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CFTC's Expanded Jurisdiction Over Swaps May Capture Certain Real Estate Investment Trusts

As a result of the pending expansion of the jurisdiction of the Commodity Futures Trading Commission (CFTC) to include most swaps, some publicly traded real estate investment trusts (REITs) may soon be considered “commodity pools” whose directors or trustees would be subject to CFTC regulation as commodity pool operators (CPOs) and whose investment managers could be subject to CFTC regulation as commodity trading advisors (CTAs).¹

How Can a REIT be Subject to CFTC Regulation?

In July 2011, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act) amended the Commodity Exchange Act (CEA) to add swaps to the CFTC's jurisdiction under a broad statutory definition, which includes many of the products REITs use to hedge their interest rate risks.² To give effect to this expanded jurisdiction, Congress enacted an expanded version of the CFTC's long-standing definition of “commodity pool”³ so that a commodity pool will include “any investment trust, syndicate, or similar form of enterprise operated for the purpose of trading in commodity interests, including any ... swap.”⁴ Congress also amended the existing definitions of CPO and CTA to include references to swaps.⁵ When considered in conjunction with prior CFTC staff positions, these new definitions of commodity pool, CPO and CTA may well capture many publicly traded mortgage REITs, as well as their operators and investment managers, even if they use only a single swap.

These new definitions will not become effective with respect to swaps until after the CFTC and the Securities and Exchange Commission (SEC) jointly adopt final rules to further define the term “swap.”⁶ Neither agency has provided definitive guidance as to

- 1 This client alert addresses publicly traded REITs, with a focus on *mortgage* REITs. Privately offered REITs and their advisors should consult the private funds section of Skadden's February 22, 2012, client alert, available [here](#), for a discussion of relevant commodity pool operator and commodity trading adviser issues.
- 2 See 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(47), 2(a)(1)(A) (as amended by the Dodd-Frank Act). The definition of “swap” in the CEA includes, among others products, any agreement, contract or transaction commonly known as an interest rate swap, rate cap, rate floor or rate collar. 7 U.S.C. § 1a(47)(A) (as amended by the Dodd-Frank Act). We note that the CFTC also regulates financial futures, broad-based stock index futures, currency futures and security futures. The use of any of these derivatives by REITs may cause their directors and advisers to be subject to regulation by the CFTC.
- 3 17 C.F.R. § 4.10(d)(1) (2011).
- 4 7 U.S.C. § 1a(10) (as amended by the Dodd-Frank Act).
- 5 A CPO now is defined as “any person engaged in a business that is of the nature of a commodity pool ... and who, in connection therewith, solicits, accepts, or receives from others, funds, securities, or property ... for the purpose of trading in commodity interests, including any ... swap[s].” 7 U.S.C. § 1a(11) (as amended by the Dodd-Frank Act). A CTA now is defined as “any person who for compensation or profit, engages in the business of advising others ... as to the value of ... trading in any ... swap.” 7 U.S.C. § 1a(12) (as amended by the Dodd-Frank Act).
- 6 Presently, the term “swap” in the Dodd-Frank Act has no effect by virtue of a CFTC exemptive order that is scheduled to expire on the earlier of July 16, 2012 (although the CFTC recently proposed to extend this date until December 31, 2012) or the adoption of a final rule by the CFTC and the SEC to further define the term “swap.” See CFTC, Amendment to July 14, 2011 Order for Swap Regulation, 76 Fed. Reg. 80,233 (Dec. 23, 2011); CFTC, Second Amendment to July 14, 2011 Order for Swap Regulation, 77 Fed. Reg. 28,819 (May 16, 2012).

when this joint rule will be adopted. CFTC Commissioner O'Malia earlier indicated that he expects that a final rule to define "swap" could be adopted as early as June 2012; however, this has not yet happened.⁷

Accordingly, unless the CFTC or its Division of Swap Dealer and Intermediary Oversight (which is responsible for CPO and CTA regulation) provides exemptive relief in the coming months, the directors of and advisers to many publicly traded mortgage REITs may become subject to the CFTC's jurisdiction due to their use of swaps and required to register with the CFTC as soon as September 2012.

How Has the CFTC's Staff Historically Viewed REITs?

The CFTC and its staff have broadly interpreted the existing definition of "commodity pool" to include any collective investment vehicle that uses *any* futures or options on futures, even if they are used only for hedging. On three prior occasions, the CFTC staff found that publicly traded mortgage REITs using futures to hedge interest rate risks fell within the definition of "commodity pool."⁸ In each case, the REIT's directors or trustees sought no-action relief in order to avoid being registered with and regulated by the CFTC as CPOs, with the REITs' investment managers or the REIT employees responsible for investment advice also seeking no-action relief from registration with the CFTC as CTAs.

In spite of the CFTC staff's broad interpretation of the term "commodity pool," many publicly traded mortgage REITs historically have not been concerned with commodity pool status or its attendant CPO registration concerns because they have used products other than exchange-traded futures, such as rate caps or over-the-counter bilateral swaps, to hedge their interest rate risks. Likewise, investment managers of these REITs have not had to consider CTA status or registration because their investment advice has not concerned CFTC-regulated products. This is about to change for many publicly traded mortgage REITs with the CFTC's expanded jurisdiction over swaps.

What About Equity REITs?

Although the CFTC staff's reasons for concluding that the REITs in these no-action letters were commodity pools were not expressly limited to mortgage REITs, the reasoning seems less applicable to equity REITs, which tend to conduct their business in a manner more similar to an operating company (*e.g.* primarily owning real assets as opposed to real-estate-related securities). Moreover, in a recent rulemaking defining the term "eligible contract participant," the CFTC referred to "entities other than commodity pools (*e.g.*, operating companies)," signaling that the CFTC does not consider operating companies to be commodity pools and, while not free from doubt, providing a potential basis for relief to publicly traded equity REITs that behave like operating companies.⁹

Who Is Required to Register as a CPO or CTA?

If a REIT falls within the "commodity pool" definition, a threshold question will be who is required to be registered and regulated as the CPO of the REIT. The CFTC has long relied upon the same core questions to identify the CPO of a commodity pool: Who will be promoting the pool by soliciting,

⁷ See 77 Fed. Reg. at 28,824.

⁸ Each letter included the following statement: "Including commodity interests in its interest rate management strategy, however, would bring the [REIT] within the [commodity] 'pool' definition." See CFTC Staff Letter No. 00-49, 2000 CFTC Ltr. LEXIS 157, at *5 (Mar. 24, 2000); CFTC Staff Letter No. 00-50, 2000 CFTC Ltr. LEXIS 158, at *5 (Mar. 24, 2000); CFTC Staff Letter No. 00-53, 2000 CFTC Ltr. LEXIS 161, at *5 (Mar. 24, 2000).

⁹ See CFTC, Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant," 77 Fed. Reg. 30,596 (May 23, 2012) (to be codified at 17 C.F.R. Pts. 1, 240).

accepting or receiving from others property for the purpose of commodity interest trading? Who will have the authority to hire and fire the pool's trading advisor? And who will have the ability to select and change the pool's futures commission merchant?¹⁰ When these questions previously were applied to publicly traded mortgage REITs that were organized as corporations, the CFTC staff reached the conclusion that each corporation's directors were the CPOs of the REIT.¹¹

In each of these situations, CFTC staff provided no-action relief that relieved the directors from CPO registration. Unfortunately, an express CFTC rule precludes any person other than the recipient of a no-action letter from relying upon the relief granted in such letter.¹² Therefore, directors and trustees of publicly traded REITs that might become commodity pools by virtue of their use of swaps likely would need to seek their own no-action relief from CPO registration.¹³

The CFTC staff also has viewed investment managers that provide REITs with advice with respect to commodity interests as falling within the CTA definition.¹⁴ For internally managed REITs, the CFTC staff also has found that the individuals employed by the REIT who provide advice with respect to commodity interests fall within the CTA definition.¹⁵ In each of these situations, though, neither the investment managers nor the REIT employees provided commodity interest trading advice to more than 15 persons nor did they hold themselves out generally to the public as CTAs; therefore, each could rely on an exemption from CTA registration pursuant to Section 4m(1) of the CEA.¹⁶

What Will Registration Mean for Entities That Will Become CPOs or CTAs to REITs?

Registration with the CFTC requires the completion of a Form 7-R Firm Application for the CPO/CTA and the completion of a Form 8-R Individual Application for each principal and each associated person (AP) of the CPO/CTA.¹⁷ In addition, each individual completing a Form 8-R must submit fingerprint cards (for FBI background checks), and each individual applying to become an AP generally must satisfy proficiency examination requirements.¹⁸

Registered CPOs and CTAs also have numerous compliance obligations. For example, a disclosure document must be prepared by most registered CPOs and CTAs and must satisfy the requirements of

¹⁰ See CFTC, Commodity Pool Operators and Commodity Trading Advisors; Exemption From Registration and From Subpart B of Part 4 for Certain Otherwise Regulated Persons and Other Regulatory Requirements, 49 Fed. Reg. 4,778, 4,780 (Feb. 8, 1984).

¹¹ See *supra* note 6. By analogy, CFTC staff likely would view the trustees of a mortgage REIT that is organized as a trust to be the CPOs of the REIT. The CFTC has not considered whether the adviser of a REIT could be the CPO. However, with respect to commodity pools that are registered investment companies (RICs), the CFTC has stated it will now require a RIC's adviser, not a RIC's directors or the RIC itself, to register as the RIC's CPO. See CFTC, Commodity Pool Operators and Commodity Trading Advisors: [Amendments to] Compliance Obligations, 77 Fed. Reg. 11,252, 11,259 (Feb. 24, 2012).

¹² See 17 C.F.R. § 140.99(a)(2) (2011).

¹³ There is a generally applicable exemption from CPO registration under CFTC Rule 4.13(a)(5) that may be available to the *independent* directors or trustees of such REITs, but the REIT must otherwise have a person or entity registered as CPO and meet various other conditions. See 17 C.F.R. § 4.13(a)(5) (2011).

¹⁴ See CFTC Staff Letter No. 00-49, 2000 CFTC Ltr. LEXIS 157, at *9 (Mar. 24, 2000); CFTC Staff Letter No. 00-50, 2000 CFTC Ltr. LEXIS 158, at *9 (Mar. 24, 2000).

¹⁵ See CFTC Staff Letter No. 00-53, 2000 CFTC Ltr. LEXIS 161, at *9 (Mar. 24, 2000).

¹⁶ See 7 U.S.C. § 6m(1) (providing a self-executing, statutory exemption from CTA registration to CTAs who, during the course of the preceding 12 months, have not furnished commodity trading advice to more than 15 persons and who do not hold themselves out generally to the public as CTAs).

¹⁷ See 17 C.F.R. §§ 3.10(a), 3.12(c) (2011). Certain persons, however, may be exempted from AP registration. See 17 C.F.R. § 3.12(h) (2011).

¹⁸ See 17 C.F.R. § 3.12(c)(3) (2011); NFA Registration Rule 401.

CFTC Rules 4.24 and 4.25 (for CPOs) or Rules 4.34 and 4.35 (for CTAs).¹⁹ A prospective investor or advisory client generally must provide a signed acknowledgment of receipt of a disclosure document before the CPO or CTA can accept or receive funds.²⁰ Registered CPOs generally must distribute a monthly account statement with respect to the pool to each investor and submit an audited annual financial report with respect to the pool to each investor as well as to the CFTC and the National Futures Association (NFA).²¹

In addition, all registered CPOs and CTAs, including the registered CPOs and CTAs of a REIT, also are required to file the CFTC's new systemic risk reporting forms, Form CPO-PQR and CTA-PR, respectively.²² Form CPO-PQR is a comprehensive report of information about the CPO and the pools operated by the CPO. The frequency with which a CPO must file a Form CPO-PQR and which schedules of Form CPO-PQR must be completed are determined by the CPO's pool assets under management. "Large CPOs," which are defined as CPOs that had at least \$1.5 billion in aggregated pool assets under management as of the close of business on any day during their reporting period (which is a calendar quarter), must file on a quarterly basis all schedules of Form CPO-PQR. All other CPOs must annually file certain of the schedules. All registered CTAs will be required to file Form CTA-PR annually.²³

All registered CPOs and CTAs also must become members of the NFA. As NFA members, CPOs and CTAs must comply with the NFA rules and bylaws, which prescribe compliance requirements (such as employee supervision and business continuity planning) and create potential liability through rules that require members to "observe high standards of commercial honor and just and equitable principles of trade."²⁴ In addition, all registered CPOs and CTAs are required to complete an annual CFTC/NFA registration update and an annual NFA questionnaire. Members of the NFA also are subject to periodic examinations and audits.

Is Relief Available to CPOs of Publicly Traded REITs?

While the expansion of the CFTC's jurisdiction may require the directors of certain publicly traded REITs and their advisers to register as CPOs and CTAs, the CFTC in 2011 adopted Rule 4.12(c) to ease the disclosure, reporting and recordkeeping requirements for registered CPOs of commodity pools whose shares are (1) offered and sold pursuant to an effective registration statement under the Securities Act of 1933 and (2) listed for trading on a national securities exchange registered as such under the Securities Exchange Act of 1934.²⁵

19 See 17 C.F.R. §§ 4.21(a), 4.31(a) (2011).

20 See 17 C.F.R. §§ 4.21(b), 4.31(b) (2011). For the investment manager, the advisory client would be the REIT itself, not the shareholders of the REIT. For the REIT, the investors would be its shareholders.

21 See 17 C.F.R. § 4.22 (2011). The National Futures Association is the self-regulatory organization for the futures (and soon swaps) industry.

22 See 17 C.F.R. § 4.27 (2011) (text of section added by 76 Fed. Reg. 71,174 effective March 31, 2012 until July 2, 2012, as amended by 77 Fed. Reg. 11,252). The instructions to Schedules A, B and C of Form CPO-PQR direct a reporting CPO to answer with respect to the pools that the CPO operated during the reporting period. The CFTC has not clarified whether this instruction is limited only to the pools for which the CPO has not claimed an exclusion or exemption or whether it includes all pools irrespective of whether the CPO has claimed exclusion or an exemption with respect to such pools.

23 See CFTC, Commodity Pool Operators and Commodity Trading Advisors: [Amendments to] Compliance Obligations, 77 Fed. Reg. 11,252, 11,269-71 (Feb. 24, 2012).

24 NFA Compliance Rule 2-4.

25 17 C.F.R. § 4.12(c) (2011). See CFTC, Commodity Pool Operators: Relief From Compliance with Certain Disclosure, Reporting and Recordkeeping Requirements for Registered CPOs of Commodity Pools Listed for Trading on a National Securities Exchange; CPO Registration Exemption for Certain Independent Directors or Trustees of These Commodity Pools, 76 Fed. Reg. 28,641 (May 18, 2011).

CPOs whose pools meet the eligibility criteria described above, subject to certain conditions, may claim exemption from:

- the requirement that a disclosure document be delivered and the CPO receive a signed acknowledgment prior to accepting the prospective investor's funds;²⁶
- the requirement that a monthly account statement be distributed directly to each investor in the pool;²⁷ and
- the requirement that a CPO maintain its records at its main business office.²⁸

What Actions Should Publicly Traded Mortgage REITs Consider?

Given the significant implications of registration as a CPO and CTA, publicly traded mortgage REITs and their advisers who may become subject to the CFTC's jurisdiction as a result of their use of swaps, will need to begin considering whether the regulatory implications of CFTC registration are outweighed by the operational benefit to the REIT from swaps usage. If so, REITs and their advisers will want to familiarize themselves with the CFTC's CPO and CTA regulations as soon as possible in order to implement in a timely fashion the procedures and programs necessary to comply with the CEA or, alternatively, to consider seeking no-action relief from the CFTC.

26 See 17 C.F.R. § 4.12(c)(2)(i) (2011).

27 See 17 C.F.R. § 4.12(c)(2)(ii) (2011).

28 See 17 C.F.R. § 4.12(c)(2)(iii) (2011).