each fiscal year of the Management Agreement. In the event of a termination of our Management Agreement, the Base Management Fee shall be pro-rated based upon the number of days elapsed in such calendar month of termination prior to the effective date of such termination. Under our Management Agreement, "Gross Equity Raised" means an amount in dollars calculated as of the date of determination that is equal to (a) the initial equity capital that ARMOUR raised following the consummation of its merger on November 6, 2009, plus (b) equity capital raised in public or private issuances of ARMOUR's equity securities (calculated before underwriting fees and distribution expenses, if any), less (c) capital returned to the stockholders of ARMOUR, as adjusted to exclude (d) one-time charges pursuant to changes in GAAP and certain non-cash charges after discussion between us and ARMOUR's board of directors and approved by a majority of ARMOUR's board of directors.

We do not receive any incentive-based compensation from ARMOUR.

We use the proceeds from the Base Management Fee in part to pay compensation to our officers and personnel who, notwithstanding that certain of them also are officers of ARMOUR, receive no compensation directly from ARMOUR.

### ***Termination Fee***

ARMOUR is obligated to pay us a termination fee equal to three (3) times the cumulative Base Management Fees paid to us in the preceding full twelve (12) months, calculated as of the effective date of the termination of the Management Agreement, only if ARMOUR terminates the Management Agreement without "Cause" (as defined in the Management Agreement). During the initial term of the Management Agreement, which expires on June 18, 2022 (the "Initial Term"), ARMOUR may only terminate the Management Agreement for Cause.

### ***Final Payment to the Sub-Manager***

We have also entered into a sub-management agreement, dated November 6, 2009 (the "Sub-Management Agreement"), with Staton Bell Blank Check LLC, a Delaware limited liability company ("SBBC" or "Sub-Manager"), which is an entity jointly owned by two directors of ARMOUR. Pursuant to the Sub-Management Agreement, SBBC provides certain operating and investment advisory services to us. In exchange for such services, we pay SBBC a sub-management fee of 25% of the net Base Management Fee earned by us under the Management Agreement with ARMOUR (the "Sub-Manager Base Management Fee"). The Sub-Management Agreement further provides that, upon the election of SBBC to terminate the Sub-Management Agreement, at the time of the expiration of the Initial Term of the Management

Agreement, ARMOUR shall pay SBBC a final payment of 6.16 times the annualized rate of the last three (3) monthly payments of the Sub-Manager Base Management Fee (the "Final Payment"). The Final Payment shall be paid on the date that is 60 days after the election of SBBC to terminate the Sub-Management Agreement.

### ***Reimbursement of Expenses***

ARMOUR pays all of its and our costs and expenses (including for goods and services obtained from third parties) incurred solely on behalf of ARMOUR or any subsidiary or in connection with the Management Agreement, except for the cost and expenses not reimbursable under the Management Agreement, which are costs and expenses specifically required to be borne by us under the Management Agreement. The expenses required to be paid by us are described later in this Item 5. The expenses required to be paid by ARMOUR include:

- all costs and expenses associated with ARMOUR's formation and capital raising activities, including, without limitation, the costs and expenses of the preparation of its registration statements, and any and all costs and expenses of any public offering of ARMOUR, any subsequent offerings and any filing fees and costs of ARMOUR being a public company, including, without limitation, filings with the SEC, the Financial Industry Regulatory Authority ("FINRA"), and any exchange or over the counter market, among other such entities;
- all of ARMOUR's costs and expenses of ARMOUR in connection with the acquisition, disposition, financing, interest rate risk mitigation, administration and ownership of its or any of its subsidiary's investment assets (including, without limitation, the assets in which ARMOUR invests) and, including, without limitation, costs and expenses incurred in contracting with third parties, including any person controlling, controlled by, or under common control with us (as may be approved by ARMOUR pursuant to the terms of the Management Agreement), to provide such services, such as legal fees, accounting fees, consulting fees, trustee fees, appraisal fees, insurance premiums, commitment fees, brokerage fees, guaranty fees, ad valorem taxes, costs of foreclosure, maintenance, repair and improvement of property and premiums for insurance on property owned by ARMOUR or any subsidiary of it;
- all costs and expenses relating to the acquisition of, and maintenance and upgrades to, ARMOUR's portfolio analytics and accounting systems (including, but not limited to Bloomberg);
- all costs and expenses of money ARMOUR or its subsidiaries borrow, including, without limitation, principal, interest and the costs associated with the establishment and maintenance of any credit facilities, warehouse loans and other indebtedness of ARMOUR and its subsidiaries (including commitment fees, legal fees, closing and other costs);
- all taxes and license fees applicable to ARMOUR or any subsidiary of its, including interest and penalties thereon;

- all legal, audit, accounting, underwriting, brokerage, listing, filing, rating agency, registration and other fees, printing, engraving, clerical, personnel and other expenses and taxes of ARMOUR incurred in connection with the issuance, distribution, transfer, registration and stock exchange listing of ARMOUR's or any of its subsidiary's equity securities or debt securities;
- other than our obligations, all fees paid to and expenses of third party advisors and independent contractors, consultants, managers and other agents (other than us) engaged by ARMOUR or any subsidiary of it or by us for ARMOUR's account or any subsidiary of it (other than us) and all employment expenses of the personnel employed by ARMOUR or any subsidiary of ARMOUR's, including, without limitation, the salaries (base and bonuses alike), wages, equity based compensation of such personnel, and payroll taxes;
- all insurance costs incurred by ARMOUR or any subsidiary of it and including, but not limited to, insurance paid for by ARMOUR to insure us for liabilities as a result of being the manager for ARMOUR;
- all custodian, transfer agent and registrar fees and charges incurred by ARMOUR;
- all compensation and fees paid to directors of ARMOUR or any subsidiary of it, all expenses of directors of ARMOUR or any subsidiary of it (including those directors who are also employees of ours), the cost of directors and officers liability insurance and premiums for errors and omissions insurance, and any other insurance deemed necessary or advisable by ARMOUR's board of directors for the benefit of ARMOUR and its directors and officers (including those directors who are also employees of ours), the cost of all meetings of ARMOUR's board of directors, and the cost of travel, hotel accommodations, food and entertainment for all participants in meetings of ARMOUR's board of directors;
- all third party legal, accounting and auditing fees and expenses and other similar services relating to ARMOUR or any of its subsidiary's operations (including, without limitation, all quarterly and annual audit or tax fees and expenses);
- all legal, expert and other fees and expenses relating to any actions, proceedings, lawsuits, demands, causes of action and claims, whether actual or threatened, made by or against ARMOUR, or which ARMOUR is authorized or obligated to pay under applicable law or its "governing instruments" (as defined in the Management Agreements) or by its board of directors;
- any judgment or settlement of pending or threatened proceedings (whether civil, criminal or otherwise) against ARMOUR or any subsidiary of ARMOUR's, or against any trustee, director or officer of ARMOUR or any subsidiary of ARMOUR's in his



capacity as such for which ARMOUR or any subsidiary of it is required to indemnify such trustee, director or officer by any court or governmental agency, or settlement of pending or threatened proceedings;

- at all times all travel and related expenses of directors, officers and employees of ARMOUR and us incurred in connection with meetings related to ARMOUR's business, attending meetings of its board of directors or its holders of securities or any subsidiary of it or performing other business activities that relate to ARMOUR or any subsidiary of it, including, without limitation, travel and expenses incurred in connection with the purchase, financing, refinancing, sale or other disposition of the assets in which ARMOUR invests or other investments of ARMOUR's; provided, however, that ARMOUR shall only be responsible for a proportionate share of such expenses, as reasonably determined by us in good faith after full disclosure to ARMOUR, in instances in which such expenses were not incurred solely for the benefit of ARMOUR;
- all expenses of organizing, modifying or dissolving ARMOUR or any subsidiary of it, costs preparatory to entering into a business or activity, and costs of winding up or disposing of a business or activity of ARMOUR or its subsidiaries;
- all expenses relating to payments of dividends or interest or distributions in cash or any other form made or caused to be made by ARMOUR's board of directors to or on account of holders of ARMOUR's securities or any subsidiary of it, including, without limitation, in connection with any dividend reinvestment plan;
- all expenses of third parties relating to communications to holders of equity securities or debt securities issued by ARMOUR or any of its subsidiaries and the other bookkeeping and clerical work necessary in maintaining relations with holders of such securities and in complying with the continuous reporting and other requirements of governmental bodies or agencies, including any costs of computer services in connection with this function, the cost of printing and mailing certificates for such securities and proxy solicitation materials and reports to holders of ARMOUR's or any of its subsidiary's securities and reports to third parties required under any indenture to which ARMOUR or any of its subsidiaries is a party;
- all expenses relating to any office or office facilities maintained by ARMOUR or any of its subsidiaries (other than any office of us and/or any person controlling, controlled by, or under common control with us, which are our obligations), including, without limitation, rent, telephone, utilities, office furniture, equipment, machinery and other office expenses for any other persons ARMOUR's board of directors authorizes ARMOUR to hire;
- all costs and expenses related to the design and maintenance of ARMOUR's web site or sites and associated with any computer software or hardware that is used solely for ARMOUR;

- other than our obligations, all other costs and expenses relating to ARMOUR's business and investment operations, including, without limitation, the costs and expenses of acquiring, owning, protecting, maintaining, developing and disposing of the assets in which ARMOUR invests, including, without limitation, appraisal, reporting, audit and legal fees;
- other than the our obligations below, and subject to a line item budget approved in advance by ARMOUR's board of directors, all other expenses actually incurred by us, any person controlling, controlled by, or under common control with us (as may be approved by ARMOUR pursuant to the terms of the Management Agreement) or his or her respective officers, employees, representatives or agents, or any person controlling, controlled by, or under common control with such respective officers, employees, representatives or agents (as may be approved by ARMOUR pursuant to the terms of the Management Agreement) which are reasonably necessary for the performance our duties and functions under the Management Agreement, including, without limitation, any fees or expenses relating to our compliance with all governmental and regulatory matters).

We are responsible for the following obligations that are not eligible to be reimbursed by ARMOUR:

- employment expenses of the personnel employed by us, including, without limitation, salaries (base and bonuses alike), wages, payroll taxes and the cost of employee benefit plans of such personnel (but excluding any stock of ARMOUR that its board of directors may determine to grant to such personnel, which stock shall not reduce employment expenses otherwise payable by us or cause us or ARMOUR to pay any payroll taxes in respect thereof); and
- rent, telephone, utilities, office furniture, equipment, machinery and other office, internal and overhead expenses of us required for ARMOUR's day to day operations, including, bookkeeping, clerical and back office services provided by us (except that ARMOUR shall pay for supplies applicable to operations (paper, software, presentation materials, etc.)).

Moreover, subject to ARMOUR's right to retain other managers and its right to limit our authorizations, we are authorized, for and on behalf, and at ARMOUR's sole cost and expense, to employ such securities dealers (including affiliates of us) for the purchase and sale of ARMOUR's mortgage assets managed by us as may, in our reasonable judgment, be necessary to obtain the best commercially available net results taking into account such factors as ARMOUR's policies, price, dealer spread, the size, type and difficulty of the transaction involved, the firm's general execution and operational facilities and the firm's risk in positioning the securities involved. Consistent with this policy, and subject to the foregoing caveats with respect to ARMOUR's rights, we are authorized to direct the execution of ARMOUR's portfolio

transactions to dealers and brokers furnishing statistical information or research deemed by us to be reasonably necessary to the performance of its investment advisory functions for ARMOUR.

In addition, we may retain the services of third parties (including affiliates of us), for and on ARMOUR's behalf, including, without limitation, accountants, legal counsel, appraisers, insurers, brokers, dealers, transfer agents, registrars, developers, investment banks, financial advisors, banks and other lenders and others as we may deem reasonably necessary or advisable in connection with ARMOUR's management and operations.

ARMOUR will be responsible for the costs and expenses related to the retention of such third parties except that (a) it is not responsible for costs and expenses that are our obligations described above and (b) We are responsible for such costs and expenses (unless otherwise approved by ARMOUR's board of directors) if a third party is retained to (i) make decisions to invest in and dispose of the assets in which ARMOUR invests, (ii) provide administrative, data processing or clerical services or prepare ARMOUR's financial records or (iii) prepare a report summarizing ARMOUR's acquisitions of the assets in which it invests, portfolio compensation and characteristics, credit quality (if applicable) or performance of the portfolio, with respect to assets that ARMOUR has determined shall be managed by us.

We have the right to cause any of our services under the Management Agreement to be rendered by our employees or any person controlling, controlled by, or under common control with us. In that case, ARMOUR is responsible to pay or reimburse us or such person controlling, controlled by, or under common control with us for the reasonable and actually incurred cost and expense of performing such services by such person, including, without limitation, administrative support services specifically requested by ARMOUR if the costs and expenses of such person would have been reimbursable under the Management Agreement if such person were an unaffiliated third party, or if such service had been performed by us.

## **Item 6 – Performance-Based Fees and Side-By-Side Management**

We do not accept performance-based fees based, for example, on a share of capital gains on or capital appreciation of, the assets of ARMOUR. Because we only manage the business and operations of ARMOUR, there is no conflict of interest based on charging different fee schedules to different clients.

As described above in Item 5, ARMOUR pays us each month in arrears compensation equal to 1/12th of the sum of (a) 1.5% of the "Gross Equity Raised" up to \$1 billion plus (b) 0.75% of the "Gross Equity Raised" in excess of \$1.0 billion within one (1) Business Day after the end of such month. Under our Management Agreement, "Gross Equity Raised" means an amount in dollars calculated as of the date of determination that is equal to (a) the initial equity capital that ARMOUR raised following the consummation of its merger on November 6, 2009, plus (b) equity capital raised in public or private issuances of ARMOUR's equity securities (calculated before underwriting fees and distribution expenses, if any), less (c) capital returned to the stockholders of ARMOUR, as adjusted to exclude (d) one-time charges pursuant to changes in GAAP and certain non-cash charges after discussion between us and ARMOUR's Board of Directors and approved by a majority of ARMOUR's Board of Directors.

As a result of a fee structure that is based on Gross Equity Raised and not tied to ARMOUR's performance, we may not be sufficiently incentivized to pursue business that maximizes risk-adjusted returns on ARMOUR's investment portfolio. Instead, we are incentivized to increase Gross Equity Raised (for example, by recommending follow-on stock offerings), which may not necessarily be in line with the interests of ARMOUR's stockholders. Moreover, under the Management Agreement, we have a contractual as opposed to fiduciary relationship with ARMOUR. Nevertheless, we make a determination, exercising our judgment in good faith, as to whether an investment opportunity is appropriate for ARMOUR. Factors in making such a determination may include ARMOUR's liquidity, ARMOUR's overall investment strategy and objectives, the composition of ARMOUR's existing portfolio, the size or amount of the available investment opportunity, the characteristics of the securities involved, the liquidity of the markets in which the securities trade, the risks involved, and other factors relating to ARMOUR and the investment opportunity.

We may in the future adopt additional conflicts of interest resolution policies and procedures designed to protect the business interests of ARMOUR.

## **Item 7 – Types of Clients**

ARRM provides investment and portfolio management services, among other business services, to ARMOUR, a publicly-traded REIT that invests primarily in Agency Securities, pursuant to the Management Agreement between us and ARMOUR (please refer to Item 4 for further details). From time to time, a portion of ARMOUR's portfolio may be invested in unsecured notes and bonds issued by U.S. Government-chartered entities, U.S. Treasuries and money market instruments, subject to certain income tests ARMOUR must satisfy for our qualification as a REIT. ARMOUR was organized as a Maryland corporation in 2008.

ARMOUR seeks attractive long-term investment returns by investing its equity capital and borrowed funds in its targeted asset class of Agency Securities. ARMOUR earn returns on the spread between the yield on its assets and its costs, including the interest cost of the funds it borrows, after giving effect to its hedges. ARMOUR intends to qualify and has elected to be taxed as a REIT under the Internal Revenue Code ("the Code"). ARMOUR is generally not subject to federal income tax to the extent that it distributes its taxable income to its shareholders and as long as it satisfies the ongoing REIT requirements including meeting certain asset, income and stock ownership tests. ARMOUR's business plan is to identify and acquire Agency Securities, finance its acquisitions with borrowings under a series of short-term repurchase agreements at the most competitive interest rates available to it and then cost-effectively mitigate its interest rate and other risks based on its entire portfolio of assets, liabilities and derivatives and our view of the market. Successful implementation of ARMOUR's business plan requires it to address interest rate risk, maintain adequate liquidity and effectively mitigate interest rate risks. We assist ARMOUR in executing its business plan in a manner consistent with its intention of qualifying as a REIT.

## **Item 8 – Methods of Analysis, Investment Strategies and Risk of Loss**

### ***Our Investment Strategy***

ARMOUR relies on our expertise to construct selectively and manage actively a diversified mortgage investment portfolio and to identify asset classes that, when properly financed and hedged, are designed to produce attractive risk-adjusted returns across a variety of market conditions and economic cycles. We focus on asset selection and the relative value of various sectors within the mortgage market. We believe that the residential mortgage market will undergo dramatic change in the coming years as the role of GSEs is diminished, which we expect to create attractive investment opportunities for ARMOUR. Therefore, we change the composition of ARMOUR's investment portfolio as we believe changes to market conditions, risks and valuations warrant. Consequently, ARMOUR may experience investment gains or losses when we sell instruments that we believe no longer provides attractive risk-adjusted returns relative to other sectors of the mortgage market.

Through our rigorous research, stringent investment underwriting analysis and disciplined security selection, we invest in and manage a portfolio of mortgage investments with attractive risk-adjusted yields. In general, we evaluate investment opportunities by reviewing: cash flow characteristics of underlying mortgages and properties; borrower credit quality; regional economic factors, including the potential for growth or contraction, future demand for residential and commercial properties and the potential for home price appreciation or depreciation; and potential drivers of defaults and loss characteristics of underlying collateral.

Our goal is for ARMOUR to profit not only from current earnings generated by its investment portfolio, but also from the identification of investment opportunities whose relative value, arising from current or expected market trends and dislocations, has diverged from other investment opportunities. Specifically, we evaluate the risk/return characteristics of individual investment opportunities against other mortgage investment opportunities as well as opportunities in other investment sectors. Our selection of assets focuses on investments that are expected to generate attractive returns relative to other investments with similar levels of risk and are expected to benefit from expected trends within the mortgage market.

The factors we consider in selecting Agency Securities include, but are not limited to, items such as interest rates, property prices, other economic indicators and loan level and borrower characteristics. These factors drive our projections of prepayments, loan modifications, defaults and loss severities. In addition, these loan cash flow projections, which may be adjusted to reflect servicer specific behavior, in combination with the deal structure, allow us to project security returns under a variety of scenarios and to select securities that provide attractive returns given the specific level of risk.

We employ our expertise and experience in financing selected assets within ARMOUR's investment portfolio, when appropriate and prudent, and to hedge its investment portfolio to manage prepayment, credit and interest rate risks as applicable.

Our active management strategy involves buying and selling securities in all sectors of the mortgage market. Therefore, the composition of ARMOUR's investment portfolio varies as we believe changes to market conditions, risks and valuations warrant. Consequently, ARMOUR

may experience investment gains or losses when it sells instruments that we no longer believe provides attractive risk-adjusted returns relative to other sectors of the mortgage market.

We expect ARMOUR's target asset allocation to evolve over time as opportunities emerge and, as we currently believed will occur, the government, through the Federal Housing Administration ("FHA") and GSEs, reduces its involvement in the U.S. housing finance market.

### ***Investment Methods***

We assist ARMOUR in carefully selecting and purchasing primarily Agency Securities, either in initial offerings or on the secondary market through broker-dealers or similar entities. We may also assist ARMOUR in identifying originators and intermediaries with which to enter into arrangements to source collateral for these securities.

We also assist ARMOUR in utilizing to-be-announced forward contracts ("TBAs") in order to invest in Agency Securities or to hedge its investments. Pursuant to these TBAs, ARMOUR would agree to purchase, for future delivery, Agency Securities with certain principal and interest terms and certain types of underlying collateral, but the particular securities to be delivered would not be identified until shortly before the TBA settlement date. ARMOUR's ability to purchase Agency Securities through TBAs may be limited by the 75% income and asset tests applicable to REITs.

We may assist ARMOUR in carefully selecting and investing directly in residential mortgage loans (prime mortgage loans and non-prime mortgage loans) through direct purchases of loans from mortgage originators and through purchases of loans on the secondary market. ARMOUR may also enter into purchase agreements with a number of loan originators and intermediaries, including mortgage bankers, commercial banks, savings and loan associates, home builders, credit unions and other mortgage conduits. We advise ARMOUR regarding investing primarily in mortgage loans secured by properties within the United States.

### ***Investment Guidelines***

Our investment advisory services are subject to the following investment guidelines that have been adopted by the board of directors of ARMOUR:

- no investment shall be made that would cause ARMOUR to fail to qualify as a REIT for federal income tax purposes;
- no investment shall be made that would cause ARMOUR to be regulated as an investment company under the Investment Company Act of 1940 (the "1940 Act");
- prior to entering into any proposed investment transaction with us, ARMOUR or any of our respective affiliates, a majority of ARMOUR's independent directors must approve the terms of the transaction; and
- ARMOUR's investment portfolio shall consist of its target assets, which consist primarily of Agency Securities.

ARMOUR may change these investment guidelines at any time with the approval of its board of directors.

### ***Borrowing Strategy***

We advise and assist ARMOUR in borrowing against investments in its target assets primarily using repurchase agreements. These borrowings generally have maturities that range from one month or less up to one year, although occasionally ARMOUR may enter into longer dated borrowing agreements to more closely match the rate adjustment period of the securities it owns. Depending on market conditions, ARMOUR may enter into additional repurchase arrangements with similar longer-term maturities or a committed borrowing facility. In order to finance its Agency Securities, we advise ARMOUR to borrow between six and ten times the amount of its stockholders' equity with respect to Agency Securities, but ARMOUR is not limited to those ranges. The level of ARMOUR's borrowings may vary periodically depending on market conditions.

Despite recent credit market developments and prevailing trends, we believe ARMOUR's target assets will continue to be eligible for financing in the repurchase agreement market.

### ***Hedging Strategy***

We may use a variety of strategies to hedge a portion of ARMOUR's exposure to interest rate, prepayment and credit risk to the extent that we believe is prudent, taking into account our investment strategy, the cost of the hedging transactions and ARMOUR's intention to qualify as a REIT. As a result, we may advise ARMOUR to not hedge certain interest rate, prepayment or credit risks if we believe that bearing such risks enhances ARMOUR's return relative to its risk/return profile.

### ***Interest Rate Risk***

We assist ARMOUR in hedging some of its exposure to potential interest rate mismatches between the interest ARMOUR earns on its longer term investments and the borrowing costs on its shorter term borrowings. Because ARMOUR's leverage is primarily in the form of repurchase agreements, its financing costs will fluctuate based on short-term interest rate indices, such as LIBOR. Because some of ARMOUR's investments is in assets that have fixed rates of interest and mature in up to 30 years, the interest it earns on those assets will generally not move in tandem with the interest rates that it pays on its repurchase agreements, which generally have a maturity of less than one year. As a result, ARMOUR may experience reduced income or losses based on these rate movements. In order to mitigate such risk, we may assist ARMOUR in utilizing certain hedging techniques as discussed below.

We design interest rate risk mitigation strategies to reduce the impact on ARMOUR's income caused by the potential adverse effects of changes in interest rates on its assets and liabilities. Subject to complying with REIT requirements, we use derivative instruments to mitigate the risk of adverse changes in interest rates on the value of its assets as well as the differences between the interest rate adjustments on its assets and borrowings. These strategies will consist primarily of ARMOUR purchasing or selling futures contracts and may also include



entering into interest rate swap, interest rate cap or interest rate floor agreements, purchasing put and call options on securities or securities underlying futures contracts, or entering into forward rate agreements. Although we advise ARMOUR that it is not limited in its use of interest rate risk mitigation strategies, we advise ARMOUR to limit its use of derivative instruments to only those techniques described above and to enter into derivative transactions only with counterparties that we believe have a strong credit rating to help mitigate the risk of counterparty default or insolvency. These transactions are entered into solely for the purpose of mitigating interest rate risk. Since ARMOUR does not qualify for hedge accounting treatment as prescribed by GAAP, its operating results may reflect greater volatility than otherwise would be the case, because gains or losses on the derivative instruments may not be offset by changes in the fair values or cash flows of the related investment or borrowing transactions within the same accounting period, or ever.

We assess ARMOUR's interest rate risk by estimating the effective duration of its assets and the effective duration of its liabilities and by estimating the time difference between the interest rate adjustment of its assets and the interest rate adjustment of its liabilities. Effective duration essentially measures the market price volatility of financial instruments as interest rates change. We estimate effective duration using various financial models and empirical data. Different models and methodologies can produce different effective duration estimates for the same securities.

### ***Prepayment Risk***

Because residential borrowers are able to prepay their mortgage loans (which underlie the Agency Securities in which ARMOUR invests) at par at any time, ARMOUR faces the risk that it will experience a return of principal on its investments earlier than anticipated, and it may have to invest that principal at potentially lower yields. Because prepayments on residential mortgages generally accelerate when interest rates decrease and slow when interest rates increase, mortgage securities typically have “negative convexity.” In other words, certain mortgage securities in which ARMOUR invests may increase in price more slowly than most bonds, or even fall in value, as interest rates decline. Conversely, certain mortgage securities in which ARMOUR invests may decrease in value more quickly than similar duration bonds as interest rates increase. In order to manage ARMOUR's prepayment and interest rate risks, we monitor, among other things, its “duration gap” and convexity exposure. Duration is the relative expected percentage change in market value of its assets that would be caused by a parallel change in short and long-term interest rates. Convexity exposure relates to the way the duration of a mortgage security changes when the interest rate and prepayment environment changes.

### ***Credit Risk***

We advise ARMOUR to accept mortgage credit exposure at levels we deem prudent, which is an integral part of our diversified investment strategy. Therefore, ARMOUR may retain all or a portion of the credit risk on its investments in Agency Securities. We seek to manage this risk through prudent asset selection, pre-acquisition due diligence, post-acquisition performance monitoring, sale of assets where we identify negative credit trends, the use of various types of credit enhancements and by using non-recourse financing, which limits ARMOUR's exposure to credit losses to the specific pool of mortgages subject to the non-recourse financing. Our overall

management of credit exposure may also include credit default swaps or other financial derivatives that we believe are appropriate.

We follow a disciplined security selection process and help ARMOUR to be, in essence, a relative value investor in its target assets. We have conducted with respect to Agency Securities, top-down market assessments of the various segments of the mortgage-related investments market in order to identify the most attractive segments and investment opportunities consistent with ARMOUR's portfolio objectives and risk management strategy. In employing this detailed analysis, we seek to identify the best values available in mortgage-related investments. We select ARMOUR's mortgage-related investments based on extensive bottom-up analysis including, among other factors, financial structure, prepayment trends, average remaining life and expected duration, amortization schedules, fixed versus floating interest rates, geographic concentration, property type, loan-to-value ratios, origination characteristics and credit scores. Considering the large size of the mortgage-related investments market, we believe we can be very selective with ARMOUR's investments and buy only the securities we deem to be the most attractive.

### ***Portfolio Construction***

We help ARMOUR realize returns to its investors by constructing a well-balanced portfolio consisting primarily of Agency Securities with a focus on managing various associated risks, including credit, interest rate, prepayment, and financing risk. We use our fixed income expertise across the range of asset classes within the mortgage-related investments markets to build a portfolio that seeks to balance income, cash, capital, leverage and the aforementioned risks. Through the careful and disciplined selection of assets, and continual portfolio monitoring, we believe we can build and maintain an investment portfolio that provides value to ARMOUR's stockholders over time, both in absolute terms and relative to other mortgage-related investment portfolios.

### ***Analytical Tools, Infrastructure and Expertise***

Our experienced investment team constructs and manages ARMOUR's mortgage-related investment portfolio through the use of focused qualitative and quantitative analysis, which helps it manage risk on a security-by-security and portfolio basis. We rely on a variety of analytical tools and models to assess ARMOUR's investments and risk management. We focus on in-depth analysis of the numerous factors that influence ARMOUR's target assets, including:

- fundamental market and sector review;
- cash flow analysis;
- controlled risk exposure; and
- prudent balance sheet management.

We also use these tools to guide the interest rate risk mitigation strategies we have developed to the extent consistent with ARMOUR's requirements for qualification as a REIT.

### ***Strategic Relationships and Experience***

We maintain relationships with financial intermediaries including prime brokers, investment banks, broker-dealers and asset custodians. We believe these relationships enhance our ability to source, finance, protect and mitigate the interest rate risk on ARMOUR's investments and, thus, enable it to succeed in various credit and interest rate environments. Our management has many years of experience and well-established contacts within the mortgage-backed securities markets and the capital and financing markets generally, and are able to bring our personal relationships to bear for ARMOUR's benefit and the benefit of its stockholders.

### ***Risk Factors***

*Investing in Agency Securities involves risk of loss that ARMOUR should be prepared to bear. ARMOUR should consider carefully the material risks described below. If any of the following events occur in the course of our providing management and investment services, ARMOUR's business, financial condition and operating results may be materially adversely affected. In that event, the trading price of its securities could decline, and ARMOUR could lose all or part of its investments.*

### **Risks Related to Structural And Market Conditions For Our Client's Investments**

- ***Volatile market conditions for mortgages and mortgage-related assets as well as the broader financial markets may adversely affect the value of the assets in which ARMOUR invests;***
- ***Continued adverse developments in the global capital markets, including defaults, credit losses and liquidity concerns, as well as mergers, acquisitions or bankruptcies of potential repurchase agreement counterparties, could make it difficult for us to assist ARMOUR in borrowing money to acquire its target assets on a leveraged basis, on favorable terms, or at all, which could adversely affect its profitability;***
- ***Continued adverse developments in the residential mortgage market may adversely affect the value of ARMOUR's target assets;***
- ***The federal conservatorship of Fannie Mae and Freddie Mac and related efforts, along with any changes in laws and regulations affecting the relationship between Fannie Mae and Freddie Mac and the federal government, may adversely affect ARMOUR's business;***
- ***Certain actions by the U.S. Federal Reserve could cause a flattening of the yield curve, which could materially adversely affect ARMOUR's business, financial condition and results of operations and its ability to pay distributions to its stockholders;***
- ***Mortgage loan modification and refinancing programs and future legislative action may adversely affect the value of, and our returns on, residential mortgage-backed securities;***

- *Changes in the underwriting standards by Freddie Mac or Fannie Mae could have an adverse impact on Agency Securities in which ARMOUR may invest;*
- *We may not be able to assist ARMOUR in operating its business or implement its operating policies and strategies successfully;*
- *Increased levels of prepayments from ARMOUR's target assets may decrease its net interest income or result in a net loss;*
- *Changes in prepayment rates may adversely affect ARMOUR's profitability;*
- *Recent market conditions may upset the historical relationship between interest rate changes and prepayment trends, which would make it more difficult for us to analyze ARMOUR's portfolio;*
- *The downgrade of the U.S. Government's or certain European countries' credit ratings and future downgrades of the U.S. Government's or certain European countries' credit ratings may materially adversely affect ARMOUR's business, financial condition and results of operations;*
- *Actions of the U.S. Government, including the U.S. Congress, Federal Reserve, U.S. Treasury and other governmental and regulatory bodies for the purpose of stabilizing or reforming the financial markets, or market response to those actions, may not achieve the intended effect or benefit ARMOUR's business and may adversely affect its business;*
- *The increasing number of proposed U.S. federal, state and local laws and regulations may affect certain mortgage-related assets in which ARMOUR intends to invest and could increase ARMOUR's cost of doing business;*
- *Changes in interest rates may adversely affect the results of ARMOUR's operations and its financial position;*
- *Interest rate mismatches between ARMOUR's future acquired target assets and its incurred borrowings used to fund its purchases of these securities may reduce ARMOUR's income during periods of changing interest rates;*
- *Interest rate caps on ARMOUR's adjustable rate target assets may reduce its income or cause it to suffer a loss during periods of rising interest rates;*
- *Because ARMOUR invests in fixed rate securities, an increase in interest rates may adversely affect ARMOUR's book value;*
- *Mitigating against interest rate exposure may adversely affect ARMOUR's earnings, and our interest rate risk mitigation transactions may fail to protect ARMOUR from the losses that they were designed to offset;*

- *We may not be able to execute desired interest risk mitigation transactions at favorable prices for ARMOUR;*
- *ARMOUR's use of derivative instruments may expose it to counterparty risk;*
- *A prolonged economic recession and further declining real estate values could impair the value of the assets that ARMOUR intends to acquire;*
- *Most of ARMOUR's investments are recorded at fair value, and quoted prices or observable inputs may not be available to determine such value, resulting in the use of significant unobservable inputs to determine value;*
- *Declines in value of the assets in which ARMOUR invests will adversely affect its financial position and results of operations, and make it more costly to finance these assets;*
- *Competition may prevent ARMOUR from acquiring its target assets at favorable yields and that would harm its results of operations; and*
- *ARMOUR may not be able to acquire investments at favorable prices.*

#### **Risks Related to Financing Strategies, Guidelines and Policies**

- *ARMOUR intends to leverage its portfolio investments in its target assets, which may adversely affect its return on its investments and may reduce cash available for distribution to ARMOUR's stockholders;*
- *If ARMOUR experiences losses as a result of our leverage policy, such losses would reduce the amounts available for distribution to its stockholders. Because the assets that ARMOUR expects to acquire may experience periods of illiquidity, ARMOUR may be prevented from selling its target assets at opportune times and prices;*
- *There is no assurance that financing arrangements will be available;*
- *ARMOUR may incur increased borrowing costs related to repurchase agreements which could harm its results of operations; and*
- *Our leverage strategy may increase the risks of ARMOUR's operations, which could reduce its net income and the amount available for distributions or cause it to suffer a loss.*

#### **Risks Related to Our Client's Corporate Structure**

- *ARMOUR's board of directors approved very broad investment guidelines for us and will not approve each investment and financing decision we make; and*

- *ARMOUR may change its target assets, investment guidelines and other operational policies, which may hamper our investment services and adversely affect the market price of ARMOUR's common stock and its ability to make distributions to its stockholders.*

### **Item 9 – Disciplinary Information**

Investment advisors registered with the SEC are required to disclose all material facts regarding any legal or disciplinary events that could be important to a client's evaluation of ARRM or the integrity of ARRM's management. ARRM has no such legal or disciplinary actions to disclose.

## **Item 10 – Other Financial Industry Activities and Affiliations**

ARRM has arrangements that are material to its advisory business with its affiliate, ARMOUR. As described above in Item 4, ARRM has entered into a Management Agreement with ARMOUR through which ARRM manages the business and affairs of ARMOUR.

We receive a monthly management fee that is based on the total of all Gross Equity Raised, as measured as of the date of determination (i.e., each month), regardless of ARMOUR's performance. Accordingly, the possibility exists that we will receive significant management fees for a given month despite the fact that ARMOUR could experience a net loss during that month. Our entitlement to such significant nonperformance-based compensation may not provide us with sufficient incentive to devote the time and effort to source and maximize risk-adjusted returns on ARMOUR's investment portfolio, which could, in turn, adversely affect its ability to pay dividends to its stockholders and the market price of its common stock. Further, the management fee structure may give us the incentive to maximize Gross Equity Raised by the issuance of new equity securities or the retention of existing equity, regardless of the effect of these actions on ARMOUR's existing stockholders. In other words, the management fee structure rewards us based primarily on the size of ARMOUR's equity, and not on its financial returns to stockholders. Nevertheless, we make a determination, exercising our judgment in good faith, as to whether an investment opportunity is appropriate for ARMOUR. Factors in making such a determination may include ARMOUR's liquidity, ARMOUR's overall investment strategy and objectives, the composition of ARMOUR's existing portfolio, the size or amount of the available investment opportunity, the characteristics of the securities involved, the liquidity of the markets in which the securities trade, the risks involved, and other factors relating to ARMOUR and the investment opportunity.



## **Item 11 – Code of Ethics, Participation or Interest in Client Transactions and Personal Trading**

We have adopted a code of ethics for avoiding prohibited acts and eliminating potential conflicts of interests. Policies against over-reaching, self-dealing, insider trading, and conflicts of interest are set forth in ARRM's code of ethics. Among other matters, the code of ethics forbids any member, officer, affiliate or employee of ARRM from trading, either personally or on behalf of others on material non-public information or communicating material non-public information to others in violation of the law.

In addition, the code of ethics set forth restrictions on the receipt of gifts, outside employment and other matters. ARRM believes that its code of ethics is appropriate to prevent or eliminate potential conflicts of interest between ARRM and its employees, managing members and ARMOUR. Yet, ARMOUR should be aware that no set of rules can anticipate or avoid all potential conflicts of interest.

We do not and will not purchase portfolio assets from, or sell them to, ARMOUR's directors, officers or ARMOUR, or any of our or their affiliates, or engage in any transaction in which they have a direct or indirect pecuniary interest (other than the Management and Sub-Management Agreements) in any circumstances.

We do not have a policy that expressly prohibits our officers, members or any of our affiliates from engaging for their own account in business activities of the types conducted by us. However, our code of conduct contains a conflicts of interest policy that prohibits our officers and employees from engaging in any transaction that involves an actual conflict of interest with ARMOUR.

We may in the future adopt additional conflicts of interest resolution policies and procedures designed to support the equitable allocation and to prevent the preferential allocation of investment opportunities among entities with overlapping investment objectives.

If you would like to receive a copy of ARRM's code of ethics, contact ARRM by telephone at (772) 617-4340 or submit a written request to 3001 Ocean Drive, Suite 201, Vero Beach, Florida 32963.

## **Item 12 – Brokerage Practices**

We consider a number of factors in selecting broker-dealers for client transactions, including:

- Demonstrated expertise in the type of transaction;
- Proposed fees and execution levels; and
- Market share, execution, sales, and trading capabilities.

We compare proposed fees to other comparable executed transactions as well as competing offers depending on the nature of the transaction. In addition to fees, estimated execution levels are considered carefully against comparable transactions.

We have a relationship with AVM, L.P., a securities broker-dealer and unaffiliated third party, which ARMOUR contracts for clearing and settlement services for its securities and derivative transactions, as well as assistance with financing transaction services such as repurchase financing and management of margin arrangements between ARMOUR and its lenders for each of its repurchase agreements, which is beneficial to ARMOUR in addressing the potential scarcity of repurchase funding.

### **Item 13 – Review of Accounts**

We review the performance of our single client account, ARMOUR, on a daily basis, monitoring changes in prices levels, financing, and hedging costs. On a monthly basis, we review the prepayment performance of all mortgage-backed securities, which data is only updated monthly. The review is conducted daily by our Head of Portfolio Management and our Chief Analyst. They are supervised by our Co-Managing Members.

ARMOUR files with the SEC and posts on its website, [www.armourreit.com](http://www.armourreit.com), a monthly report containing detail on portfolio composition, prepayment performance, hedging, and financing. On a quarterly basis, ARMOUR files a Form 10-Q and annually it files a Form 10-K with the SEC.

#### **Item 14 – Client Referrals and Other Compensation**

As described above in Item 5, we have entered into the Sub-Management Agreement with SBBC, or Sub-Manager, which is an entity jointly owned by affiliates of ARMOUR. Pursuant to the Sub-Management Agreement, SBBC provides certain operating and investment advisory services to us. In exchange for such services, we pay SBBC a Sub-Manager Base Management Fee equal to 25% of the net Base Management Fee earned by us under the Management Agreement with ARMOUR. The Sub-Management Agreement further provides that, upon the election of SBBC to terminate the Sub-Management Agreement, at the time of the expiration of the Initial Term of the Management Agreement, ARMOUR shall pay SBBC a Final Payment of 6.16 times the annualized rate of the last three (3) monthly payments of the Sub-Manager Base Management Fee. The Final Payment shall be paid on the date that is 60 days after the election of SBBC to terminate the Sub-Management Agreement.

**Item 15 – Custody**

Neither we nor our related persons have custody of ARMOUR's funds, bank accounts or securities.

## **Item 16 – Investment Discretion**

As described above in Item 4 and Item 8, we have discretionary authority to determine the type and amount of Agency Securities to be bought and sold for ARMOUR's account, subject to certain limitations.

We manage the business affairs of ARMOUR in conformity with certain restrictions, including contractual restrictions, investment guidelines and any other material operating policies adopted by ARMOUR. Our role as the manager of and investment advisor to ARMOUR is subject to the direction and oversight of ARMOUR's board of directors. Under the Management Agreement, ARMOUR, in its discretion, is able to limit our management, services, and other activities performed by us pursuant to the Management Agreement. Additionally, under the Management Agreement, ARMOUR has the right to limit our duties, in ARMOUR's discretion, to "mortgage assets."

Under the Management Agreement, ARMOUR's board of directors is able to direct us to perform similar management and services for any of ARMOUR's subsidiaries; provided, however, that we neither have the right nor the obligation to supervise any other manager, or to manage or otherwise participate in any way in any securitization transaction undertaken by ARMOUR or any joint venture formed by ARMOUR.

Our investment advisory services are subject to the following investment guidelines that have been adopted by the board of directors of ARMOUR:

- no investment shall be made that would cause ARMOUR to fail to qualify as a REIT for federal income tax purposes;
- no investment shall be made that would cause ARMOUR to be regulated as an investment company under the Investment Company Act of 1940 (the "1940 Act");
- prior to entering into any proposed investment transaction with us, ARMOUR or any of our respective affiliates, a majority of ARMOUR's independent directors must approve the terms of the transaction; and
- ARMOUR's investment portfolio shall consist of its target assets, which consist primarily of Agency Securities.

ARMOUR may change these investment guidelines at any time with the approval of its board of directors.

### **Item 17 – Voting Client Securities**

ARRM has not accepted and will not accept authority to vote ARMOUR's securities. Therefore, we are not required to adopt proxy voting guidelines and procedures in accordance with Rule 206(4)-6 of the Investment Advisers Act of 1940.

## **Item 18 – Financial Information**

Registered investment advisers are required in this Item 18 to provide investors with certain financial information or disclosures about their financial condition. ARRM has no financial commitment that impairs its ability to meet contractual commitments to ARMOUR, and has not been the subject of a bankruptcy proceeding.