

# Compliance Matters For Equity REITS Using Derivatives

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Real estate investment trusts that invest in real property (commonly known as “Equity REITS”) and use certain types of derivatives should take action to comply with recently adopted requirements of the Commodity Futures Trading Commission (“CFTC”). Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”), itself called the Wall Street Transparency and Accountability Act, established a new framework for regulating the over the counter (“OTC”) derivatives market.

OTC derivatives, also known as swaps, are contracts that provide for options, contingent transfers and other risk-shifting payment obligations. These derivatives generally include all contracts that are or will be known as swaps, such as interest rate and currency swaps, credit default swaps, equity swaps and commodity swaps. However, swaps exclude both foreign exchange (“FX”) spot transactions as well as physically settled commodity forward contracts and trade options between commercial parties for business purposes.

## **Requirements on Entities Engaging in Swaps**

The Dodd-Frank Act and the CFTC impose various requirements on entities engaging in swaps. These requirements include swap documentation requirements, recordkeeping and reporting requirements and trading and clearing requirements. However, the requirements that apply to any given entity depend on that entity’s classification under the Dodd-Frank Act. Swap dealers and major swap participants, for example, must comply with more of the requirements than financial end-users, who must comply with more requirements than non-financial end users.

Most Equity REITs should be deemed to be non-financial end-users, though the determination of an Equity REIT’s classification will depend on its business activities. While non-financial end-users remain subject to the Dodd-Frank Act’s swap documentation requirements and its recordkeeping and reporting requirements, they may be excepted from several of the Dodd-Frank Act’s requirements, including the exchange-trading and central clearing requirements.

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In order to qualify as a non-financial end user and elect the exception to the exchange-trading and central clearing requirements, an entity must meet three criteria:

- (a) satisfy the definition of a non-financial entity,
- (b) use the excepted swaps to hedge or mitigate commercial risk, and
- (c) furnish certain required information.

### Dodd-Frank's Definition

In order to meet the definition of a non-financial entity, a company must fall outside of the Dodd-Frank Act's definition of "financial entity," which includes swap dealers, major swap participants, security-based swap dealers, major security-based swap participants, commodity pools, private funds, employee benefit plans and entities predominately engaged in the business of banking or in activities that are financial in nature. Last autumn, CFTC issued a no-action letter in which it interpreted commodity pools to exclude Equity REITs that primarily derive their income from the ownership and management of real estate, that use derivatives for the limited purpose of mitigating exposure to changes in interest rates or fluctuations in currency, that comply with all of the REIT requirements under the Internal Revenue Code and that identify themselves as Equity REITs in their tax returns and continue to qualify as Equity REITs (or, if the REIT has not yet filed its first tax return, has stated its intention to so qualify and ultimately effectuates its stated intention).

In order to use swaps to hedge or mitigate commercial risk, the swaps must be economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise. This definition is broad,

and it is not necessary that an Equity REIT qualify its swaps for hedge accounting treatment under applicable accounting standards or for bona fide hedging treatment under applicable rules. However, a swap must not be used for a purpose that is in the nature of speculation, investing or trading and must not be used to hedge or mitigate the risk of another swap or security-based swap position unless that other position itself is used to hedge or mitigate commercial risk.

### The CFTC's Annual Filing Requirement

In order to furnish the required information, an Equity REIT must make an annual filing with a CFTC-registered swap data repository ("SDR") or must give the required information to a counterparty responsible for reporting to an SDR the swaps as to which it elects the end-user clearing exception (or, if an Equity REIT is the reporting counterparty for these swaps, must include the required information with the swap data it reports to an SDR, although an Equity REIT generally would not be the reporting counterparty for swaps it enters into with financial entities). The required information generally includes:

- notice of election of the end-user clearing exception and the identity of the counterparty to the swap who is electing the exception (the "electing counterparty")
- how the electing counterparty generally meets its financial obligations associated with entering into non-cleared swaps
- if the electing counterparty makes public filings with the Securities and Exchange Commission ("SEC"), whether it has obtained approval from its board of directions (or an "appropriate" commit-

tee or other governing body) to enter into swaps that are exempt from otherwise applicable exchange trading and central clearing requirements

In order to comply with the approval requirement, an Equity REIT should obtain approval by September 9, 2013, which is when the exchange trading and central clearing requirements otherwise become applicable.

Even though an Equity REIT may avoid the exchange trading and central clearing requirements, it still must comply with other swap rules, including swap documentation, recordkeeping and any applicable reporting requirements.

### **Compliance**

In order to comply with the CFTC swap documentation rules, an Equity REIT must comply with two requirements. First, it must obtain a legal entity identifier number, known as a CFTC Interim Complaint Identifier (“CICI”) number, so that the CFTC can determine the distribution and concentration of risk among

counterparties from swap data received. This requirement applies to existing swaps or as of the trade date of an Equity REIT’s initial swap. Second, an Equity REIT must electronically adhere to the August 2012 and March 2013 DF Protocols published by the International Swaps and Derivatives Association, Inc. (“ISDA”). Neither a swap dealer nor a major swap participant may enter into a new swap or modify an existing swap with an entity that has not adhered to the ISDA protocols or entered into comparable agreements.

In order to comply with the CFTC’s record-keeping rules, all swap counterparties must keep full, complete, and systematic records of all swaps for the life of each swap plus five years. CFTC generally requires non-financial end-users to electronically report swaps with other non-financial end-users immediately upon entering into those swaps. However, swap dealers, major swap participants and other financial entities generally are required to report swaps with Equity REITs, with no reporting requirements by the Equity REITs.