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Division of Swap Dealer and
Intermediary Oversight

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CFTC Letter No. 12-44
No-Action
December 7, 2012
Division of Swap Dealer and Intermediary Oversight

Re: **No-Action Relief from the Commodity Pool Operator Registration Requirement for Commodity Pool Operators of Certain Pooled Investment Vehicles Organized as Mortgage Real Estate Investment Trusts**

The Division of Swap Dealer and Intermediary Oversight (the "Division") has received numerous requests for no-action relief from the Commodity Pool Operator ("CPO") registration requirement for operators of vehicles operated as mortgage real estate investment trusts ("mREITs").[1]

Many mREITs use swaps as part of their business model, which were recently included within the Commission's jurisdiction as a result of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.[2] This caused the operators of mREITs to fall within the statutory definition of CPO, and, absent relief from the Division or the Commission, to register as CPOs.

MREITs are entities that own direct or indirect interests in mortgages on real estate or other interests in real property.[3] The activities of mREITs can vary from acquiring mortgages or servicing underlying assets to buying whole loans or mortgage backed securities ("MBS"). MREITs generally use interest rate swaps, swaptions, caps, floors, or collars to hedge interest rates or foreign exchange swaps to transform income. They may also use certain credit default swaps to hedge the risk of default on their mortgage-backed securities holdings.

For an entity to be classified as an mREIT, it must elect to be taxed as a real estate investment trust ("REIT") under the Internal Revenue Code of 1986 (the "Code"). To qualify

[1] The Division received numerous letters requesting no-action relief for certain mREITs. Specifically, the Commission received letters on behalf of various clients from Skadden, Arps, Slate, Meagher & Flom LLP, Hunton & Williams, LLP, Sidley Austin LLP, Foley & Lardner, LLP, and Davis, Polk & Wardwell LLP. The Division also received a request for interpretative relief from the Mortgage Bankers Association seeking an interpretative exclusion from the definition of "commodity pool," and supplementary information from Morrison & Foerster, LLP.
[2] Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, 124 Stat. 1376, 1666-67, 1672 (2010), 7 U.S.C. 1a(10), 1a(11), 1a(12) (as amended).
[3] *See* 26 U.S.C. 856, 857.

annually as a REIT, an entity must satisfy two income tests. First, at least 75 percent of the mREIT's annual gross income must be derived from certain qualifying real estate related sources, including, but not limited to, interest generated from mortgage backed securities.[4] Second, the Code requires that at least 95 percent of an mREIT's annual gross income must consist of items that in combination would satisfy the 75 percent test plus other passive income such as interest and dividends.[5]

Under both tests, income from a "qualified REIT hedging transaction" is excluded from the calculation. The Code 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, and credit risk 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.

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

Most SEC-registered mREITs are not considered "investment companies" under Section 3 of the Investment Company Act of 1940 (the "40 Act") [6] because they meet the exclusion set forth in Section 3(c)(5)(C) of the 40 Act,which provides an additional qualifying assets test. In determining whether an mREIT can claim relief under Section 3(c)(5)(C), the Securities and Exchange Commission ("SEC") has focused on whether at least 55 percent of the issuer's assets consist of mortgages or other liens on and interests in real estate, otherwise called "qualifying interests" by the SEC.[7] The SEC has generally viewed the following as "qualifying interests":

- Assets that represent an actual interest in real estate;

- Loans or liens that are fully secured by real estate;

[4] *See* 26 U.S.C. 856(c)(2) (stating that qualifying real estate related sources include interests in real property, gains from the disposition of non-dealer property, distributions from other REITs, real estate commitment fees, certain temporary investment income, interest on obligations secured by mortgages on real property, and income from pass through mortgage certificates,
[5] *See* 26 U.S.C. 856(c)(3).
[6] 15 U.S.C. 80a-3.
[7] 76 FR 55300, 55305 (Sept. 7, 2011) (citing various SEC no-action letters).

- Assets that are viewed as the functional equivalent of, and provide the same economic experience as, an actual interest in real estate or a loan or lien fully secured by real estate; and

- Certain commercial real estate B notes.[8]

Additionally, the remaining 45 percent of the issuer's assets will consist primarily of real estate type interests.[9] This has generally meant that SEC staff examines whether at least 25 percent of the issuer's assets consist of real estate type assets (subject to reduction depending upon whether the fund invested more than 55 percent of its assets in "qualifying interests") and not more than 20 percent of its assets are invested in miscellaneous investments.[10]

The Division of Trading and Markets, a predecessor to the Division, issued three letters in 2000 granting no-action relief to the directors of mREITs using futures and options to mitigate interest rate risk.[11] These letters granted relief based on representations from the mREIT that those REITs would limit the income derived from the mREIT's futures positions to less than 5 percent of its gross taxable income, and that the mREIT would limit its initial margin and option premiums to no more than one percent of the fair market value of the mREIT's total assets.[12]

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."[13] At that time there was no statutory definition of a commodity pool.

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.[14] 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 still be afforded the protections under Part 4 of the Commission's regulations.[15]

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[8] *Id.*
[9] *Id.*
[10] *Id.*
[11] CFTC Staff Letter No. 00-49, Comm. Fut. L. Rep. (CCH) ¶28,100 (Mar. 24, 2000); CFTC Staff Letter No. 00-50, Comm. Fut. L. Rep. (CCH) ¶28,101 (Mar. 24, 2000); CFTC Staff Letter No. 00-53, Comm. Fut. L. Rep. (CCH) ¶28,115 (Mar. 24, 2000).
[12] *Ibid.*
[13] 46 FR 26004, 26014 (May 8, 1981).
[14] 46 FR 26004, 26005 (May 8, 1981).
[15] *Id.*

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."[16] Thus, the Commission 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 operated as an additional indicator of the Commission's broader understanding of the phrase "operated for the purpose of."

The Commission recently affirmed and refined this interpretation in the preamble to the final rule entitled Commodity Pool Operators and Commodity Trading Advisors: Compliance Obligations.[17] 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."[18] 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.

Consistent with the reasoning articulated by the Division of Trading and Markets with respect to mREITs that invest in futures and/or options, and the Commission's recent statements regarding the use of swaps by collective investment schemes, the Division believes that mREITs are properly considered commodity pools and, absent relief from the Division, an mREIT's operator would be required to register as a CPO.[19] Based on the representations in the letters submitted to the Division, however, the Division will not recommend that the Commission take an enforcement action against the operator of an mREIT provided that the mREIT satisfies the following criteria:

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[16] *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 Dodd-Frank Act's recent amendments to the CEA in Section 4m(3). 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). By inclusion of commodity pools that engage primarily in trading commodity interests as a factor to differentiate between those CTAs required to be registered from those not required to register, 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.

[17] 77 Fed. Reg. 11252 (Feb. 24, 2012).

[18] *Id.* at 11258.

[19] **The Division notes that we remain open to discussions with mREITs to consider the facts and circumstances of their mREIT structures with a view to determining whether or not they might not be properly considered a commodity pool.**

- Limits the initial margin and premiums required to establish its commodity interest positions to no more than 5 percent of the fair market value of the mREIT's total assets;

- Limits the net income derived annually from its commodity interest positions that are not qualifying hedging transactions to less than five percent of the mREIT's gross income;

- Interests in the mREIT are not marketed to the public as or in a commodity pool or otherwise as or in a vehicle for trading in the commodity futures, commodity options, or swaps markets; and

- Either:

    - The company has identified itself as a "mortgage REIT" in Item G of its last U.S. income tax return on Form 1120-REIT; or

    - The company has not yet filed its first U.S. income tax return on Form 1120-REIT, but has disclosed to its shareholders that it intends to identify itself as a "mortgage REIT" in its first U.S. income tax return on Form 1120-REIT.[20]

In granting CPOs the relief described herein, the Division seeks to strike the appropriate balance between the Commission's regulatory objectives and the operational circumstances facing certain specialized funds.

This no-action relief is not self-executing. Rather, a CPO that is eligible for the relief must file a claim to perfect the use of the relief. A claim submitted by a CPO will be effective upon filing, so long as the claim is materially complete.

Specifically, the claim of no-action relief must:

a. State the name, main business address, and main business telephone number of the mREITs for which the relief is being claimed;

b. Be electronically signed by a person authorized to bind the mREIT; and

c. Be filed with the Division using the email address *dsionoaction@cftc.gov* with the subject line of such email "mREIT" prior to December 31, 2012 (for an mREIT in operation as of December 1, 2012) or, for an mREIT that begins to operate after December 1, 2012, within 30 days after it begins to operate as an mREIT.

[20] Nothing in this letter should be construed as foreclosing the ability for an mREIT to rely upon any letter issued by the Division should the mREIT satisfy the criteria set forth therein.

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 the mREIT or its operator from compliance with any other applicable requirements contained in the Act or in the Commission's regulations issued thereunder. For example, the mREIT and its operator remain subject to all antifraud provisions of the Act. Further, this letter, and the relief contained herein, is based upon the representations made to the Division. 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,

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