Client Advisory

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Real Estate

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Hedging Interest and FX Hedging: The Consequences of Having US Investors

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Summary

Non-US real estate funds engaging in hedging of interest rate or foreign exchange risks (whether by exchange traded or over-the-counter (OTC) derivatives) and which also have US investors or US sponsors, even though such funds are domiciled and operated outside the US, may still find themselves and their operators subject to the jurisdiction of the US Commodity Futures Trading Commission (CFTC) as a consequence of the US Dodd-Frank Act, which has:

a) expanded the scope of what constitutes a "commodity interest" to catch OTC interest rate and foreign exchange derivatives; and

b) rescinded an important exemption from registration previously relied on by many non-US operators of real estate funds.

24 April 2012 is a critical date for compliance purposes.

Why is this?

The US Commodity Exchange Act (CEA) gives the CFTC oversight over commodity pool operators (CPOs) and commodity trading advisors (CTAs), who, if required to register, are subject to extensive disclosure, reporting, recordkeeping and (for key personnel) individual registration and examination requirements. The CFTC's jurisdiction over CPOs and CTAs extends internationally to include operators and advisers of non-US funds, including real estate funds, transacting in commodity interests where the fund participants or operators include US persons.

The Dodd-Frank Act expanded the term "commodity interest" under the CEA to include OTC derivatives (i.e., swaps) as well as exchange traded derivatives (i.e., futures).

So, an operator of a real estate fund in the UK or Europe that has a single US investor and enters into a single interest rate swap as part of a hedge to the debt financing or of a real estate purchase, could potentially be caught by the CEA.

Can this be avoided?

Historically, operators of private funds transacting in commodity interests have relied on CFTC Rule 4.13(a)(4), an exemption from CPO registration (which was allowed for private placement of interests to sophisticated investors), which required a notification to the US National Futures Association (NFA). This exemption also applied in relation to non-US real estate funds with US investors or operators, but has now been rescinded by the CFTC effective 24 April 2012. Any CPO that has already filed a 4.13(a)(4) notice with the NFA must register with the CFTC as a CPO and be in full compliance with all applicable regulations by 31 December 2012, unless another exemption applies or the CPO no longer has any US person investors or operators. Operators of funds that could qualify under the exemption but have not yet filed a notice with the NFA because, for example, they have only been transacting in swaps and not futures, have until 23 April 2012, to file such a notice, which would extend the registration and compliance date from 24 April to 31 December 2012.

Are there other exemptions?

Although other exemptions from registration as a CPO exist, they are unlikely to apply unless the particular fund transacts in a minimal amount of commodity interests. Such *de minimis* exemption limits the amount of "commodity interest" activity under one of two mathematical tests. The other possible exemptions would only be available if the "commodity interests" of a fund were limited to "foreign futures" and "foreign options," i.e., those not traded on a US exchange or any OTC derivatives. Although the elimination of the CFTC Rule 4.13(a)(4) exemption could effectively eliminate one of the more widely used exemptions from registration as a CTA as well, many CTAs should still be able to rely on another applicable exemption to avoid registration due to the greater number of exemptions available for CTAs.

Consequences of having to be registered

Registered CPOs are subject to extensive registration, reporting and compliance requirements and must provide to investors and the NFA a detailed disclosure document for each "commodity pool" they operate unless an alternative exemption exists. Associated persons and certain principals also will be subject to examination requirements. The Dodd-Frank Act also has added an additional reporting obligation that will require non-US CPOs to report information on all of their commodity pools, even those that have no US investors.

Off-exchange foreign exchange transactions

The consequences of the extraterritorial reach of US legislation potentially will be greater for any operator of a real estate fund engaging in OTC derivatives transactions in foreign exchange. Although not finalised, the rules pursuant to the Dodd-Frank Act may require that any operator of a fund engaging in foreign exchange swaps will be subject to further CFTC registration and capital requirements as a "retail foreign exchange dealer" if all of its US investors do not meet certain sophistication requirements.

What is a "fund" for these purposes?

A "fund" means any type of collective investment structure or vehicle in which the funds of various investors are solicited and combined into a single account for investment purposes. Although joint ventures should generally not fall within the definition of a fund, depending upon their structuring a possibility remains that they could. A fund will be a "commodity pool" (and thus subject to CFTC registration) if it engages in any transactions involving "commodity interests," i.e., futures or swaps, whether for speculative, investment or hedging purposes. The operator of a commodity pool is not the person or entity providing the trading advice (which is the CTA), but rather the person or entity that has the day-to-day management responsibility of the "commodity pool" and the entity that can hire or fire the CTA. For a corporation, the operator generally is the board of directors. Thus, if a non-US real estate fund has one director on its board that is a US person, the board may be required to register as a CPO even if the fund does not have any US investors.

Who is a "US person" for these purposes?

A "US person" is defined to include any natural person resident in the US as well as any entity (partnership, corporation, etc.) organized under US law or with its principal place of business in the US. Any estate or trust that has income subject to US income tax also is a US person. Finally, any entity organized principally for passive investment that has 10% or more of its beneficial interests held by US persons also is a US person.

What is the consequence of not being registered?

The CFTC can exercise its enforcement authority against any such unregistered CPO or CTA. Under such authority, the CFTC can seek to have a court impose civil penalties, equitable remedies and issue injunctive relief against the offender. The civil penalties cannot be more than the greater of US$100,000 or triple the monetary gain to the person for each violation. The equitable remedies include restitution to anyone who has sustained losses and disgorgement of gains received in connection with the failure to register. The injunctive relief can range from temporary prohibitions against the person's activity to a permanent ban against engaging in any activity covered under the CEA. Violations of the CEA also can give rise to criminal prosecution by the Department of Justice.

Although the CFTC's ability to successfully enforce against unregistered CPOs and CTAs that are domiciled outside of the US may be constrained, the chairman of the CFTC, Gary Gensler, has made it clear that the CFTC is particularly concerned about foreign CPOs with US investors and has stated that it is "critical to bring the pools...back into the light so their customers can benefit from the CFTC's oversight." The CFTC also has signed memorandums of understanding with many of the European regulators, including the UK's Financial Services Authority. Finally, the CEA potentially provides a private right of action to those who have suffered losses due to an unregistered CPO or CTA.

What do real estate fund operators need to do now?

Real estate fund operators should currently be determining the amount of "commodity interest" activity of their real estate funds and whether their investors or operators include any US persons. Any operator of a real estate fund with such US investors and/or operators and commodity interest activity should determine if any exemption from registration as a CPO and/or CTA applies for each particular real estate fund it operates. If no other exemption applies, the operator should file a notice of exemption from CPO registration under soon-to-be rescinded CFTC Rule 4.13(a)(4) by 23 April 2012 for each real estate fund, if applicable. If such notice is not filed, the operator will be required to be in full compliance with all of the requirements of CPO registration on 24 April 2012, or else have eliminated its US investors/operators. However, even if a notice is filed, the fund will only escape compliance until 31 December 2012.

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