



## U.S. COMMODITY FUTURES TRADING COMMISSION

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Division of Swap Dealer and  
Intermediary Oversight

Gary Barnett  
Director

CFTC Letter No. 12-13  
Interpretation  
October 11, 2012  
Division of Swap Dealers and Intermediary Oversight

National Association of Real Estate Investment Trusts  
1875 I Street, NW, Suite 600  
Washington, D.C. 20006

**Re: Request for Interpretation of the Definition of “Commodity Pool” under Section 1a(10) of the Commodity Exchange Act**

Dear Mr. Edwards:

This is in response to your correspondence, dated September 4, 2012, to the Division of Swap Dealer and Intermediary Oversight (“Division”) of the Commodity Futures Trading Commission (“Commission”). You request an interpretation of the definition of “commodity pool” under Section 1a(10) of the Commodity Exchange Act (“CEA”),<sup>1</sup> such that real estate investment trusts (“REITs”) that hold income-producing real estate and engage in real estate management activities, including leasing and maintaining real estate, providing a variety of tenant services, and developing and redeveloping real estate (“equity REITs”) are not within the statutory definition of “commodity pool.”

In support of your request for interpretative guidance, you provide information about the operations of equity REITs, as well as information about the restrictions imposed on REITs through the Internal Revenue Code (“IRC”). You state that the Internal Revenue Service (“IRS”) has defined the term equity REIT to be a REIT whose primary source of income is not derived from mortgage interest or fees.<sup>2</sup> You further state that the defining characteristic of equity REITs is that they acquire and develop their own properties and must primarily operate these properties rather than immediately reselling them.<sup>3</sup> Because of the requirements that

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<sup>1</sup> 7 U.S.C. 1a(10).

<sup>2</sup> Letter from the National Association of Real Estate Investment Trusts, September 4, 2012, at 1 (“NAREIT Letter”). See, Instructions to Form 1120-REIT, available at <http://www.irs.gov/pub/irs-pdf/i1120rei.pdf> (page 7).

<sup>3</sup> NAREIT Letter at 3.

equity REITs hold, develop, and operate real estate, you argue that equity REITs are not commodity pools, but rather, operating companies.<sup>4</sup>

In support of your position that equity REITs are operating companies, you state that several other entities consider equity REITs to be operating companies.<sup>5</sup> According to your letter, these entities include Standard & Poor's and the North American Industry Classification System, which is maintained by the U.S. Department of Commerce to classify businesses for data collection, analysis, and publication.<sup>6</sup> Additionally, you cite an IRS revenue ruling recognizing that a REIT may engage in an active business or trade because "it is permitted to perform activities that can constitute active and substantial management and operational functions with respect to rental activity that produces income qualifying as rents from real property."<sup>7</sup>

You state that the use of derivatives by equity REITs is limited to activities that support its primary focus of real estate ownership and operation through a reduction in the cost of capital when financing a purchase.<sup>8</sup> You state that this limited use of derivatives is further enforced through the IRC. First, at least 75 percent of the equity REIT's annual gross income must be derived from certain qualifying real estate related sources, including, but not limited to, interests in real property, gains from the sale of non-dealer property.<sup>9</sup> Second, the IRC requires that at least 95 percent of an equity REIT's annual gross income must consist of items that would satisfy the 75 percent test plus other passive income such as interest and dividends.<sup>10</sup>

You further state that under both tests, income from a "qualified REIT hedging transaction" is excluded from the calculation. You state that the IRC limits what is a "qualified REIT hedging transaction" to those transactions:

- Entered into in the normal course of its business primarily to manage the risk of interest rate, price, or currency fluctuations related to the carrying of qualifying real estate assets; or
- Entered into primarily to manage the risk of currency fluctuations with respect to any qualifying income under the two income tests.

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<sup>4</sup> *Id.*

<sup>5</sup> *Id.* at 4.

<sup>6</sup> *Id.*, citing, Bill Barnhart, *Tech Stocks Show Way for Market*, Chicago Tribune, Oct. 4, 2001, available at [http://articles.chicagotribune.com/2001-10-04/business/0110040235\\_1\\_s-p-stock-indexes-tech-stocks-show](http://articles.chicagotribune.com/2001-10-04/business/0110040235_1_s-p-stock-indexes-tech-stocks-show) (stating that Standard & Poor's "believes that REITs have become operating companies subject to the same economic and financial factors as other publicly traded U.S. companies listed on major American stock exchanges.")

<sup>7</sup> *Id.* at 6-7, citing, Rev. Rul. 2001-29, 2001-26 I.R.B. 1348.

<sup>8</sup> *Id.* at 4.

<sup>9</sup> *Id.* at 5. *See*, 26 U.S.C. §856(c)(2).

<sup>10</sup> NAREIT Letter at 5, citing, 26 U.S.C. §856(c)(3).

Moreover, you add that all qualifying REIT hedging transactions must be identified on the day they are executed. You state that if income is derived from a transaction that is not considered a “qualified REIT hedging transaction” under the IRC, it is “nonqualifying income,” which cannot exceed 5% of the REIT’s annual gross income. If such nonqualifying income exceeds 5% of the REIT’s annual gross income, the entity will no longer be eligible for REIT status. Once REIT status is lost, the entity will be unable to reclaim REIT status for a period of 5 years.

To further support your request for relief, you state that interpretative guidance is necessary to provide legal certainty to equity REITs and their counterparties with respect to their legal status as “eligible contract participants” and their ability to claim the end-user exemption from the clearing mandate.<sup>11</sup>

In 1981, the Commission proposed and adopted the definition of “pool” in Commission Regulation 4.10(d), which provided that “pool” means “any investment trust, syndicate or similar form of enterprise operated for the purpose of trading commodity interests.”<sup>12</sup> At that time there was no statutory definition of a commodity pool. The statutory definition of commodity pool, as it currently appears in Section 1a(10) of the CEA, is substantively identical to the Commission’s longstanding regulatory definition of the term “pool.”<sup>13</sup>

From the time of its adoption in 1981, the Commission has declined to constrain the phrase “operated for the purpose of trading” to the narrowest of possible interpretations. The reasons that the Commission articulated for rejecting a narrow understanding of the phrase were grounded in its dual concerns for customer and market protection. The Commission noted in the Preamble to the 1981 rule that commenters were concerned that the definition was overly broad.<sup>14</sup> One commenter suggested a brightline percentage test as a function of commodity interests to other portfolio holdings to determine whether a collective investment scheme should be considered a pool. The Commission declined to set a specific percentage as a threshold over which an entity would be considered a commodity pool due to concerns that an entity which would not exceed the set trading level could still be marketed as a commodity pool to participants, who should be afforded the protections under Part 4 of the Commission’s regulations.<sup>15</sup>

Several other commenters suggested that the definition should be narrowed to only those funds whose “principal purpose” was the trading of commodity interests. The Commission rejected that suggestion because it could “inappropriately exclude from the scope of the Part 4 rules certain persons who are, in fact, operating commodity pools.”<sup>16</sup> Thus, the Commission

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<sup>11</sup> NAREIT Letter at 7.

<sup>12</sup> 46 FR 26004, 26014 (May 8, 1981).

<sup>13</sup> See, 7 U.S.C. §1(a)(10), and 17 C.F.R. 4.10(d).

<sup>14</sup> 46 FR 26004, 26005 (May 8, 1981).

<sup>15</sup> *Id.*

<sup>16</sup> *Id.* at 26006. The Commission’s conclusion that commodity pools are not limited to those funds whose primary purpose is trading commodity interests is consistent with the recent amendments to the CEA in Section 4m(3).

recognized that there may be entities whose primary business focus may be outside the commodity interest sphere, yet may still have a significant exposure to those markets, which may implicate the Commission's concerns regarding both customer and market protection. The rejection of the more narrow "principal purpose" language further indicated the Commission's determination to expand the constrained meaning of the phrase "operated for the purpose of." There is no evidence in the legislative record to indicate that when Congress adopted a statutory definition of "commodity pool," that is substantively identical to the Commission's longstanding regulatory definition of "pool," it intended for the Commission to modify its understanding of the scope of phrase "operated for the purpose of."

The Commission affirmed and refined this interpretation in the preamble to the final rule entitled Commodity Pool Operators and Commodity Trading Advisors: Compliance Obligations.<sup>17</sup> Explaining its amendments to Commission Regulations 4.5 and 4.13(a)(3) to include swaps in the trading thresholds, the Commission stated, "any swaps activities undertaken by a CPO would result in that entity being required to register because there would be no de minimis exclusion for such activity. As a result, one swap contract would be enough to trigger the registration requirement."<sup>18</sup> This statement is the Commission's most recent guidance with respect to the relationship between an entity's swaps activity and the requirement that its operator register as a CPO.

The Division believes that REITs that primarily derive their income from the ownership and management of real estate and that use derivatives for the limited purpose of "mitigat[ing] their exposure to changes in interest rates or fluctuations in currency"<sup>19</sup> are outside the definition of "commodity pool" under Section 1a(10) of the CEA and Commission Regulation 4.10(d). Based on the foregoing representations made by the National Association of Real Estate Investment Trusts, pursuant to Commission Regulation 140.99, the Division hereby interprets the definition of commodity pool under Section 1a(10) of the CEA and Commission Regulation 4.10(d) to not include REITs that satisfy the following criteria:

- The REIT primarily derives its income from the ownership and management of real estate and uses derivatives for the limited purpose of "mitigat[ing] their exposure to changes in interest rates or fluctuations in currency";<sup>20</sup>
- The REIT is operated so as to comply with all of the requirements of a REIT election under the Internal Revenue Code, including 26 U.S.C. §856(c)(2) (the 75 percent test) and 26 U.S.C. §856(c)(3) (the 95 percent test); and

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Section 4m(3) was amended to exempt certain commodity trading advisors ("CTAs") from registration provided that their business does not primarily consist of acting as a CTA, and that the CTA does not serve as a CTA to a commodity pool that is engaged primarily in trading commodity interests. 7 U.S.C. 6m(3). This statutory exemption for CTAs recognizes that there may be entities that are properly considered commodity pools that are not engaged primarily in trading commodity interests.

<sup>17</sup>77 Fed. Reg. 11252 (Feb. 24, 2012).

<sup>18</sup>*Id.* at 11258.

<sup>19</sup> NAREIT Ltr. at 4.

<sup>20</sup> *Id.*

- The REIT has identified itself as an equity REIT in Item G of its last U.S. income tax return on Form 1120-REIT and continues to qualify as such, or, if the REIT has not yet filed its first tax filing with the Internal Revenue Service, the REIT has stated its intention to do so to its participants and effectuates its stated intention.

Relief under this interpretative letter is self-effectuating.

This letter, and the positions taken herein, represent the view of this Division only, and do not necessarily represent the position or view of the Commission or of any other office or division of the Commission. The relief issued by this letter does not excuse any entity relying upon its terms from compliance with any other applicable requirements contained in the Act or in the Commission's regulations issued thereunder. Further, this letter, and the relief contained herein, is based upon the representations made to the Division, and applicable laws and regulations in their current form. Any different, changed or omitted material facts or circumstances might render this letter void.

Should you have any questions, please do not hesitate to contact Amanda Olear, Special Counsel, at 202-418-5283.

Very truly yours,

Gary Barnett

cc: Regina Thoele, Compliance  
National Futures Association, Chicago