NATIONAL ASSOCIATION OF
REAL ESTATE INVESTMENT TRUSTS®

September 4, 2012

Mr. Gary Barnett
Director
Division of Swap Dealer and Intermediary Oversight
U.S. Commodity Futures Trading Commission
1155 21st Street, NW
Washington, D.C. 20581

RE: Request for Concurrence with Interpretation of the Definition of "Commodity Pool" under Section 1a(10) of the Commodity Exchange Act

Dear Mr. Barnett:

The National Association of Real Estate Investment Trusts® (NAREIT),[1] the worldwide representative voice for real estate investment trusts (REITs) and publicly traded real estate companies with an interest in U.S. real estate and capital markets, requests that the Division of Swap Dealer and Intermediary Oversight (the Division) of the U.S. Commodity Futures Trading Commission (the Commission or the CFTC) issue an "interpretative letter," as such term is defined in CFTC Rule 140.99(a)(3),[2] that will provide legal certainty to equity real estate investment trusts (equity REITs) by confirming that equity REITs are operating companies and therefore not within the definition of "commodity pool" that was added to the Commodity Exchange Act (the CEA) by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2012 (the Dodd-Frank Act).[3]

Executive Summary

Equity REITs are operating companies that hold income-producing real estate and engage in real estate related activities, like leasing and maintaining real estate, providing a variety of tenant services and developing and redeveloping property. Like many other operating companies, equity REITs generally use swaps to mitigate their exposure to changes in interest rates on their borrowings and to fluctuations in currency that could otherwise affect their business operations. However, given the Commission's broad interpretation of the "commodity pool" definition, there may be some confusion about the status of equity REITs, which use swaps to hedge and elect a tax status that shares a common term – "investment trust" – with the statutory

[1] NAREIT's members are REITs and other businesses throughout the world that own, operate and finance income-producing real estate, as well as those firms and individuals who advise, study and service those businesses.

[2] 17 C.F.R. § 140.99(a)(3) (2011).

[3] 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) (hereinafter the "Dodd-Frank Act").

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commodity pool definition. To eliminate the legal uncertainty that may confront equity REITs, as well as their swaps counterparties, beginning October 12, 2012, NAREIT is submitting this request to the Division for an interpretative letter confirming that equity REITs do not fall within the "commodity pool" definition. For purposes of this request, we are defining an equity REIT as any entity that filed its last federal income tax return (or, in limited circumstances, intends to file its next federal income tax return) on Form 1120-REIT and identified itself as an "Equity REIT" in Item G of the Form. For the most recent tax year for which the Internal Revenue Service has released data, there were 1,218 companies that identified themselves as equity REITs on their Forms 1120-REIT for the 2008 tax year.

By electing REIT tax status, an equity REIT is severely constrained in its income-producing activities and the sources of its earnings, effectively precluding any realistic possibility that equity REITs could engage in speculative investments in derivatives. For example, to maintain an effective election as an equity REIT under the Internal Revenue Code of 1986, as amended (Code), at least 75 percent of the REIT's annual gross income must come from qualified real estate sources plus at least 95 percent of a U.S. REIT's annual gross income must be from real estate sources, as well as passive income like non-real estate interest and dividends. Thus, only five percent of a REIT's annual gross income can be from non-real estate or non-passive sources without jeopardizing the REIT's status.

I. Introduction

The Dodd-Frank Act amended the CEA to add a statutory definition of "commodity pool," which provides that any investment trust, syndicate or similar form of enterprise operated for the purpose of trading in commodity interests is a commodity pool.[4] In this definition, "commodity interests" include not only exchange-traded futures and commodity options, which historically have been regulated by the CFTC, but also swaps, which have been added to the CFTC's jurisdiction as a result of the Dodd-Frank Act and are now included within the definition of "commodity interests".[5]

As explained in detail below, equity REITs are "bricks and mortar" companies, formed for the purpose of owning and operating income-producing real estate and are recognized by the Internal Revenue Service, in indices, in international industry classifications and by industry analysts as operating companies, as opposed to passive commodity pools. The Commission has long implicitly recognized that operating companies are not commodity pools. The "operating company" nature of an equity REIT thus provides an ample basis for concluding that an equity REIT is not a commodity pool. Nonetheless, NAREIT is concerned that equity REITs' elected tax status, and, in some cases, their organizational status as a trust under state law, together with the phrase "investment trust," combined with recent Commission statements on the breadth of possible interpretation of the commodity pool definition, may cause confusion as to whether equity REITs may be viewed, either by Commission staff or swap counterparties, as "commodity pools" whose operators would be subject to regulation as commodity pool operators (CPOs).

For example, last February, in the preamble to a final rulemaking, the Commission twice noted that CPO registration could be triggered when an investment trust, syndicate or similar form of

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4 *See* Dodd-Frank Act § 721, 7 U.S.C. § 1a(10).

5 *See* Dodd-Frank Act § 722.

enterprise engages in even one swap contract.[6] Further, in June as part of ongoing proceedings in the U.S. District Court for the District of Columbia, the Commission stated that there is "no minimum trading threshold for qualification as a CPO... a pooled investment vehicle operator is a statutory CPO if it trades even a single commodity, option or swap."[7]

Despite these broad pronouncements, we note that the Commission also has acknowledged limits to its interpretation of the statutory commodity pool definition. Most importantly, last May in the preamble to a final rulemaking, the Commission identified operating companies as examples of entities that are not commodity pools.[8] This distinction is consistent with a position that CFTC staff previously has taken in letter-based relief.[9] While the Commission's distinction and staff's prior letter-based relief both provide clear statements that distinguish operating companies from commodity pools, neither provides specific characteristics or criteria that would allow other entities to conclude that they too would be viewed as "operating companies" and therefore not commodity pools. The absence of such determinative criteria means that, even with the benefit of outside counsel, entities that otherwise would not consider themselves to be commodity pools, such as equity REITs, may be unable to reach a firm conclusion about their regulatory status under the CEA. We are seeking this relief to help fill in these gaps by confirming that equity REITs are operating companies that are not covered by the commodity pool definition.

II. Equity REITs Are Operating Companies

Equity REITs[10] are public and private companies that have been formed for the purpose of owning and operating income-producing real estate, such as apartments, shopping centers, office buildings, health care facilities, hotels and warehouses. Many are traded on major stock exchanges and others are required to file with the Securities and Exchange Commission although their stock is not listed on an exchange. In addition to owning income-producing real estate, most equity REITs engage in a variety of other real estate related activities, like leasing, maintaining and developing real property and providing tenant-related services (*e.g.*, providing utilities and security services). One of the defining characteristics of equity REITs is that they acquire and develop their own properties (either directly or indirectly through joint ventures) and must primarily operate those properties (as opposed to acquiring or developing and then soon reselling

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6 *See* Commodity Pool Operators and Commodity Trading Advisors: Compliance Obligations, 77 Fed. Reg. 11,252, 11,258, 11,263 (Feb. 24, 2012) (stating that one swap contract entered into by a fund would be "enough to trigger the [CPO] registration requirement").

7 *See* Defendant Commodity Futures Trading Commission's Cross-Motion for Summary Judgment, and Motion to Dismiss in Part at 15, Investment Company Institute, Chamber of Commerce of the United States of America v. United States Commodity Futures Trading Commission, No. 1:12-cv-00612 (BAH) (D.D.C. June 18, 2012).

8 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, 30,653 (May 23, 2012) (hereinafter, the "Final Entity Rules") (responding to a concern that the aspects of the "eligible contract participant" definition could be "applied to entities other than commodity pools (*e.g.*, operating companies)").

9 *See e.g.*, CFTC Staff Letter No. 00-89, Comm. Fut. L. Rept. (CCH) ¶28,248 (Sept. 11, 2000) (concluding that a limited partnership engaged in pork production is not a commodity pool as a result of hedging its hog production and related feed costs).

10 Item G of the Instructions to Form 1120-REIT, which a company must file with the Internal Revenue Service to elect REIT status, defines an equity REIT as a REIT in which the primary source of income is not derived from mortgage interest or fees. *See* http://www.irs.gov/pub/irs-pdf/i1120rei.pdf (page 7).

properties).[11] The Internal Revenue Service (the IRS) shows that in 2008 1,660 U.S. REITs filed tax returns, of which 1,218 (roughly 73 percent) were equity REITs; as measured by market capitalization, approximately 90 percent of exchange-listed REITs are equity REITs. Therefore, while REITs have the term "trust" in their generic name and some may be organized legally as "trusts, they are not "trusts" of the passive type intended to be covered by the definition of a "commodity pool" and are in fact indistinguishable from other categories of operating companies holding interests in real estate, or other non-financial assets.

Equity REITs are understood to be operating companies in a number of different contexts. Standard & Poor's (S&P) classifies equity REITs as operating companies in all of its broad equity indices;[12] currently the S&P 100 includes one equity REIT, the S&P 500 includes 16 equity REITs, the S&P 400 includes 27 equity REITs and the S&P 600 includes 29 equity REITs. According to the press release announcing S&P's initial inclusion of REITs in all of its broad equity indices, the decision showed that S&P "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."[13]

Additionally, the North American Industry Classification System (the NAICS), the standard maintained by the U.S. Department of Commerce and used by United States, Canadian and Mexican federal statistical agencies to classify businesses for the purpose of collecting, analyzing, and publishing statistical data related to the North American business economy, views equity REITs as operating companies rather than investment trusts. The NAICS presently lists equity REITs in the "Lessors of Real Estate" sector, where the SIC system and NAICS has traditionally classified active real estate operators," as opposed to the "Other Financial Vehicles" sector.[14]

Like other operating companies, equity REITs mitigate their exposure to changes in interest rates or fluctuations in currency by using a variety of derivatives, including, but not limited to, interest rate swaps, interest rate swaptions, interest rate caps, floors and collars, and currency swaps. Most typically, an equity REIT will achieve a lower cost of capital when it acquires a property by securing a floating interest rate mortgage and then using a swap contract to hedge its interest rate exposure. None of these activities would cause equity REITs to become confused with pooled investment vehicles that are operated for the purpose of trading in commodity interests. Nor would these activities cause equity REITs to be anything other than operating companies.

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[11] *See* 26 U.S.C. § 857(b)(6), which imposes a confiscatory 100% excise on all REIT profits from "dealer sales".

[12] Standard & Poor's, a brand of the McGraw Hill Companies, is one of the world's leading index providers. Over $1.25 trillion is directly indexed to Standard & Poor's family of indices, which includes the S&P 500, the world's most followed stock market index. *See* http://www.standardandpoors.com/about-sp/main/en/us.

[13] Bill Barnhart , *Tech Stocks Show Way for Market*, Chicago Tribune, Oct. 4, 2001, http://articles.chicagotribune.com/2001-10-04/business/0110040235_1_s-p-stock-indexes-tech-stocks-show.

[14] *See* North American Industry Classification System – Revision for 2007, 71 Fed. Reg. 28,532 (Mar. 16, 2006). These changes became effective in 2007; as originally adopted in 1997, NAICS classified all REITs in the category of "Funds, Trusts and Other Financial Vehicles" along with mutual funds and other passive investments.

III. Equity REITs Are Not Operated for the Purpose of Trading Commodity Interests

Furthermore, the fact that these operating companies have elected to be taxed as REITs for U.S. federal income tax purposes under the Code, strictly limits the amount and type of income that an equity REIT can receive from commodity interest activities. In order to qualify annually as a REIT, a company must satisfy two annual income tests (among other requirements). First, at least 75 percent of a company's annual gross income must be derived from certain qualifying real estate-related sources (the 75 Percent Income Test".[15] Second, the Code requires that at least 95 percent of a company's annual gross income must consist of items that meet the 75 Percent Income Test plus passive income, including interest and dividends (the 95 Percent Income Test).[16] These income tests mean that a REIT cannot have more than five percent of its income from activities other than from real estate or certain limited passive sources, which prevents a company primarily operating other businesses from electing or maintaining REIT status.

Under the REIT income tests, income from a derivative transaction used for hedging must be treated in one of two ways. First, if the derivative transaction is not a "qualified REIT hedging transaction," as defined by the Code, then income from such transaction must be treated as "nonqualifying income" for the purposes of the 75 Percent Income Test and the 95 Income Percent Test. This means that if an equity REIT enters into a derivative transaction either for speculative purposes or for nonqualifying hedging purposes, the income from such transaction, combined with all nonqualifying income from all other sources, cannot exceed five percent of the equity REIT's annual gross income or the entity will lose its status as a REIT.

If, on the other hand, the derivative transaction is a qualified REIT hedging transaction, then income from such transaction does not count as gross income for purposes of the 75 Percent Income Test or the 95 Percent Income Test (*i.e.*, this income is excluded from both the numerator and the denominator). Given the narrow criteria for what constitutes qualifying REIT hedging transactions, in order to produce excluded income from such transactions, the equity REIT generally must experience some interest rate, price or currency fluctuation that is associated with debt that the equity REIT incurred to acquire or carry its real estate assets.

The Code narrowly defines what constitutes a qualified REIT "hedging transaction." A qualified REIT hedging transaction must be either: i) entered into by the REIT in the normal course of its business primarily to manage a risk of interest rate or price changes or currency fluctuations with respect to ordinary obligations (borrowings) incurred or to be incurred by the REIT to acquire or carry qualifying "real estate assets"; or, ii) entered into primarily to manage the risk of currency fluctuations with respect to any item of income or gain that is qualifying income for purposes of the 75 Percent Income Test or the 95 Percent Income Test (or any asset that produces such income).[17] Further, the REIT must clearly identify the hedging transaction as such before the close of the day on which the REIT entered into the hedging transaction.[18] Failure of a

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15 *See* 26 U.S.C. § 856(c)(2). These 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.

16 *See* 26 U.S.C. § 856(c)(3).

17 *See* 26 U.S.C. §§ 856(c)(5)(G), 1221(b)(2).

18 *See* 26 U.S.C. §§ 856(c)(5)(G)(ii), 1221(a)(7).

transaction to satisfy the requirements for treatment as a qualified REIT hedging transaction will generally result in any income from such transaction being treated as nonqualifying income for purposes of the 75 Percent Income Test and the 95 Percent Income Test.

In addition, at least 75 percent of a REIT's assets must be comprised of real estate assets as well a narrow list of assets, such as cash, that Congress recognizes as necessary to operate a real estate business (the 75 Percent Asset Test).[19] This rule also prevents a company primarily owning non-real estate assets from being eligible to elect or maintain REIT status.

If an entity that has elected to be taxed as a REIT fails to annually satisfy the 75 Percent Income Test, the 95 Percent Income Test the 75 Percent Asset Test and a host of other rules aimed at only allowing real estate companies to be REITs, the consequences are severe. The entity would lose its REIT status and would be unable to re-claim REIT status for a five-year period unless the IRS grants an exception. However, without its REIT status, the entity's income would be taxed at the ordinary federal corporate income tax rate, which currently is 35 percent, and also would be subject to state income tax. Furthermore, the entity likely would violate covenants in its borrowing agreements**,** which would constitute an event of default. The Code's limitations on an equity REIT's use of commodity interests makes certain that an equity REIT cannot be operated for the purpose of trading commodity interests. In fact, these provisions significantly restrict the purpose and extent of a REIT's use of commodity interests.

IV. Equity REITs Are Not "Investment Trusts."

The term "investment trust," although it appears in the definitions of commodity pool and CPO, is never defined in the CEA.[20] The evolution of the term "investment trust" suggests that around the time the term was added to the CPO definition in the CEA, it was equated with truly passive investment vehicles.[21] But the present day statutory tax treatment of REITs demonstrates that equity REITs have evolved to a level of operational activity that distinguishes them from the completely passive types of entities traditionally characterized as "investment trusts." In other words, although the words "investment trust" appear in the term "REIT," this label is simply a holdover from the 1960 adoption of the REIT form in the Code; it is not a description of the operational activities of a modern equity REIT. Moreover, in 1976 Congress allowed a corporation to elect REIT status and today over two-thirds of exchange-listed REITs are organized as corporations under state law rather than as business trusts. Further, in 1986 Congress changed the REIT tax rules significantly by allowing REIT employees to perform all customary services for their tenants. This legislative modification laid the groundwork for the "modern REIT era," which blossomed in the early 1990s with the successful initial public stock offerings of previously private real estate operators.

The IRS has recognized the fundamental changes that Congress has made since 1960 by concluding that a REIT may engage in an active trade or business 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

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[19] *See* 26 U.S.C. § 856(c)(4).

[20] *See* 7 U.S.C. §§ 1a(10) and (11).

[21] *See e.g.*, Investment Company Institute, et al., v. William B. Camp, Comptroller of the Currency, D.DC 1967, 274 F. Supp. 624, 646 (1967); Moses v. Burgin et al., D. Mass. 1970, 316 F. Supp, 31, 54 (1970); Loss, Securities Regulation, 2nd edition, vol. 1 (Little, Brown and Company, 1961), p. 144.

property."[22] In other words, the IRS now recognizes that a REIT that performs these functions (*i.e.*, an equity REIT) is an operating company rather than a passive manager akin to an investment trust.

V. Division Concurrence Is Necessary to Curtail Legal Uncertainty.

Without explicit interpretative relief from the Division to confirm that equity REITs are not commodity pools, equity REITs are likely to face questions about their regulatory status that will extend beyond just immediate questions about the applicability of CPO regulations. One likely question concerns whether equity REITs even satisfy the definition of "eligible contract participant" (ECP). As the result of a final CFTC rule, entities soon will be required to determine whether they believe they are commodity pools, and thus only able to qualify as ECPs under CEA Section 1a(18)(A)(iv) as implemented through Commission Rule 1.3(m), or whether they are not commodity pools, and thus able to qualify as ECPs under one of the other prongs of the definition.[23] The ability to conclusively determine whether an entity is an ECP is imperative to the orderly function of the OTC swap market. ECP status is a requirement for any entity to enter into OTC swap transactions and an incorrect representation concerning ECP status means that an entity's swap transaction may be unlawful.[24] This concern is far from academic, as an equity REIT will be required to make an affirmative ECP representation every time it enters into a swap transaction.

Commodity pool status also will be determinative in the end-user exemption from the clearing mandate.[25] As a threshold issue, an entity must determine that it is not a "financial entity," as defined in CEA Section 2(h)(7)(C)(i), in order to use the End-User Exemption; however, in order to make such a determination, an entity must be able to conclude that it is not a commodity pool.[26] If entities are unable to clearly make such a determination because of the ambiguity surrounding the possible interpretations of the commodity pool definition, they will be faced with a choice. They either can run the risk of a possible CEA violation or they can forego the use of an exemption that Congress intended to be made available to lessen the costs associated with risk-mitigating activities. Again, equity REITs will be asked for affirmative representations each time they want to invoke the end-user exemption.

The National Futures Association's (the NFA) bylaws underscore the difficulties equity REITs are likely to face if their brokers and counterparties harbor any doubts about an equity REIT's CFTC registration status. Under NFA bylaw 1101, members of the NFA are prohibited from conducting business with any persons or entities who are required to be registered with the

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22 Rev. Rul. 2001-29, 2001-26 I.R.B. 1348. Notably, the IRS's 2001 ruling used an "active trade or business" standard, which is a much higher standard for an operating business compared to the traditional "trade or business" standard.

23 7 U.S.C. § 1a(18)(A)(iv); 17 C.F.R. §§ 1.3(m)(5) and (6). The Final Entity Rules state that an entity that is a commodity pool may only use the commodity pool prong of the ECP definition, as implemented through Commission Rule 1.3(m)(6). *See* 77 Fed. Reg. at 30,654. With respect to commodity pools, the compliance date for Rule 1.3(m)(6) is December 31, 2012. *See* 77 Fed. Reg. at 30,700.

24 *See* 7 U.S.C. § 2(e) (making it unlawful for any person, other than an ECP, to enter into a swap unless traded on a designated contract market).

25 *See* 7 U.S.C. § 2(h)(7), *See* End-User Exemption to the Clearing Requirement for Swaps, 77 Fed. Reg. 42,560 (July 19, 2012) (to be codified at 17 C.F.R. § 39.6).

26 *See* 7 U.S.C. § 2(h)(7)(C)(i)(V).

CFTC, but who are not so registered. In the near future, NFA members will include not only futures commission merchants (FCMs), but swap dealers (SDs) and major swap participants (MSPs). Therefore, in any transactions with FCMs, SDs or MSPs, equity REITs will be required to represent that they are not commodity pools and that their "operators" are not required to be registered as CPOs. To the extent there is not explicit confirmation by the Commission or its staff that equity REITs are not commodity pools, equity REITs might well find NFA members unwilling to accept the representations from equity REITs.

And of course, as the Division is aware, if an entity is later found to be a commodity pool, its "operator" could face civil and criminal liability, as well as private rights of action in certain circumstances, for its failure to register as a CPO.[27] This is particularly troubling in the context of trusts and corporations, where Commission staff has indicated that the individual trustees or directors may be viewed to be the CPOs of the trust or corporation, respectively.[28]

V. Relief Requested

All of this legal uncertainty, if unaddressed, would mean that, going forward, a range of hedging and investment activities threaten to be chilled by additional, and we believe, unnecessary and unintended regulatory risk. By any reasonable assessment, equity REITs are operating companies, not passive pools. Their activities focus on developing, owning and actively managing commercial real estate and, to that end, they employ and manage a staff to carry out such activities. We believe the Commission has provided a clear basis for concluding that equity REITs, as operating companies, are not commodity pools, and we believe the public interest would be served by confirming this conclusion with definitive interpretative relief.

For these reasons, NAREIT, on behalf of its equity REIT membership, respectfully requests that the Division provide legal certainty to equity REITs by issuing an interpretive letter confirming that equity REITs that satisfy the following criteria do not fall within the commodity pool definition:

1. The company is operated so as to comply with all the requirements of a REIT election under the Code, including the 75 Percent Income Test, the 95 Percent Income Test and the 75 Percent Asset Test; and,
2. Either:
    a. the company has identified itself as an "Equity REIT" in Item G of its last U.S. income tax return on Form 1120-REIT;[29] or,
    b. 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 an "Equity REIT" in Item G of its next U.S. income tax return on Form 1120-REIT.

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27 *See* 7 U.S.C. §§ 13a-1, 13 and 25.

28 *See e.g.* CFTC Staff Letter No. 00-49, Comm. Fut. L. Rept. (CCH) ¶28,100 (Mar. 24, 2000); CFTC Staff Letter No. 00-50, Comm. Fut. L. Rept. (CCH) ¶28,101 (Mar. 24, 2000); CFTC Staff Letter No. 00-53, Comm. Fut. L. Rept. (CCH) ¶28,115 (Mar. 24, 2000).

29 *See* http://www.irs.gov/pub/irs-pdf/f1120rei.pdf for the form used for the most recent taxable year.

Feel free to contact me at tedwards@nareit.com,Victoria Rostow, NAREIT's Senior Vice President, Policy & Regulatory Affairs, at vrostow@nareit.com or Mark Young or Daniel Konar of Skadden, Arps, Slate, Meagher & Flom LLP, at mark.d.young@skadden.com or daniel.konar@skadden.com, if you would like to discuss this letter in greater detail.

Respectfully submitted,

Tony M. Edwards
Executive Vice President & General Counsel

CERTIFICATION

In accordance with Commodity Futures Trading Commission Rule 140.99(c)(3)(i), I hereby certify that the material facts set forth in the enclosed letter dated September 4, 2012 are true and complete to the best of my knowledge.

Further, in accordance with Commodity Futures Trading Commission Rule 140.99(c)(3)(ii), if at any time prior to the issuance of an interpretative letter any material representation made in the enclosed letter ceases to be true and complete, NAREIT undertakes to inform Commission staff promptly and in writing of all materially changed facts and circumstances. If a material change in facts or circumstances occurs subsequent to the issuance of a interpretative letter, NAREIT undertakes to promptly notify Commission staff.

Dated: September 4, 2012

Tony M. Edwards