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By Electronic Delivery

September 1, 2011

Stephen Larson
Associate Chief Counsel (Financial Institutions and Products)
Internal Revenue Service
1111 Constitution Avenue, NW
Washington DC

RE: *Commodity-Linked Notes*

Dear Steve:

The Investment Company Institute,[1] as we discussed in our recent meeting and the letter we submitted on August 18,[2] strongly urges the Internal Revenue Service (the "Service") to:

- resume immediately issuing private letter rulings to regulated investment companies ("RICs") seeking commodities exposure through investments in controlled foreign corporations ("CFCs") and commodity-linked notes ("CLNs") (hereafter, "the rulings process"); and

- publish guidance addressing both the CFC and CLN approaches.

The substantial competitive pressures resulting from the rulings process suspension, described in detail in the August 18 letter, are increasing. Prompt action to restart the rulings process and address the industry's concerns is required.

Published guidance would benefit both the Service and the industry. The Service would benefit most particularly from published guidance on CLNs as considerable time is required to evaluate each CLN for which a private letter ruling is sought. Consequently, we enclose for your consideration a proposed revenue procedure providing that CLNs meeting certain specified requirements generate section 851(b)(2) qualifying income. This proposed revenue procedure

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[1] The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $12.9 trillion and serve over 90 million shareholders.

[2] *See* Institute Letter to Stephen Larson, dated August 18, 2011.

supplements the proposed revenue procedure on the CFC approach that we submitted on August 18. Taken together, these draft revenue procedures would provide published guidance reflecting the 79 private letter rulings that the Service has issued to RICs seeking commodities exposure during the past five years.

A strong legal foundation, as discussed below, supports the proposed revenue procedure on the CLN approach to commodities exposure. First, a CLN clearly is a security and thereby generates qualifying income under section 851(b)(2). Second, the draft we enclose includes several requirements present in the private letter rulings – that go well beyond what we believe is necessary – to address any lingering concerns that anyone within the Service may have regarding whether a CLN is a security.[3]

Qualifying income under section 851(b)(2) includes income from "securities" as defined in section 2(a)(36) of the Investment Company Act of 1940, as amended ("the 1940 Act").[4] Thus, if a CLN falls within this definition, income from the CLN is qualifying income.

The definition of "security" under section 2(a)(36) is quite expansive. Specifically, for example, the definition includes "any note, . . . bond, debenture, evidence of indebtedness, . . . or, in general, any interest or instrument commonly known as a 'security' . . . ."[5] A wide range of instruments clearly fall within this broad definition of security. As a matter of statutory construction, the only issue should be whether a CLN is one of these instruments. The answer to this question is clear: a CLN is a security under this broad definition.

Moreover, as numerous commentators have noted, despite the fact that the definition of "security" under the Securities Act of 1933 ("the 1933 Act"), the Securities Exchange Act of 1934 ("the 1934 Act"), and the 1940 Act are substantially similar, the Securities and Exchange Commission

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[3] Because the August 18 letter reviewed the legislative history of the 1986 amendments to section 851(b)(2), we do not repeat that analysis here.

[4] 15 U.S.C. §§ 80a-1 *et seq.*

[5] The complete definition reads as follows:

> Any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option or privilege on any security (including a certificate of deposit) or on any group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

("SEC") interprets the term "security" more broadly under the 1940 Act than under the other two federal securities laws.[6] Indeed, on multiple occasions, the SEC staff has concluded that certain notes are "securities" under the 1940 Act even where such notes might fail to qualify as "securities" under the 1933 Act and the 1934 Act.[7]

A more restrictive approach to the definition of security has been taken by the Service, however, in the numerous private letter rulings addressing RIC investments in CLNs. The restrictions imposed appear intended to provide further support, beyond that provided by the expansive 1940 Act definition, that CLNs are securities. Although we do not believe that the requirements included in the private letter rulings are necessary to the securities determination, we have included them in the draft revenue procedure to address any lingering concerns and speed the issuance of published guidance. The guidance requested will both relieve industry members from the time and expense of obtaining a standard private letter ruling[8] and free up limited resources at the Service.

Two aspects of the draft revenue procedure's requirements should give the Service and Treasury further comfort that CLNs meeting these requirements are "securities" – under even a very narrow view of that term – for section 851(b)(2) purposes. First, a CLN is a "security having 1 or more payments indexed to the value, level, or rate of, or providing for the delivery of, 1 or more commodities," making it a "hybrid instrument" for purposes of the Commodity Exchange Act ("CEA").[9] Under the CEA, a hybrid instrument is deemed to be predominantly a security – and therefore is excluded from regulation under the CEA – if it satisfies the four conditions enumerated in section 2(f) of the CEA.[10] We have incorporated all four of those conditions into the draft revenue

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[6] *See, e.g.*, Tamar Frankel and Ann Taylor Schwing, The Regulation of Money Managers: Mutual Funds and Advisers, § 5.07 (2d ed. 2001).

[7] *See e.g.,* GINS Capital Corp., SEC No-Action Letter (Sep. 16, 1985) (concluding that, in its view, promissory notes held by a financial institution as evidence of loans are securities for purposes of the 1940 Act, even though they may not be so for purposes of the 1933 Act or the 1934 Act); Education Loan Marketing Association, Inc., SEC No-Action Letter (Mar. 6, 1986) (citing GINS Capital Corp., SEC No-Action Letter, above, in support of concluding that promissory notes secured by revenue from repayment of student loans are securities for purposes of the 1940 Act, even though they may not be securities for purposes of the 1933 Act and the 1934 Act); Harrell International, Inc., SEC No-Action Letter (May 24, 1989) (concluding that "tailor made" notes secured by assets provided by the holder of the notes to the issuer of the notes are securities under the 1940 Act, even though such notes may not be securities for purposes of the 1933 Act and 1934 Act); *see also* Bank of America Canada, SEC No-Action Letter (Jul. 25, 1983).

[8] A RIC might seek a private letter ruling if the RIC wished to invest in a CLN falling outside of the proposed revenue procedure's parameters.

[9] CEA § 1a(21) (definition of hybrid instrument).

[10] The conditions in section 2(f) require, among other things, payment in full by the RIC to the issuer at the time the CLN is acquired and no potential for any additional payment by the RIC.

procedure, so that a CLN must qualify for the section 2(f) exclusion as a precondition to relying on the revenue procedure.

Second, additional requirements – such as the presence of a coupon tied to prevailing interest rates and mandatory early redemption to provide essentially the equivalent of principal protection for the majority of the face amount of the CLN – provide sufficient debt-like features to ensure that the CLN as a whole is properly viewed as a security.[11]

* * *

We again urge the Service to resume issuing private letter rulings on the CFC and CLN approaches without delay. We also urge the issuance of published guidance along the lines of the draft revenue procedures we have submitted for your consideration. We remain very concerned about the current situation and are committed to work with the Service and Treasury to resolve it quickly.

Thank you again, Steve, for the ongoing dialogue over the past few weeks on this critically important issue. If I can provide you with any additional information or answer any questions regarding our letters and/or the proposed revenue procedures that we have submitted for your consideration, please do not hesitate to contact me.

Sincerely,

/s/ Keith Lawson

Keith Lawson
Senior Counsel – Tax Law

Enclosure

cc: David Silber
Susan Baker
Cathy Fung

[11] We are not addressing the separate question of whether a CLN is debt for tax purposes. Likewise, the draft revenue procedure includes language that is intended to clarify that the Service is not addressing the question either.

September 1, 2011

Rev. Proc. 2011-_____

1. Purpose

This revenue procedure provides guidance for regulated investment companies ("RICs") regarding the application of section 851(b)(2) to income and gain from investments in certain commodity-linked notes ("CLNs").

2. Background

.01 Section 851(b)(2) provides that a corporation shall not be considered a RIC for any taxable year unless at least 90 percent of its gross income is derived from certain specified sources ("qualifying income"). Qualifying income under section 851(b)(2) includes "dividends, interest, payments with respect to securities loans (as defined in section 512(a)(5)), and gains from the sale or other disposition of stock or securities (as defined in section 2(a)(36) of the Investment Company Act of 1940, as amended) or foreign currencies, or other income (including but not limited to gains from options, futures or forward contracts) derived with respect to [the RIC's] business of investing in such stock, securities, or currencies, and . . . . net income derived from an interest in a qualified publicly traded partnership . . . ."

.02 Section 2(a)(36) of the Investment Company Act of 1940 (the "1940 Act") defines the term "security" as follows:

> any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security (including a certificate of deposit) or on any group or on any group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

15 U.S.C. § 80a-2(a)(36).

.03 A RIC wishing to gain exposure to commodities may acquire a financial instrument in the form of a note that provides for a return linked, to a greater or lesser degree, to changes in the value of one or more referenced commodities. Such a note is referred to as a CLN.

.04 The definition of security under section 2(a)(36) of the 1940 Act includes certain instruments that are not considered to be debt for federal income tax purposes.

.05 In amendments to the Commodity Exchange Act ("CEA") adopted as part of the Commodity Futures Modernization Act of 2000,[1] Congress excluded from regulation under the CEA any hybrid instrument that is "predominantly a security." Under section 2(f)(1) of the CEA, a hybrid instrument[2] is considered to be predominantly a security if:

> "(A) the issuer of the hybrid instrument receives payment in full of the purchase price of the hybrid instrument, substantially contemporaneously with delivery of the hybrid instrument;
>
> (B) the purchaser or holder of the hybrid instrument is not required to make any payment to the issuer in addition to the purchase price paid under subparagraph (A), whether as margin, settlement payment, or otherwise, during the life of the hybrid instrument or at maturity;
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> (C) the issuer of the hybrid instrument is not subject by the terms of the instrument to mark-to-market margining requirements; and
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> (D) the hybrid instrument is not marketed as a contract of sale of a commodity for future delivery (or option on such a contract) subject to [the CEA]."

3. Scope

.01 This revenue procedure applies to a RIC that holds one or more CLNs that meet the requirements of this section.

.02 A CLN meets the requirements of this section if it has the following terms:

> (1) The CLN has a scheduled maturity of between six months and three years.

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[1] P.L. No. 106-554, 114 Stat. 2763.

[2] Under section 1(a)(21) of the CEA, a hybrid instrument is defined as "a security having one or more payments indexed to the value, level, or rate of or providing for the delivery of, one or more commodities."

(2) The CLN references a commodity index or sub-index (hereinafter "index"). The index may be a total return index or an excess return index. The index value is published and made available to the public at least weekly. The index is not constructed specifically for, or at the request of, the RIC. The RIC cannot have any direct or indirect control over the decisions made with respect to the components, and/or weighting of such components, in the index.

(3) The CLN has a leverage factor of no greater than three.

(4) The CLN provides for the payment of a coupon (either periodically or at maturity, and upon any early redemption) tied to a market rate of interest (such as LIBOR, a commercial paper rate, or Treasury bill rate). The coupon may reflect a fixed spread above or below the referenced market rate.

(5) The RIC as holder of the CLN has the right to put the CLN to the issuer for early redemption at the calculated redemption price based on the closing index value as of the end of the next business day after notification to the issuer. The CLN may also provide that the closing index value on the day of notification is to be used if notification is provided by a specified time during that day.

(6) The CLN provides for an automatic early redemption, at the calculated redemption price based on the closing index value as of the end of the next business day, if the value of the index falls by a specified percentage from its value at the time the RIC acquired the CLN. The specified percentage cannot exceed the percentage that, when multiplied by the leverage factor, equals 45%. For example, if the leverage factor is three, the decline in value may not exceed 15%.

(7) The repayment obligation under the CLN upon early redemption, automatic redemption, or at maturity is calculated in accordance with a formula providing for repayment of the face amount of the CLN increased or decreased by an adjustment. The adjustment is equal to the product of (i) the face amount of the CLN, (ii) the percentage increase or decrease in the index value from the date the RIC acquired the CLN to the applicable date for the redemption, and (iii) the leverage factor. Any accrued but unpaid coupon amount shall also be paid by the issuer upon any redemption. The overall repayment obligation may be reduced by a specified fee. In addition, if the index referenced by the CLN is a total return index, the redemption price formula for the CLN also includes an adjustment for the reversal of the interest rate factor included in the total return index.

(8) The issuer of the CLN receives payment in full of the purchase price of the CLN substantially contemporaneously with the delivery of the CLN.

(9) The RIC, while holding the CLN, is not required to make any payment to the issuer of the CLN (other than the purchase price paid substantially contemporaneously with delivery), whether as margin, settlement payment, or otherwise, during the term of the CLN or at maturity.

(10) The issuer of the CLN is not subject by the terms of the CLN to mark-to-market margining requirements of the CEA.

(11) The CLN is not marketed as a contract of sale of a commodity for future delivery (or option on such contract) subject to the CEA.

4. Procedure

In the case of a RIC to which this revenue procedure applies, income and gain from a CLN that meets the requirements of section 3 constitute qualifying income under section 851(b)(2).

5. Effective Date

This revenue procedure is effective for CLNs held by a RIC on or after September _____, 2011.

6. Drafting Information

The principal author of this revenue procedure is _____ of the Office of Associate Chief Counsel (Financial Institutions & Products). For further information, contact [him/her] at (202) 622-_____ (not a toll-free call).