

**Investment Company Institute Response to  
Permanent Subcommittee on Investigations Hearing on  
“Compliance with Tax Limits on Mutual Fund Commodity Speculation”  
January 26, 2012**

The Investment Company Institute<sup>1</sup> is providing this written response to the U.S. Senate Permanent Subcommittee on Investigations hearing on mutual fund investment in commodities. ICI supports the 70-plus rulings issued by the Internal Revenue Service (“IRS”) recognizing that mutual funds and other registered investment companies (“funds”) properly can gain indirect exposure to commodities by investing in controlled foreign corporations (“CFCs”) and commodity-linked notes (“CLNs”). This response provides a very brief overview of fund regulation and investment, including investments that seek exposure to the commodity markets. Section II explains that there is no tax policy prohibiting funds from investing in commodities. Section III explains that the numerous private letter rulings (“PLRs”) on funds gaining exposure to commodities through investments in CFCs and CLNs are correct interpretations of current law and fully consistent with relevant tax policy. Finally, Section IV explains that the IRS has focused properly on interpreting the tax law, and that non-tax regulatory policy concerns do not provide a basis for the IRS to disregard established practice that comports with long-standing principles of tax law.

**I. Overview: Fund Regulation and Investment**

Over 90 million shareholders depend on funds to help achieve their investment goals, such as saving for college, the purchase of a home, or a secure retirement. Funds are arguably the most highly regulated of all investment products. They must adhere to extensive requirements under all four major federal securities laws, including the Investment Company Act of 1940 (“1940 Act”). This regulatory scheme is, first and foremost, concerned with investor protection, and is administered by the Securities and Exchange Commission (“SEC”), whose central mission is investor protection.<sup>2</sup>

Funds also comply with the requirements of Subchapter M under the Internal Revenue Code (“Code”). Generally speaking, Subchapter M provides that a fund will be provided with “flow through” treatment (with its income taxed only at the shareholder level) if the fund derives at least 90 percent of its income from stock and securities. A failure to comply with Subchapter M would subject shareholders to an additional layer of tax, thereby reducing their investment returns.

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<sup>1</sup> 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 \$12.47 trillion and serve over 90 million shareholders.

<sup>2</sup> The protections afforded under the securities laws include, among others: limits on the use of leverage; antifraud provisions; comprehensive disclosure to investors, including with regard to fees and expenses, the investment objectives and strategies of the fund, and the risks of investing in the fund; oversight by an independent board of directors, particularly with regard to potential conflicts of interest; restrictions on transactions with affiliates; and requirements regarding custody of the fund’s assets.

As permitted by the 1940 Act and Subchapter M, funds may invest in a variety of financial instruments to achieve their stated investment objectives. Some funds, for example, seek to offer a broad-based diversified portfolio that provides investors with exposure to a variety of asset classes within a single fund. Other funds have more specialized objectives—for example, a single-state tax-exempt bond fund or a fund seeking exposure to a particular sector. Investors, alone or with assistance from a financial professional, may invest in one or more of such funds to build investment portfolios suited to their particular investment needs.

Regardless of investment objective, all funds invest, first and foremost, in “securities,” as such term is broadly defined under the 1940 Act. Investing at least a large portion of its portfolio in securities is what makes a fund an “investment company” as defined in the 1940 Act.<sup>3</sup> Likewise, being predominantly invested in securities is what makes a fund able to satisfy the requirements of Subchapter M.

Funds may invest in securities to gain indirect exposure to assets like commodities or real estate. Some funds may seek such exposure as a non-primary component in a broad based investment strategy, such as index funds, asset allocation funds, target date funds, or inflation-protected funds. Yet another—and relatively small—group of funds may seek more extensive exposure to commodities.

Some funds gain commodities exposure by investing in a “controlled foreign corporation” or “CFC”. Although the CFC is established outside the U.S., it remains subject to regulation under U.S. law. For example, the CFC must comply with key substantive provisions of the 1940 Act<sup>4</sup>.

## **II. The Ability of Funds to Earn Qualifying Income from Indirect Exposure to Commodities is Consistent with Current Tax Policy**

Some who criticize the IRS letter rulings seem to start from the premise that the tax law prohibits funds from investing in commodities. This is simply not correct. In order to qualify for Subchapter M tax treatment, funds must meet certain requirements, including a requirement that at least 90% of the fund’s income be from qualifying sources (so-called “qualifying income”). Qualifying income includes income and gains from stock and securities.<sup>5</sup> As long as the fund invests in stock and

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<sup>3</sup> Section 3(a)(1) of the 1940 Act defines “investment company” to include, among other things, any issuer which “is or holds itself out as being engaged primarily or proposes to engage primarily in the business of investing, reinvesting or trading in securities” or which “is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer’s total assets (exclusive of Government securities and cash items) on an unconsolidated basis.”

<sup>4</sup> In particular, the CFC must comply with Section 8 (investment policies), Section 17 (affiliated transactions and custody requirements) and Section 18 (capital structure and leverage).

<sup>5</sup> See I.R.C. § 851(b)(2).

securities, the income therefrom is qualifying income. The fact that the income or gain from a stock or security investment may reflect the values of assets that would not generate qualifying income if held directly by the fund—such as commodities or real estate—is of no consequence.

A fund that satisfies the requirements of Subchapter M is considered to be a “regulated investment company” or “RIC” as defined in the Code. We use the term RIC in the tax discussion that follows.

Some have cited the legislative history of the amendments to the definition of “qualifying income” in the Tax Reform Act of 1986 as support for the assertion that Congress intended that even indirect exposure to commodities is not permissible for RICs. This is an incorrect reading of the legislative history. There is nothing in any of the committee reports, floor debates or member statements that addresses direct or indirect investment in commodities by RICs. The only statements by government officials were by Treasury Department representatives expressing the views of the Reagan Administration. Statements by Treasury officials are not statements of Congressional intent.

Moreover, the Treasury statements were made in the context of broader assertions that qualifying income of a RIC should be “limited to income from property held for investment, as opposed to property held for sale to customers” and to “income from stocks and securities, as opposed to other property.”<sup>6</sup> Treasury indicated that it would oppose an expansion of qualifying income “to include gains from other types of property, such as commodities.”<sup>7</sup> Thus, Treasury did not assert that commodities were somehow more objectionable from a policy perspective than other assets. Rather, the tax policy relating to a RIC’s investment in commodities is the same as it is with respect to a RIC’s investment in assets such as real estate or collectibles. This policy does not in any way prevent a RIC from earning qualifying income from stock of a company that trades commodities, owns real estate, or engages in an active business, even if the RIC owns 100% of the stock of the company. Just as a RIC can own all the stock of a manufacturing company and earn qualifying income from that stock, a RIC can own all the stock of a commodity-trading company, or a company that holds rental real estate, and earn qualifying income from the stock. The nature of the activity in which the company engages is simply not relevant.

One illustration of this policy is the ability of RICs to invest in real estate investment trusts (“REITs”). REITs are similar to RICs in that they do not bear an entity-level tax if they distribute their income on a current basis. REITs differ from RICs in that they are required to invest predominantly in

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<sup>6</sup> See Statement of Dennis E. Ross, Tax Legislative Counsel, U.S. Treasury Department, in *Hearings on Issues Relating to Passthrough Entities before the Subcommittee on Select Revenue Measures of the Committee on Ways and Means* at 137. (June 10, 1986).

<sup>7</sup> *Id.* Virtually identical language is contained in a February 5, 1986, letter from Roger Mentz, Treasury’s Acting Assistant Secretary for Tax Policy, to Rep. Flippo, who had introduced a prior version of the amendment.

real estate. A number of RICs gain indirect exposure to real estate by investing in REITs. Over 35 years ago, the IRS issued a published ruling expressly concluding that a RIC's investment in a REIT is an investment in stock or securities that gives rise to qualifying income.<sup>8</sup>

The fact that there is no tax policy against RICs gaining indirect exposure to commodities is demonstrated by the 2004 amendment to section 851(b)(2) that treats the income from publicly traded partnerships ("PTPs") that are "qualified publicly traded partnerships" ("QPTPs") as qualifying income.<sup>9</sup> These QPTPs are treated as partnerships for tax purposes and thus the nature of the underlying income would generally flow through to the RIC under normal Subchapter K principles.<sup>10</sup> Before the 2004 amendment, if a RIC invested in a PTP that had gains from commodities or real estate, the RIC's income from the PTP would not be qualifying income. The amendment changed this treatment so that a RIC's income from investing in such a QPTP is qualifying income to the RIC. The portion of a RIC's assets that can be invested in one or more QPTPs is 25%, the same percentage that applies to a RIC's investment in a CFC. There are currently over 40 QPTPs that invest in or trade commodities.<sup>11</sup> Current law would not treat income from these QPTPs as qualifying income for RICs if there were a tax policy precluding RICs from gaining indirect exposure to commodities.

Finally, we note that there is broad support for amending the Internal Revenue Code to treat income from direct investments in commodities as qualifying income for RICs. This change would eliminate the need for RICs to use CFCs and CLNs to gain such exposure indirectly. In 2010, the House of Representatives gave extensive consideration to—and passed—an amendment to Subchapter M providing that a RIC's direct investments in commodities give rise to qualifying income. This amendment, along with other amendments to Subchapter M, was the subject of a hearing in the Select Revenue Measures Subcommittee of the Ways and Means Committee. The amendment was reported by the full Committee and passed by the House by unanimous consent.

### **III. The Numerous PLRs Issued by the IRS Since 2006 Correctly Apply Current Law**

The PLRs issued by the IRS conclude that a RIC's income from indirect investments in commodities through CFCs or CLNs is qualifying income. As explained below, the PLRs correctly apply current law and, in the case of CLNs, reflect a more conservative approach than the law actually requires.

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<sup>8</sup> See Rev. Rul. 74-177, 1974-1 C.B. 165.

<sup>9</sup> See I.R.C. § 851(b)(2), (h).

<sup>10</sup> This treatment is confirmed by the flush language of section 851(b).

<sup>11</sup> According to the National Association of Publicly Traded Partnerships, there are over 40 PTPs that are categorized as "commodity fund PTPs." See <http://naptf.org/PTP101/CommodityFunds.html>.

## A. Controlled Foreign Corporations

Stock of a CFC is plainly “stock” for purposes of the qualification rules. Consequently, all of a RIC’s income from stock of a CFC is income from investments in “stock or securities” within the meaning of the “qualifying income” test of section 851(b)(2).

The fact that the issuer of the stock is a CFC and that a RIC may own 100 percent of the stock is irrelevant to this analysis. First, section 851(b) expressly contemplates that RICs may invest in CFCs.<sup>12</sup> Second, section 851(b) permits a RIC to have one or more wholly-owned subsidiaries. Treas. Reg. §1.851-2 expressly provides that a RIC “may own all the stock of another corporation as long as it otherwise satisfies the . . . diversification requirements.” Under the diversification test of Code section 851(b)(3), a RIC may invest up to 25% of its assets in one company.<sup>13</sup> Thus, the qualification rules expressly authorize a RIC to own 100% of another corporation, domestic or foreign, as long as the corporation represents no more than 25% of the RIC’s assets.

As discussed above, the fact that the CFC engages in commodity-related transactions, or other activity that would not give rise to qualifying income if engaged in by the RIC directly, is also of no consequence. Although Subchapter M limits the types of investments in which a RIC may invest directly, it does not include any prohibitions on the underlying activities or investments of the corporations in which a RIC invests. It is true that the commodity-related income of the CFC would not be qualifying income if earned directly by the RIC; the same would be true, however, if the RIC earned income directly from an active trade or business. While a RIC cannot run a manufacturing plant, it clearly can hold some or all of the stock in a corporation that runs a manufacturing plant. From a Subchapter M perspective, there is no difference between a RIC investing in a CFC that invests in commodities and a RIC investing in a CFC that engages in an active trade or business. In both cases, the RIC is receiving income from its CFC stock that is qualifying income.

RICs, like other taxpayers, are free to structure their investments and business activities in various ways, including by making investments through a wholly-owned corporation. The tax law generally respects the separateness of a wholly-owned corporation from its owner.<sup>14</sup> Based on this principle, the use of intermediary corporations as “blockers” is widespread and has long been accepted by both Congress and the IRS.

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<sup>12</sup> The flush language of section 851(b) provides “dividend” treatment for subpart F income inclusions from a CFC under section 951(a)(1)(A)(i) if the CFC distributes an amount equal to the inclusions to the RIC in the same taxable year.

<sup>13</sup> See I.R.C. § 851(b)(3).

<sup>14</sup> See, e.g., *Moline Properties, Inc. v. Commissioner*, 319 U.S. 436 (1943); *NIPSCO v. Commissioner*, 115 F.3d 506 (7<sup>th</sup> Cir. 1997).

The extensive use of blockers by tax-exempt organizations to avoid unrelated business income tax (“UBIT”) is a prominent example of this practice. Foreign investors also frequently utilize blocker corporations to make investments into the U.S. or for investments in alternative investment funds (such as hedge funds) that in turn make investments into the U.S. The use of blockers by tax-exempt organizations, foreign investors and others has been the subject of a number of hearings in recent years, including hearings held by the Senate Finance Committee, the House Ways and Means Committee, and this Subcommittee.<sup>15</sup>

The effectiveness of such blockers under current tax law is widely accepted. For example, in 2007 the staff of the Joint Committee on Taxation (“JCT”) made the following observations about the use of blockers by tax-exempt organizations:

[I]f tax-exempt organizations hold potentially UBIT-producing partnership investments through a corporation, the corporation’s separate existence generally is respected for Federal tax purposes so that the lookthrough rule does not apply, and dividends paid by the corporation to the tax-exempt investors generally are excluded from the investors’ unrelated business taxable income. Tax-exempt organizations thus may have an incentive to invest in alternative investment funds through these ‘UBIT blockers’ or ‘blocker corporations.’ Such corporations often are established offshore in low-tax or zero-tax jurisdictions to avoid corporate tax at the blocker corporation level . . . .<sup>16</sup>

The JCT’s observations about the efficacy of blockers, as quoted above, are confirmed by numerous private letter rulings issued by the IRS going back as far as 1988. These PLRs hold that blocker corporations are effective to protect tax-exempt investors from UBIT that would otherwise result if the organization made the same investment directly rather than indirectly through the blocker.<sup>17</sup>

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<sup>15</sup> See, e.g., *The Cayman Islands and Offshore Tax Issues: Hearing Before the S. Comm. on Finance*, 110th Cong. (Jul. 24, 2008); *Offshore Tax Issues: Reinsurance and Hedge Funds: Hearing Before the S. Comm. on Finance*, 110th Cong. (Sept. 26, 2007); *Fair and Equitable Tax Policy for America’s Working Families: Hearing Before the H. Comm. on Ways & Means*, 110th Cong. (Sept. 6, 2007); *Tax Haven Banks and U.S. Tax Compliance: Hearing Before the Permanent Subcomm. on Investigations*, 111th Cong. (Mar. 4, 2009); *Dividend Tax Abuse: How Offshore Entities Dodge Taxes on U.S. Stock Dividends: Hearing Before the Permanent Subcomm. on Investigations*, 110th Cong. (Sept. 11, 2008).

<sup>16</sup> See JCT, Present Law and Analysis Relating to Selected International Tax Issues (JCX 85-07) at 14 (Sept. 24, 2007).

<sup>17</sup> See PLR 200623069 (Jun. 9, 2006); PLR 200315034 (Apr. 11, 2003); PLR 200315028 (Apr. 11, 2003); PLR 200251016 (Dec. 20, 2002); PLR 200252096 (Dec. 26, 2002); PLR 9407007 (Nov. 12, 1993); PLR 9027051 (Apr. 13, 1990); PLR 9024086 (Mar. 22, 1990); PLR 9024026 (Mar. 15, 1990); PLR 8922047 (Mar. 6, 1989); PLR 8836037 (Jun. 14, 1988); PLR 8819034 (Feb. 10, 1988).

Significantly, Congress has expressly indicated its agreement with the conclusions reached in these PLRs. In 1996, Congress considered the ability of tax-exempt organizations to avoid UBIT by investing through CFCs. As part of the Small Business Job Protection Act of 1996, Congress amended the Code to apply a look-through rule for UBIT purposes when a CFC owned by a tax-exempt organization engages in certain insurance activities.<sup>18</sup> In other words, if the CFC engages in such activities, the nature of the income as insurance income passes through the CFC to the tax-exempt organization and is subject to UBIT. The 1996 legislation did not extend such a look-through rule to other types of income that a CFC owned by a tax-exempt organization might earn. The fact that Congress changed the law to apply a look-through rule in this one instance confirms that in the absence of such legislation, the CFC effectively converts the character of the income into income that is not subject to UBIT.

Congress's view on the effect of blockers was expressed clearly in the legislative history accompanying the 1996 legislation. The Conference Report discusses the fact that the IRS had issued a number of PLRs ruling that CFC blockers were effective for UBIT purposes. It also notes that the IRS, rather inexplicably, had issued one PLR that applied a look-through approach. The Conference Report expressly states that the "conferees believe that [the PLR applying a look-through approach] is incorrect in its application of a look-through rule in characterizing income inclusions under subpart F for unrelated business income tax purposes."<sup>19</sup>

Individual members of Congress have varying views on the practice of using blockers. Some members seek to amend the Code to ban the use of blockers, at least in certain contexts.<sup>20</sup> Other members have introduced legislation that would change the tax rules to make the use of blockers unnecessary in certain contexts.<sup>21</sup> While these alternative approaches reflect differing views on how to deal with blockers, they all start with the proposition that blockers "work" under the law as it currently stands.

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<sup>18</sup> See I.R.C. § 512(a)(17).

<sup>19</sup> See H.R. REP. NO. 104-737, at 294 n.50 (1996). To the same effect, see JCT, *General Explanation of Tax Legislation Enacted in the 104th Congress* (JCS-12-96), at 215, n.159 (Dec. 18, 1996).

<sup>20</sup> See section 103 of S.1346, the "Stop Tax Haven Abuse Act."

<sup>21</sup> A bill introduced by Congressman Rangel in 2007 would have permitted tax-exempt entities to invest directly in hedge and other investment funds, and thus "would eliminate the current-law incentive . . . to invest in hedge funds and other investment funds through offshore 'blocker' corporations formed in tax haven jurisdictions." Press Release, House Ways & Means Committee, H.R. 3790, Tax Reduction and Reform Act of 2007 (Oct. 29, 2007). A bill introduced by Congressman Levin in 2009 would have amended the UBIT rules to exclude from acquisition indebtedness the debt of a partnership incurred to purchase or carry securities or commodities in determining the unrelated business taxable income of the limited partner. H.R. 3497, 111th Cong. (2009). This change also would have made it easier for tax-exempt entities to invest directly in private equity funds. The amendment passed by the House in 2010 to treat a RIC's income from direct investments in commodities as qualifying income represents a similar effort.

The recent codification of the economic substance doctrine<sup>22</sup> does not affect the ability of taxpayers to utilize blocker corporations. The legislative history of the amendment codifying the doctrine expressly states the following:

The determination of whether the economic substance doctrine is relevant to a transaction is made in the same manner as if the provision had never been enacted. Thus, the provision does not change present law standards in determining when to utilize an economic substance analysis.<sup>23</sup>

The legislative history further makes clear that the doctrine is not to apply to transactions that “under longstanding judicial and administrative practice are respected, merely because the choice between meaningful economic alternatives is largely or entirely based on comparative tax advantages.”<sup>24</sup> Among the examples of such transactions listed in the legislative history are the following: “a U.S. person’s choice between utilizing a foreign corporation or a domestic corporation to make a foreign investment” and “the choice to utilize a related-party entity in a transaction, provided that the arm’s length standard of section 482 and other applicable concepts are satisfied.”<sup>25</sup>

Thus, codification of the economic substance doctrine did not, and was not intended to, change the framework for analyzing the effectiveness of blocker entities. Rather, any change to the long-standing and accepted practice of using blockers would require a change in the tax law.

The IRS is required to apply the law as it currently stands. The PLRs regarding RIC investments in CFCs that provide indirect exposure to commodities are fully consistent with current law as it has long been administered by the IRS. As noted above, the IRS’s view that CFCs are effective blockers for UBIT purposes was endorsed expressly by Congress in the legislative history of the Small Business Job Protection Act of 1996. There is no tax policy reason to adopt a different approach for RICs.

## **B. Commodity-Linked Notes**

Qualifying income, as provided by Code section 851(b)(2), includes income from “securities’ (as defined in section 2(a)(36) of the Investment Company Act of 1940).” Thus, if a financial

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<sup>22</sup> See I.R.C. § 7701(o).

<sup>23</sup> JCT, *Technical Explanation of the Revenue Provisions of the “Reconciliation Act of 2010,” as amended, in combination with the “Patient Protection and Affordable Care Act”* (JCX 18-10), at 152 (Mar. 21, 2010).

<sup>24</sup> *Id.*

<sup>25</sup> *Id.* at 152-153 (footnotes omitted).



instrument, including a CLN, falls within the 1940 Act definition of a “security,” income from the instrument is qualifying income.

The definition of “security” under section 2(a)(36) of the 1940 Act is expansive. The definition includes “any note . . . bond, debenture, evidence of indebtedness . . . or, in general, any interest or instrument commonly known as a ‘security’ . . . .” A wide range of instruments fall within this broad definition of security. As a matter of statutory construction, the only issue for tax purposes is whether a CLN is one of these instruments.

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. All three of these federal securities laws include a “note” within the definition of security.<sup>26</sup> The Supreme Court has applied the “family resemblance” test in determining whether a note is a security for purposes of the federal securities laws, stating that courts are to begin with a presumption that every note is a security.<sup>27</sup> This presumption may be rebutted only by a showing that the note bears a strong resemblance to one of several specific categories of notes that courts have found not to be securities, or by a court determining that a new category should be added.<sup>28</sup> The Court further provided factors to be used in determining whether a note bears a strong resemblance to one of those enumerated categories.<sup>29</sup> CLNs do not bear a resemblance to any of the categories of notes the Court found not to be securities, when analyzed according to the factors provided by the Court. Accordingly, CLNs are securities for purposes of the federal securities laws, including the 1940 Act.

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<sup>26</sup> See Section 2(a)(1) of the 1933 Act; Section 3(a)(10) of the 1934 Act; Section 2(a)(36) of the 1940 Act.

<sup>27</sup> See *Reves v. Ernst & Young*, 494 U.S. 56, 65 (1990).

<sup>28</sup> *Id.* at 65-67. The categories of notes specified by the Court as not being securities are: (i) a note delivered in consumer financing; (ii) a note secured by a mortgage on a home; (iii) a short-term note secured by a lien on a small business or some of its assets; (iv) a note evidencing a “character” loan to a bank customer; (v) a short-term note secured by an assignment of accounts receivable; (vi) a note that simply formalizes an open-account debt incurred in the ordinary course of business; and (vii) a note evidencing a loan by a commercial bank for current operations.

<sup>29</sup> *Id.* These factors require a court to examine: (i) the transaction to assess the motivations that would prompt a reasonable seller and buyer to enter into it; (ii) the instrument’s plan of distribution to determine whether it is an instrument in which there is common trading for speculation or investment; (iii) whether the investing public would reasonably expect the instrument to be considered a security (e.g., rather than consumer or commercial bank loans or financing); and (iv) whether some other factor, such as the existence of another regulatory framework, significantly reduces the risk of the instrument, thereby rendering application of the securities laws unnecessary. The courts have stated that an instrument need not be distributed publicly to be found to be a security under this analysis. See *Trust Co. of Louisiana v. N.N.P. Inc.*, 104 F.3d 1478, 1489 (5th Cir. 1997).

As commentators have observed, the SEC interprets the term “security” more broadly under the 1940 Act than under the other two federal securities laws.<sup>30</sup> 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.<sup>31</sup>

Despite the broad interpretation of “security” in the 1940 Act, the IRS has taken a more restrictive approach in the numerous PLRs addressing RIC investments in CLNs. Although we do not believe that the restrictions imposed in the PLRs are necessary, we recognize that these restrictions provide further assurance to the IRS that CLNs are securities. These restrictions include the requirement that CLNs have four features that preclude the application of the Commodity Exchange Act (the “CEA”) to a CLN.<sup>32</sup> These features—which include 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—prevent the CLN from being regulated as a commodity or an interest in a commodity. Thus, any concern that regulators might view the CLN as a commodity rather than a security is fully addressed. Additional requirements in the PLRs—such as the presence of a coupon tied to prevailing interest rates and mandatory early redemption to provide 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.”

As an alternative to investing in notes with the characteristics required by the PLRs, RICs also could gain exposure to commodities by investing in any one of numerous “exchange-traded notes” or “ETNs” that are tied to commodities. ETNs are traded on national securities exchanges, registered under the 1934 Act and regulated by the SEC. ETNs have all the hallmarks of publicly-traded securities and plainly fall within the 1940 Act definition of a security. ETNs would give RICs more exposure to commodities than RICs can obtain by investing in notes that meet the requirements in the PLRs. ETNs can provide leverage greater than that permitted by the PLRs and there is typically no protection of any portion of the principal amount invested. The PLRs thus reflect a conservative approach to the types of instruments that RICs can invest in to gain indirect exposure to commodities.

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<sup>30</sup> See, e.g., TAMAR FRANKEL & ANN TAYLOR SCHWING, *THE REGULATION OF MONEY MANAGERS: MUTUAL FUNDS AND ADVISERS* § 5.07 (2d ed. 2001).

<sup>31</sup> See e.g., GINS Capital Corp., SEC No-Action Letter (Sept. 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).

<sup>32</sup> See CEA § 2(f).

#### **IV. The IRS Properly Focuses on Interpreting the Tax Law Rather Than Attempting to Further Non-Tax Regulatory Policy Objectives**

We understand that some on the Subcommittee have concerns regarding excessive speculation in the commodities markets and the impact that such speculation can have on prices. We believe that such concerns are misplaced with respect to RICs. Moreover, these concerns are not germane to the proper interpretation of the tax law. Such non-tax regulatory policy does not provide a basis for the IRS to disregard established practice that comports with long-standing principles of tax law.

We also have doubts as to whether reversal of the IRS's ruling position would assuage the concerns expressed by some on the Subcommittee. As explained above, RICs can obtain indirect exposure to commodities through alternative means, such as by investing in PTPs. These alternatives would be less efficient, but they are nonetheless available and permissible under the tax law.

Finally, it is important to note that the increase in the number of RICs offering investors some exposure to commodities is a direct result of investor demand for such exposure. Investors invest in such RICs in order to diversify their portfolios and provide a hedge against inflation and turbulence in other areas of the financial markets. If RICs were not able to provide that exposure, investors would turn to alternative investments tied to commodities, such as ETNs. This development would not be beneficial from an investor protection policy perspective. RICs are heavily regulated pursuant to the 1940 Act, the underlying policy of which is protecting investors. In contrast, ETNs are essentially unregulated, highly leveraged instruments, and investors frequently find it difficult to evaluate the risks, including the substantial credit risks, that they undertake by investing in ETNs. We hope the Subcommittee will be mindful of these and other adverse consequences in evaluating the relevant policy considerations that bear on the ability of RICs to gain indirect exposure to commodities through CFCs and CLNs.