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Division of Swap Dealer and
Intermediary Oversight

Eileen T. Flaherty
Director

CFTC Letter No. 17-68
No-Action
September 22, 2017
Division of Swap Dealer and Intermediary Oversight

Re: Interpretation of the term Commodity Pool with respect to "A"

Mr. :

This letter is in response to your request dated July 26, 2017 to the Division of Swap Dealer and Intermediary Oversight ("Division") of the Commodity Futures Trading Commission ("Commission") on behalf of "A", requesting the Division issue an interpretative letter, stating that neither "A", nor certain of the holding companies within the "A" family, (each a "Holding Company" and collectively, the "Holding Companies," or, with "A") fall within the definition of a commodity pool, as that term is defined by Section 1a(10) of the Commodity Exchange Act ("CEA"),[1] and Commission regulation 4.10(d)(1).[2]

Background

You represent the facts as follows. "A" is a global asset manager, with holdings across multiple sectors, including real estate, infrastructure, renewable power, and private equity. Specific to this request, "A" owns and operates a large portfolio of real estate assets across multiple countries.

"A", through multiple sub-structures, purchases, improves, and manages these real estate assets, generating income from traditional real-estate sources, such as rent payments, hospitality fees, real estate development, and lease terminations. "A" typically holds such assets for a period of five to seven years and often utilizes a special purpose vehicle ("SPV") to hold each real estate asset. In turn, these SPVs are owned, either in whole or in part, by a Holding Company of which "A" is the ultimate parent.

Because the real estate assets are often acquired through the use of financing, and are located in jurisdictions whose home currencies are not the US dollar, the Holding Companies use swaps for the limited purpose of mitigating exposure to changes in interest rates or fluctuations in non-US denominated currencies associated with asset financing and purchases.[3]

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[1] 7 U.S.C. § 1a(10).
[2] Commission regulations referred to herein are found at 17 C.F.R. Ch.I (2017).
[3] For example, with respect to FX swaps, when a foreign real estate asset is purchased by an SPV, the value of its investment may vary with changes in currency exchange rates. Additionally, foreign cash flows that are repatriated on a regular basis give rise to currency risk. "A" takes a comprehensive view of this FX exposure, and therefore

Issue

Absent relief from the Division, and as a result of their use of swaps involving interest rate and foreign exchange ("FX") positions, "A" may be required to register a commodity pool operator ("CPO") for the Holding Companies.

Similar Prior Relief

In 2012, DSIO published CFTC Staff Letter 12-13 ("Equity REIT Letter"),[4] which provided that, under certain circumstances, the operator of a real estate investment trust ("REIT") was not within the definition of a commodity pool for purposes of Section 1a(10) of the Act or Commission Regulation 4.10(d). Specifically, the letter stated that:

> *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" are outside the definition of "commodity pool" under Section 1a(10) of the CEA and Commission Regulation 4.10(d).*[5]

However, the Equity REIT Letter also limited the application of the relief to those REITs that, among other things, comply with the provisions with Internal Revenue Code §856(c)(2) (the "75 Percent Test")[6] and §856(c)(3) (the "95 Percent Test").[7] These provisions prohibit the REIT from earning income outside of a list of permitted sources. You represent that "A" is generally unable to meet these requirements,[8] and for these and other reasons, such as the Holding Companies frequently being organized offshore, which precludes a REIT election under the IRS Code,[9] "A" is unable to take advantage of the interpretative relief made available in the Equity REIT Letter.

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hedges the FX risk at the Holding Company level on a consolidated basis. It does so both for presently existing exposures and exposures that it is reasonably confident will exist (i.e., anticipatory FX exposures). Anticipatory FX exposures occur, for example, when a "A" entity, in connection with its acquisition of a foreign real estate asset, signs a purchase or sale agreement prior to closing.

With respect to interest rate swaps, such swaps are generally entered into by the "A" entity that holds title to the real estate assets or that is the borrower. Occasionally, though, the relevant Holding Company will enter into interest rate swaps in advance of purchasing the relevant assets and funding the associated loans (i.e., anticipatory interest rate exposures). However, such transactions are done only when a loan is highly probable of occurring (e.g., when an existing loan matures and needs to be replaced, or in anticipation of the acquisition of a new property).

[4] CFTC staff Letter 12-13, published October 11, 2012, available at http://www.cftc.gov/idc/groups/public/@lrlettergeneral/documents/letter/12-13.pdf.

[5] Id at 4.

[6] 26 U.S.C. §856(c)(2).

[7] 26 U.S.C. §856(c)(3).

[8] You note that although "A" earns its income from largely the same sources as many other REITs, "A" did not intend to qualify as a REIT per the IRS code, and as such, does not employ the same structures that a REIT does to comply with these provisions. Specifically, REITs are often structured to use a Taxable REIT Subsidiary ("TRS") that aggregates the income from non-qualifying sources. The TRS pays taxes on this non-qualifying income, which is then excluded from the REIT's 75 Percent or 95 Percent Test limits. Because "A" does not make use of similar structures, it is unable to exclude such income from the 75 Percent and 95 Percent Test calculations.

[9] See, 26 U.S.C. §856(a)(3).

Significant Similarities to Prior Interpretation

Although "A" does not meet all of the terms of the Equity REIT Letter, and thus is unable to claim relief thereunder, you suggest that it does share significant similarities to the entities described therein. You state that similar to the Equity REITs described in the letter, "A" engages in a variety of real estate related activities, such as leasing, maintaining and developing real property, and providing tenant-related services. As such, you assert "A" is not an investment trust with merely a passive financial interest in the real estate. Rather, you conclude that "A" is an owner/operator of the properties.

Limitations on Sources of Income

As noted, "A" states that it is unable to elect REIT status because of, among other reasons, the sources from which it derives income. Although "A" does not meet the strict limitations of the 75 Percent Test and 95 Percent Test, "A" states that it nonetheless derives its income primarily from activities associated with the ownership and operation of its real estate assets, such as real estate hospitality, real estate development, and parking revenue. Specifically, "A" represents that at least % of its gross income[10] at the Holding Company level, is real estate related, because it comports with the categories listed below in Appendix A.

Limitations on Swaps Use

"A" states that the only derivatives used are interest rate and FX swaps to offset interest rate and currency risk associated with the real estate assets at issue. "A" further attests that all such FX and interest rate swaps fall under the definition of "economically appropriate hedging transactions" pursuant to Commission regulation 50.50(c).[11]

In relevant part, Commission regulation 50.50(c) provides that a swap is used to hedge or mitigate commercial risk if, among other things, such swap is economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise. It also provides that for a swap to hedge or mitigate a commercial risk, the swap cannot be used "for a purpose that is in the nature of speculation, investing, or trading,"[12] or to hedge or mitigate the risk of another swap.[13]

Accordingly, "A" states that it only uses swaps for the limited purpose of offsetting its business risk. Further, "A" asserts that the economically appropriate hedging requirements of Commission regulation 50.50(c) not only limit "A's" use of swaps at the instruments inception, but also, to the extent that "A" should become "over-hedged" as the result of a favorable move in the market, "A" will act promptly to reduce the swaps's notional value to again conform to Commission regulation 50.50(c).

[10] Exclusive of any income from qualified hedging transactions per Commission regulation 50.50(c).
[11] 17 CFR 50.50(c).
[12] 17 CFR 50.50(c)(2)(i).
[13] 17 CFR 50.50(c)(2)(ii).

"A's" Annual Affirmation

Consistent with the limitations on swaps use and income restrictions noted above, "A" agrees, should the Division require it, to provide an annual confidential notification to the Division that no less than % of "A's" gross annual income[14] is derived from the sources listed below in Appendix A, and that the interest rate and FX swaps used meet the definition of Commission regulation 50.50(c).

Interpretation that "A" is Not a Pool

The Division believes that subject to the following conditions, "A" and the Holding Companies that it operates are outside the definition of "commodity pool" under Section 1a(10) of the CEA and Commission Regulation 4.10(d):

- "A's" significant similarities to those entities described in the Equity REIT Letter;
- "A's" limited use of swaps for only economically appropriate hedging purposes as defined by Commission regulation 50.50(c);
- "A's" representation that % of its gross annual income will come from real estate related sources per the categories listed below in Appendix A of this letter[15]; and
- "A's" undertaking to provide the Division with an annual affirmation that the preceding two factors continue to be met.

Based on these foregoing representations made by "A", and subject to the continued and timely confidential annual notification made to the Division regarding the above, pursuant to Commission Regulation 140.99, the Division hereby interprets that "A" and the Holding Companies that it operates fall outside of the definition of commodity pool under Section 1a(10) of the CEA and Commission regulation 4.10(d).

The interpretation contained in this letter does not excuse "A" or any Holding Company from compliance with any other applicable requirements contained in the Commodity Exchange Act or in the Commission regulations issued thereunder. 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. Finally, the Division retains the authority to condition further, modify, suspend, terminate, or otherwise restrict the terms of the relief provided herein, in its discretion.

[14] Subject to the limitations described in note 10 supra.
[15] Subject to the limitations described in note 10 supra.

Should you have any questions, please do not hesitate to contact Amanda Olear, Associate Director, at 202-418-5283 or Michael Ehrstein, Special Counsel, at 202-418-5957.

Very truly yours,

Eileen T. Flaherty
Director, Division of Swap Dealer
And Intermediary Oversight

Appendix A

Real Estate related Sources of % or Greater of "A's" Gross Annual Income

(a) rents from real property;
(b) gain from the sale or other disposition of stock, securities, and real property (including interests in real property and interests in mortgages on real property);
(c) abatements and refunds of taxes on real property;
(d) income and gain derived from foreclosure property (as defined in subsection (e) of 26 U.S.C. § 856);
(e) amounts (other than amounts the determination of which depends in whole or in part on the income or profits of any person) received or accrued as consideration for entering into agreements:
    - to make loans secured by mortgages on real property or on interests in real property or
    - to purchase or lease real property (including interests in real property and interests in mortgages on real property);
(f) gain from the sale or other disposition of a real estate asset;
(g) qualified temporary investment income (as defined in 26 U.S.C. § 856(c)(5)(D));
(h) dividends;
(i) interest;
(j) hospitality services (e.g., revenue related to hotel operations including room rent, food and beverage);
(k) real estate development;
(l) lease termination penalties;
(m) real-estate related performance fees;
(n) other real-estate related and commercial investments;
(o) real-estate related non-recurring fees; and
(p) real-estate related recurring fees.[16]

[16] Categories (a) through (i) are taken from the 75 Percent and 95 Percent Tests in the IRS Code. Examples of revenues from certain of the other categories include:

- Category (n): Parking revenues, film and photo shoot income; storage revenues and signage revenues.
- Category (o): Non-recurring film and photo shoot fees; non-recurring storage fees, non-recurring signage fees.
- Category (p): Property management fees; real estate investment management fees; real estate asset management fees.