AETHER SYSTEMS INC
Form 10-K/A
May 02, 2005

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

FORM 10 K/A

Amendment No. 2

ý ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

FOR THE FISCAL YEAR ENDED DECEMBER 31, 2004

OR

o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

COMMISSION FILE NUMBER: 000 27707

AETHER SYSTEMS, INC.

(EXACT NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER)

DELAWARE (State or other jurisdiction of incorporation or organization)	**52-2186634** (IRS Employer Identification Number)
621 E. Pratt St., Suite 601, Baltimore, MD (Address of principal executive offices)	**21202** (Zip Code)

(Registrant s telephone number, including area code): **(443) 573 9400**

SECURITIES REGISTERED PURSUANT TO SECTION 12(b) OF THE ACT: **NONE.**

SECURITIES REGISTERED PURSUANT TO SECTION 12(g) OF THE ACT:
COMMON STOCK, PAR VALUE $.01

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ý No o

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of regulation S K is not contained herein, and will not be contained, to the best of the registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of the Form 10 K or any amendment of this Form 10 K. o

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act). Yes ý No o

The aggregate market value of the voting stock held by nonaffiliates of the registrant was $134,092,738 ($3.44 per share) as of June 30, 2004.

As of March 2, 2005, 44,000,921 shares of the registrant s common stock, $.01 par value per share, were outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

None.

Explanatory Note to Amendment No. 2

The Company is filing this Amendment No. 2 to its Annual Report on Form 10-K/A for the year ended December 31, 2004, as filed with the Securities and Exchange Commission on March 16, 2005 and amended and restated on April 12, 2005.

This Amendment No. 2 restates in its entirety Amendment No. 1 to add the following information:

Part III of Form 10-K, which information was to have been incorporated by reference from Aether s proxy statement for its 2005 annual meeting of stockholders.

The remainder of the information contained in the Form 10-K/A filed on April 12, 2005 is unchanged.

Explanatory Note to Amendment No. 1

On April 12, 2005, the Company filed Amendment No. 1 to its Annual Report on Form 10-K for the year ended December 31, 2004, as filed with the Securities and Exchange Commission on March 16, 2005. Amendment No. 1 restated the original Form 10-K and included the following changes resulting from the Company s and the Company s independent registered public accounting firm s completed analysis of internal controls over financial reporting as required by section 404 of the Sarbanes-Oxley Act of 2002, as permitted by the Exemptive Order

issued by the Securities and Exchange Commission on November 30, 2004 (Release No. 50754) under section 36 of the Securities Exchange Act of 1934:

addition to Item 8 of management s report on internal controls over financial reporting and the report on internal controls over financial reporting from KPMG LLP, the Company s independent registered public accounting firm;

replacement of Item 9A, Controls & Procedures;

additional consent of KPMG LLP, independent registered public accounting firm (exhibit 23.1); and

additions to the section 302 certification letters from the Company s chief executive officer and chief financial officer to address internal control over financial reporting (exhibit 31.1 and 31.2, respectively).

The remainder of the information contained in the original Form 10-K filed on March 16, 2005 was not amended in Amendment No. 1.

AETHER SYSTEMS, INC.

ANNUAL REPORT ON FORM 10-K/A

FOR THE YEAR ENDED DECEMBER 31, 2004

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FORWARD-LOOKING STATEMENTS

This Annual Report on Form 10-K/A contains forward-looking statements that involve risks and uncertainties. When used in this Report, the words anticipate, believe, estimate, intend, may, will, expect and similar expressions as they relate to our company or our management intended to identify a statement as a forward-looking statement. Our actual results, performance or achievements could differ materially from the results expressed in, or implied by, these forward-looking statements. Factors that could cause or contribute to such differences include those discussed in Item 7 of this Report under the heading Risk Factors. Forward-looking statements reflect our reasonable beliefs and expectations as of the time we make them, and we have no obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise. In this Annual Report on Form 10-K/A, we refer to Aether Systems, Inc. as Aether, the Company, we or us.

PART I

ITEM 1. BUSINESS

INTRODUCTION

Our business objectives are to become profitable as quickly as possible and to realize value, in the form of tax savings, from our significant accumulated tax loss carryforwards. In pursuit of these objectives during 2004, we accomplished the following:

We sold our mobile and wireless data businesses, which had continued to lose money;

We further reduced our operating expenses;

We simplified our balance sheet and repaid the balance of our 6% convertible subordinated notes; and

We implemented a strategy of building and managing a leveraged portfolio of residential mortgage-backed securities.

As a result of these activities, at the end of 2004 our business was focused on investing primarily in adjustable rate, residential mortgage-backed securities issued by the Federal Home Loan Mortgage Association (FHLMC), the Federal National Mortgage Association (FNMA) and the Government National Mortgage Association (GNMA).

At December 31, 2004, we had approximately $131.7 million of cash (including restricted cash) and cash equivalents, investments in mortgage-backed securities, and other investments available for sale. At December 31, 2004, we owned approximately $62.2 million of mortgage-backed securities at fair value. Our total assets were approximately $136.6 million, and our total liabilities were approximately $6.0 million. We had accumulated federal net operating losses of approximately $765.5 million that we can carry forward and use to offset future taxable income until they expire between 2012 and 2024. We also had accumulated federal capital losses of approximately $245.3 million that we can carry forward and use to offset future capital gains until they expire between 2006 and 2009.

In this Report, discussions of our Company s operations will reflect our ongoing mortgage-backed securities business. Our historical financial results reflect the operations of our ongoing business as continuing operations. The financial results of our mobile and wireless data businesses are reported as discontinued operations.

Mortgage-Backed Securities Strategy

We began to make investments in mortgage-backed securities (MBS) during the second quarter of 2004, and we have continued to implement our MBS business strategy gradually and conservatively. While we had more than half of our available cash invested in mortgage-backed securities as of December 31, 2004, we will need to expand our business to achieve our objectives. As we have previously reported, we expect that an important part of our MBS strategy will be to leverage our invested cash by borrowing additional funds for investment. We plan to do this by entering into short-term repurchase agreements with financial institutions that have received the highest available long-term debt rating from a nationally recognized rating agency. These borrowings will allow us to expand the size of our portfolio, as well as to seek increased overall returns from our investments (both in amount and yield). As discussed below in Item 7 under the heading Risk Factors Borrowings may negatively affect the performance of our portfolio of MBS, the use of leverage involves substantial risks and uncertainties and could negatively affect the performance of the MBS portfolio. In addition to leveraging the portfolio, we may, from time to time in the future, seek to sell additional shares of our common stock to raise additional cash that would be available for investment.

Our earnings from these activities will be the spread between the interest income we earn on the mortgage-backed securities we own, less the interest expense we incur to finance the purchase of such securities (to the extent we employ leverage) and the other expenses of managing our business. The expenses of managing our business include the management fee and the incentive fee we have agreed to pay to our outside investment manager.

To assist in the management of our MBS business, we have retained outside professional financial and investment advisors with substantial experience in the MBS market and in managing a leveraged portfolio of MBS investments. In June 2004, we engaged FBR Investment Management, Inc. (FBR) as our outside investment advisor to carry out the day-to-day management of the MBS portfolio, subject to oversight by our management and our Board of Directors and to investment policies adopted by our Board. FBR currently manages a multi-billion dollar leveraged portfolio of mortgage-backed securities for one of its affiliates. In addition, we have contracted with FinPro, Inc. (FinPro) to provide us with independent oversight of FBR and to assist us in developing, evaluating and managing our MBS strategy. FinPro is an investment advisory and management consulting firm that specializes in providing financial advisory services to financial institutions. FinPro has substantial experience in the MBS market and related markets.

Development of MBS Strategy and Other Activities

The timing and amount of MBS purchases that we make, the level of leverage that we employ and the alternative investment strategies we explore depend upon market conditions, which we continuously monitor, the advice and recommendations of our outside professional investment and financial advisors, with whom we regularly confer and applicable regulatory requirements. In light of market conditions that existed during the second half of 2004 and into the first quarter of 2005, we limited our purchases of MBS to $63.8 million in securities (including purchase premiums) acquired pursuant to forward purchase commitments entered into during the third quarter of 2004 (settled in September and October 2004) and did not employ any leverage with respect to our MBS portfolio. Our position reflected our relative views of the total return we could achieve on our investments in MBS and the borrowing costs associated with leveraging those investments. In general, short-term borrowing rates were increasing more quickly than the yields earned by MBS during this period. During February 2005, we began to see certain favorable changes in market conditions and in late February and early March 2005, we entered into forward purchase arrangements representing commitments to purchase MBS in March and April 2005 with an estimated aggregate face value of $375.0 million. In order to settle these forward purchase contracts and acquire the underlying MBS, we will be required to borrow funds, which we expect to do by entering into short-term repurchase arrangements, as discussed above and below under the heading Mortgage-Backed Securities Leverage and Borrowing Strategy. While we expect to have sufficient funds to purchase the MBS securities from a combination of our available cash and funding from one or more of the financial institutions with which we have master repurchase agreements in place, those master repurchase agreements are not funding commitments. If we are unable to secure necessary funds through repurchase agreements or otherwise, our financial condition and results could be adversely affected, as discussed below in Item 7 under the heading Risk Factors We will depend on borrowings to expand our MBS portfolio. If we fail to obtain or to renew sufficient funding on favorable terms or at all, we may incur losses.

While we continue to focus on our MBS business, in an effort to achieve our overall business objectives we are also evaluating other potential opportunities that could serve either to complement or diversify our MBS business. We have been contacted by a number of third parties regarding a variety of real estate-related opportunities and are evaluating these opportunities as appropriate within the context of achieving our business objectives as well as ensuring that we remain exempt from registration as an investment company under the Investment Company Act of 1940, as amended (the Investment Company Act). We may in the future pursue one or more of these opportunities, if we conclude that they could enhance our ability to achieve our stated objectives more quickly or more reliably. We have not made any decisions to pursue any of these alternatives, and we expect to continue to focus our business activities on our mortgage-backed securities strategy. The mix of our assets and the amount of leverage we incur may change significantly over time and also may vary in response to changing market conditions.

Disposition of Wireless and Mobile Data Businesses

In 2004, we sold our mobile and wireless data businesses, which were organized into three operating segments. In January 2004, we sold our Enterprise Mobility Solutions (EMS) segment for $18.0 million in cash and a $1.0 million note (which was paid in full in August 2004). In September 2004 we sold our Transportation and Mobile Government segments for $25.0 million in cash and $10.0 million in cash, respectively. For information on these dispositions, see Note 15 of the notes to our consolidated financial statements included in Item 8 of this Report.

Tax Aspects of Our Business Strategy

An important aspect of our business strategy is to realize value, in the form of tax savings, from our accumulated tax loss carryforwards. Under federal and state tax laws, we may use these carryforwards to substantially reduce the income taxes we otherwise would have to pay on future taxable income. As a result, we could have little or no income tax liability for a period of time. Our ability to realize value from these tax loss carryforwards is subject to various risks and uncertainties, including regulations that, under certain circumstances, may limit our ability to use these carryforwards to reduce future taxes that we might otherwise owe.

The Internal Revenue Code and applicable Internal Revenue Service (IRS) regulations, contain limitations on certain changes in ownership of our stock by certain stockholders (generally persons who hold, or who acquire, at least 5% of our outstanding shares, calculated in accordance with IRS regulations) which, if exceeded, could reduce or eliminate our ability to use our accumulated tax loss carryforwards in the future (if those changes resulted in a change of ownership as that term is defined in Section 382 of the Internal Revenue Code and applicable IRS regulations). These same tax rules and the need to avoid an ownership change could also restrict the amount of additional shares we could issue to raise new capital for investment in our business.

In an effort to mitigate these risks, we are considering recommending to our shareholders a reorganization that would create transfer restrictions on our stock to reduce the risk that we would experience an ownership change under the tax laws which would limit our use of tax loss carryforwards or otherwise restrict our ability to issue additional shares out of concern that such issuance (combined with such transfers) would create an ownership change. The imposition of these transfer restrictions would require stockholder approval.

In an effort to seek to accelerate the realization of the value from our accumulated net operating loss and capital loss carryforwards, we may seek additional capital, from time to time, through periodic offerings of shares of our stock as market conditions allow. Such additional capital would then be used to expand our business in pursuit of additional taxable income. In general, we would expect to seek to sell shares only when such sales would not be dilutive to the value of our outstanding shares at the time of any such offering. This means we generally would not expect to sell shares at any time when the offering price is below the per share book value of our assets. Because we cannot predict the future trading price of our stock, we cannot predict when or whether we would be able to sell shares of stock to raise additional capital under the desired conditions. In addition, as noted above, provisions of the Internal Revenue Code and certain applicable IRS regulations will limit the number of additional shares of stock we can sell from time to time without causing a limitation on our ability to use our accumulated tax loss carryforwards to reduce our future tax obligations.

Raising additional capital will allow us to expand our MBS portfolio (both by investing that capital in MBS and borrowing additional amounts to leverage the newly raised capital). In addition, to the extent we pursue additional or other business strategies, we could use additional capital to expand these strategies. If we are successful in implementing our MBS strategy, a larger portfolio should generate greater earnings, which would allow us to consume our tax loss carryforwards more quickly, thereby accelerating our realization of future tax savings. As the size of our MBS business grows over time, we may seek to add to our employee base so that our staff will have additional industry-specific capabilities and expertise to help manage our portfolio. In this event, we likely would reduce our reliance on outside professionals for such advice and assistance. In addition, we may expand our corporate staff over time to enhance other corporate functions, such as financial, legal and other administrative and compliance activities, to the extent our business grows and makes such additions cost-effective.

Although we may choose to pay dividends in the future, we do not currently anticipate paying dividends to our stockholders in the near term as we seek to realize value from our loss carryforwards by increasing our earnings as quickly as possible. Instead, we expect to re-invest earnings in our business to promote its expansion. We expect that our tax loss carryforwards will allow us to reinvest earnings without reduction for income tax payments for as long as those carryforwards remain available to us.

If we were to pay dividends to stockholders from current earnings, these dividends would, generally speaking, be eligible to be treated as qualified dividends for federal income tax purposes, currently taxed at a maximum federal rate of 15%, assuming that the recipient stockholder meets the various requirements under the Internal Revenue Code for such treatment. The maximum rate for qualified dividends is currently projected to increase to the maximum federal income tax rate applicable to ordinary income (currently 35%) for tax years beginning after December 31, 2008 in accordance with the Jobs and Growth Tax Relief Reconciliation Act of 2003.

For a discussion of tax risks and uncertainties applicable to our business strategy, see the discussion below in Item 7 under the heading Risk Factors Regulatory and tax risks of our MBS business.

MORTGAGE-BACKED SECURITIES

Investment Approach and Policies

Our Board of Directors has authorized the investment of up to $100 million of our available cash in our MBS business. We also are permitted to leverage our invested cash between five and eight times. Our Board may increase, decrease or waive these limitations in the future, at its discretion. If we were to invest $100 million of our available cash and cash equivalents in our MBS business, and if we were to incur leverage of eight times our cash investment to purchase additional MBS, our total MBS portfolio would have a value (at cost) of approximately $900 million.

Our Board of Directors, after consultation with FBR, FinPro and other outside advisors, has adopted a set of investment guidelines and policies that govern our MBS business. These guidelines and policies remain subject to ongoing review and refinement as we develop our MBS business, as well as amendment or waiver at the discretion of the Board. Under the terms of our management agreement with FBR, we must approve in advance any actions by FBR that are not within the scope of our guidelines and policies. As a matter of corporate policy, we will not approve any action that deviates from our guidelines and policies unless such deviation has been reviewed with FinPro and, with the advice of management and FinPro, approved by our Board of Directors.

Our current MBS guidelines and policies include the following:

FBR must obtain our permission before purchasing MBS individually in an amount exceeding $50 million or purchasing hybrid adjustable rate MBS greater than 5 years to reset, fixed-rate MBS, or MBS derivatives.

FBR must obtain our permission before taking any actions that would cause the portfolio s asset-to-equity ratio to exceed 9:1.

FBR may not enter into repurchase agreements on our behalf with any counter-party in an amount that would exceed 35% of the aggregate amount of our then outstanding repurchase agreements.

FBR may not enter into interest rate swap agreements or futures contracts without our prior approval.

Risk management systems will be used to actively monitor and manage our exposure to interest and mortgage prepayment rates, the shape of the yield curve, credit risk, risk of capital loss, the availability and cost of financing, and changing yield spreads relating to MBS.

Our Board of Directors has the power to modify or waive these policies and strategies without the consent of the stockholders to the extent that the Board of Directors determines that the modification or waiver is in the best interests of our stockholders. Among other factors, developments in the market that affect our policies and strategies or that change our assessment of the market may cause our Board of Directors to revise our policies and strategies.

Leverage and Borrowing Strategy

We expect to use short-term repurchase agreements as our principal source of financing in connection with leveraging our MBS portfolio. Amounts due upon maturity of our repurchase agreements will be funded primarily through rollover/reissuance of new repurchase agreements along with principal and interest payments received from MBS we own. As of December 31, 2004, we had not entered into any repurchase agreements. In the future, we anticipate that we will enter into repurchase agreements primarily with financial institutions that have the highest rating from a nationally recognized rating agency. We have established master repurchase arrangements with four financial institutions, in amounts that we believe are currently in excess of our anticipated needs. These master agreements do not constitute commitments by us or by the counterparties. We expect to enter into repurchase transactions with one or more of these financial institutions to provide us with most of the funding we will need to satisfy our commitments to purchase approximately $375.0 million of MBS under the forward purchase arrangements we entered into during February and March 2005.

A repurchase agreement, although structured as a sale and repurchase obligation, acts as a financing under which we effectively pledge our MBS as collateral to secure a short-term loan. (While the MBS is used as collateral, we continue to receive principal and interest payments in respect of the MBS.) Generally, the other party to the agreement makes the loan in an amount equal to a percentage of the market value of the pledged collateral. At the maturity of the repurchase agreement, we are required to repay the loan and correspondingly receive back our collateral. These types of leveraging arrangements for MBS purchases typically permit more than 90% of the purchase price of the underlying MBS to be financed through the repurchase agreement.

Repurchase agreements may require us to pledge additional assets to the lender in the event the estimated fair value of existing pledged collateral declines below a specified percentage. The pledged collateral may fluctuate in value during the life of the repurchase agreement due to, among other things, principal repayments, market changes in interest rates and credit quality. In such cases, a lender may require us to post additional collateral, or we may choose to sell the pledged security and repay the loan. This type of activity is one of the risks of a leveraged strategy discussed below in Item 7 under the heading Risk Factors Borrowings may adversely affect the performance of our portfolio of MBS. We expect to use repurchase agreements that will have original maturities ranging from 30 to 90 days. In the event a lender under a repurchase agreement decides not to renew a repurchase agreement at its maturity, we will be required to use our own cash or obtain other financing to close out the repurchase agreement and pay off the loan. In addition, as discussed below in Item 7 under the heading Risk Factors Differences in timing of interest rate adjustments on our acquired securities and our borrowings may adversely affect our MBS strategy and the returns on the portion of our cash we invest in MBS, because the interest rates paid by our MBS investments typically will not adjust more than once per year, in an environment of increasing short-term interest rates, our borrowing costs may increase more quickly than the interest rates paid by our MBS portfolio. This could have a significant negative effect on our financial performance and could materially reduce the yield we realize from our MBS portfolio.

In the event of our insolvency or bankruptcy, certain repurchase agreements may qualify for special treatment under the Bankruptcy Code, the effect of which, among other things, would be to allow the creditor under the agreement to avoid the automatic stay provisions of the Bankruptcy Code and to foreclose on the collateral agreement without delay. In the event of the insolvency or bankruptcy of a lender during the term of a repurchase agreement, the lender may be permitted, under applicable insolvency laws, to repudiate the contract, and our claim against the lender for damages may be treated simply as an unsecured claim. In addition, if the lender is a broker or dealer subject to the Securities Investor Protection Act of 1970, or an insured depository institution subject to the Federal Deposit Insurance Act, our ability to exercise our rights to recover our securities under a repurchase agreement or to be compensated for any damages resulting from the lender s insolvency may be further limited by those statutes. These claims would be subject to significant delay and, if and when received, may be substantially less than the damages we actually incur.

We intend to enter into repurchase agreements only with financial institutions that have received the highest available long-term debt rating from a nationally recognized rating agency. If this credit rating is not met, we will not enter into repurchase agreements with that lender without the consent of our Board of Directors. In the event one of our lenders is downgraded, the approval of our Board of Directors will have to be obtained before entering into additional repurchase agreements with that lender. We seek to diversify our exposure by entering into repurchase agreements with numerous separate lenders so that no one lender constitutes more than 35% of all of our outstanding repurchase agreements. If, during the term of a repurchase agreement, a lender were to file for bankruptcy, we might experience difficulty recovering the pledged security and might have only an unsecured claim against the lender s assets for the difference between the amount we borrowed and the estimated fair value of the collateral we pledged to such lender (if any).

We may also use derivative transactions and other hedging strategies, such as interest rate swaps and caps, options to purchase swaps and caps, financial futures contracts and options on futures, to help mitigate prepayment and interest rate risks if we determine that the cost of these transactions is justified by their potential benefit. We would use hedging to mitigate declines in the market value of our mortgage-backed securities during periods of increasing or decreasing interest rates or to limit or cap the interest rates on our borrowings. We expect that the extent and type of our hedging activity will vary based on the level and volatility of interest rates and mortgage principal prepayments, the type of mortgage-backed securities we acquire and other changing market conditions. We will not enter into hedging transactions for speculative purposes. The use of hedging strategies involves risks, which are described below in Item 7 under the heading Risk Factors Borrowings may adversely affect the performance of our portfolio of MBS.

Aether s MBS Investments

The MBS that we acquire and trade are agency mortgage-backed securities which, although not rated, carry an implied AAA rating. Agency mortgage-backed securities are mortgage-backed securities where a government agency or federally chartered corporation, such as FHLMC, FNMA or GNMA, guarantees payments of principal or interest on the securities. Agency mortgage-backed securities consist of pass-through certificates issued or guaranteed by an agency.

The MBS that we acquire provide funds for mortgage loans made primarily to residential homeowners. These securities generally represent interests in pools of mortgage loans made by savings and loan institutions, mortgage bankers, commercial banks and other mortgage lenders. These pools of mortgage loans are assembled for sale to investors (like us) by various government, government-related and private organizations. MBS differ from other forms of traditional debt securities, which normally provide for periodic payments of interest in fixed amounts with principal payments at maturity or on specified call dates. Instead, MBS provide for a monthly payment, which consists of both interest and principal. In effect, these payments are a pass-through of the monthly interest and principal payments made by the individual borrower on the mortgage loans, net of any fees paid to the issuer or guarantor of the securities. Additional payments result from prepayments of principal upon the sale, refinancing or foreclosure of the underlying residential property. Some MBS, such as securities issued by GNMA, are described as modified pass-through securities. These securities entitle the holder to receive all interest and principal payments owed on the mortgage pool, net of certain fees, regardless of whether the mortgagors actually make mortgage payments when due.

The investment characteristics of pass-through mortgage-backed securities differ from those of traditional fixed-income securities. The major differences include the payment of interest and principal on the MBS on a more frequent schedule, as described above, and the possibility that principal may be prepaid at any time due to prepayments on the underlying mortgage loans or other assets. These differences can result in significantly greater price and yield volatility than is the case with traditional fixed-income securities.

Various factors affect the rate at which mortgage prepayments occur, including changes in interest rates, general economic conditions, the age of the mortgage loan, the location of the property and other social and demographic conditions. Generally prepayments on MBS increase during periods of falling mortgage interest rates and decrease during periods of rising mortgage interest rates. We may reinvest prepayments at a yield that is higher or lower than the yield on the initial underlying MBS security purchased, thus affecting the weighted average yield of our investments.

To the extent MBS are purchased at a premium, faster than expected prepayments result in accelerated amortization of the premium paid, which can have a negative effect on the yield from our mortgage-backed securities portfolio. Conversely, if these securities were purchased at a discount, faster than expected prepayments accelerate our recognition of the discount and can have a positive effect on the yield from our mortgage-backed securities portfolio.

FHLMC Certificates

FHLMC is a privately-owned, government-sponsored enterprise created pursuant to an act of Congress on July 24, 1970. The principal activity of FHLMC currently consists of the purchase of mortgage loans or participation interests in mortgage loans and the resale of the loans and participations in the form of guaranteed MBS. FHLMC guarantees to each holder of FHLMC certificates the timely payment of interest at the applicable pass-through rate and ultimate collection of all principal on the holder s pro rata share of the unpaid principal balance of the related mortgage loans, but does not guarantee the timely payment of scheduled principal of the underlying mortgage loans. The obligations of FHLMC under its guarantees are solely those of FHLMC and are not backed by the full faith and credit of the United States. If FHLMC were unable to satisfy these obligations, distributions to holders of FHLMC certificates would consist solely of payments and other recoveries on the underlying mortgage loans and, accordingly, defaults and delinquencies on the underlying mortgage loans would adversely affect monthly distributions to holders of FHLMC certificates.

FHLMC certificates may be backed by pools of single-family mortgage loans or multi-family mortgage loans. These underlying mortgage loans may have original terms to maturity of up to 40 years. FHLMC certificates may be issued under cash programs (composed of mortgage loans purchased from a number of sellers) or guarantor programs (composed of mortgage loans acquired from one seller in exchange for certificates representing interests in the mortgage loans purchased).

FHLMC certificates may pay interest at a fixed rate or an adjustable rate. The interest rate paid on adjustable-rate FHLMC certificates (FHLMC ARMs) adjusts periodically within 60 days prior to the month in which the interest rates on the underlying mortgage loans adjust. The interest rates paid on certificates issued under FHLMC s standard ARM programs adjust in relation to the Treasury index. Other specified indices used in FHLMC ARM programs include the 11th District Cost of Funds Index published by the Federal Home Loan Bank of San Francisco, LIBOR and other indices. Interest rates paid on fully-indexed FHLMC ARM certificates equal the applicable index rate plus a specified number of basis points. The majority of series of FHLMC ARM certificates issued to date have evidenced pools of mortgage loans with monthly, semi-annual or annual interest adjustments. Adjustments in the interest rates paid are generally limited to an annual increase or decrease of either 100 or 200 basis points and to a lifetime cap of 500 or 600 basis points over the initial interest rate. Certain FHLMC programs include mortgage loans which allow the borrower to convert the adjustable mortgage interest rate to a fixed rate. Adjustable-rate mortgages which are converted into fixed-rate mortgage loans are repurchased by FHLMC or by the seller of the loan to FHLMC at the unpaid principal balance of the loan plus accrued interest to the due date of the last adjustable rate interest payment.

FNMA Certificates

FNMA is a privately-owned, federally-chartered corporation organized and existing under the Federal National Mortgage Association Charter Act. FNMA provides funds to the mortgage market primarily by purchasing home mortgage loans from local lenders, thereby replenishing their funds for additional lending. FNMA guarantees to the registered holder of a FNMA certificate that it will distribute amounts representing scheduled principal and interest on the mortgage loans in the pool underlying the FNMA certificate, whether or not received, and the full principal amount of any such mortgage loan foreclosed or otherwise finally liquidated, whether or not the principal amount is actually received. The obligations of FNMA under its guarantees are solely those of FNMA and are not backed by the full faith and credit of the United States. If FNMA were unable to satisfy its obligations, distributions to holders of FNMA certificates would consist solely of payments and other recoveries on the underlying mortgage loans and, accordingly, defaults and delinquencies on the underlying mortgage loans would adversely

affect monthly distributions to holders of FNMA.

FNMA certificates may be backed by pools of single-family or multi-family mortgage loans. The original term to maturity of any such mortgage loan generally does not exceed 40 years. FNMA certificates may pay interest at a fixed rate or an adjustable rate. Each series of FNMA ARM certificates bears an initial interest rate and margin tied to an index based on all loans in the related pool, less a fixed percentage representing servicing compensation and FNMA s guarantee fee. The specified index used in different series has included the Treasury Index, the 11th District Cost of Funds Index published by the Federal Home Loan Bank of San Francisco, LIBOR and other indices. Interest rates paid on fully-indexed FNMA ARM certificates equal the applicable index rate plus a specified number of basis points. The majority of series of FNMA ARM certificates issued to date have evidenced pools of mortgage loans with monthly, semi-annual or annual interest rate adjustments. Adjustments in the interest rates paid are generally limited to an annual increase or decrease of either 100 or 200 basis points and to a lifetime cap of 500 or 600 basis points over the initial interest rate. Certain FNMA programs include mortgage loans which allow the borrower to convert the adjustable mortgage interest rate of the adjustable-rate mortgage to a fixed rate. Adjustable-rate mortgages which are converted into fixed-rate mortgage loans are repurchased by FNMA or by the seller of the loans to FNMA at the unpaid principal of the loan plus accrued interest to the due date of the last adjustable rate interest payment. Adjustments to the interest rates on FNMA ARM certificates are typically subject to lifetime caps and periodic rate or payment caps.

All of the MBS we held as of December 31, 2004 and all of the MBS covered by the forward purchase arrangements we entered into during February and March 2005 are FNMA certificates.

GNMA Certificates

GNMA is a wholly owned corporate instrumentality of the United States within the Department of Housing and Urban Development. The National Housing Act of 1934 authorizes GNMA to guarantee the timely payment of the principal of and interest on certificates which represent an interest in a pool of mortgages insured by the Federal Housing Administration or partially guaranteed by the Department of Veterans Affairs and other loans eligible for inclusion in mortgage pools underlying GNMA certificates. Section 306(g) of the Housing Act provides that the full faith and credit of the United States is pledged to the payment of all amounts which may be required to be paid under any guaranty by GNMA.

At present, most GNMA certificates are backed by single-family mortgage loans. The interest rate paid on GNMA certificates may be a fixed rate or an adjustable rate. The interest rate on GNMA certificates issued under GNMA s standard ARM program adjusts annually in relation to the Treasury index. Adjustments in the interest rate are generally limited to an annual increase or decrease of 100 basis points and to a lifetime cap of 500 basis points over the initial coupon rate.

REGULATION

We intend to operate under an exception from the definition of an investment company set forth in Section 3(c)(5) of the Investment Company Act for companies that are primarily engaged in the business of purchasing or otherwise acquiring mortgages and other liens on and interests in real estate. Absent such exception or another applicable exception, we would be required to register as an investment company under the Investment Company Act and would be required to comply with the various regulations adopted by the SEC for application to registered investment companies. The staff of the SEC has expressed the view that, in order to be considered to be primarily engaged in the real estate business, a company must have at least 55% of its assets in qualifying real estate interests, which the SEC staff has said, through no-action positions, include whole pool mortgage interests issued by FHLMC, FNMA or GNMA, and at least 25% of its assets in other real estate related assets. This 25% minimum is reduced to the extent a company invests more than 55% of its assets in qualifying real estate interests. Neither the SEC nor its staff has defined the term real estate related assets for purposes of the 25% requirement set forth above. The staff has indicated, however, that a loan will qualify as a real estate related asset if at least 55% of the fair market value of the loan is secured by real estate at the time the company acquires the loan. The staff has also indicated that agency partial pool certificates and certain interests in companies that invest in mortgages or other interests in real estate are real estate related assets. We intend to conduct our business in such a manner as to be

excepted from the definition of an investment company under Section 3(c)(5) of the Investment Company Act. The MBS investments we have purchased qualify as qualifying real estate assets, based on the current views of the SEC Staff. If we failed to remain exempt from the regulations applicable to investment companies, our business could be adversely affected, as discussed below under the heading Risk Factors Loss of Investment Company Act exemption would adversely affect us.

To the extent we explore alternative or additional business strategies, we may be limited by the rules and regulations of the Investment Company Act. We will not pursue any strategy which would interfere with our exemption from registration under the Investment Company Act.

COMPETITION

Our ability to generate income from our MBS business depends, in large part, on our ability to acquire MBS in the marketplace in order to assemble a leveraged MBS portfolio and earn favorable spreads over our cost of funds. In acquiring MBS, we compete with real estate investment trusts (REITs), financial institutions, such as banks, life insurance companies, savings and loan associations, and institutional investors, such as mutual funds and pension funds, other lenders and other entities that purchase MBS, many of which have greater financial resources than we do. The existence of these competitors, as well as the possibility of additional competitors in the future, may increase competition for the acquisition of MBS resulting in higher prices and lower yields on our assets. In addition, we and other companies that invest in MBS may look to sell such investments at the most favorable prices when market conditions dictate in order to reduce our leverage or reduce the overall amount we have invested in MBS. At such times, we likely will be competing with other sellers to obtain the best available sale prices for our MBS. Our outside investment advisor acquires and sells MBS for an $11 billion portfolio that it manages for an affiliate. This may create a conflict of interest with its obligations to us, as discussed below under the heading Risk Factors The manager of our MBS portfolio may have a potential conflict of interest.

GENERAL CORPORATE MATTERS

Aether was originally formed as Aeros, L.L.C. in January 1996. We changed our name to Aether Technologies International, L.L.C. in August 1996 and to Aether Systems L.L.C. in September 1999. Immediately prior to completing our initial public offering of common stock on October 20, 1999, we converted from a limited liability company to a Delaware corporation and changed our name to Aether Systems, Inc. Our principal executive offices are located at 621 E. Pratt St., Suite 601, Baltimore, MD 21202. Our telephone number is (443) 573-9400 and our fax number is (443) 573-0383.

Our Internet address is www.aethersystems.com. We make available free of charge, on or through our website, our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports filed or furnished to the Securities and Exchange Commission (the SEC) pursuant to Section 13(a) or Section 15(d) of the Securities Exchange Act of 1934 (the Exchange Act) as soon as reasonably practicable after we electronically file such material with, or furnish it to, the SEC. We are providing the address of our internet website solely for the information of investors. We do not intend the internet address to be an active link, and the contents of the website are not a part of this Report.

We have adopted a general code of ethics for our business. We have also adopted a code of ethical conduct that applies solely to our principal executive officer, principal financial officer, principal accounting officer, controller and persons performing similar functions. The Board of Directors is responsible for reviewing and authorizing any waivers from both the code of ethics and code of ethical conduct for senior financial officers and we will file any waivers from, or amendments to, these codes with the SEC. Both the general code of ethics and the code of ethical conduct for senior financial officers, as well as the charters for our audit committee, nomin