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Client Alert
News Flash

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CFTC's Clearing Deadline May Loom for Certain REITs

REITS will need to determine if they are financial entities and so required to meet Monday's mandatory clearing deadline

An important deadline from the Commodity Futures Trading Commission (CFTC) is approaching that may affect certain real estate investment trusts (REITs). Under the Dodd-Frank Act, many types of hedges, including certain interest rate swaps (IRS) and index credit default swaps (CDS), will be required to be cleared through a Derivatives Clearing Organization (DCO). This requirement will apply to many "financial entities" on June 10, 2013 and to other participants in the swaps market on September 9, 2013.

In some circumstances, REITs may qualify as financial entities and may therefore have to clear certain IRS and index CDS entered into on or after June 10, 2013. If a REIT is required to clear IRS and index CDS on June 10, 2013 but does not have clearing relationships with its clearing members in place to do so, it may be legally prohibited from entering into such swaps.

One exception from the clearing requirement is available to "end-users," which are non-financial entities that enter into swaps to hedge or mitigate their commercial risk. Therefore, if a REIT is a non-financial entity, it would not likely have to clear any swaps until September 9, 2013, and may also be eligible for the end-user exception from mandatory clearing.

Notably, though, any "commodity pool" is a financial entity. Therefore, if a REIT qualifies as a commodity pool, it will also be deemed to be a financial entity and would be required to clear certain IRS and index CDS beginning June 10, 2013. Additionally, if a REIT is a commodity pool, it would not be eligible for the end-user exception from mandatory clearing.

The CFTC provided an interpretation in October 2012, which states that an equity REIT will not be deemed a "commodity pool" if:

- The REIT primarily derives its income from the ownership and management of real estate and uses derivatives for the limited purpose of mitigating their exposure to changes in interest rates or fluctuations in currency;
- 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
- The REIT has identified itself as an equity REIT in Item G of its last US 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.[1]

The CFTC interpretation in Letter 12-13 excludes equity REITs meeting its conditions from the term "commodity pool." However, a subsequent letter provides relief (under certain circumstances) for the operators of mortgage REITs from registration as commodity pool operators, but takes the position that mortgage REITs holding swaps are commodity pools.[2] These entities will thus be subject to the clearing mandate for swaps beginning on June 10, if those swaps are required to be cleared under the CFTC's clearing determination.

Additionally, a REIT will be a financial entity if, among other things, it is deemed to be "predominantly engaged in activities that are in the business of banking, or in activities that are financial in nature, as defined in section 4(k) of the Bank Holding Company Act of 1956."[3] On April 3, 2013, the Federal Reserve Board (FRB) published a final rule further defining "predominately engaged in financial activities" for purposes of Title I of the Dodd-Frank Act. Under the FRB's interpretation, a company is "predominantly engaged in financial activities" if one of two conditions exists: (i) the annual gross revenues derived by the company and all of its subsidiaries from "financial activities," as well as from the ownership or control of an insured depository institution, represent 85 percent or more of the consolidated annual gross revenues of the company; or (ii) the consolidated assets of the company and all of its subsidiaries related to financial activities, as well as related to the ownership or control of an insured depository institution, represent 85 percent or more of the consolidated assets of the company.[4] Whether or not the CFTC will apply this interpretation to interpret the similar phrase in CEA Section 2(h)(7)(C) remains unclear.

Moreover, even if a REIT qualifies as a non-financial entity, it will only be eligible for the end-user exception if it enters into swaps to hedge or mitigate commercial risk. If a REIT enters into swaps on behalf of its SPE subsidiaries, that REIT must therefore determine whether the end-user exception is available because the commercial risk that is being hedged belongs to its subsidiary instead of the REIT itself. Although in many instances, if the subsidiary itself would qualify as a commercial end-user, the parent REIT will be able to rely on the pass-through end-user exception for affiliates acting for and on behalf of a commercial end-user.[5] This determination requires a fact-specific analysis in light of the CFTC's guidelines and must be structured appropriately.

Below is a table setting forth the factors that would cause an entity to be deemed to be a financial entity.

"Financial Entity"[6] status for the purposes of the clearing obligations and the end-user exception

1	□	Swap dealer
2	□	Security-based swap dealer
3	□	Major swap participant
4	□	Major security-based swap participant
5	□	Commodity pool
6	□	A private fund as defined in section 202(a) of the Investment Advisers Act of 1940 (15 U.S.C. 80-b-2(a))
7	□	An employee benefit plan as defined in paragraphs (3) and (32) of section 3 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002)
8	□	A person predominantly engaged in activities that are in the business of banking, or in activities that are financial in nature, as defined in section 4(k) of the Bank Holding Company Act of 1956.

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Endnotes

1 See CFTC Letter 12-13 (Oct. 11, 2012).

2 See CFTC Letter 12-44 (Dec. 12, 2012).

3 See Commodity Exchange Act § 2(h)(7)(C)(i)(VIII).

4 See Definitions of "Predominantly Engaged In Financial Activities" and "Significant" Nonbank Financial Company and Bank Holding Company, 78 Fed. Reg. 20756 (Apr. 5, 2013).

5 See Commodity Exchange Act § 2(h)(7)(D).

6 See Commodity Exchange Act § 2(h)(7)(C).