S. Hrg. 112–343

COMPLIANCE WITH TAX LIMITS ON MUTUAL FUND COMMODITY SPECULATION

HEARING

BEFORE THE

PERMANENT SUBCOMMITTEE ON INVESTIGATIONS

OF THE

COMMITTEE ON
HOMELAND SECURITY AND
GOVERNMENTAL AFFAIRS
UNITED STATES SENATE

ONE HUNDRED TWELFTH CONGRESS

SECOND SESSION

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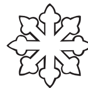

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COMPLIANCE WITH TAX LIMITS ON MUTUAL FUND COMMODITY SPECULATION

THURSDAY, JANUARY 26, 2012

U.S. SENATE,
PERMANENT SUBCOMMITTEE ON INVESTIGATIONS,
OF THE COMMITTEE ON HOMELAND SECURITY
AND GOVERNMENTAL AFFAIRS,
Washington, DC.

The Subcommittee met, pursuant to notice, at 10:31 a.m., in room SD–342, Dirksen Senate Office Building, Hon. Carl Levin, Chairman of the Subcommittee, presiding.

Present: Senators Levin, Carper, and Coburn.

Staff Present: Elise J. Bean, Staff Director and Chief Counsel; Mary D. Robertson, Chief Clerk; David H. Katz, Counsel; Christopher Barkley, Staff Director to the Minority; Eric Walker, Detailee (FDIC); Dennis Bogusz, Congressional Fellow; Courtney Cardin, Law Clerk; Michael Wolf, Law Clerk; Arielle Woronoff, Law Clerk; Bill Gaertner, Law Clerk; Tamir Haddad, Intern; Julie Kovin, Law Clerk; David Smith and Amanda Slater (Senator Carper).

OPENING STATEMENT OF SENATOR LEVIN

Senator LEVIN. Good morning, everybody. For 10 years now, this Subcommittee has focused attention on the problem of excessive speculation in the commodity markets, including the crude oil, natural gas, and wheat markets. Most recently, in last November's hearing, we examined efforts to apply a new position limits rule to protect consumers, businesses, and the commodity markets themselves from excessive speculation. For years now, the American people have been whipsawed by unpredictable and often escalating commodity prices. We have been hurt at the pump, we have been hurt at the dinner table, and we have been hurt in our pocketbooks. We are talking about gasoline prices, electricity and heating costs, food prices, and industrial raw materials that together affect virtually every American family and business budget.

The fundamental purpose of commodity markets, unlike stock markets, is not to attract investors, but to enable producers and users of physical commodities to arrive at a fair price for their goods and to hedge their price risks over time. Speculators, who don't intend to use or deliver the commodities that they trade or hedge commodity prices so that they can have price certainty, seek instead to profit from the price changes. A market which was intended to facilitate price discovery and hedging is now dominated by speculators who are driving up price volatility, hedging failures,

and in many cases, driving up commodity prices. The reality today is that commodity prices are more reflective of trading by speculators than fundamental forces of supply and demand.

At our November hearing, the Commodity Futures Trading Commission told us that 80 percent of the outstanding futures contracts for crude oil are now held by speculators. CFTC Commissioner Bart Chilton has said:

"For those who say no evidence exists linking excessive speculation and prices, they just are not looking. Scores of studies and papers," he said, "exist which document the linkage."

Now, the unprecedented flood of speculative money in commodity markets today comes from index traders, hedge funds, money managers, and exchange-traded products. Our November hearing also exposed a new wave of commodity speculation coming from the $11 trillion mutual fund industry. Exhibit 1a is a chart which shows that, since 2008—and that chart is in front of us, to my left—more than 40 commodity-related mutual funds have begun pouring speculative funds into the commodities markets and now have accumulated assets of over $50 billion.[1]

For most of the 70 years they have been in existence, mutual funds were not significant participants in U.S. commodity markets. Now, some mutual funds have become major commodity speculators, and more want to follow. When we looked at what had changed, we discovered that 6 years ago mutual funds began petitioning for and receiving IRS private letter rulings that, for the first time, enabled them to invest heavily in commodities, despite longstanding provisions in Section 851(b)(2) of the Internal Revenue Code. Those private letter rulings of the IRS essentially opened the floodgates to the mutual fund petitioners, allowing them to engage in billions of dollars in commodity speculation.

Section 851(b)(2), which has been in the Tax Code since mutual funds got started in the 1930s, restricts the types of income that mutual funds are allowed to obtain. That allowance is put on them in the law in exchange for favorable tax treatment. If the mutual funds abide by this section's income source restrictions, those mutual funds do not have to pay corporate income taxes like other corporations. This tax break collectively saves the mutual fund industry billions of dollars each year. In simple terms, the statute requires that 90 percent of a mutual fund's gross income must be derived from securities, interest, or foreign currency investments. That means not more than 10 percent of their income can come from alternatives like commodities.

This 90-percent rule has been in place for decades. But in 2006, as financial engineering took hold on Wall Street, the mutual fund industry began pressing the IRS to permit it to use complex financial transactions that would, in essence, enable mutual funds to get around the 90-percent rule and engage in commodity investments beyond the 10-percent limit. Dozens of individual mutual funds made these requests in petitions for private letter rulings.

In response, from 2006 to 2010, the IRS issued 72 private letter rulings allowing the mutual funds to whom the letters were addressed to use either wholly owned offshore corporations or finan-

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[1] See Exhibit No. 1a which appears in the Appendix on page 44.

cial instruments called "commodity-linked notes" to make unrestricted commodity investments, notwithstanding the 10-percent limit in Section 851. The IRS private letter rulings said that the mutual funds could treat the income from those sources not as income from a commodities investment but as income from a "securities" investment in the stock of the company that they owned or in a note that was designed to avoid the restrictions of Section 851.

For example, the IRS allowed mutual funds to establish wholly owned controlled foreign corporations (CFCs), whose sole function is to trade commodities in the futures and swaps markets. In every case we have examined, mutual funds have established these CFCs as offshore shell corporations in the Cayman Islands, the classic example of a tax haven. The CFCs—these offshore shell corporations—have no offices, no employees of their own, no independent business operations; their commodity portfolios are run by employees who work in the United States for the mutual fund that set up the offshore arrangement. For example, one mutual fund told us that all of the commodity investment decisions for their offshore corporation were made by the mutual fund's employees in Rockville, Maryland. Another told us that all commodity trading decisions were made by their traders in New York. Still another mutual fund told us openly that their offshore commodity fund had no "Cayman presence," describing it as "smoke and mirrors" to obtain the tax benefit.

Now, these CFCs are corporate fictions, offshore shams, paper exercises whose sole purpose is to make an end run around the legal restrictions on commodity investments by mutual funds. At the same time, the IRS has issued private letter rulings explicitly allowing those offshore schemes. The IRS private letter rulings provide, for example, that if a mutual fund owns the stock of the offshore shell corporation that it established, it can treat income from commodity investments made by that offshore shell corporation and distributed back to the United States as income from a securities investment rather than a commodities investment.

In addition, the IRS has issued private letter rulings stating that mutual funds can use commodity-linked notes to invest in commodities and treat the resulting income as from a securities investment, even though the notes were created for the sole purpose of investing in commodities and end-running Section 851.

Now, by treating this type of income as derived from securities rather than from commodities, the IRS has elevated form over substance, enabling mutual funds to use agents as though they were independent actors, and to use financial engineering to do indirectly what the law does not let them do directly. The result is opening the door to increasing commodity speculation.

But that is not all. In the past, under the 90-percent rule, mutual funds spent the lion's share of their money on stocks, bonds, and other securities, providing needed capital for economic growth and for jobs. They were an engine of investment in America. But as the commodity spigot opens, every dollar spent on commodity speculation diverts money from their securities investments. So instead of investing in U.S. businesses, mutual funds will spend more and more increasing sums making bets on commodity price move-

ments. Capital investments do our economy a lot more good than betting on prices.

Now, to understand the context of the issues at stake, let us take a look at the history of the tax law's limits on mutual funds. When Federal tax breaks for mutual funds were first enacted in 1936, Congress adopted limits on what mutual funds could invest in. They allowed mutual funds to utilize income from interest, stock dividends, and stock sales. Commodities were not on the list of allowed investments. That was the same year, by the way, that Congress enacted the Commodities Exchange Act of 1936, the first Federal law to control excessive speculation in commodity markets. So Congress was well aware of U.S. commodity markets and did not make commodities an allowable investment for mutual funds in 1936.

In 1954, Congress enacted Subchapter M of the Internal Revenue Code to reform taxation of mutual funds. Subchapter M again listed the types of income that mutual funds were allowed to earn in exchange for favorable tax treatment. That list was unchanged from 1936, and commodities were not on the list.

In 1986, 50 years after the first mutual funds got started, Congress slightly expanded the types of income that a mutual fund could earn while retaining its tax advantages, adding investments in foreign currencies to investments in securities. Commodities were not added by Congress. The Treasury Department issued a letter at the time noting that it "would generally not treat as qualifying income gains from trading commodities."

In 2010, the mutual fund industry supported an unsuccessful legislative attempt to change the Tax Code to allow mutual funds to make unrestricted commodity investments. As introduced in 2009, and passed by the House in 2010, the Regulated Investment Company Modernization Act would have explicitly permitted mutual funds to utilize income from "commodities" under Section 851. But the Senate did not accept that provision. It was removed from the bill which only then was approved by the Senate. Removal of the commodities provision was, in fact, the only change made in the House-passed bill. The bill was sent back to the House which agreed to the bill as amended by the Senate. So the short story is that Congress did not agree to adding commodities to the list of acceptable income for mutual funds under the 90-percent rule. If the industry wants to try again to change the law to allow more commodity investments by mutual funds, the change needs to be considered not by private letter rulings or regulation, but by Congress after a full debate of the pros and cons.

Six months after Congress made its decision in that Modernization Act, in June 2011, the IRS suspended its issuance of new private letter rulings in this area so it could review the underlying policy issues. Later in the year, Senator Coburn and I sent a joint letter to the Treasury and the IRS asking the IRS "to permanently halt the further issuance of [the] private letter rulings." And our letter is Hearing Exhibit 1d.[1]

Now, some have suggested that the IRS ought to allow mutual funds to use offshore corporations to make commodity investments

[1] See Exhibit No. 1d which appears in the Appendix on page 51.

based on the court case known as Moline Properties, which required the IRS to recognize a certain corporate structure. But in Moline Properties, the Supreme Court stated that, "in matters relating to the revenue, the corporate form may be disregarded where it is a sham or unreal." The Cayman corporations being used for mutual fund commodity investments have no employees, no place of business, no profits of their own, and no obvious nontax purpose. There is no office, other than mailboxes. They are exactly the type of sham corporations that the Supreme Court said that the IRS can disregard.

Now, another relevant event is the 2010 congressional codification of the economic substance doctrine which permits the IRS to disregard transactions that have no substantial nontax purpose. Mutual funds have not offered any substantial business or economic purpose for considering these offshore CFCs or constructing commodity-linked notes. Their only purpose is to serve the mutual funds' effort to recharacterize the resulting income as derived from "securities" so that they can make unlimited commodity investments while retaining their privileged tax status. A Tax Notes analysis by two tax practitioners, Hearing Exhibit 3d,[1] observed that "it is hard to imagine that there could be a nontax purpose outweighing the tax purpose on the facts of the rulings."

Now, finally, there is a long line of cases and private letter rulings in which Federal courts have upheld the IRS' efforts to go after sham corporations or transactions which have no purpose other than tax avoidance or which serve only as conduits for parties seeking to avoid taxation. They include cases like Gregory v. Helvering, Aldon Homes, Aiken Industries, and the recent case of Southgate Master Fund. In Southgate, the Fifth Circuit, citing numerous precedents, wrote the following:

"The starting point for our analysis is the cardinal principle of income taxation: a transaction's tax consequences depend on its substance, not its form. This principle 'is no schoolboy's rule; it is the cornerstone of sound taxation[.]'" The court wrote: "This foundational principle finds its voice in the judicial anti-abuse doctrines, which 'prevent taxpayers from subverting the legislative purpose of the tax code by engaging in transactions that are fictitious or lack economic reality simply to reap a tax benefit.'"

One of the issues we are going to explore today is why the IRS did not follow that approach when analyzing requests by the mutual funds to use offshore corporations and structured notes to make their commodity investments. By issuing the private letter rulings that it has issued in the mutual fund area, the IRS is undermining its own longstanding efforts to go after sham corporations and transactions that are used to avoid paying a tax.

These are not arcane issues; they raise fundamental issues affecting our economic future, the functioning of our Tax Code, and the use of offshore schemes and financial engineering to avoid our tax laws. The IRS private letter rulings have unleashed a new flood of speculative commodity investments that are damaging to American families, businesses, and our economy. Commodity speculation that contributes to $4-a-gallon gasoline is no joke, and neither is

[1] See Exhibit No. 3d which appears in the Appendix on page 81.

a tax policy that threatens to fuel a new explosion in speculation in commodities. The IRS letter rulings enable U.S. firms to use offshore shell corporations and financially engineered notes to make commodity investments, despite longstanding Tax Code restrictions, and it sets precedents that eat away at the integrity of our Tax Code. We should not just stand by and let that happen.

Today's oversight hearing is intended to address these concerns. We will be hearing from IRS Commissioner Douglas Shulman and Emily McMahon, who is the Acting Assistant Secretary of the Treasury for the Office of Tax Policy, two of the most senior tax officials in the Administration. We thank them for their presence. We are grateful that you were able to be here with us today.

I now invite our Ranking Member, Dr. Coburn, to share his views.

OPENING STATEMENT OF SENATOR COBURN

Senator COBURN. Thank you, Mr. Chairman, and thank you all for being here. Some points.

There is no definition of "excessive speculation." We live in global markets. The price of oil does not have anything to do with what the speculation on the Chicago Board of Exchange is right now because there is a worldwide market for oil, and with the click of a computer button, you can trade that—whether you trade here or you trade in London or you trade in Paris or you trade in Abu Dhabi.

The fact is we have seen what we think is something that goes around the intention of what Congress has created in terms of mutual funds and the greater risk that is associated with commodity speculation. And with that, Mr. Chairman, I agree.

The second point is tax avoidance is not illegal. Tax evasion is, and we need to keep that in mind as we look at it. I do not know what the answer is to the questions that have been raised today and the ultimate answer in terms of the letters that you have granted. But I know a couple things are true. One is that we need to continue to have the freest and fairest and open markets we can have to have the best price discovery, and speculation is a significant component of that. I have asked multiple panels before me what excessive speculation is, and I have never been able to get an answer to that. The fact is that worldwide demand is growing for almost everything that is listed on our commodity exchanges and some of the commodity exchanges throughout the world. But the fact is we do not price just in our country commodities. They are priced based on worldwide demand.

So my hope is as we go through this—I agree with the Chairman. If our intent is not to allow a mutual fund to speculate in commodities, then we should not be allowing the mutual funds so that the consumer knows that. That is one. But that will not stop speculation in commodities because they will just go somewhere else if they are intent on doing that. So I think it is important we keep in mind that we are going to have minimal effect, even if we come to a conclusion through this hearing, on what is going to be the ultimate outcome in terms of speculative behavior in the world because we no longer are isolated just in our country.

I think it is true that we ought to have much more transparency and straightforwardness about what our intent is. And so I thank you for being here. My hope is that we can have a better understanding of what has happened, what needs to happen, and what we might need to do to achieve that transparency in light of the fact that we know we are in a world market and that money is going to go where the greatest return is based on what the risk is. And where I would agree with the Chairman, is I think we need to make sure that people know who are investing in these mutual funds that are not speculating commodities what the significant risk is. And it is my belief they do know that now, but I think we have an obligation to make sure that is the case.

I yield back.

Senator LEVIN. Thank you very much, Dr. Coburn, for your work and the work of your staff in this matter. It is our joint intent that even though there may not be consensus on the effect of speculation, that there is consensus that our laws are intended to be followed, and they cannot be and should not be run around by sham transactions.

I now want to welcome our witnesses for this morning's hearing: Doug Shulman, who is the Commissioner of the Internal Revenue Service, and Emily McMahon, the Acting Assistant Secretary for Tax Policy for the Department of the Treasury.

Commissioner Shulman, I want to thank you for being here again today. You have testified before this Subcommittee in the past. We welcome you back, and we are always pleased to have you.

Ms. McMahon, I think this may be your first appearance, and we give you a warm welcome as well.

Pursuant to Rule VI, all witnesses who testify before the Subcommittee are required to be sworn. At this time I would ask you then to please stand and raise your right hand. Do you swear that the testimony you are about to give will be the truth, the whole truth, and nothing but the truth, so help you, God?

Mr. SHULMAN. I do.

Ms. MCMAHON. I do.

Senator LEVIN. We will use our traditional timing system today, and please limit your oral testimony to 10 minutes. At a minute before that 10-minute period runs out, you will be given a signal by a yellow light a minute before the red light comes on, which will give you an opportunity to conclude your remarks.

Commissioner Shulman, we will have you go first, and after we have heard your testimony and Ms. McMahon's testimony, we will then proceed to questions.

TESTIMONY OF HON. DOUGLAS H. SHULMAN,[1] COMMISSIONER, INTERNAL REVENUE SERVICE

Mr. SHULMAN. Thank you, Chairman Levin and Ranking Member Coburn. I appreciate having the opportunity to testify before the SubcCommittee on the issue of regulated investment companies, or RICs, investing in commodities.

[1] The prepared statement of Mr. Shulman appears in the Appendix on page 36.

Let me start by explaining that the IRS is involved in this issue because it is charged with, as the Chairman said, providing guidance to taxpayers as to whether investments that RICs choose to make will produce qualifying RIC income, as defined by the tax law.

In order to maintain its tax status, a RIC must derive 90 percent of its income from investments that meet the qualifications of Section 851 of the Code, which generally requires investments be related to stock, securities, or foreign currencies. The term "securities" is specifically defined in the Tax Code in Section 851 by cross-reference to the definition of that same term in the Investment Company Act of 1940.

It is the scope of that definition of the word "security"—and particularly its application to investments providing indirect exposure to commodities—that has been the focus of the 70 or so private letter rulings that are the subject of this hearing.

Now, while I was not at the agency at the time our position was first established and did not participate in any of the decisions about our position or the private letter ruling process in the past, it may be useful for me to provide a brief explanation of how the IRS arrived at the position reflected in the private letter rulings and then summarize the IRS's posture on this issue today.

In 2005, some RICs started, to guidance from the IRS, as to whether certain investments made to achieve exposure to commodity prices would qualify for the 90-percent income test. The IRS was unable to find any authoritative guidance on the proper scope of the definition of "security" from either the Securities and Exchange Commission or the Commodity Futures Trading Commission.

This situation resulted in the IRS being asked to issue private letter rulings addressing specific proposed RIC commodity-related investments based on the IRS's own best interpretation of the tax law, including the cross-references to the 1940 Act. Private letter rulings were issued on this subject starting in 2006. As you said, they were issued on two basic structures: structured notes and investments in controlled foreign corporations. I have attached details of our counsel's analysis of this issue to my written testimony to give you a better sense of their analysis.

Last summer, though, as you mentioned, the IRS decided to stop issuing private letter rulings until our staff could look at the overall set of issues and consider guidance of broader applicability. That is where we are today.

Mr. Chairman, I want to just close by stating that I am confident that our staff did its best to interpret a difficult set of tax law provisions. And while I believe that their conclusions were reasonable in the context of an unclear statute, at the agency we have an open mind on this issue. The fact that we suspended private letter rulings last summer allows the opportunity for us to take a fresh look at this issue.

You have raised important policy and legal questions that I assure you will be fully considered as we determine the appropriate next steps.

So with that, that ends my testimony, and I will obviously be happy to answer questions when the time comes.

Senator LEVIN. Thank you very much, Commissioner. Secretary McMahon.

TESTIMONY OF EMILY S. MCMAHON,[1] ACTING ASSISTANT SECRETARY FOR TAX POLICY, U.S. DEPARTMENT OF THE TREASURY

Ms. MCMAHON. Thank you, Chairman Levin and Ranking Member Coburn. I appreciate the opportunity to testify today on the issue of investments in commodities by regulated investment companies.

Commissioner Shulman's testimony describes a series of private letter rulings issued by the Internal Revenue Service on this subject. I would like to begin by describing the role of the Treasury Department in the private letter ruling and published guidance process.

A private letter ruling is a determination issued by the IRS to a particular taxpayer that interprets and applies the tax laws to the taxpayer's particular set of facts. As a matter of policy and practice, the Treasury Department does not participate in the consideration or issuance of private letter rulings by the IRS. Moreover, other than in highly unusual circumstances, Treasury Department personnel do not know which taxpayers have requested or received private letter rulings. Treasury Department personnel become aware of the issuance of a private letter ruling only when that ruling is eventually issued to the public by the IRS in redacted form. Consistent with that policy and practice, the Treasury Department did not participate in the formulation, or review or oversee the issuance, of any of the private letter rulings addressing commodity-related investments by RICs. Nor has the Treasury Department studied the effect of the private letter rulings on the mutual fund industry.

The Office of Tax Policy is actively involved, however, in the development of published guidance, including both tax regulations and other administrative guidance published in the Internal Revenue Bulletin. In this capacity, Treasury personnel participate in the development of the substantive law that private letter rulings reflect.

Thus, in 2005 and 2006, Treasury Department personnel did participate in the development of two published revenue rulings that address commodity-related investments by a RIC. These revenue rulings, 2006–1 and 2006–31, are described in more detail in Commissioner Shulman's written testimony. Subsequent to those revenue rulings, the IRS and Treasury Department periodically discussed the possibility of additional guidance in this area as a potential candidate for the Priority Guidance Plan.

As stated in Commissioner Shulman's testimony, the IRS has suspended the issuance of private letter rulings addressing commodity-related investments by RICs. Treasury Department personnel were not involved in that decision.

Subsequent to the suspension, the Investment Company Institute (ICI) called several members of the staff of the Office of Tax Policy to ask why the IRS issuance of rulings had been suspended and

[1] The prepared statement of Ms. McMahon appears in the Appendix on page 42.

what the future might hold. Treasury staff could not, and did not, provide answers to those questions. On September 28, 2011, at the ICI's request, ICI representatives met with Treasury and IRS personnel to discuss ICI proposals for published guidance that would permit commodity-related investments by RICs.

The Treasury Department and IRS are currently considering the possibility of issuing published guidance on this subject.

The Subcommittee's letter inviting me to testify at this hearing stated that the Regulated Investment Company Modernization Act of 2010 "reaffirmed [Congress'] intent to exclude commodities from mutual funds' qualifying income under Section 851." The House version of the bill, H.R. 4337, would have expanded the definition of qualifying income to include income derived from direct or indirect exposure to commodities. However, that amendment to the definition was removed from the bill before enactment, leaving unchanged the statutory provisions upon which the IRS revenue rulings and private letter rulings were based. Under those provisions, the definition of qualifying income is linked to the 1940 Act definition of "security," and income derived from such securities is not explicitly excluded from qualifying income merely because it reflects exposure to commodity prices.

Under Section 7701 of the Internal Revenue Code, whenever the economic substance doctrine is relevant to a transaction, the transaction is treated as having economic substance only if, as a factual matter, the transaction changes in a meaningful way the taxpayer's economic position and the taxpayer has a substantial nontax purpose for entering into the transaction. These questions are inherently factual. The private letter rulings issued by the IRS do not address the potential application of the economic substance doctrine, and the Treasury Department does not have independent knowledge of the facts underlying the rulings. Therefore, we cannot express a view on the application of Section 7701(o) to the transactions described in the private letter rulings.

Finally, I would note that the extent to which investors should be able to obtain exposure to commodity price fluctuations through investments in RICs is not fundamentally a tax policy issue. The Code provisions in question do raise, however, the issue of whether the Treasury Department and the IRS should be required to interpret a nontax statute—in this case, the 1940 Act—that does not otherwise fall within their jurisdiction in order to determine the availability of favorable tax treatment under the Code. The Securities and Exchange Commission has not issued any guidance of which we are aware that addresses the financial instruments described in the IRS private letter rulings, whether those financial instruments are securities for 1940 Act purposes, as required to produce qualifying income. At the same time, we are not aware of any action the SEC has taken to preclude RICs from making those investments. Administering the relevant Code provisions under these circumstances is challenging from both a practical and a policy perspective.

Thank you, and I look forward to taking your questions.

Senator LEVIN. Thank you, Ms. McMahon.

First, a short bit on the impact of speculation in commodities on our cost of gasoline, and then I am going to get to really what is

the part of this where I think that Senator Coburn and I agree. We obviously do not agree on the question of whether or not speculation has an impact on commodity prices. We have different points of view on it. Fair enough. We have had hearings on the subject. People have different opinions of the subject. But where we do not have different opinions is on the question of whether or not we can tolerate sham corporations in the Caymans being used to avoid the tax laws of this country. But first just a bit on commodity prices.

Take a look at Exhibit 8,[1] if you both would. We are going to put it up for you as well, but it is in your book. It is a chart reflecting commodity index prices for fuel, food, and metals going back 20 years. You can see on this chart that until about 2002, the prices were relatively stable. But beginning in 2002, about 10 years ago, prices began to get more volatile and started to climb. The year 2002 is also about the time when investments in commodity index funds started to become popular. The chart shows a crash in prices in 2008 during the financial crisis, but you can see that the prices never fall back to the pre-2002 level, and since May 2009, prices have again increased dramatically, approaching record levels.

Now, this chart, by the way, was put together by a data analysis firm called Index Mundi using IMF data, and it is, again, part of the exhibits here and will be made part of the record.

Now, the real question that we need to confront and you folks needs to confront, and I very much welcome your testimony, Commissioner, that you are willing to take a fresh look at this despite those letters that have been issued, is the moratorium, which you issued in June 2010, which was good news. That is the status quo, a moratorium, and our request in a letter that we have written you, a joint letter from Dr. Coburn and myself, asked that you make that moratorium permanent.

Are there nontax purposes for these transactions that the offshore tax havens are making and then transferring the proceeds to their parent corporation?

What your letters do is state that mutual funds can set up a foreign corporation it controls whose sole purpose is to invest in commodities. If the mutual funds own that stock, which they do, they can treat the distribution of income from that wholly owned offshore shell corporation as income derived with respect to a mutual fund's "business of investing in securities" rather than as a commodities investment.

Now, that means that the mutual fund can treat the offshore shell company's income as meeting the 90-percent test in Section 851 and outside of the 10-percent limit on alternative investments.

Now, here is what we have learned. We have learned that these offshore shell corporations, these wholly owned subsidiaries established by the mutual funds, are in every case wholly owned Cayman Island corporations. They are shells. No physical offices, no employees of their own, no independent operations. The mutual fund's U.S. employees run their commodities portfolios from their U.S. offices. There are no offices in the Cayman Islands with people that are making decisions on what these CFCs do.

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[1] See Exhibit No. 8 which appears in the Appendix on page 195.

One mutual fund told us that all of the commodity investment decisions come from their Rockville, Maryland, office, as I said. And another one acknowledged that there is no Cayman presence; it is just "smoke and mirrors," in their words, to obtain the tax benefit.

All of the profits and losses by their offshore shells are returned to the mutual funds that own them here in the United States. No income is kept offshore, no U.S. taxes are evaded. That is not the issue here. The income is returned, and when we say no taxes are evaded here, of course, there is a tax which would apply to mutual funds if they violate the 90-percent rule, so that is really the question here. It is not an evasion issue, as Senator Coburn points out. It is an avoidance issue by use of shell corporations which have no purpose, no business purpose, no nontax purpose at all.

Now, clearly—and I think, Commissioner, you will agree with this—if the offshore shell corporation did not return the income, the mutual fund would lose its favored tax status. So the mutual funds try to ensure that that income is returned to the United States, which is further proof that it is nothing but a shell corporation.

Now, the facts indicate—and the mutual funds acknowledge this, by the way—that these shell corporations are paper exercises, which the mutual funds use to make commodity investments. They characterize the resulting income as being derived from the business of investing in securities, however, instead of commodities investments.

Now, issuing these letters and then approving of this offshore gimmick means that the IRS is elevating form over substance. Mutual funds are not investing in their offshore shells. They are running them. They are using a sham or a conduit to do indirectly what they cannot do directly by law.

Now, you have a line of cases where the courts have supported the IRS when you have refused to recognize sham corporations. You have a number of private letter rulings where you have not recognized sham corporations. In one private letter ruling in 2001—citing the *Moline* case, by the way—the IRS advises taxpayers that "a parent corporation and its subsidiary are separate taxable entities unless the subsidiary is a sham or acts as a mere agent of the parent." For 80 years you have been fighting to be able to disregard sham corporations. The IRS has tried to disregard them where there is no nontax purpose in their creation.

So here we have wholly owned corporate shells, no employees, no place of business, no independent operations, no income that is not turned over to the U.S. parent. The shell is typically run by the mutual fund's own employees here in the United States who control the commodity portfolio.

In *Gregory v. Helvering,* the Supreme Court warns against exalting artifice above reality.

In Southgate, the Fifth Circuit says the tax consequences of a transaction are determined based on the underlying substance of the transaction rather than its legal form.

The issue here is not whether or not the offshore corporation's stock is a security. That is not the issue here. Whatever definition of "security" you want to take, whether or not it has been defined by the SEC, whether it is defined by the CFTC, that is not the

issue. Of course, it is a security. It is stock. The issue is whether or not the offshore corporation which issues that security and transfers it to its parent is a sham corporation with no substantial nontax purpose. The issue is whether the offshore shell is a conduit that the IRS can and should disregard to ensure compliance with Section 851. So we do not have to debate what constitutes a security here. That is stock. That is not the issue.

Now, Commissioner, let me ask you this question: If a mutual fund were to violate the income restrictions of Section 851, the tax consequences would be, would they not, that the fund would have to pay up to 35 percent in corporate income taxes on its income.

Mr. SHULMAN. Yes, I think that is correct. I think, generally, that is correct. The way you get not taxed at the entity level is by meeting the restrictions. I think in practice mutual funds all meet it, or else they would not be a mutual fund, and they would set up a structure another way. So there is generally not taxes coming in from these things as they blow through their 90 percent. They either set it up this way or they do not, unless the allocation shifts unexpectedly during the year.

Senator LEVIN. But you do agree that if they violated those income restrictions in that Tax Code Section 851, they would then have to pay the corporate income tax?

Mr. SHULMAN. Yes.

Senator LEVIN. Now, do you both agree that if a mutual fund bought and sold commodity futures or a commodity swap—in other words, if a mutual fund made a direct investment in commodities, the income from those investments would not qualify as income from securities or interest or foreign currencies under the 90-percent income in Section 851?

Ms. MCMAHON. Yes, I would agree with that. Yes.

Senator LEVIN. All right. So now the question is whether or not they can avoid that impact by creating a shell corporation, which everyone agrees is a paper corporation with no business purpose, no economic purpose down in the Caymans. The question is whether or not by creating that corporation and just having the stock of that corporation transfer to them that converts it somehow magically into a securities transaction.

Now, why do you think mutual funds are setting up these corporations offshore rather than here in the United States? Commissioner Shulman.

Mr. SHULMAN. Well, I think they are setting up these structures to get some commodity exposure.

Senator LEVIN. To be able to invest in commodities, which they are restricted from doing in Section 851?

Mr. SHULMAN. Well, they are setting them up to get some exposure to commodities and trying to do in a way that meets the test in the tax law.

Senator LEVIN. And avoids any Section 851 violation.

Mr. SHULMAN. Sure, it would.

Senator LEVIN. OK. Now, if they used a wholly owned U.S. corporation to do the commodity investing, would that corporation's profits then be subject to U.S. tax?

Mr. SHULMAN. I assume so, depending on the structures.

Senator LEVIN. So a Cayman corporation is not subject to U.S. tax or any other corporate income tax, so they can accumulate and invest money more quickly than corporations which do pay taxes. So as you say, the reason that they are doing this is so that they can avoid a conflict with Section 851. If they directly invested in commodities, they would then be subject to the limitations of Section 851.

Now, the question that then raises is: Did the IRS ask the mutual funds who created the shell corporations in the Caymans whether there was a business purpose other than tax avoidance? Was that asked of them when they requested the letter?

Mr. SHULMAN. As I said, I was not involved in the private letter rulings. Actually, I did not focus on this issue until after we suspended them. So I do not know what was asked.

Senator LEVIN. Can you look back and check that?

Mr. SHULMAN. Yes.[1]

Senator LEVIN. OK.

Senator LEVIN. Now, does the IRS care about people circumventing our tax laws through the use of shell/sham corporations offshore?

Mr. SHULMAN. The answer is yes, let me just give you a little further analysis on that. You had asked about economic substance and why we didn't attack this under the economic substance rule, and you quoted some of the cases we have been involved in.

One, as I think you rightly pointed out, this agency has been very aggressive attacking sham corporations that are trying to use the Code in ways that are not permissible to lower taxes in the United States. We typically raise this doctrine for structures designed to lower tax, such as phony losses, inflated bases, and that is where we have gone to court, and that is where most of the common law comes from.

In this case, I would argue that we should have the debate that you have put on the table. Does the Code allow investment in controlled foreign corporations that then invest in some sort of a commodity-related investment, which is very different because there is no tax being avoided. There is tax paid on those investments in the United States by the mutual fund's shareholders, just as if those mutual fund's shareholders were not in a mutual fund and were investing directly in commodities.

Senator LEVIN. Well, isn't the tax that is being avoided the corporate tax which would be triggered if it was not qualified income under Section 851?

Mr. SHULMAN. As I said before, the activity would not happen, and that is legitimate.

Senator LEVIN. Now, that is a different point. If the IRS said that activity that you just have engaged in, creating a shell corporation with no nontax purpose, that sham business, that income is going to count under Section 851. If you told them that and they still did it, they would have to pay a corporate tax in the United States, right?

Mr. SHULMAN. Sure, but I guess what I am saying is——

Senator LEVIN. You do not think they will do it.

[1] See Exhibit No. 9 which appears in the Appendix on page 196.

Mr. SHULMAN. My guess is they would not do it.

Senator LEVIN. That proves that tax avoidance is their purpose, which is exactly our point. That is the proof of it, that they would not engage in that transaction if, in fact, it had the result under the law. So avoiding that tax is their goal, and the question is: Can they use a sham corporation, a shell corporation in the Caymans that has no business purpose, no economic purpose, can they use it to achieve that goal? And your letter says, "Yes, you can use"—or, "We are not even going to ask. We are not going to ask you whether or not that shell corporation has any business purpose." I do not know that. You are going to check that out for me as to whether or not you asked the question.

But, my heavens, if the IRS is fighting against these offshore shell corporations, how do we look the other way? How do we give a green light to the use of them to qualify this kind of investment under our Tax Code? It so totally runs contrary to what you are fighting for, which is do not use these shell corporations offshore for any nontax purpose; we are going to pierce this veil. That is what you fight for. And yet you write a letter—not you but your predecessors—that says either, "We are not going to ask you if there is any business purpose to this," or, "We know there is no business purpose to it, but technically that can be considered a security, the stock which is issued by your wholly owned corporation, with no people down there, no presence down there. We are going to count that as a security for the purpose of Section 851, even though it is based on a totally shell/sham corporation." That runs inconsistent with your effort to pierce those shell corporations.

Mr. SHULMAN. Yes, what I am trying to do is distinguish—I will repeat, we have suspended the private letter rulings, we are open to this, and there are a whole bunch of points you have made that you have written to us that we are going to take very seriously as we figure out where to go forward. So that is the state of play.

What I am trying to distinguish is that a very specific issue with people who came forward and asked about the technical reading of the law. There are lots of places where the corporate form is respected in the tax law, and what we try to do is analyze what is the right reading of the law, would it be sustained in the courts, etc.

I think I am just trying to move away from a broad generalization about our approach. We have been very aggressive with sham corporations that are designed to lower taxes, and keep this as a narrow discussion about corporations and mutual funds trying to get commodity exposure, which I think was their purpose, not to avoid tax because the tax flows through.

Senator LEVIN. Well, it is designed to avoid triggering a tax.

Mr. SHULMAN. I do not want to insult you by repeating it, but as I have said, those taxes are never triggered. They either would have set up this thing or not.

Senator LEVIN. They want to avoid triggering the taxes, right?

Mr. SHULMAN. That is not how I would look at it.

Senator LEVIN. They want to avoid triggering a tax? You do not think that is the whole purpose here, they want to avoid triggering a tax?

Mr. SHULMAN. Well, they just want to set up——

Senator LEVIN. They want to have their cake, which is investing in commodities, and eat it, too, by not paying what the tax would be if they did that directly in the United States.

Mr. SHULMAN. They want to invest in commodities——

Senator LEVIN. That is their open goal, for heaven's sake. They acknowledge that is what their goal is. The question is whether the IRS is going to tolerate the use of those shell corporations to achieve that goal or whether or not they ought to come to Congress and change the law. That is the question.

Mr. SHULMAN. Right.

Senator LEVIN. When you put your imprimatur on that, it does not undermine your efforts, your important efforts, sometimes heroic efforts, sometimes against great odds, to pierce the veil of these phony shell corporations in the Caymans and other offshore tax havens. That is what is created here for you. That is the headache you are creating for yourself. It may be slightly different. It is not where they are trying to get a tax reduction. It may be where they are trying to avoid triggering a tax. But the outcome is exactly the same. You are putting your stamp of approval in these letters. Thank God now there is a moratorium, but you put your stamp of approval on a mechanism which is inconsistent with what you are arguing in so many cases, very properly, that you are not going to be deterred from the use of sham transactions. That is what the stakes are here.

Do you want to comment? I am going to call on my colleagues.

Mr. SHULMAN. No, I mean, my comment would be similar to what I said before, which is as Commissioner of the IRS, an agency that has been very aggressive attacking a lot of corporations around issues of economic substance. I want to be very clear for the record that the private letter rulings that we issued that only pertain and can only be relied on by the one company that we issue it to, not broad applicability, are not precedent and in no way speak about the other attacks that we have around the economic substance doctrine. So that is what I am trying to say.

Senator LEVIN. Thank you, Commissioner. Senator Carper.

OPENING STATEMENT OF SENATOR CARPER

Senator CARPER. Thanks, Mr. Chairman.

Ms. McMahon, I sort of join this in mid-flight. Just explain to me what do you think the Chairman is up to here. What is he driving at? How would you describe it?

Ms. MCMAHON. As I understand it, the Chairman has several concerns: generally the question of whether mutual funds, RICs, should be allowed to have commodity exposure. I think our view on that broader question is that that is not a tax policy question per se, and we are not experts on that topic.

However, there is a second question as to whether the tax law as it currently exists should be interpreted in a manner that would facilitate or permit mutual funds to have indirect commodity exposure, and I understand that Chairman Levin is concerned that our interpretation, the IRS interpretation, of the existing law has inappropriately facilitated commodity exposure, RICs' obtaining commodity exposure.

I think the statutory language that we are looking at is not very clear on this question, and because of that the IRS has been placed in a difficult position of trying to determine what the limits may or may not be on these investments. I think their interpretation so far has been a reasonable one under the circumstances, but I would echo Commissioner Shulman's statement that we have an open mind on this question, and we are thinking very hard about the points that have been raised here today.

Senator CARPER. Mr. Shulman, is that a fair characterization of what Senator Levin is aiming at here?

Mr. SHULMAN. It sounded good, but I generally do not characterize Chairmen's statements and thoughts.

Ms. MCMAHON. I would not have done so either if I had not been asked to do so. [Laughter.]

Mr. SHULMAN. It was a good job.

Senator CARPER. My next question is of the Chairman: How did she do? What do you think?

Senator LEVIN. Well, she was pretty close on number two. Number one really is something this Subcommittee has looked into, the first issue she raised about the impact of speculation on commodity prices. But you can agree—and Dr. Coburn does not have the same view I do on that issue. But where Dr. Coburn and I have agreed and sent a letter to the IRS is that the moratorium on these letters which they have sent, which gives the green light to specific mutual funds to proceed in this area, runs right into a number of doctrines. One is the law which specifies what the mutual funds can use for interest and income. But, second, it runs head on into what the IRS is fighting for, which is to pierce these phony corporations offshore who have no nontax purpose, and that is what the issue is here. There is a moratorium on these, which we are grateful for, from about a year and a half ago I guess now. Our letter requests that it be made permanent.

You can argue the first issue. People will disagree on commodities and whether or not speculation in commodities has an effect on price, and what the effect is. The Commodity Futures Trading Commission Commissioner says, sure, there is an effect on price. We put charts up showing the effect. But whether that is true or not, I think we all agree—and the Commissioner and the Secretary agree here—that we cannot permit sham transactions to lead to tax avoidance. That is the issue here.

Senator CARPER. Do you concur with that, Mr. Shulman?

Mr. SHULMAN. Yes, we have been aggressive, using the economic substance doctrine for corporations that we think do not meet the test of the doctrine, and would be sustained in the courts, are used to lower taxes.

Senator CARPER. All right. What advice do you have for us? This is a question for both of you.

Mr. SHULMAN. I think the simplest advice is I would agree, the IRS does not like being in a position where the law is unclear and it has to go and make interpretations. The best thing that could happen with this debate is if the outcome desired is the outcome that this Subcommittee has been discussing in the letter, is to get clarity in the law and have Congress pass the law and get clear one way or the other. Absent that, we are going to be forced to be

in this uncomfortable position of doing what we do all the time with a grossly complex law. This is having to make interpretations about what is the best reading of the law, what will be sustained in the courts, that is what we will do.

As the Chairman noted, we stopped issuing these private letter rulings, and we think there needs to be either law, preferably, but in the absence of law, guidance of general applicability that can be relied on across the industry and stop taking these one-off with very specific fact patterns and moving forward in that direction.

Senator CARPER. In my old job as governor of Delaware, from time to time we would suggest to the legislature what tax law changes we thought should be made to provide clarity in areas like this. Has this Administration provided similar guidance to us in the form of recommended legislation to address these issues?

Ms. MCMAHON. Senator, I do not believe that we have recommended a particular clarification one way or another on this point.

Senator CARPER. Could I just ask if that is the case, then why not?

Ms. MCMAHON. Well, I think that, as I said earlier, there is a fundamental question, which is not a tax question, as to whether RICs should or should not be permitted to have commodity exposure. That is not something that we as tax experts can answer. I think once that question has been answered one way or another, it would be very helpful to have the tax law clarified to be consistent with the conclusion on that question. But we, the Treasury Department, have not so far expressed a view, I believe, on the——

Senator CARPER. Has some other part of the Administration that owns that issued—have they said——

Ms. MCMAHON. Well, I think that question is fundamentally the responsibility of the CFTC or SEC.

Senator CARPER. All right. Do any other tax-exempt entities use controlled foreign corporations to gain exposure to certain investments?

Ms. MCMAHON. Yes, Senator.

Senator CARPER. Could you talk about that just for a little bit, please?

Ms. MCMAHON. Well, it is fairly common for tax-exempt entities that invest in various types of private equity or other investment funds to invest in those funds through offshore corporations in order to avoid possible taxation under the unrelated business income tax rules.

Senator CARPER. OK. A second but related line of questions is: Can mutual funds only gain access to commodities through these controlled foreign corporations or commodity-linked notes? Is that pretty much it?

Ms. MCMAHON. I am not aware of other ways in which they might.

Senator CARPER. Mr. Shulman, are you?

Mr. SHULMAN. I think there is a variety of ways that I am aware of, and let me just clarify for you. This is an issue that I studied up on as part of this hearing. It is not one I was involved with. I am just moving into it. But I think there are controlled foreign corporations, there are the structured notes. I think mutual funds can

invest in partnerships if they wish to, but all these things get complicated with tax structuring. There are qualified publicly traded partnerships that are available to invest in. So there is a variety of vehicles, but from my understanding, the predominant way is through these two—the structured notes and the controlled foreign corporations, which were the subject of the private letter rulings.

Senator CARPER. Let me see if I understand this. We have these mutual funds that are, if you will, investing in commodities. They are not doing it here through corporations in the United States, so States that are interested in—and all States are interested in having corporations register in them, including Delaware. But what we have is a situation where instead of these mutual funds establishing or investing in corporations here in America, registered in one of our 50 States, and presumably taxes being paid to the Federal Government for those investments, we encourage that activity to take place outside of this country in places like the Cayman Islands, and corporations from which States derive no value, no income, and from which the Federal Government derives no taxes. Is that the situation we are in?

Mr. SHULMAN. I would not characterize it that way. First of all, the IRS is not in the business in the way that our lawyers who look when private letter rulings come in, they do not look at what they are encouraging or not. They are trying to say what is allowed under the statute.

Senator CARPER. I am not suggesting it is what you encourage. I am not suggesting this is what the IRS is encouraging. But we as a Federal Government, is this what we are encouraging?

Mr. SHULMAN. Sure. I mentioned earlier, and I think the Chairman mentioned as well, the basic tax of mutual funds is being paid in these entities. There is not tax not being paid because the way mutual funds are taxed is the underlying activity flows through to the investors and they pay. So someone who lives in Delaware would be paying their Delaware taxes and their Federal taxes based on whatever the income was there. But that is a whole different discussion which is obviously a legitimate one.

Senator CARPER. All right. Can I change the subject just for a second, Mr. Chairman? One of the things that the Chairman, Dr. Coburn, and I are very much focused on is deficit reduction. I am sure everybody in the room cares about it, and there are different ways to do that: grow the economy, curtail spending, look for wasteful spending in the Federal Government. Another way is the maximize the income that we are trying to bring into the treasury by making sure that folks are paying their fair share, whether they happen to be an individual or a business. So we focus a lot on forgone taxes, but you have an opportunity, I presume, to look at the revenue flow coming into the treasury. I do not know if you look at it every week or every month. In my role as governor, I drilled down every month, the beginning of every month, when we got the revenue report from the Division of Revenue. We looked at literally every category to see what was happening month by month by month, and I tried to stay on it. I do not do that so much as a Senator, but I presume you do that in your role. We are about 3 months into this fiscal year. I do not know if we have numbers through the end of December. But if you would just give us like a

quick snapshot of what does the revenue picture look like for the first 3 months of this fiscal year. Are we doing a little better than we might have anticipated, better than budget or not? And is growth better or worse than might otherwise have been expected?

I know that is not what you prepared or were asked to testify on, but it would be of great interest to me as we try to maximize revenues here.

Mr. SHULMAN. Yes, I do not have this off the top of my head because, as you said, it was not exactly what I was prepared for, let us come back to you, and we would be happy to give you details of the revenue——

Senator CARPER. I would like you to answer that for the record, if you would.

Mr. SHULMAN. Yes, for the record I will come back and give you revenue flows. We track it closely at the Treasury Department. It's mostly the folks who do economics at Treasury, and I do not want to give you a wrong answer.

Senator CARPER. What we are hearing anecdotally is the deficit number continues to drop, down from 1.5 to 1.3. Now we are down to under a trillion, only $980 billion. That is still a lot of money. That is encouraging. I just wondered if we could sort of get you to pinpoint where the growth is.

Mr. Chairman, as usual, you raise intriguing and important issues. This is one that is certainly intriguing. Thank you for letting me participate.

Senator LEVIN. Thank you so much for your participation.

Just one quick question, perhaps, while Senator Carper is here. You made reference, I think, to certain rulings relative to charities or nonprofits. Is that correct, Ms. McMahon?

Ms. MCMAHON. Well, I think I was intending to say that——

Senator LEVIN. The UBIT reference you made.

Ms. MCMAHON. Right, that there were structures commonly used that employ——

Senator LEVIN. By the nonprofits and charities?

Ms. MCMAHON. Right.

Senator LEVIN. Are mutual funds a charity?

Ms. MCMAHON. No.

Senator LEVIN. And one other thing that I mentioned before you got here, Senator Carper, was that there was an effort made to add the investments or speculation in commodities a year and a half ago, and the House said it is OK, but we said we would not pass the bill with that provision in it. So the Senate did not accept that amendment which the House passed, so that is part of the legislative history. I assume that is relevant history, is it, Commissioner Shulman? That is relevant history that the Senate did not adopt that specific language?

Mr. SHULMAN. Well, it is something that you raised, and we will obviously——

Senator LEVIN. Is it relevant legislative history is my question.

Mr. SHULMAN. To answer directly, we generally do not view things that are moved into a statute and pulled out in the middle of the process before it is passed into law as definitive guidance.

Senator LEVIN. How about relevant? I did not use "definitive." Nothing is definitive here. But how about relevant?

Mr. SHULMAN. Generally, tax provisions that are put in and pulled out before the law is ever passed, unless——

Senator LEVIN. It does not show anything about congressional intent? That is not relevant to what the congressional intent is, if it is not a——

Mr. SHULMAN. I do not think it is definitive.

Senator LEVIN. OK. Let us try relevant. Is it relevant? Try it again.

Mr. SHULMAN. I think it could send a variety of signals, but I am not prepared to say every time there is a provision in legislation and it moves out between the Houses that we are going to view that as congressional intent.

Senator LEVIN. I guess I am asking you, is it relevant to the question of congressional intent? Just relevant.

Mr. SHULMAN. Sure. It is a piece of information in the whole analysis, yes.

Senator LEVIN. That is all I was asking. We have gone over economic substance and sham doctrines. There is another well-established tax doctrine, too, which relates to conduits. In 1972, I guess, the principles were set out in a case called Aiken Industries and subsequent regulations of the IRS that the IRS is allowed to disregard any entity which functions as an intermediary for a taxpayer and to treat its income as income attributable to the taxpayer itself. One ruling in 2002 explains, "Where the parent corporation so controls the affairs of the subsidiary that it is merely an instrumentality of the parent, the corporate entity of the subsidiary may be disregarded."

Are you familiar with that doctrine, the conduit doctrine?

Mr. SHULMAN. Yes, I am familiar at a high level.

Senator LEVIN. OK. Will you look into the facts that exist about these shell corporations and in your review of this whole matter take a look as to whether or not they are simply conduits, and in the case of those notes whether or not the banks that enter into those notes are simply agents or instrumentalities for the mutual funds? Will you check out that doctrine?

Mr. SHULMAN. Absolutely.

Senator LEVIN. Do you know, Commissioner, how many private letter ruling requests are pending relative to these 72 rulings which have been issued?

Mr. SHULMAN. Yes, 72 issued. There are 28 that have requested private letter rulings since we stopped issuing them.

Senator LEVIN. OK, and those are the ones that there is a moratorium on?

Mr. SHULMAN. Correct.

Senator LEVIN. Commissioner, you said that a private letter ruling can be relied on by only one taxpayer, and I think that is, in fact, your policy. However, we know of two mutual funds that have set up offshore corporations to trade in commodities without any private letter ruling. They told us they thought that they were allowed to do so based on other letters, so I think your statement here today is very important and hopefully will be relied upon and counted on as being factually accurate that the letters which are issued only relate to those particular companies or mutual funds which requested those letters. That is the status. But I did want

you to know that there are a couple mutual funds who did not get those letters who are operating those offshore tax shelters or tax structures. I am just informing you of that, and if you are interested as to the names of those, my staff can give those to you.

Perfect. That was my next question. We are all set for you. Are you ready?

Senator COBURN. Thank you. You probably asked all the questions.

Senator LEVIN. I hope so, yes.

Senator COBURN. Thank you.

I know Senator Levin has asked this question, but my most important thought about this issue is: Is the purpose for setting up an offshore commodities trading firm to avoid taxes? Is there another reason to do that other than to avoid taxes?

Mr. SHULMAN. We had some discussion about this. Generally, people came in for private letter rulings, which we have suspended, but they come in to say, "If we set it up with these detailed facts, does the IRS interpret that that is allowable under the law?" In the past we said yes. Now we are going to take a look and see what we think.

Generally they would not set it up. They would use some other structure. They would make another investment. They would go into another business if they did not do it. So taxes at the entity level is very rare. I know of one circumstance in all of mutual funds where a mutual fund decided to be taxable, so it is very rare for a mutual fund to pay taxes. That is what the Registered Investment Company Act and Section 851 allows them to do.

I think the other point I made was that I want to be clear that the activity that happens in the controlled foreign corporation flows through and taxes are paid ultimately by the mutual fund's shareholders. So there is no loss of revenue to the Federal Government in these transactions, but there is the whole question of does the law even allow them to be set up in the first place, which I think is the question that was put on the table.

Senator COBURN. Well, actually, I think there is lost revenue because if, in fact, a mutual fund is going to invest in a company that does commodity trading and does not do it in a tax-sheltered location, they are going to pay taxes on that, trading profits before they share with the stockholders of the fund. In other words, if I set up a corporation, ABC Corporation, and I am going to trade commodities, and I am going to make money, and you are going to be a shareholder in that, and I do that onshore, then I am exposed to corporate income taxes in this country, if I do it onshore, correct?

Mr. SHULMAN. I think so.

Senator COBURN. Yes. So, therefore, I am going to pay taxes there, and then I am going to give a distribution to the stockholders of what is left. And then they are going to pay taxes on whatever that distribution is if it is above their investment in it or if it is a dividend for it. So the point is the reason they are set up in offshore is to eliminate that corporate tax on those trades, correct?

Ms. MCMAHON. If I could answer that briefly, the income that is generated by the controlled foreign corporations through commodities activities is actually treated as Subpart F income which flows

up for U.S. tax purposes to the RIC, and ultimately the shareholders, so that there is actually U.S. tax in this particular structure.

Senator COBURN. But at the shareholder level.

Ms. MCMAHON. Well, technically the income is includable in the income of the RIC.

Senator COBURN. Right.

Ms. MCMAHON. And then as long as the RIC complies with the requirements that apply for it to have passthrough treatment, it would not be taxed at the RIC level. But it is included——

Senator COBURN. Right, so it gets taxed by the shareholder.

Ms. MCMAHON. And it is taxed by the shareholder. But that is no different than any other income that they——

Senator COBURN. OK. Well, let us take GE for a minute. GE pays a dividend, which you pay income tax on, but GE also—GE is a terrible example. They have not paid any income tax in a number of years. As a matter of fact, you have been paying them.

Let us take John Deere. They make earnings. They pay a corporate income tax. They distribute those earnings in terms of dividends, and then those earnings, which have already been taxed once, are then going to be taxed again by whoever receives that dividend. Correct?

Ms. MCMAHON. Yes.

Senator COBURN. So no matter how you base it, the reason for putting that account offshore is to lessen the tax that could be acceptable if you did the exact same thing onshore.

Mr. SHULMAN. First of all, the hypothetical you gave I think is accurate. I think if they decide to do the exact same activity onshore, it will be taxed at the corporate level. Before, Senator Carper asked are there other ways that mutual funds can gain access to commodities. There is a variety of questions in the law around partnerships, around qualified publicly traded partnerships. So the chances of a corporation setting up in the United States for the sole purpose of doing the kind of direct investment in commodities and then moving—being fully owned by a mutual fund, the chances of that hypothetical actually occurring are pretty slim.

The real question is—which I want to be clear, I think it is a legitimate question that is being put on the table here. Can these things be set up to invest in commodities or not?

Senator COBURN. Well, I think the Chairman's and my reading of the law is we do not think so.

Senator LEVIN. Well, we do not think so, but I am amazed at your reluctance to say yes to the most obvious question—you said yes to me finally about an hour ago—to Dr. Coburn's question. The reason that these are set up in these offshore locations is so that they can avoid that impact of that section of the Tax Code. The answer is—they acknowledge that, for God's sake. Why can't the IRS look that square in the face and say, "Of course, that is the reason they are doing it." You did it an hour ago. I am amazed at your reluctance to simply say yes to Dr. Coburn's question. Of course, that is the reason. They acknowledge that is the reason. And you say, "Well, they are not going to do something which would lead to their paying taxes." Of course, that is true. So the other side of that coin is the reason they are putting it in the Caymans is to

avoid that problem. Why not just say yes and then go on from there? I mean, why is there any reluctance? That is what I do not understand here.

Mr. SHULMAN. Why do I have reluctance?

Senator LEVIN. Yes, to say that is the reason that they are in the Caymans.

Mr. SHULMAN. Because having responsibility for the whole U.S. tax system, some of the things that have been asked implicate some of the other cases we have and other things that are happening outside. And so to make blanket generalizations about our views on controlled foreign corporations, when we will attack them, when we will not and when they are tax avoidance and when they are not has other implications beyond the issue at hand.

My reluctance is that I am trying to be respectful, and I am very clear what this hearing is about. It is the private letter rulings and you believing that they were issued contrary to the intent of the law and that our lawyers' interpretation was wrong. I have told you we have stopped the private letter rulings, and we are going to take a broad look at that. So my goal would be on the record to leave it at that and not say things that are going to implicate us continuing our aggressive push around things like offshore tax evasion and around aggressive corporate structures to avoid paying taxes.

The question on the table, which is a legitimate one, is: Should through the Code there be the ability to invest indirectly in commodities through structured notes or through controlled foreign corporations? And we are going to take a hard look at that.

Senator COBURN. Nobody that has applied for one of these private letter rulings and has gotten it has done anything wrong. Their motivation is to make money. You have granted a private letter ruling, and they have taken advantage of that. So this is not to implicate anybody that has been there.

But in terms of transparency of markets, my main concern in visiting with the Chairman on this is that people are going to invest in speculative things if that is where they think they can get the most return, and they think they can. The thing that ought to be there is transparency so that they know what the risk is as they go into this, and when you have a mutual fund that is doing this, a large amount of money can be lost. Or at least the risk for a large amount of money is out there; otherwise, they would not be speculating in commodities in the first place.

As I said earlier, I do not know what too much speculation is, but I know we cannot do anything in the long term in this country that is going to affect that because we are in a world market. The only way we are going to do that is through international agreements if we think that is justifiable.

So I do not have any criticism with what you have done. The fact that you are looking at it I think is great, and I think we ought to continue to do that, and we ought to be maybe more clear in how we write laws and to give you more guidance, and once of our worst habits in Congress is we say we write a law and this is the intent. We will let the Administration or the bureaucracy decide what the rulings on it are. I think we need to know a little bit more about that before we put it out to give you the rulings to write. In other

words, you would not be sitting here today if we were much more clear about what the intent was in 2010.

Thank you.

Senator LEVIN. Thank you, Dr. Coburn.

Do you know of any nontax purpose that mutual funds have for opening up these corporations in the Caymans?

Mr. SHULMAN. Well, the CFCs in the private letter rulings I think were set up specifically so that they could invest in commodities.

Senator LEVIN. And be consistent with the Tax Code? And comply with——

Mr. SHULMAN. And income definitions.

Senator LEVIN. And hope that they are complying with the Tax Code and Section 851.

Mr. SHULMAN. Yes.

Senator LEVIN. I happen to agree with Dr. Coburn, by the way. This is not a question of mutual funds taking advantage of what they are trying to take advantage of. I think the investment in commodities has the impact we have talked about, but we do not have to agree on that. What seems to me is so clear is the purpose of their investment or their creation of these shell corporations. There is no doubt about it. They do not deny it. Just ask them. They will tell you. They are trying to avoid the implications of not being eligible for nontax treatment under Section 851. They are not hiding that. What troubles me is that if you allow that, if you allow the shell corporations to be used for that purpose, there is only a tax avoidance purpose that they want to comply with—they have to comply with Section 851, as you point out. They do not want to pay taxes at a corporate level. That is what Dr. Coburn's question is. What troubles me is why there is any doubt in your mind as to what the purpose is. They acknowledge it. But then when the IRS says they are going to allow that to be used, allow a shell/sham corporation to be used for that purpose, it undermines all the efforts we are making to put those shell/sham corporations out of business, frankly. They have no purpose other than tax avoidance.

By the way, I agree with Dr. Coburn. We are not talking illegality here. We are talking tax avoidance.

So I am going to end this on a positive note even though I have expressed my dismay at the reluctance to acknowledge what is open. Ask the mutual funds. I am sure there are many representatives here. And as you point out, they do not want to pay taxes. And they would not go there if they had to pay taxes. Of course, that is the point. That is why they are going there. But you cannot quite say that, and that is what troubles me because if you cannot say that, then I wonder about how much you are really going to go after these conduits, these shell corporations, however they are used, by the way. That is the part that leaves me with uncertainty.

But what is certain is what you have said here, and that is that you are going to take a look at this from that perspective, can the IRS resume accurately put its blessing on the use of what are openly shell corporations with no nontax purpose? Can you put your imprimatur on that anymore? And what are the implications of your doing that for all the other areas where you are trying to prevent that from happening? And if there are other ways that mutual

funds can speculate consistent with the law, that is one thing. I mean, I am not going to start giving tax advice. I do not think there are because I think the law is clear, by the way. It has been clear for 80 years. We listed what can be done and what that means, unless those things are what you are doing, you do not get tax freedom at the corporate level.

The economic substance doctrine has been codified by Congress, by the way. This is not any uncertainty or ambiguity. In 2010, we codified the economic substance doctrine. It says that you can disregard transactions or entities that create no meaningful change in the economic position of the taxpayer and have no substantial purpose other than—and this is the word of the law—"to achieve a tax effect." The effect here is to avoid violating or being inconsistent with a section of the Tax Code, which would trigger a tax at the corporate level. That is the purpose. That is the effect.

And so would you finally agree, to end on a positive note, that in 2010 that economic substance doctrine applies to the transactions that are analyzed in the private letter rulings? Would you agree that the law saying that you may apply an economic substance doctrine to transactions, that is applicable, should you decide to apply it, to these transactions?

Mr. SHULMAN. So while I like the idea of ending on a positive note, I am not sure I can agree to that. I think that economic substance is very fact intensive. We typically raise this in other circumstances. We typically do not raise economic substance with specific taxpayers that we have granted private letter rulings.

Senator LEVIN. I am talking about in the policy that you are going to look at, the overall generic policy.

Mr. SHULMAN. I just think it is something different. I do not think we need to raise that in the policy. I think we could decide to allow this or disallow this without implicating economic substance. It is really about a reading of the law, and I think it is not necessary and, frankly, all of our court cases where we have been successful with economic substance have very different sets of fact patterns than these.

Senator LEVIN. Well, we passed a law in 2010 talking about economic substance saying that something has got to be real, it cannot be fake, and we are going after these totally phony transactions, which is what this is acknowledged to be. It is a shell. It is a sham. And for you to say that it might not be even relevant to your decision here—is it at least relevant? Is it something you would want to look at?

Mr. SHULMAN. You have brought up the point about it, and I gave you my commitment that all of our points we are going to look at closely. I will tell you, though, the economic substance doctrine is a very specific tool, and we have a lot of tools. We have private letter rulings. We have suspended those. We have regulation or guidance. We have said we are going to look at that. And then obviously Congress could get very clear with the law, which would be our preference to all this. And so I do not want to implicate the economic substance doctrine where we do not have to, and I am not sure it is necessary here because we want to continue to win in court. Congress codified a judicial doctrine based on common law principles that we have been very aggressive and very careful

about developing our positions, and that is why we have been so successful. And I do not want to generalize about the kinds of transactions where that could win. When we see an issue that we want to attack on economic substance, we will. Our lawyers will look at that. We have had a good record with that, and we plan to continue that.

Senator LEVIN. Finally, if there is no economic substance to the creation of these corporations other than tax avoidance issues, if there is no nontax purpose, to use your words, to create these corporations, is that relevant?

Mr. SHULMAN. Sure, I mean, the prongs of the economic substance doctrine we would look at, and to the extent that any position was changed going forward and people violated those prongs, everything is fair game. I am just saying right now we do not need to go attack these economic substance. We can actually put guidance out or have the law changed.

Senator LEVIN. Thank you both. We have a vote that is on now, and apparently there is only 5 minutes left. To end on a positive note, we appreciate your reassurance that you are going to take a fresh look at this and you are going to apply doctrines in ways hopefully that are not going to create precedents that are negative in terms of going after sham transactions, we are going to leave on that positive note. Again, we are grateful for your appearance here today.

[Whereupon, at 12:10 p.m., the Subcommittee was adjourned.]

APPENDIX

PRESS RELEASE

U. S. Senate Permanent Subcommittee on Investigations

HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS COMMITTEE

Carl Levin, Chairman

FOR IMMEDIATE RELEASE
January 26, 2012
Contact: Tara Andringa 202-228-3685

Opening Statement of Senator Carl Levin
U.S. Senate Permanent Subcommittee on Investigations Hearing on Compliance with Tax Limits on Mutual Fund Commodity Speculation

For 10 years now, this Subcommittee has focused attention on the problem of excessive speculation in the commodity markets including the crude oil, natural gas, and wheat markets. Most recently, in last November's hearing, we examined efforts to apply a new position limits rule to protect consumers, businesses, and the commodity markets themselves from excessive speculation. For years now, the American people have been whipsawed by unpredictable and often escalating commodity prices. We've been hurt at the pump, we've been hurt at the dinner table, and we've been hurt in our pocket books. We're talking about gasoline prices, electricity and heating costs, food prices, and industrial raw materials that together affect virtually every American family and business budget.

The fundamental purpose of commodity markets, unlike stock markets, is not to attract investors, but to enable producers and users of physical commodities to arrive at a fair price for their goods and hedge their price risks over time. Speculators – who don't intend to use or deliver the commodities they trade or hedge commodity prices so they can have price certainty -- seek instead to profit from the price changes. A market which was intended to facilitate price discovery and hedging is now dominated by speculators who are driving up price volatility, hedging failures, and in many cases, commodity prices. The reality today is that commodity prices are more reflective of trading by speculators than fundamental forces of supply and demand.

At our November hearing, for example, the Commodity Futures Trading Commission (CFTC) told us that 80% of the outstanding futures contracts for crude oil are now held by speculators. CFTC Commissioner Bart Chilton has said:

> "For those who say no evidence exists linking excessive speculation and prices, they just aren't looking. ... Scores of studies and papers exist which document the linkage."

The unprecedented flood of speculative money in commodity markets today comes from index traders, hedge funds, money managers, and exchange traded products. Our November hearing also exposed a new wave of commodity speculation coming from the $11 trillion mutual fund industry. Exhibit 1 is a chart which shows that, since 2008, more than 40 commodity related mutual funds have begun pouring speculative funds into the commodities markets and now have accumulated assets of over $50 billion.

Opening the Floodgates. For most of the 70 years they have been in existence, mutual funds were not significant participants in U.S. commodity markets. Now, some mutual funds have become major commodity speculators, and more want to follow. When we looked into what changed, we discovered that six years ago, mutual funds began petitioning for and receiving IRS private letter rulings that, for the first time, enabled them to invest heavily in commodities, despite longstanding restrictions in Section 851(b)(2) of the Internal Revenue Code. Those IRS private letter rulings essentially opened the floodgates to the mutual fund petitioners, allowing them to engage in billions of dollars in commodity speculation.

Section 851. Section 851(b)(2), which has been in the tax code since mutual funds got started in the 1930s, restricts the types of income that mutual funds are allowed to obtain in exchange for favorable tax treatment. If the mutual funds abide by this section's income source restrictions, those mutual funds do not have to pay corporate income taxes like other corporations. This tax break collectively saves the mutual fund industry billions of dollars each year. In simple terms, the statute requires that 90% of a mutual fund's gross income must be derived from securities, interest, or foreign currency investments. That means not more than 10% of their income can come from alternatives like commodities.

This 90% rule has been in place for decades. But in 2006, as financial engineering took hold of Wall Street, the mutual fund industry began pressing the IRS to permit it to use complex financial transactions that would, in essence, enable mutual funds to get around the 90% rule and engage in commodity investments beyond the 10% limit. Dozens of individual mutual funds made these requests in petitions for private letter rulings.

In response, from 2006 to 2010, the IRS issued 72 private letter rulings allowing the mutual funds to whom the letters were addressed to use either wholly-owned offshore corporations or financial instruments called "commodity linked notes" to make unrestricted commodity investments, notwithstanding the 10% limit in Section 851. The IRS private letter rulings said that the mutual funds could treat the income from those sources – not as income from a commodities investment – but as income from a "securities" investment in the stock of the company they owned or in the note they designed to avoid the restrictions of Section 851.

For example, the IRS allowed mutual funds to establish wholly-owned controlled foreign corporations or CFCs whose sole function is to trade commodities in the futures and swaps markets. In every case we've examined, mutual funds have established these CFCs as offshore shell corporations in the Cayman Islands, the classic example of a tax haven. The CFCs have no offices, no employees of their own, no independent business operations, and their commodity portfolios are run by employees who work in the United States for the mutual fund that set up the offshore arrangement. For example, one mutual fund told us all of the commodity investment decisions for their offshore corporation were made by the mutual fund's employees in Rockville, Maryland. Another told us all commodity trading decisions were made by their traders in New York. Still another mutual fund told us openly that their offshore commodity fund had no "Cayman presence," describing it as "smoke and mirrors" to obtain the tax benefit.

These CFCs are corporate fictions, offshore shams, paper exercises whose sole purpose is to make a blatant end-run around the legal restrictions on commodity investments by mutual funds. At the same time, the IRS has issued private letter rulings explicitly allowing these offshore schemes. The IRS private letter rulings provide, for example, that if a mutual fund owns the

stock of the offshore shell corporation it established, it can treat income from commodity investments made by that offshore shell corporation and distributed back to the United States as income from a securities investment rather than a commodities investment.

In addition, the IRS has issued private letter rulings stating that mutual funds can use commodity-linked notes to invest in commodities and treat the resulting income as from a securities investment, even though the notes were created for the sole purpose of investing in commodities and end-running Section 851.

By treating this type of income as derived from securities rather than commodities, the IRS has elevated form over substance, enabled mutual funds to use agents as though they were independent actors, and use financial engineering to do indirectly what the law doesn't let them do directly. The result is opening the door to increasing commodity speculation.

But that's not all. In the past, under the 90% rule, mutual funds spent the lion's share of their money on stocks, bonds, and other securities – providing needed capital for economic growth and jobs. They were an engine of investment in America. But as the commodity spigot opens, every dollar spent on commodity speculation diverts money from their securities investments. So instead of investing in U.S. businesses, mutual funds will spend increasing sums making bets on commodity price movements. Capital investments do our economy a lot more good than betting on prices.

Contradicting Congressional Intent on Commodities. To understand the context of the issues at stake, let's take a quick look at the history of the tax law's limits on mutual funds. When federal tax breaks for mutual funds were first enacted in 1936, Congress adopted limits on what mutual funds could invest in – they allowed mutual funds to utilize income from interest, stock dividends, and stock sales. Commodities were not on the list of allowed investments. That was the same year Congress enacted the Commodities Exchange Act of 1936, the first federal law to control excessive speculation in commodity markets. So Congress was well aware of U.S. commodity markets and didn't make commodities an allowable investment for mutual funds in 1936.

In 1954, Congress enacted Subchapter M of the Internal Revenue Code to reform taxation of mutual funds. Subchapter M again listed the types of income that mutual funds were allowed to earn in exchange for favorable tax treatment. That list was unchanged from 1936, and commodities were not on the list.

In 1986, fifty years after the first mutual funds got started, Congress slightly expanded the types of income that a mutual fund could earn while retaining its tax advantages, adding investments in foreign currencies to investments in securities. Commodities were not added by Congress. The Treasury Department issued a letter at the same time noting that it "would generally not treat as qualifying income gains from trading commodities."

In 2010, the mutual fund industry supported an unsuccessful legislative attempt to change the tax code to allow mutual funds to make unrestricted commodity investments. As introduced in 2009, and passed by the House in 2010, the Regulatory Investment Company Modernization Act would have explicitly permitted mutual funds to utilize income from "commodities" under Section 851. But the Senate did not accept that provision. It was removed from the bill which only then was approved by the Senate. Removal of the commodities provision was, in fact, the

only change made in the House-passed bill. The bill was sent back to the House which agreed to the bill as amended by the Senate. So the short story is that Congress did not agree to adding commodities to the list of acceptable income for mutual funds under the 90% rule. If the industry wants to try again to change the law to allow more commodity investments by mutual funds, the change should be made, not by private letter rulings or regulation, but by Congress after a full debate of the pros and cons.

Six months after Congress made its decision in the RIC Modernization Act, in June 2011, the IRS suspended its issuance of new private letter rulings in this area, so it could review the underlying policy issues. Later in the year, Senator Coburn and I sent a joint letter to Treasury and the IRS asking the IRS "to permanently halt the further issuance of [the] private letter rulings." Our letter is Hearing Exhibit 1d.

Shams and Conduits. Some have suggested that the IRS ought to allow mutual funds to use offshore corporations to make commodity investments based on the court case known as Moline Properties, which required the IRS to recognize a corporate structure. But in Moline Properties, the Supreme Court also stated that, "in matters relating to the revenue, the corporate form may be disregarded where it is a sham or unreal." The Cayman corporations being used for mutual fund commodity investments have no employees, no place of business, no profits of their own, and no obvious nontax purpose. There is no there, there. They are exactly the type of sham corporations that the Supreme Court said the IRS can disregard.

Another relevant event is the 2010 Congressional codification of the economic substance doctrine which permits the IRS to disregard transactions that have no substantial nontax purpose. Mutual funds have not offered any substantial business or economic purpose for creating these offshore CFCs or constructing commodity-linked notes. Their only purpose is to serve the mutual funds' effort to re-characterize the resulting income as derived from "securities," so they can make unlimited commodity investments while retaining their privileged tax status. A Tax Notes analysis by two tax practitioners, Hearing Exhibit 3d, observed that "it is hard to imagine that there could be a nontax purpose outweighing the tax purpose on the facts of the rulings."

Finally, there is a long line of cases and private letter rulings in which federal courts have upheld IRS efforts to go after sham corporations or transactions which have no purpose other than tax avoidance or which serve only as conduits for parties seeking to avoid taxation. They include cases like Gregory v. Helvering, Aldon Home s, Aiken Industries, and the recent case of Southgate Master Fund, LLC. In Southgate, the Fifth Circuit, citing numerous precedents, wrote the following:

> "The starting point for our analysis is the cardinal principle of income taxation: a transaction's tax consequences depend on its substance, not its form. This principle 'is no schoolboy's rule; it is the cornerstone of sound taxation[.]' ... This foundational principle finds its voice in the judicial anti-abuse doctrines, which 'prevent taxpayers from subverting the legislative purpose of the tax code by engaging in transactions that are fictitious or lack economic reality simply to reap a tax benefit.'"

One of the issues we will explore today is why the IRS did not follow this approach when analyzing requests by the mutual funds to use offshore corporations and structured notes to make their commodity investments. By issuing the private letter rulings that it has in the mutual fund

area, the IRS is undermining its own longstanding efforts to go after sham corporations and transactions used to avoid paying tax.

These are not arcane tax issues; they raise fundamental issues affecting our economic future, the functioning of our tax code, and the use of offshore schemes and financial engineering to avoid our tax laws. The IRS private letter rulings have unleashed a new flood of speculative commodity investments damaging to American families, businesses, and our economy. Commodity speculation that contributes to $4 gasoline is no joke, and neither is a tax policy that threatens to fuel a new explosion in commodity speculation. The IRS letter rulings enable U.S. firms to use offshore shell corporations and financially engineered notes to make commodity investments, despite longstanding tax code restrictions, setting precedents that eat away at the integrity of our tax code. Congress shouldn't just stand by and let that happen.

Today's oversight hearing is intended to address those concerns. We will hear from IRS Commissioner Douglas Shulman and Emily McMahon who is Acting Assistant Secretary of the Treasury for the Office of Tax Policy, two of the most senior tax officials in the Administration. I invite our Ranking Member, Dr. Coburn, to share his views.

# # #

Opening Statement of Senator Tom Coburn
"Compliance with Tax Limits on Commodity Speculation"
January 26, 2012

I want to start by thanking Sen. Levin and his staff for keeping a vigilant eye on matters related to the tax code. Today's hearing is a great opportunity to look at the tax treatment of mutual funds that invest heavily in commodities.

Over the years, this subcommittee has spent a lot of time looking at commodity investments, which is more relevant than ever. Everyday investors increasingly want commodities in their portfolios, and are looking to buy them in record amounts.

Commodities are so popular, in fact, that it's hard to drive down the street without hearing commercials offering the chance to buy gold.

For its part, the market has responded by providing ways to do just that. There are now dozens of ETF's and mutual funds that concentrate on commodities, with billions under management.

That reason for the interest in commodities is not a complete surprise. As an asset that generally grows at the rate of inflation, many invest in commodities as a hedge to protect what they've earned.

Moreover, inflation is becoming a very real and looming threat. It is a silent tax increase that eats away the value of our money and drives up the price of the things we buy.

Unfortunately, one of the main sources of inflation is our government. The Federal Reserve is printing trillions of dollars while Congress is adding $1 trillion a year to the debt. Until we can take a substantial bite out of our $15 trillion debt, inflation concerns are not going away. With it, interest in commodities is not likely to go away, either.

Our hearing today is focused on one of the most popular ways to buy commodities, and that is mutual funds.

Commodity mutual funds came under increased scrutiny after the IRS temporarily suspended its program for issuing private letter rulings this past summer. Private letter rulings are an ad hoc way for the IRS to approve of the various tax structures used to set up these funds. They have been necessary because Congress has failed to pass clear and simple tax reform for the past 25 years.

The private rulings effectively allow mutual funds to use creative structures to facilitate commodity investments that would otherwise not be allowed. And because of this some see these private rulings as a way to help mutual funds get around legal prohibitions. Even more, some are concerned that as these rulings let mutual funds increase these investments, it can lead to excessive speculation into commodities.

By calling a timeout, the IRS has given us a useful opportunity to talk about how to resolve these important matters. As we move forward, though, I would propose we keep in mind a number of points.

First, there is a difference between tax *avoidance* and tax *evasion*. Avoiding taxes is both legal and acceptable. Evading taxes is wrong and should be prosecuted. Under current law, the practices used by mutual funds are entirely legal, and even blessed by the IRS. This means we are left with a question of policy, not a question of compliance with the law.

Second, we still do not have a working definition of "excessive speculation." While I believe that excessive speculation is a real problem, defining it is a challenge. Until we can do so with some accuracy, both Congress and the IRS should be careful in writing new rules restricting the private investments of ordinary Americans.

Third, we need to stay focused on the big picture. It is doubtful that we would be having this conversation if our federal budget was under control. The damage we have done, and continue to do, to our economy is driving people to seek even the small returns offered by commodities. If our economy was growing, money would quickly flow back into the capital markets. Unfortunately, too many decisions by the government seem to work against this.

For my part, I have offered a plan called *Back in Black* that would achieve $9 trillion in savings over the next decade. They would go a long way toward solving issues like the one we face today.

Again, I believe this hearing is an important opportunity to discuss concerns about the tax treatment of commodity mutual funds. Hopefully we will be closer to a productive solution by the time we finish.I plan to keep an open mind as we consider various options.

I look forward to hearing from our witnesses.

PREPARED TESTIMONY
OF
DOUGLAS H. SHULMAN
COMMISSIONER OF INTERNAL REVENUE
BEFORE THE
U.S. SENATE PERMANENT SUBCOMMITTEE ON INVESTIGATIONS
HEARING ON INVESTMENTS IN COMMODITIES BY
REGULATED INVESTMENT COMPANIES
JANUARY 26, 2012

Introduction

Chairman Levin, Ranking Member Coburn, members of the subcommittee, thank you for this opportunity to testify on the issue of regulated investment companies (RICs) investing in commodities.

I would start by explaining that the IRS is involved in this issue because it is charged with providing guidance to taxpayers as to whether investments RICs choose to make will produce qualifying RIC income, as defined in the tax law.

In order to maintain its tax status, a RIC must derive 90% of its income from investments that meet the qualifications of section 851, which generally requires that investments be related to stock, securities, or foreign currencies. The term "securities" is specifically defined in section 851 by cross reference to the definition of that same term in the Investment Company Act of 1940 (the 1940 Act).

It is the scope of that definition – and particularly its application to investments providing indirect exposure to commodities – that have been the focus of the approximately 70 private letter rulings that are the subject of this hearing.

It may be useful for me to provide a brief explanation of how the agency arrived at the position reflected in the private letter rulings and then summarize where the IRS is on this issue today. By late 2005 the investment markets had developed to a point where many RICs felt the need to add exposure to commodity prices to their investment portfolios. As a result, they requested guidance from the IRS as to whether investments made to achieve this exposure would qualify for the 90% income test. The IRS was unable to find any authoritative guidance on the proper scope of the definition of "security" from either the Securities and Exchange Commission (SEC) or the Commodities Futures Trading Commission (CFTC), which is the primary regulator for the commodity markets in the United States.

This situation resulted in the IRS being asked to issue private letter rulings addressing specific proposed RIC commodity-related investments based on the IRS's own best interpretation of the tax law, including cross-references to the

1940 Act. Private letter rulings were issued on this subject starting in 2006. By 2010 the volume of private letter ruling requests was becoming a concern, and consideration was given to issuing some form of broader published guidance. The RIC Modernization Act was then pending, though, and at that point the bill contained a provision that would have affirmatively treated income from direct investments in commodities as qualifying income. As a result, consideration of a guidance project was put on hold. The provision in the RIC Modernization Act relating to commodities was removed prior to passage, however, leaving the statutory language on this issue unchanged.

In July 2011, the IRS notified the RIC industry that it would not issue further private letter rulings until the staff could look at the overall set of issues and consider guidance of broader applicability. That remains our current posture.

That, Mr. Chairman, is the short version. A little more detail is appropriate, however, in order to answer the specific questions you have raised. Therefore I have included in my written testimony a summary of the legal issues at stake, which was prepared by the IRS Office of Chief Counsel. That summary is included below.

This concludes my testimony. I would be happy to take your questions.

Summary of Legal Issues Surrounding Commodity-Related Investments by RICs

Internal Revenue Service 2006 Revenue Rulings

In 2006, the IRS published Revenue Rulings 2006–1 [2006-1 C.B. 261] and 2006–31 [2006-1 C.B. 1133]. These rulings addressed section 851(b)(2) of the Internal Revenue Code, which requires that each taxable year at least 90 percent of the gross income of a RIC must consist of income from specified sources (qualifying income). Qualifying income includes both gain from the sale or disposition of securities and income from securities. The Code, however, does not define the term "security." Instead, it cross-references the 1940 Act, which is administered by the SEC. That is, section 851(b)(2) defines qualifying income as including "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 ... derived with respect to [a RIC's] business of investing in such stock, securities, or currencies."

At issue in Revenue Ruling 2006-1, the first of the two published rulings, was whether income from a total return swap on a commodities index would be qualifying income. The Ruling arose because the Office of Tax Policy and the IRS became aware of certain investment funds being or intended to be offered to the public as RICs that made extensive use of such instruments. Neither the 1940 Act itself, the regulations under the 1940 Act, nor SEC staff Interpretations yielded an answer to the question whether the swaps were 1940 Act securities. IRS and Treasury staff consulted with SEC and CFTC staff, but this also did not lead to an answer. In the absence of definitive guidance as to whether such a swap would be a 1940 Act security, the IRS in the Ruling examined the relevant legislative history underlying enactment of the section 851(b)(2) cross-reference to the 1940 Act, and held that "[a] derivative contract with respect to a commodity index is not a security for purposes of section 851(b)(2)."

A number of questions were quickly raised regarding Revenue Ruling 2006-1. Revenue Ruling 2006–31 was subsequently issued to modify and clarify Revenue Ruling 2006–1, including by making clear that the holding of Revenue Ruling 2006-1 was not intended to preclude income from certain instruments that create commodity exposure, such as certain structured notes, from being qualifying income.

Due at least in part to these revenue rulings, as well as the general uncertainty regarding the extent of permissible commodity-linked investments by RICs, the IRS received a large and increasing number of requests for private letter rulings. Private letter rulings can be relied upon only by the taxpayers to which they are addressed. In that sense, they can provide the IRS with a vehicle to explore market realities and test legal approaches to novel questions before promulgating published guidance in an area.

The private ruling requests asked for approval of one or both of the following positions: (1) that a RIC's income inclusion that results from its controlled foreign corporation (CFC) earning income from commodity investments is qualifying income; and (2) that income from structured notes with returns based on commodity price movements also will produce qualifying income.

Controlled Foreign Corporations

Under the first of these approaches, some RICs achieve indirect exposure to commodities by investing up to 25 percent of a fund's assets in a foreign subsidiary that is treated as a CFC. The CFC then makes commodity-related investments. The U.S. parent RIC generally includes amounts in income under subpart F of the Code when the CFC earns income from its commodity investments. The nature of the income – from the standpoint of the RIC – is simply a subpart F income inclusion, and not identified as income from an investment in commodities.

The Code generally permits a RIC to hold all of the shares of a subsidiary if the value of that holding does not exceed 25 percent of the value of the RIC's total holdings. Moreover, Congress expressly addressed the issue of subpart F income inclusions in the so-called "flush language" of section 851(b). That paragraph of section 851(b) treats a subpart F inclusion as a dividend for this purpose, and hence as qualifying income, if there is a matching distribution out of earnings and profits.

Independent of the "flush language," some RICs sought private letter rulings to determine whether a subpart F inclusion could constitute qualifying income on the separate basis that such income is "other income" derived with respect to the RIC's business of investing in the stock of the subsidiary under section 851(b)(2). At the time of the rulings, IRS staff took the position that the two provisions were not intended to be coordinated because, among other reasons, they were introduced into the legislative process with no indication that the "flush language" was intended to limit the "other income" provision. Therefore, the staff concluded that, rather than having one provision narrow the other, the "other income" clause should be evaluated without regard to the "flush language." The rulings concluded that subpart F inclusions could be treated as "other income," and accordingly that current distributions from the CFCs were not required for such inclusions to be qualifying income.

The private letter rulings assume that the CFC is treated as a corporation that is separate from the RIC. This approach reflects several considerations, including section 851's express contemplation that RICs might own CFCs, the tax law principle that a taxpayer's choice of entity for conducting investment or business activity should generally be respected, and the tax law principle that, if properly organized and managed, a corporation should generally be respected as separate from its shareholders for tax purposes.

Commodity-linked Structured Notes

The second approach covered by the private letter rulings relates to structured notes with a return based on movements in commodity prices. A commodity-linked structured note is an instrument entered into with a counterparty, generally a financial institution. In addition to interest on its investment, a RIC receives income measured, or "structured," with reference to the movement of the value of a commodity index or indices, often with a leverage factor.

The structured notes rulings, in general, are based on the premise that structured notes with enough resemblance to typical debt instruments and characteristics suggesting some minimum certainty of repayment of principal, such as a minimum of 51 percent principal protection and related features, may qualify as a "note," an "evidence of indebtedness," or an "investment contract" within the 1940 Act definition. Some of the factors the IRS looked for included up-front payment in full of the purchase price of the note; a short, fixed maturity (often, a year and a day); an automatic redemption feature, termed a "knockout," that triggers the note's redemption if the index falls too far in value; and the note not being subject to mark-to-market margining requirements, or treated as a contract of sale of commodities for future delivery (or as an option on such a contract), under the Commodities Exchange Act.

It has been argued that derivatives of all types are outside the definition of "security" under the 1940 Act. It is true that derivatives were not widely viewed as investment vehicles when the 1940 Act was enacted. The1940 Act's definition of "security," however, is not static, and contains several generic items designed to encompass new instruments as they develop, including "evidence of indebtedness," "investment contract," and any "instrument commonly known as a 'security'." The extent to which investments with commodity-linked payoffs are also securities and, if so, how they are identified, have been active subjects of comment in the securities law area for some time, but there do not appear to be any conclusive answers.

Recent Legislative Actions

Section 201 of the RIC Modernization Act as originally introduced would have allowed income from direct investment in commodities to be qualifying income. However, the Senate amended the bill to remove section 201 before passing the RIC Modernization Act by unanimous consent. The removal of section 201 of the bill left the statutory language unchanged. There was no change to the cross-reference to the 1940 Act or to the definition of "security" under that Act.

Additionally, the Dodd–Frank Wall Street Reform and Consumer Protection Act amended both the federal commodity and securities laws to provide the CFTC with jurisdiction over swaps, including those on broad-based security indices. It also provided the SEC with jurisdiction over security-based swaps, which are

swaps on narrow-based security indices and single securities. The two agencies share authority over mixed swaps, which are swaps that have mixed attributes.

However, Dodd-Frank did not make any explicit change to the definition of "securities" in the 1940 Act.

Current Status of IRS Advice

This history has led to the current IRS position. The number of RIC requests for private letter rulings increased dramatically since 2006, creating concern within the IRS from both an administrative and a technical standpoint. After the RIC Modernization Act failed to provide a clear, unambiguous answer, the IRS decided to stop issuing private letter rulings until it could provide guidance of general applicability. The possibility of that guidance is currently under consideration.

**Testimony of Emily S. McMahon, Acting Assistant Secretary for Tax Policy,
U.S. Department of the Treasury
Before the U.S. Senate Homeland Security and Government Affairs Permanent Subcommittee on Investigations
Hearing on "Compliance with Tax Limits on Mutual Fund Commodity Speculation"
January 26, 2012**

Chairman Levin, Ranking Member Coburn, and members of the Subcommittee, I appreciate the opportunity to testify on the issue of investments in commodities by regulated investment companies (RICs).

Treasury's Role in the RIC Guidance

Commissioner Shulman's testimony describes a series of private letter rulings issued by the Internal Revenue Service (IRS) on this subject. I would like to begin by describing the role of the Treasury Department in the private letter ruling and published guidance process. A private letter ruling is a determination issued by the IRS to a particular taxpayer that interprets and applies the tax laws to the taxpayer's particular set of facts. As a matter of policy and practice, the Treasury Department does not participate in the consideration or issuance of private letter rulings by the IRS. Moreover, other than in highly unusual circumstances, Treasury Department personnel do not know which taxpayers have requested or received private letter rulings. Treasury Department personnel become aware of the issuance of a private letter ruling only when that ruling is eventually issued to the public by the IRS in redacted form. Consistent with that policy and practice, the Treasury Department did not participate in the formulation, or review or oversee the issuance, of any of the private letter rulings addressing commodity-related investments by RICs. Nor has the Treasury Department studied the effect of the private letter rulings on the mutual fund industry.

The Office of Tax Policy is actively involved, however, in the development of published guidance, including both tax regulations and other administrative guidance that is published in the Internal Revenue Bulletin. In this capacity, Treasury personnel participate in the development of the substantive law that private letter rulings reflect.

Thus, in 2005 and 2006, Treasury Department personnel did participate in the development of two published revenue rulings that address commodity-related investments by a RIC. These revenue rulings, Rev. Rul. 2006-1, 2006–1 C.B. 261, and Rev. Rul. 2006–31, 2006–1 C.B. 1133, are described in Commissioner Shulman's written testimony. Subsequent to those revenue rulings, the IRS and Treasury Department periodically discussed the possibility of additional guidance in this area as a candidate for the Priority Guidance Plan.

Suspension of the Issuance of Private Letter Rulings in This Area and Subsequent Developments

As stated in Commissioner Shulman's testimony, the IRS has suspended the issuance of private letter rulings addressing commodity-related investments by RICs. Treasury Department personnel were not involved in that decision.

Subsequent to the suspension, the Investment Company Institute (ICI) called several members of the staff of the Office of Tax Policy to ask why the IRS issuance of rulings had been suspended and what the future might hold. Treasury staff could not, and did not, provide answers to those questions. On September 28, 2011, at the ICI's request, ICI representatives met with Treasury and

IRS personnel to discuss ICI proposals for published guidance that would permit commodity-related investments by RICs.

The Treasury Department and IRS are considering the possibility of issuing published guidance on the subject of commodity-related investments by RICs.

Regulated Investment Company Modernization Act of 2010

This Subcommittee's letter inviting me to testify at this hearing stated that the Regulated Investment Company Modernization Act of 2010 (RMA), Pub. L. No. 111–325, 124 Stat. 3537, "reaffirmed [Congress'] intent to exclude commodities from mutual funds' qualifying income under Section 851(b)(2)." The House version of the bill (H.R. 4337) would have expanded the definition of qualifying income to include income derived from direct or indirect exposure to commodities. However, that amendment to the definition was removed from the bill before enactment, leaving unchanged the statutory provisions upon which the IRS revenue rulings and private letter rulings were based. Under those provisions, the definition of qualifying income is linked to the 1940 Act definition of "security," and income derived from such securities is not explicitly excluded from qualifying income merely because it reflects exposure to commodity prices.

Economic Substance Doctrine

Under section 7701(o) of the Internal Revenue Code (the Code), whenever the economic substance doctrine is relevant to a transaction, the transaction is treated as having economic substance only if, as a factual matter, (1) the transaction changes in a meaningful way the taxpayer's economic position, and (2) the taxpayer has a substantial non-tax purpose for entering into the transaction. These questions are inherently factual. The private letter rulings issued by the IRS do not address the potential application of the economic substance doctrine, and the Treasury Department does not have independent knowledge of the facts underlying the rulings. Therefore, we cannot express a view on the application of section 7701(o) to the transactions described in the private letter rulings.

Tax Policy Issues

The extent to which investors should be able to obtain exposure to commodity price fluctuations through investments in RICs is not fundamentally a tax policy issue. The Code provisions in question do raise, however, the issue of whether the Treasury Department and the IRS should be required to interpret a non-tax statute (in this case, the 1940 Act) that does not otherwise fall within their jurisdiction in order to determine the availability of favorable tax treatment under the Code. The Securities and Exchange Commission (SEC) has not issued any guidance of which we are aware that addresses whether the financial instruments described in the IRS private letter rulings are securities for 1940 Act purposes (as required to produce qualifying income). At the same time, we are not aware of any action the SEC has taken to preclude RICs from making these investments. Administering the relevant Code provisions under these circumstances is challenging from both a practical and a policy perspective.

Thank you, and I look forward to taking your questions.

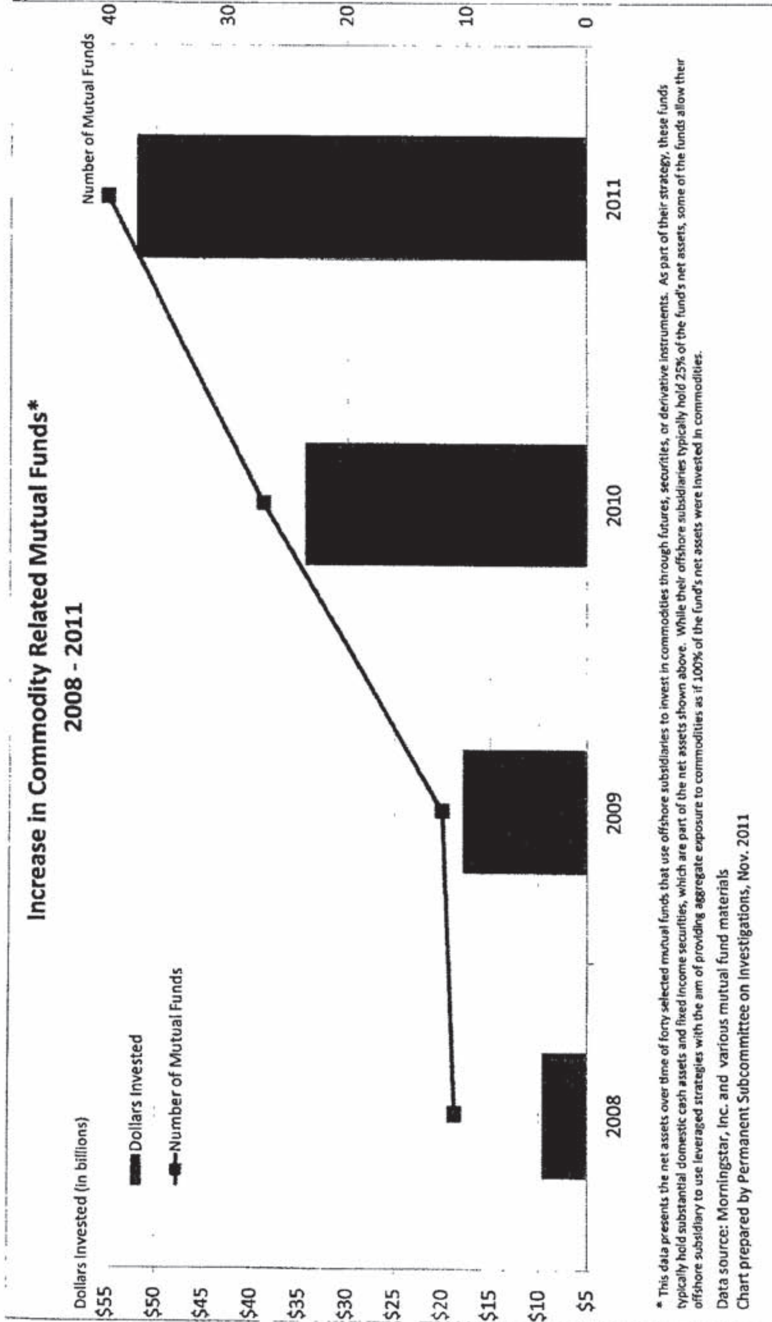

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EXHIBIT #1a

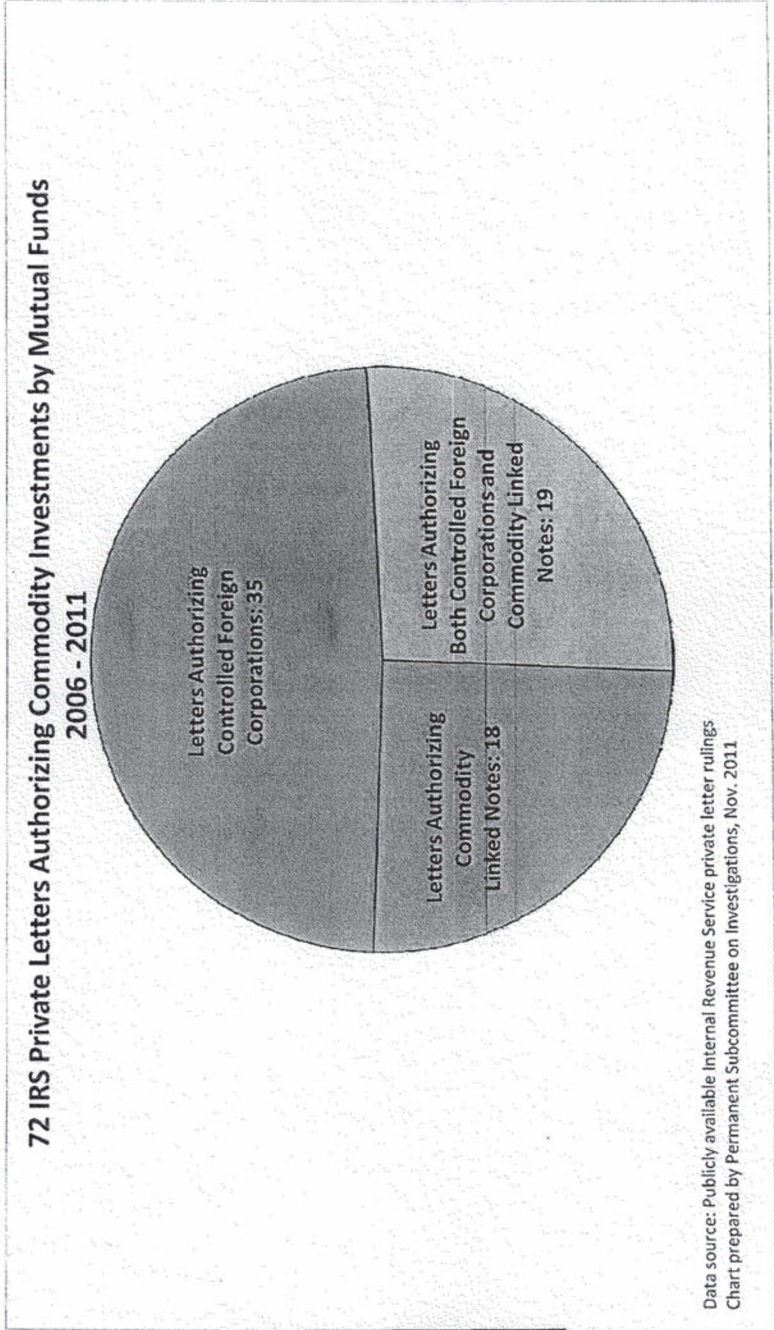

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EXHIBIT #1b

IRS Private Letters Authorizing Commodity Investments by Mutual Funds

	Date	PLR Number	CFC	Notes	CFC & Notes	Description
1	7/14/2006	200628001		x		Each fund authorized to invest in commodities-linked notes having the terms and conditions of the note set forth in the PLR.
2	9/15/2006	200637018		x		Each fund authorized to invest in commodities-linked notes having the terms and conditions of the note set forth in the PLR. Hybrid instrument.
3	11/24/2006	200647017			x	Fund authorized to invest in commodities-linked notes having the terms and conditions of the note set forth in the PLR. CFC subsidiary incorporated as an exempted limited company under the laws of another country. Subpart F income.
4	1/5/2007	200701020		x		Master fund authorized to invest in commodities-linked notes having the terms and conditions of the note set forth in the PLR. Fund invests all of its assets in Master fund.
5	2/2/2007	200705026		x		Fund authorized to invest in commodities-linked notes having the terms and conditions of the two notes set forth in the PLR. Section 2(f)(1) of the CEA provides that the CEA is not applicable to a hybrid instrument that is predominantly a security. Notes 1 and 2 are both leveraged.
6	5/18/2007	200720011		x		Fund and Portfolio authorized to invest in commodities-linked notes having the terms and conditions of the two notes set forth in the PLR.
7	6/29/2007	200726026		x		Funds authorized to invest in commodities-linked notes having the terms and conditions of the two notes set forth in the PLR.
8	10/12/2007	200741004	x			Funds authorized to form two CFC subsidiaries as exempted limited companies under the laws of another country. Subpart F income.
9	10/26/2007	200743005	x			Funds authorized to form nine CFC subsidiaries as exempted limited companies under the laws of another country. Subpart F income.
10	11/9/2007	200745008		x		Funds are authorized to invest in commodities-linked notes having the terms and conditions of the note set forth in the PLR.
11	11/9/2007	200745021		x		Funds authorized to invest in commodities-linked notes having the terms and conditions of the two notes set forth in the PLR. Fund A is a series of business trusts. Fund B is a closed end management company. Notes constitute qualifying income to funds under section 851(b)(2).
12	5/30/2008	200822010	x			Funds authorized to form four CFC subsidiaries as exempted limited companies under the laws of another country. Subpart F income.
13	5/30/2008	200822012		x		Fund authorized to invest in commodities-linked notes having the terms and conditions of the two notes set forth in the PLR.
14	8/1/2008	200831019		x		Funds and partnerships authorized to invest in commodities-linked notes having the terms and conditions of the two notes set forth in the PLR.

Data source: Publicly available Internal Revenue Service private letter rulings
Chart prepared by Permanent Subcommittee on Investigations, Nov. 2011

Permanent Subcommittee on Investigations
EXHIBIT #1c

IRS Private Letters Authorizing Commodity Investments by Mutual Funds

	Date	PLR Number	CFC	Notes	CFC & Notes	Description
15	10/3/2008	200840039			x	Fund authorized to invest in commodities-linked notes having the terms and conditions of the four notes set forth in the PLR. CFC subsidiary incorporated as exempted a limited company under the laws of another country. Subpart F income.
16	10/17/2008	200842014			x	Fund authorized to invest in commodities-linked notes having the terms and conditions of the six notes set forth in the PLR. Fund authorized to form and invest a percentage of funds in two CFC subsidiaries incorporated as exempted limited companies under the laws of another country. Subpart F income.
17	11/7/2008	200845013		x		Fund authorized to invest in a commodities-linked note.
18	3/20/2009	200912003			x	Fund authorized to invest in commodities-linked notes having the terms and conditions of the two notes set forth in the PLR. Fund authorized to form a CFC subsidiary incorporated as an exempted limited company under the laws of another country. Subpart F income.
19	5/29/2009	200922010	x			Each of three funds authorized to form a CFC subsidiary as a Type A company under the laws of another country. Subpart F income.
20	6/5/2009	200923011	x			Fund authorized to form a CFC subsidiary as a Type A company giving limited liability to all shareholders. Subpart F income.
21	7/31/2009	200931003			x	Fund authorized to invest in commodities-linked notes having the terms and conditions of the four notes set forth in the PLR. Fund authorized to form a CFC subsidiary as a Type A company under the laws of another country. Subpart F income.
22	7/31/2009	200931008			x	Fund authorized to invest in commodities-linked notes having the terms and conditions of the four notes set forth in the PLR. Fund authorized to form a CFC subsidiary incorporated as a Type A company under the laws of another country. Subpart F income.
23	8/7/2009	200932007	x			Funds authorized to form four CFC subsidiaries, each as a company under the laws of another country. Subpart F income.
24	9/4/2009	200936002	x			Fund authorized to form a CFC subsidiary incorporated as a Type A company under the laws of another country. Subpart F income.
25	9/25/2009	200939017			x	Fund authorized to invest in commodities-linked notes having the terms and conditions of the two notes set forth in the PLR. Fund authorized to form a CFC subsidiary incorporated as a Type A company under the laws of another country. Subpart F income.
26	11/13/2009	200946036			x	Each of 96 funds authorized to invest in one more commodities-linked notes. Fund 1 authorized to form a CFC subsidiary incorporated as a Type A company under laws of another country. Subpart F income.
27	11/20/2009	200947032	x			Funds authorized to form four CFC subsidiaries as a Type A company under the laws of another country. Subpart F income.

Data source: Publicly available Internal Revenue Service private letter rulings
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IRS Private Letters Authorizing Commodity Investments by Mutual Funds

	Date	PLR Number	CFC	Notes	CFC & Notes	Description
28	11/20/2009	200947026	x			Fund authorized to form a CFC subsidiary as a Type A company giving limited liability to all shareholders. Subpart F income.
29	12/24/2009	200952019		x		Funds authorized to invest in commodities-linked notes having the terms and conditions of the two notes set forth in the PLR.
30	2/5/2010	201005023	x			Fund authorized to form a CFC subsidiary as a company under the laws of another country. Subpart F
31	2/19/2010	201007044	x			Fund authorized to form a CFC subsidiary as a company under the laws of another country. Subpart F
32	5/21/2010	201020003	x			Fund authorized to form a CFC subsidiary as a company under the laws of another country. Subpart F income.
33	6/18/2010	201024004	x			Fund authorized to form a CFC subsidiary as a Type A company giving limited liability to all shareholders. Subpart F income.
34	6/18/2010	201024003	x			Fund authorized to form a CFC subsidiary under the laws of another country. Subpart F income.
35	6/25/2010	201025031			x	Fund authorized to invest in commodities-linked notes having the terms and conditions of the note set forth in the PLR. Fund authorized to form a CFC subsidiary incorporated as a Type A company under the laws of another country. Subpart F income.
36	7/2/2010	201026017	x			Funds authorized to form six CFC subsidiaries as companies under the laws of another country. Subpart F income.
37	7/30/2010	201030004			x	Funds authorized to invest in commodities-linked notes having the terms and conditions of the note set forth in the PLR. Fund authorized to form nine CFC subsidiaries as Type X companies. Subpart F income.
38	8/6/2010	201031007		x		Fund seeks a long-term total return in excess of inflation. Fund authorized to invest in three notes. Note 2 discusses leverage. Note 3 discusses knock-out and automatic redemption.
39	8/27/2010	201034011			x	Each of six funds is permitted to invest in either certain structured notes or in a CFC. CFC subsidiaries incorporated as exempted limited companies under the laws of another country. Subpart F income.
40	9/17/2010	201037012			x	Fund authorized to invest in commodities-linked notes having the terms and conditions of the four notes set forth in the PLR. Fund authorized to form two CFC subsidiaries incorporated as Type A companies under the laws of another country. Subpart F income.
41	9/17/2010	201037014	x			Funds authorized to form two CFC subsidiaries as Type A companies giving limited liability to all shareholders. Subpart F income.
42	10/1/2010	201039002			x	Fund authorized to invest in two commodities-linked notes. Fund authorized to form two CFC subsidiaries incorporated as Type A companies under the laws of another country. Subpart F income.
43	10/15/2010	201041033	x			Fund authorized to form two CFC subsidiaries authorized to form as limited companies incorporated under the law of another country. Subpart F income.

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IRS Private Letters Authorizing Commodity Investments by Mutual Funds

	Date	PLR Number	CFC	Notes	CFC & Notes	Description
44	10/22/2010	201042015	x			Fund authorized to form a CFC subsidiary organized as a Type X company under the laws of another country. Subpart F income.
45	10/22/2010	201042001	x			Fund authorized to form a CFC subsidiary authorized under the laws of another country. Subpart F income.
46	10/29/2010	201043016		x		Six funds authorized to invest in commodities-linked notes having the terms and conditions of the note set forth in the PLR. Funds discuss knock out dates and leverage factors.
47	10/29/2010	201043017	x			Fund authorized to form a CFC subsidiary organized as a Type X company under the laws of another country. Subpart F income.
48	12/3/2010	201048021	x			Funds authorized to form five CFC subsidiaries incorporated as Type A companies. Subpart F income.
49	12/3/2010	201048022	x			Funds authorized to form nine CFC subsidiaries incorporated as Type A companies. Subpart F income.
50	12/10/2010	201049015	x			Funds authorized to form four CFC subsidiaries. One subsidiary authorized to form as a Type X company and three subsidiaries authorized to form as Type Y companies. Subpart F income.
51	12/23/2010	201051014	x			Fund authorized to form a CFC subsidiary as a Type X company under the laws of another country. Subpart F income.
52	1/14/2011	201102055			x	Fund authorized to invest in one commodities-linked note and one CFC subsidiary as a Type X company under the laws of another country. Subpart F income.
53	1/14/2011	201102047	x			Fund authorized to form a CFC subsidiary as a Type A company giving limited liability to all shareholders. Subpart F income.
54	1/21/2011	201103019		x		Funds authorized to invest in commodities-linked notes having the terms and conditions of the note set forth in the PLR.
55	1/21/2011	201103033			x	Funds A, B and Portfolio authorized to invest in one commodities-linked note. Fund B and Portfolio each authorized to form two CFC subsidiaries as companies under the laws of another country. Subpart F income.
56	1/21/2011	201103009	x			Fund authorized to form a CFC subsidiary as a company under the laws of another country. Subpart F income.
57	1/21/2011	201103017	x			Fund authorized to form a CFC subsidiary as a company under the laws of another country. Subpart F income.
58	1/28/2011	201104013			x	Fund authorized to invest in commodities-linked notes having the terms and conditions of the four notes set forth in the PLR. Fund authorized to form a CFC subsidiary as a Type A company under the laws of another country. Subpart F income.
59	2/18/2011	201107012			x	Fund authorized to invest in four commodities-linked notes. Fund authorized to form two CFC subsidiaries as companies under the laws of another country. Subpart F income.

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IRS Private Letters Authorizing Commodity Investments by Mutual Funds

	Date	PLR Number	CFC	Notes	CFC & Notes	Description
60	2/25/2011	201108003		x		Funds authorized to invest in a commodities-linked note having the terms and conditions set forth in the PLR. The note can be leveraged.
61	2/25/2011	201108018			x	Fund authorized to invest in commodities-linked notes having the terms and conditions of the four notes set forth in the PLR. Fund authorized to form two CFC subsidiaries as Type A companies under the laws of another country. Subpart F income.
62	2/25/2011	201108008	x			Funds authorized to form six CFC subsidiaries as companies under the laws of another country. Subpart F income.
63	4/1/2011	201113015		x		Fund authorized to invest in commodities-linked notes having the terms and conditions of the note set forth in the PLR.
64	4/22/2011	201116014	x			Funds authorized to form three CFC subsidiaries as companies under the law of another country. Subpart F income.
65	5/20/2011	201120017	x			Fund authorized to form a CFC subsidiary as a Type A company giving limited liability to all shareholders. Subpart F income.
66	6/3/2011	201122012	x			Fund authorized to form a CFC subsidiary as a Type A company giving limited liability to all shareholders. Subpart F income.
67	7/15/2011	201128022	x			Fund represents that its CFC subsidiary will qualify as an association taxable as a corporation. Subpart F income.
68	7/22/2011	201129002	x			Fund authorized to form a CFC subsidiary as a Type A company giving limited liability to all shareholders. Subpart F income.
69	8/5/2011	201131001			x	Porfolio authorized to invest in four commodities-linked notes. Portfolio authorized to form a CFC subsidiary as a Type X company under the laws of another country. Subpart F income.
70	8/12/2011	201132008	x			Fund authorized to form CFC subsidiary as a Type A company giving limited liability to all shareholders. Subpart F income.
71	8/26/2011	201134014	x			Fund authorized to form a CFC subsidiary as a Type A company giving limited liability to all shareholders. Subpart F income.
72	9/2/2011	201135001		x		Funds authorized to invest in two commodities-linked notes. Note A deals with a leveraged note, and Note B will pay a monthly coupon in arrears.
		TOTAL	35	18	19	

Data source: Publicly available Internal Revenue Service private letter rulings
Chart prepared by Permanent Subcommittee on Investigations, Nov. 2011

JOSEPH I. LIEBERMAN, CONNECTICUT, CHAIRMAN

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JON TESTER, MONTANA
MARK BEGICH, ALASKA

SUSAN M. COLLINS, MAINE
TOM COBURN, OKLAHOMA
SCOTT P. BROWN, MASSACHUSETTS
JOHN McCAIN, ARIZONA
RON JOHNSON, WISCONSIN
ROB PORTMAN, OHIO
RAND PAUL, KENTUCKY
JERRY MORAN, KANSAS

MICHAEL L. ALEXANDER, STAFF DIRECTOR
NICHOLAS A. ROSSI, MINORITY STAFF DIRECTOR

United States Senate

COMMITTEE ON
HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS
WASHINGTON, DC 20510-6250

December 20, 2011

VIA U.S. MAIL & EMAIL (Floyd.Williams@IRS.gov)

The Honorable Douglas H. Shulman
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

RE: Private Letter Rulings to Mutual Funds
Seeking Commodities Exposure

Dear Commissioner Shulman:

Since 2006, the Internal Revenue Service (IRS) has issued over 70 private letter rulings allowing mutual funds that operate as regulated investment companies for U.S. federal income tax purposes to make unlimited indirect investments in commodities through controlled foreign subsidiaries or commodity-linked notes, despite Internal Revenue Code Section 851(b)(2) which requires such funds to derive 90% of their income from securities and no more than 10% from other sources, including commodities. We support the recent decision of the IRS to suspend issuance of new letters in this area to review the underlying policy issues. Pending the results of that review, we believe it may be appropriate to permanently suspend all future private letter rulings in this area and reevaluate the tax treatment of all mutual funds currently allowed to treat indirect commodity investments as income derived from "securities" under Section 851.

Speculation in U.S. Commodity Markets. Since 2002, the U.S. Senate Permanent Subcommittee on Investigations has conducted a series of investigations into commodity prices, focusing on how excessive speculation in the futures and swaps markets may have affected commodity prices, normal supply and demand factors, and American consumers and businesses.[1] Commodity markets enable producers and users of physical commodities to arrive at a fair price for their goods and hedge their price risks over time. Speculators can make a positive contribution to commodity markets by facilitating price discovery and hedging activities. In recent years, however, evidence indicates that speculators have come to invest heavily in many commodity markets and may have contributed to distorted prices, price volatility, and hedging failures. In response, Congress has enacted a series of legislative acts to reduce excessive speculation in the commodity markets.[2]

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[1] See, e.g,, "The Role of Market Speculation in Rising Oil and Gas Prices: A Need to Put the Cop Back on the Beat," S. Prt. 109-65 (June 27, 2006); "Excessive Speculation in the Natural Gas Market," S. Hrg. 110-235 (June 25 and July 9, 2007), "Excessive Speculation in the Wheat Market," S. Hrg. 110-235 (June 25 and July 9, 2007); and "Excessive Speculation and Compliance with the Dodd-Frank Act," (November 3, 2011).

[2] See, e.g., CFTC Reauthorization Act of 2008, P.L. 110-246; Sections 727 and 737 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, P.L 111-203.

Permanent Subcommittee on Investigations
EXHIBIT #1d

For most of the 70 years they have been in existence, mutual funds were not significant participants in U.S. commodity markets. After the IRS began issuing private letter rulings in 2006, allowing them to engage in a variety of indirect commodity investments, however, mutual funds have poured billions of speculative dollars into commodity investments. Allowing mutual funds nearly unfettered access to commodity markets through these letter rulings appears to be contrary to Congressional intent and allows mutual funds to get around otherwise clear restrictions on their commodity investments.

Section 851's Income Source Restrictions. Mutual funds operate under a dual set of statutory restrictions, those provided by the Internal Revenue Code (IRC), which is enforced by the IRS, and those provided by the Investment Company Act of 1940 (1940 Act), which is overseen by the Securities and Exchange Commission (SEC). The tax provisions essentially restrict the types of income that mutual funds are allowed to claim in exchange for favorable tax treatment.[3] The income source restrictions are contained in Section 851(b)(2), which requires that 90% of a mutual funds' gross income must be derived from equities, securities, or currencies, and not more than 10% from alternatives like commodities.

Section 851(b)(2) defines the qualifying income in relevant part to include:

> "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 its business of investing in such stock, securities, or currencies."[4]

A "security" is defined under the 1940 Act 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."[5]

[3] Under the tax code, mutual funds that comply with the relevant tax provisions are not subjected to any taxation at the corporate level. Instead, all of the mutual fund's income is attributed to its shareholders who are then subject to tax on an individual basis. See IRC Subchapter M.

[4] IRC Section 851(b)(2).

[5] Investment Company Act of 1940, Section 2(a)(36).

Neither Section 851 nor the 1940 Act definition allows mutual funds to derive more than 10% of their income from commodities, whether through futures, forward contracts, options, swaps, notes, or other commodity-related products.

Significant Increase in Commodity Investment. To date, the IRS has issued 72 private letter rulings allowing mutual funds to treat income from investments in certain commodity linked notes or through controlled foreign corporations (CFCs) that invest in commodities as qualified income under Section 851(b)(2).[6] The letters hold that distributions from the commodity linked notes and dividends from the commodity-related CFCs can be treated as income derived from securities, rather than income derived from commodities, and thus, meet the income source restrictions in Section 851(b)(2). By treating this income as derived from securities rather than commodities, the IRS has enabled mutual funds to do indirectly what they are prohibited by law from doing directly.

Since 2006, the IRS private letter rulings have opened the floodgates for the $11 trillion mutual fund industry to make sizeable investments in the commodity markets. In a recent hearing, the Subcommittee identified at least 40 commodity related mutual funds with accumulated assets in excess of $50 billion.[7] These funds have all set up offshore wholly-owned CFCs that exist solely to trade commodities in the futures and swaps markets. The mutual funds typically organize their CFCs as Cayman Island subsidiaries; operate them as shell entities with no physical offices or employees of their own; and run the CFCs' commodity portfolios from their U.S. offices. That the Cayman CFCs are empty shells designed to allow U.S. mutual funds to create commodity related investment portfolios, run by their own U.S. employees, is openly acknowledged.

The sales materials of these mutual funds show they are marketing their funds to average investors as commodity funds and using their CFCs to delve into a wide array of commodity investments, from swaps to exchange traded notes to futures. The 40 mutual funds identified by the Subcommittee generally invest 25% of their total assets in their Cayman subsidiaries and often use U.S.-based assets as collateral or margin to secure the commodity investments being made by their CFCs in the futures and swap markets. In many instances, the mutual funds provide aggregate exposure to commodities as if 100% of the fund's net assets were invested in commodity related investments. Some mutual funds offer investors leveraged exposure to their commodity related investments. One mutual fund identified by the Subcommittee reported having over $22 billion invested in commodity related assets with approximately 900,000 investors, 75% of which are individuals.[8]

The IRS private letter rulings hold that when a mutual fund forms an offshore shell corporation, holds 100% of its stock, and then uses that CFC to invest in commodities, the mutual fund may treat this activity as an investment in the stock of the CFC and not as an investment in commodities. But the CFC is not an independent business; it is a shell corporation under the mutual fund's control. The mutual fund's investment in its CFC amounts to a paper exercise to permit the mutual fund itself to make commodity investments.

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[6] See "Excessive Speculation and Compliance with the Dodd-Frank Act," hearing before the U.S. Senate Permanent Subcommittee on Investigations (November 3, 2011) (hereinafter "Subcommittee Hearing"), Exhibit 7d.
[7] Subcommittee Hearing Exhibit 7a.
[8] Id., materials related to PIMCO Commodity Real Return Strategy Fund.

Some may contend that a 1943 Supreme Court case known as Moline Properties requires the IRS to recognize corporate structures such as the CFCs set up by mutual funds to invest in commodities.[9] But Moline Properties itself states:

> "In general, in matters relating to the revenue, the corporate form may be disregarded where it is a sham or unreal. In such situations the form is a bald and mischievous fiction. Higgins v. Smith, 308 U.S. 473, 477, 478 S., 60 S.Ct. 355, 357, 358; Gregory v. Helvering, 293 U.S. 465, 55 S.Ct. 266, 97 A.L.R. 1355."[10]

Mutual fund CFCs set up to invest in commodities are exactly the type of sham entities designed to perform a "bald and mischievous fiction" -- circumventing longstanding statutory income source restrictions -- that Moline Properties permits the IRS to disregard. That Supreme Court precedent, thus, does not require nor countenance the IRS' validating a corporate fiction or facilitating an end-run around the income source restrictions on mutual funds.

In addition to allowing mutual funds to use offshore shell entities to invest in commodities, IRS private letter rulings have permitted mutual funds to use commodity-linked notes to do the same. The private letters allow mutual funds to treat these notes as "securities" and deem the construction, funding, and sale of interests in those notes as securities investments, despite the fact that the notes are designed for the purpose of investing in commodities. This approach contradicts an earlier IRS Revenue Ruling which held that Congress did not intend to allow "an expansive construction of the term 'securities'" to enable mutual funds to invest in commodities.[11] In addition, the private letter rulings fail to take into account Congressional codification of the economic substance doctrine which permits the IRS to look through transactions that have no purpose other than tax avoidance.[12] In the private letter rulings issued by the IRS, the mutual funds offer no business purpose for creating offshore CFCs or constructing commodity-linked notes to make their commodity investments other than to characterize the resulting income as derived from "securities" and so retain their favored tax status while making unlimited commodity investments.[13] The IRS does not seem to recognize the mutual funds' commodity-linked notes and offshore CFCs for what they are – transactions with no purpose other than a tax purpose -- to enable mutual funds to circumvent the income source restrictions in Section 851(b)(2).

It is the Subcommittee's understanding that, before proceeding with their activities, each of the 40 commodity related mutual funds identified in the Subcommittee hearing obtained a private letter ruling from the IRS explicitly allowing it to treat any income from its commodity investments as security-based income under Section 851.[14] The IRS private letter rulings, thus,

[9] Moline Properties v. Commissioner of Internal Revenue, 319 U.S. 436 (1943).
[10] Id.
[11] See Rev. Rul. 2006-1, at 5.
[12] See Health Care and Education Reconciliation Act, P.L. 111-52, Section 1409, codified at IRC Section 7701(o).
[13] See, e.g., "IRS Implicitly Rules on Economic Substance Doctrine and Blockers," by David H. Shapiro and Jeffrey W. Maddrey, Tax Notes, 1461, 1462-63 (March 21, 2011)("[N]o mention is made of a business purpose in any of the rulings ... and it is hard to imagine that there could be a nontax purpose outweighing the tax purpose on the facts of the rulings").
[14] Each mutual fund needed to obtain its own ruling, because a taxpayer may not rely on a private letter ruling provided to another taxpayer. See IRC Section 6110(k)(3) and Section 11.02 of Revenue Procedure 2011-1.

contributed to the decision of those mutual funds to make speculative investments in commodity markets. Representatives of the mutual fund industry have told the Subcommittee that the industry intends to seek additional private letter rulings to further expand its investments in commodity-related products.

Conflicting with Congressional Intent on Commodities. Deeming commodity linked notes and commodity related offshore shell CFCs to be investments in securities rather than in commodities appears to conflict with Congressional intent and enable mutual funds to get around the otherwise clear restrictions of Section 851(b)(2) on their commodity investments.

When federal tax provisions for mutual funds were first enacted in 1936, Congress excluded commodities from the sources of qualifying income.[15] Income sources at that time were limited to dividends, interest, and gains from the sale or other disposition of stock or securities. Congress enacted the first federal law to control excessive speculation in commodity markets that same year.[16] Despite its work on the issue, Congress made no mention of commodities as an allowable investment for mutual funds in 1936. Instead, mutual funds were designed to provide a mechanism for investors of modest means to gain exposure to the securities markets.[17]

In 1954, when Congress enacted Subchapter M of the Internal Revenue Code reforming the taxation of mutual funds, Congress again expressed its intent to limit the sources of income that mutual funds could claim in exchange for favorable tax treatment. Subchapter M again limited the sources of qualifying income to income derived from dividends, interest, and gains from the sale or other disposition of stock or securities. As in 1936, Congress was clearly aware of the existence of commodity markets, but did not list commodity investments in the statute as one of the types of qualifying income.

In 1986, Congress expanded the list of sources of qualifying income under Section 851(b)(2), but for the third time, excluded investments in commodities.[18] The 1986 amendment provided an explicit list of additional sources of income that mutual funds could claim, adding "foreign currency, and other income (including but not limited to gains from options or futures contracts) derived with respect to its business of investing in such stock, securities, or currencies." Congress could have expanded the list further to include commodities, but chose not to do so.[19] Indeed, as the IRS noted in its Rev. Rule 2006-1 holding that a derivative contract referencing a commodity index was not a securities for purposes of Section 851, Congress did not intend "an expansive construction of the term 'securities.'"[20]

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[15] "The Federal income tax provisions applicable to mutual funds were first enacted in 1936. The basic structure of and principle of these provisions, which are found in subchapter M of the Internal Revenue Code, have remained unchanged." 132 Cong. Rec. 4045, 1986 (Remarks of Senator Armstrong)(March 7, 1986). In 1936, mutual funds were referred to as mutual investment companies.

[16] See the Commodity Exchange Act of 1936, P.L. 74-765.

[17] See 132 Cong. Rec. 4046 (Remarks of Senator Armstrong)(March 7, 1986).

[18] See Tax Reform Act of 1986, P.L. 99-514.

[19] See letter from Acting Assistant Secretary of the Treasury (Tax Policy) J. Roger Mentz, dated February 5, 1986, inserted into the Congressional Record by Senator Armstrong, at 132 Cong. Rec. 4046. Mr. Mentz's letter stated that Treasury would generally not treat as qualifying income gains from trading in commodities, even if the purpose of that trading was to hedge a related stock investment.

[20] Rev. Rul. 2006-1, at 5.

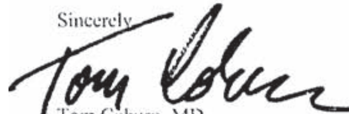
In 2010, Congress reaffirmed its intent to exclude commodities from the qualifying income of mutual funds when it enacted a bill to modernize statutory provisions affecting mutual funds, the Regulated Investment Company Modernization Act, P.L. 111-325. As originally introduced in 2009, and as passed by the House in 2010, Section 201(a) of that Act, then designated H.R. 4337, would have explicitly permitted mutual funds to invest in "commodities" under Section 851(b)(2). Several Senators expressed concern that allowing the $11 trillion mutual fund industry unrestricted commodity investments would exacerbate excessive speculation in the commodity markets and objected to the provision. In response, the provision was removed from the bill which was then approved by the Senate. Removal of the commodities provision was, in fact, the only change made in the House-passed bill. The House then agreed to the bill as amended by the Senate, enacting it into law while reaffirming Congressional intent to exclude commodities from the qualifying income for mutual funds.

Despite Congress' intent to limit mutual fund investment in commodities, the IRS has used its administrative authority to permit such investments. The resulting private letter rulings have unleashed a flood of speculative commodity investments that may have contributed to excessive speculation. The IRS should not use its private letter authority to enable mutual funds to do indirectly what the law does not permit them to do directly.

Requested Relief. This letter urges the IRS to take immediate action to permanently halt the further issuance of private letter rulings that allow mutual funds to circumvent the income source restrictions in IRC 851(b)(2) and make unlimited indirect investments in commodities. In addition, the IRS should reevaluate the tax treatment of all mutual funds currently allowed to treat indirect commodity investments as income derived from "securities" under Section 851.

Thank you for your consideration.

Sincerely,



Tom Coburn, MD
Ranking Minority Member
Permanent Subcommittee on Investigations

Carl Levin
Chairman
Permanent Subcommittee on Investigations

cc: The Honorable Tim Geithner, Secretary of the Treasury
Emily McMahon, Acting Assistant Treasury Secretary (Tax Policy)

Internal Revenue Service

Number: **200628001**
Release Date: 7/14/2006
Index Number: 851.02-00

Department of the Treasury
Washington, DC 20224

Person To Contact:
, ID No.

Telephone Number:

Refer Reply To:
CC:FIP:B02
PLR-100681-05

Date:
April 10, 2006

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Funds =

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Dear :

Permanent Subcommittee on Investigations
EXHIBIT #2a

This responds to the request dated January 3, 2005, and supplemental correspondence dated March 27, 2006, and April 6, 2006, submitted by your authorized representative on behalf of Funds. Funds request that the Internal Revenue Service rule that income and gain arising from the commodities-linked note described in this letter will constitute qualifying income to Funds under section 851(b)(2) of the Internal Revenue Code of 1986, as amended (the Code).

FACTS

Each Fund is registered as a management investment company under the Investment Company Act of 1940, 15 U.S.C. 80a-1 et seq., as amended (the 1940 Act). Each Fund intends to qualify as a regulated investment company (RIC) under Subchapter M, part 1 of the Code.

Each Fund intends to invest in commodities-linked notes having the terms and conditions of the following note ("Note"): The Note will be issued to a Fund at par value in increments of $x. Its payout formula will be determined with reference to Index. Its term will be one year and one day. A Fund, as holder of the Note, has the right to put the Note to the issuer at the calculated redemption price based on the closing Index as of the end of the next day after notification to the issuer. In addition, if the Index falls to a level that is equal to or more than y% below the beginning Index value on any day, the Note will "knockout" and automatically redeem based on the closing Index value of the next day. The repayment obligation upon early redemption, knockout, or at maturity is calculated by first multiplying (A) the face amount of the Note, by (B) a leverage factor of z, by (C) the percentage of the increase or decrease of the beginning Index level compared to the ending Index level for the applicable period. To this amount is added the face amount of the Note plus a coupon amount calculated at a w% rate times the face amount of the Note. From this amount is subtracted an annual fee amount of v basis points of the notional value (leveraged face amount) of the Note.

Funds make the following representations with respect to this Note:

(1) The issuer of the Note will receive payment in full of the purchase price of the Note substantially contemporaneously with the delivery of the Note;

(2) A Fund while holding the Note will not be required to make any payment to the issuer of the Note in addition to the purchase price paid for the Note, whether as margin, settlement payment, or otherwise, during the life of the Note or at maturity;

(3) The issuer of the Note is not subject by the terms of the instrument to mark-to-market margining requirements of the Commodities Exchange Act, 7 U.S.C. 2, as amended (CEA); and

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

LAW AND ANALYSIS

Section 851(b)(2) of the Code provides that a corporation shall not be considered a RIC for any taxable year unless it meets an income test (the "qualifying income requirement"). Under this test, at least 90 percent of its gross income must be derived from certain enumerated sources. Section 851(b)(2) defines qualifying income, in relevant part, as—

> 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 1940 Act) 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 . . . .

Section 2(a)(36) of the 1940 Act defines the term "security" as—

> 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.

Section 2(f)(1) of the CEA provides that the CEA is not applicable to a hybrid instrument that is predominantly a security. Section 2(f)(2) of the CEA provides that a hybrid instrument shall be 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 the 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;

(C) the issuer of the hybrid instrument is not subject by the terms of the instrument to mark-to-market margining requirements; and

(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.

Section 2(f)(3) of the CEA provides, in part, that for purposes of section 2(f)(2)(C) of the CEA, mark-to market margining requirements do not include the obligation of an issuer of a secured debt instrument to increase the amount of collateral held in pledge for the benefit of the purchaser of the secured debt instrument to secure the repayment obligations of the issuer under the secured debt instrument.

CONCLUSION

Based on the facts as represented, we rule that income and gain arising from the Note constitute qualifying income to Funds under section 851(b)(2) of the Code.

Sincerely,

William E. Coppersmith
William E. Coppersmith
Chief, Branch 2
Office of the Associate Chief Counsel
(Financial Institutions & Products)

Internal Revenue Service

Number: **200647017**
Release Date: 11/24/2006

Index Number: 851.02-00

Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication

Person To Contact:
, ID No.

Telephone Number:

Refer Reply To:
CC:FIP:B02
PLR-125782-06
Date: August 10, 2006

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Subsidiary =

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Permanent Subcommittee on Investigations
EXHIBIT #2b

Dear :

This responds to your request received May 17, 2006, and supplemental correspondence dated June 22, 2006, submitted by your authorized representative on behalf of Fund. Fund requests that the Internal Revenue Service rule that: 1) income and gain arising from the commodities-linked notes described in this letter will constitute qualifying income to Fund under section 851(b)(2) of the Internal Revenue Code of 1986, as amended; and 2) that income earned from the ownership of a wholly-owned subsidiary that is a controlled foreign corporation constitutes qualifying income to Fund under section 851(b)(2).

FACTS

Fund is organized as a State business trust and is registered as an open-end management investment company under the Investment Company Act of 1940, 15 U.S.C. 80a-1 et seq., as amended (the 1940 Act). Fund intends to qualify as a regulated investment company (RIC) under section 851.

Commodities-linked Notes

Fund intends to invest in commodities-linked notes having the terms and conditions of the following note (Note): The Note will be issued to a Fund at par value of $v. Its payout formula will be determined with reference to one of the following indices: Index 1, Index 2, Index 3, or Index 4 (Index). Its term will be nine months. Fund, as holder of the Note, has the right to request prepayment of the Note at any time at the calculated redemption price based on the closing Index on the trading day on which the request is received or, in certain circumstances, the next following trading day. In addition, if on any day, the closing price of the Index falls to a level that is at least w% below the closing price of the Index on the day the Note was issued, then a mandatory repayment of the Note is triggered and the Note will "knockout" and automatically redeem based on the closing Index value of the next trading day. The repayment obligation upon early redemption, knockout, or at maturity equals the face amount of the Note plus or minus the following adjustment. In calculating the adjustment, the face amount of the Note is multiplied by (A) a leverage factor of x, and by (B) the percentage increase or decrease of the closing price of the Index on the day the Note was issued as compared to its value on the applicable payment calculation date. The total is then adjusted to account for a coupon amount calculated at a y rate times the face amount of the Note, for an annual fee amount of z basis points of the notional value (leveraged face amount) of the Note, and for the reversal of an interest factor included in the Index.

Fund makes the following representations with respect to this Note:

(1) The issuer of the Note will receive payment in full of the purchase price of the Note substantially contemporaneously with the delivery of the Note;

(2) Fund while holding the Note will not be required to make any payment to the issuer of the Note in addition to the purchase price paid for the Note, whether as margin, settlement payment, or otherwise, during the life of the Note or at maturity;

(3) The issuer of the Note is not subject by the terms of the instrument to mark-to-market margining requirements of the Commodities Exchange Act, 7 U.S.C. 2, as amended (CEA); and

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

Controlled Foreign Corporation

Fund intends to form a wholly-owned subsidiary (Subsidiary) that will be a foreign corporation. Subsidiary will be incorporated as an exempted limited company under the laws of Country. Under the laws of Country, an exempted limited company provides for limited liability for all holders of shares. A shareholder's liability is limited to the amount, if any, unpaid with respect to the shares acquired by the shareholder. Subsidiary will file an election on Form 8832 to be taxed as a corporation pursuant to §301.7701-3 of the Procedure and Administration regulations.

Fund represents that, although Subsidiary will not be registered as an investment company under the 1940 Act, Subsidiary will comply with the requirements of section 18(f) of the 1940 Act, Investment Company Act Release No. 10666, and related SEC guidance pertaining to asset coverage with respect to transactions in commodity index swap agreements and other transactions in derivatives.

Fund will invest a portion of its assets in its Subsidiary, subject to the limitations set forth in section 851(b)(3). Subsidiary will invest in commodity and financial futures and options contracts, and fixed income securities that serve as collateral for these contracts. Subsidiary may also invest in cash-settled nondeliverable forward contracts.

It is expected that all of Subsidiary's income will be subpart F income; Fund may also receive income from Subsidiary, however, that is not properly characterized as subpart F income.

LAW AND ANALYSIS

Section 851(b)(2) provides that a corporation shall not be considered a RIC for any taxable year unless it meets an income test (the "qualifying income requirement"). Under this test, at least 90 percent of its gross income must be derived from certain enumerated sources. Section 851(b)(2) defines qualifying income, in relevant part, as—

> 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 1940 Act) 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 . . . .

Section 2(a)(36) of the 1940 Act defines the term "security" as—

> 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.

Section 2(f)(1) of the CEA provides that the CEA is not applicable to a hybrid instrument that is predominantly a security. Section 2(f)(2) of the CEA provides that a hybrid instrument shall be 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 the 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;

(C) the issuer of the hybrid instrument is not subject by the terms of the instrument to mark-to-market margining requirements; and

(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.

Section 2(f)(3) of the CEA provides, in part, that for purposes of section 2(f)(2)(C) of the CEA, mark-to-market margining requirements do not include the obligation of an issuer of a secured debt instrument to increase the amount of collateral held in pledge for the benefit of the purchaser of the secured debt instrument to secure the repayment obligations of the issuer under the secured debt instrument.

In addition, section 851(b) provides that, for purposes of section 851(b)(2), there shall be treated as dividends amounts included in gross income under section 951(a)(1)(A)(i) or 1293(a) for the taxable year to the extent that, under section 959(a)(1) or 1293(c) (as the case may be), there is a distribution out of the earnings and profits of the taxable year which are attributable to the amounts so included.

Section 957 defines a controlled foreign corporation (CFC) as any foreign corporation in which more than 50 percent of (1) the total combined voting power of all classes of stock entitled to vote, or (2) the total value of the stock is owned by United States shareholders on any day during the corporation's taxable year. A United States shareholder is defined in section 951(b) as a United States person who owns 10 percent or more of the total voting power of a foreign corporation. Fund will own 100 percent of the voting power of the stock of Subsidiary. Fund is a United States person. Subsidiary therefore will qualify as a CFC under these provisions.

Section 951(a)(1) provides that, if a foreign corporation is a CFC for an uninterrupted period of 30 days or more during any taxable year, every person who is a United States shareholder of this corporation and who owns stock in this corporation on the last day of the taxable year in which the corporation is a CFC shall include in gross income the sum of the shareholder's pro rata share of the CFC's subpart F income for the taxable year.

Section 952 defines subpart F income to include foreign base company income determined under section 954. Under section 954(a)(1), foreign base company income includes foreign personal holding company income determined under section 954(c). Section 954(c) defines foreign personal holding company income to include dividends, interest, royalties, rents, and annuities; gains in excess of losses from transactions (including futures, forward, and similar transactions) in any commodities; and net income from notional principal contracts not entered into for purposes of hedging any other described income item.

Subsidiary's investments may generate foreign personal holding company income under section 954(c), which is subpart F income. Fund would therefore include in income the sum of the pro rata share of Subsidiary's subpart F income for the taxable year in accordance with section 951.

CONCLUSION

Based on the facts as represented, we rule that income and gain arising from the Notes constitutes qualifying income to Fund under section 851(b)(2). We further rule that income derived by Fund from its investments in Subsidiary, whether or not attributable to subpart F income, is income derived with respect to Fund's business of investing in the stock of Subsidiary and thus constitutes qualifying income to Fund under section 851(b)(2).

This ruling is directed only to the taxpayer who requested it, and is limited to the facts as represented by the taxpayer. Section 6110(k)(3) provides that this letter may not be used or cited as precedent.

Sincerely,

Susan Thompson Baker
Susan Thompson Baker
Assistant to the Branch Chief, Branch 2
Office of Associate Chief Counsel
(Financial Institutions and Products)

Internal Revenue Service

Number: **200741004**
Release Date: 10/12/2007
Index Number: 851.02-00

Department of the Treasury
Washington, DC 20224

Person To Contact:
, ID No.
Telephone Number:

Refer Reply To:
CC:FIP:B02
PLR-112252-07
Date:
July 10, 2007

Legend:

Trust =

Fund A =

Fund B =

State A =

State B =

Country =

Dear :

This responds to your request dated March 8, 2007, and supplemental correspondence dated March 20, 2007, submitted by your authorized representative on behalf of Fund A and Fund B (each a "Fund," and collectively, the "Funds"). Funds request that the Internal Revenue Service rule that income arising from investments in its wholly-owned subsidiaries constitutes qualifying income for purposes of section 851(b)(2) of the Internal Revenue Code of 1986, as amended (the "Code").

FACTS

Fund A is organized as a series of Trust, a business trust organized under the laws of State A. Fund B is a statutory trust organized under the laws of State B. Each

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Fund is registered as an open-end management investment company (or series thereof) under the Investment Company Act of 1940, 15 U.S.C. 80a-1 et seq., as amended (the 1940 Act). Each Fund qualifies as a regulated investment company (RIC) under section 851 of the Code.

Each Fund has an investment objective of total return and pursues its investment objective by investing in commodity-linked derivative instruments backed by a portfolio of fixed-income securities.

Each Fund intends to form a wholly-owned subsidiary (each a "Subsidiary," and collectively the "Subsidiaries") that will be a foreign corporation. Each Subsidiary will be incorporated as an exempted limited company under the laws of Country. Under the laws of Country, an exempted limited company provides for limited liability for all holders of shares. A shareholder's liability is limited to the amount, if any, unpaid with respect to the shares acquired by the shareholder. Each Subsidiary will file an election on Form 8832, Entity Classification Election, to be taxed as a corporation pursuant to section 301.7701-3 of the Procedure and Administration Regulations.

Funds represent that, although the Subsidiaries will not be registered as investment companies under the 1940 Act, each Subsidiary will comply with the requirements of section 18(f) of the 1940 Act, Investment Company Act Release No. 10666, and related SEC guidance pertaining to asset coverage with respect to transactions in commodity index swap agreements and other transaction in derivatives.

Each of the Funds will invest a portion of its assets in its wholly-owned Subsidiary, subject to the limitations set forth in section 851(b)(3). Each Subsidiary is expected to invest in commodity futures and notional principal contracts but may also invest in other securities, debt or cash. It is expected that all of the Subsidiaries' income will be subpart F income. Each Fund, however, may also receive income from its Subsidiary that is not properly characterized as subpart F income.

LAW AND ANALYSIS

Section 851(b)(2) of the Code provides that a corporation shall not be considered a RIC for any taxable year unless it meets an income test (the "qualifying income requirement"). Under this test, at least 90 percent of its gross income must be derived from certain enumerated sources. Section 851(b)(2) defines qualifying income, in relevant part, as—

> 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 1940 Act) 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 . . . .

Section 851(b) of the Code further provides that, for purposes of section 851(b)(2), there shall be treated as dividends amounts included in gross income under section 951(a)(1)(A)(i) or section 1293(a) for the taxable year to the extent that, under section 959(a)(1) or section 1293(c) (as the case may be), there is a distribution out of the earnings and profits of the taxable year that are attributable to the amounts so included.

Section 957 of the Code defines a controlled foreign corporation ("CFC") as any foreign corporation in which more than 50 percent of (1) the total combined voting power of all classes of stock entitled to vote, or (2) the total value of the stock is owned by United States shareholders on any day during the corporation's taxable year. A United States shareholder is defined in section 951(b) as a United States person who owns 10 percent or more of the total voting power of a foreign corporation. Each Fund will own 100 percent of the voting power of its Subsidiary. Each Fund is a United States person. Each Subsidiary therefore will qualify as a CFC under these provisions.

Section 951(a)(1) provides that, if a foreign corporation is a CFC for an uninterrupted period of 30 days or more during any taxable year, every person who is a United States shareholder of this corporation and who owns stock in this corporation on the last day of the taxable year in which the corporation is a CFC shall include in gross income the sum of the shareholder's pro rata share of the CFC's subpart F income for the taxable year.

Section 952 of the Code defines subpart F income to include foreign base company income determined under section 954. Under section 954(a)(1), foreign base company income includes foreign personal holding company income determined under section 954(c). Section 954(c) defines foreign personal holding company income to include dividends, interest, royalties, rents, and annuities.

Subsidiaries' investments in commodity futures, notional principal contracts, debt, cash, and other securities will produce income that may generate foreign personal holding company income under section 954(c) of the Code, which is subpart F income. Each Fund would therefore include in income the sum of its respective pro rata shares of its Subsidiary's subpart F income for the taxable year in accordance with section 951.

Section 851(b) of the Code includes a specific rule providing dividend treatment for certain subpart F inclusions (those attributable to distributions out of earnings and profits). Subpart F inclusions also constitute RIC qualifying income under section 851(b)(2)(A), which states that qualifying income includes "other income ... derived with respect to [the RIC's] business of investing in ... stock, securities, or currencies" (the "other income rule").

The investment by each Fund in its Subsidiary, which is a corporation for federal income tax purposes, will be an investment in stock. Each Fund's income from its Subsidiary will be derived from its stock ownership and thus will be "income derived with respect to its business of investing in such stock" under the other income rule of section 851(b)(2)(A) of the Code.

CONCLUSION

We rule that income derived by each Fund from its investments in its wholly-owned Subsidiary is qualifying income to each Fund under section 851(b)(2) of the Code without regard to whether the income is subpart F income or is from another source and without regard to whether the income has been distributed.

No opinion is expressed as to whether each Fund qualifies as a RIC that is taxable under subchapter M, part I of the Code.

This ruling is directed only to the taxpayers who requested it. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.

Sincerely,

Susan Thompson Baker
Susan Thompson Baker
Assistant to the Branch Chief, Branch 2
Office of the Associate Chief Counsel
(Financial Institutions & Products)

Subchapter M—Regulated Investment Companies and Real Estate Investment Trusts

Part
I. Regulated investment companies.
II. Real estate investment trusts.
III. Provisions which apply to both regulated investment companies and real estate investment trusts.
IV. Real estate mortgage investment conduits.
[V. Repealed.]

AMENDMENTS

2004—Pub. L. 108-357, title VIII, §835(b)(12), Oct. 22, 2004, 118 Stat. 1594, struck out item for part V "Financial asset securitization investment trusts".

1996—Pub. L. 104-188, title I, §1621(c), Aug. 20, 1996, 110 Stat. 1867, added item for part V.

1988—Pub. L. 100-647, title I, §1018(u)(30), Nov. 10, 1988, 102 Stat. 3591, added item for part IV.

1978—Pub. L. 95-600, title III, §362(d)(8), Nov. 6, 1978, 92 Stat. 2852, added item for part III.

PART I—REGULATED INVESTMENT COMPANIES

Sec.
851. Definition of regulated investment company.
852. Taxation of regulated investment companies and their shareholders.
853. Foreign tax credit allowed to shareholders.
853A. Credits from tax credit bonds allowed to shareholders.
854. Limitations applicable to dividends received from regulated investment company.
855. Dividends paid by regulated investment company after close of taxable year.

AMENDMENTS

2009—Pub. L. 111-5, div. B, title I, §1541(b)(3), Feb. 17, 2009, 123 Stat. 362, added item 853A.

1980—Pub L. 96-223, title IV, §404(b)(7), Apr. 2, 1980, 94 Stat. 307, inserted "and taxable interest" after "dividends" in item 854 for taxable years after Dec. 31, 1980, and before Jan. 1, 1982.

1960—Pub. L. 86-779, §10(b)(1), Sept. 14, 1960, 74 Stat. 1008, inserted "and Real Estate Investment Trusts" in subchapter M heading, part I and part II designations thereunder and part I designation preceding table of sections numbered 851 to 855.

§851. Definition of regulated investment company

(a) General rule

For purposes of this subtitle, the term "regulated investment company" means any domestic corporation—

(1) which, at all times during the taxable year—

(A) is registered under the Investment Company Act of 1940, as amended (15 U.S.C. 80a-1 to 80b-2) as a management company or unit investment trust, or

(B) has in effect an election under such Act to be treated as a business development company, or

(2) which is a common trust fund or similar fund excluded by section 3(c)(3) of such Act (15 U.S.C. 80a-3(c)) from the definition of "investment company" and is not included in the definition of "common trust fund" by section 584(a).

(b) Limitations

A corporation shall not be considered a regulated investment company for any taxable year unless—

(1) it files with its return for the taxable year an election to be a regulated investment company or has made such election for a previous taxable year;

(2) at least 90 percent of its gross income is derived from—

(A) 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 its business of investing in such stock, securities, or currencies, and

(B) net income derived from an interest in a qualified publicly traded partnership (as defined in subsection (h)); and

(3) at the close of each quarter of the taxable year—

(A) at least 50 percent of the value of its total assets is represented by—

(i) cash and cash items (including receivables), Government securities and securities of other regulated investment companies, and

(ii) other securities for purposes of this calculation limited, except and to the extent provided in subsection (e), in respect of any one issuer to an amount not greater in value than 5 percent of the value of the total assets of the taxpayer and to not more than 10 percent of the outstanding voting securities of such issuer, and

(B) not more than 25 percent of the value of its total assets is invested in—

(i) the securities (other than Government securities or the securities of other regulated investment companies) of any one issuer,

(ii) the securities (other than the securities of other regulated investment companies) of two or more issuers which the taxpayer controls and which are determined, under regulations prescribed by the Secretary, to be engaged in the same or similar trades or businesses or related trades or businesses, or

(iii) the securities of one or more qualified publicly traded partnerships (as defined in subsection (h)).

For purposes of paragraph (2), there shall be treated as dividends amounts included in gross income under section 951(a)(1)(A)(i) or 1293(a) for the taxable year to the extent that, under section 959(a)(1) or 1293(c) (as the case may be), there is a distribution out of the earnings and profits of the taxable year which are attributable to the amounts so included. For purposes of paragraph (2), the Secretary may by regulation exclude from qualifying income foreign currency gains which are not directly related to the company's principal business of investing in stock or securities (or options and futures with respect to stock or securities). For purposes of paragraph (2), amounts excludable from gross income under section 103(a) shall be treated as included in gross income. Income derived from a

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partnership (other than a qualified publicly traded partnership as defined in subsection (h)) or trust shall be treated as described in paragraph (2) only to the extent such income is attributable to items of income of the partnership or trust (as the case may be) which would be described in paragraph (2) if realized by the regulated investment company in the same manner as realized by the partnership or trust.

(c) Rules applicable to subsection (b)(3)

For purposes of subsection (b)(3) and this subsection—

(1) In ascertaining the value of the taxpayer's investment in the securities of an issuer, for the purposes of subparagraph (B), there shall be included its proper proportion of the investment of any other corporation, a member of a controlled group, in the securities of such issuer, as determined under regulations prescribed by the Secretary.

(2) The term "controls" means the ownership in a corporation of 20 percent or more of the total combined voting power of all classes of stock entitled to vote.

(3) The term "controlled group" means one or more chains of corporations connected through stock ownership with the taxpayer if—

(A) 20 percent or more of the total combined voting power of all classes of stock entitled to vote of each of the corporations (except the taxpayer) is owned directly by one or more of the other corporations, and

(B) the taxpayer owns directly 20 percent or more of the total combined voting power of all classes of stock entitled to vote, of at least one of the other corporations.

(4) The term "value" means, with respect to securities (other than those of majority-owned subsidiaries) for which market quotations are readily available, the market value of such securities; and with respect to other securities and assets, fair value as determined in good faith by the board of directors, except that in the case of securities of majority-owned subsidiaries which are investment companies such fair value shall not exceed market value or asset value, whichever is higher.

(5) The term "outstanding voting securities of such issuer" shall include the equity securities of a qualified publicly traded partnership (as defined in subsection (h)).

(6) All other terms shall have the same meaning as when used in the Investment Company Act of 1940, as amended.

(d) Determination of status

(1) In general

A corporation which meets the requirements of subsections (b)(3) and (c) at the close of any quarter shall not lose its status as a regulated investment company because of a discrepancy during a subsequent quarter between the value of its various investments and such requirements unless such discrepancy exists immediately after the acquisition of any security or other property and is wholly or partly the result of such acquisition. A corporation which does not meet such requirements at the close of any quarter by reason of a discrepancy existing immediately after the acquisition of any security or other property which is wholly or partly the result of such acquisition during such quarter shall not lose its status for such quarter as a regulated investment company if such discrepancy is eliminated within 30 days after the close of such quarter and in such cases it shall be considered to have met such requirements at the close of such quarter for purposes of applying the preceding sentence.

(2) Special rules regarding failure to satisfy requirements

If paragraph (1) does not preserve a corporation's status as a regulated investment company for any particular quarter—

(A) In general

A corporation that fails to meet the requirements of subsection (b)(3) (other than a failure described in subparagraph (B)(i)) for such quarter shall nevertheless be considered to have satisfied the requirements of such subsection for such quarter if—

(i) following the corporation's identification of the failure to satisfy the requirements of such subsection for such quarter, a description of each asset that causes the corporation to fail to satisfy the requirements of such subsection at the close of such quarter is set forth in a schedule for such quarter filed in the manner provided by the Secretary,

(ii) the failure to meet the requirements of such subsection for such quarter is due to reasonable cause and not due to willful neglect, and

(iii)(I) the corporation disposes of the assets set forth on the schedule specified in clause (i) within 6 months after the last day of the quarter in which the corporation's identification of the failure to satisfy the requirements of such subsection occurred or such other time period prescribed by the Secretary and in the manner prescribed by the Secretary, or

(II) the requirements of such subsection are otherwise met within the time period specified in subclause (I).

(B) Rule for certain de minimis failures

A corporation that fails to meet the requirements of subsection (b)(3) for such quarter shall nevertheless be considered to have satisfied the requirements of such subsection for such quarter if—

(i) such failure is due to the ownership of assets the total value of which does not exceed the lesser of—

(I) 1 percent of the total value of the corporation's assets at the end of the quarter for which such measurement is done, or

(II) $10,000,000, and

(ii)(I) the corporation, following the identification of such failure, disposes of assets in order to meet the requirements of such subsection within 6 months after the last day of the quarter in which the corporation's identification of the failure to satisfy the requirements of such subsection occurred or such other time period

prescribed by the Secretary and in the manner prescribed by the Secretary, or

(II) the requirements of such subsection are otherwise met within the time period specified in subclause (I).

(C) Tax

(i) Tax imposed

If subparagraph (A) applies to a corporation for any quarter, there is hereby imposed on such corporation a tax in an amount equal to the greater of—

(I) $50,000, or

(II) the amount determined (pursuant to regulations promulgated by the Secretary) by multiplying the net income generated by the assets described in the schedule specified in subparagraph (A)(i) for the period specified in clause (ii) by the highest rate of tax specified in section 11.

(ii) Period

For purposes of clause (i)(II), the period described in this clause is the period beginning on the first date that the failure to satisfy the requirements of subsection (b)(3) occurs as a result of the ownership of such assets and ending on the earlier of the date on which the corporation disposes of such assets or the end of the first quarter when there is no longer a failure to satisfy such subsection.

(iii) Administrative provisions

For purposes of subtitle F, a tax imposed by this subparagraph shall be treated as an excise tax with respect to which the deficiency procedures of such subtitle apply.

(e) Investment companies furnishing capital to development corporations

(1) General rule

If the Securities and Exchange Commission determines, in accordance with regulations issued by it, and certifies to the Secretary not earlier than 60 days prior to the close of the taxable year of a management company or a business development company described in subsection (a)(1), that such investment company is principally engaged in the furnishing of capital to other corporations which are principally engaged in the development or exploitation of inventions, technological improvements, new processes, or products not previously generally available, such investment company may, in the computation of 50 percent of the value of its assets under subparagraph (A) of subsection (b)(3) for any quarter of such taxable year, include the value of any securities of an issuer, whether or not the investment company owns more than 10 percent of the outstanding voting securities of such issuer, the basis of which, when added to the basis of the investment company for securities of such issuer previously acquired, did not exceed 5 percent of the value of the total assets of the investment company at the time of the subsequent acquisition of securities. The preceding sentence shall not apply to the securities of an issuer if the investment company has continuously held any security of such issuer (or of any predecessor company of such issuer as determined under regulations prescribed by the Secretary) for 10 or more years preceding such quarter of such taxable year.

(2) Limitation

The provisions of this subsection shall not apply at the close of any quarter of a taxable year to an investment company if at the close of such quarter more than 25 percent of the value of its total assets is represented by securities of issuers with respect to each of which the investment company holds more than 10 percent of the outstanding voting securities of such issuer and in respect of each of which or any predecessor thereof the investment company has continuously held any security for 10 or more years preceding such quarter unless the value of its total assets so represented is reduced to 25 percent or less within 30 days after the close of such quarter.

(3) Determination of status

For purposes of this subsection, unless the Securities and Exchange Commission determines otherwise, a corporation shall be considered to be principally engaged in the development or exploitation of inventions, technological improvements, new processes, or products not previously generally available, for at least 10 years after the date of the first acquisition of any security in such corporation or any predecessor thereof by such investment company if at the date of such acquisition the corporation or its predecessor was principally so engaged, and an investment company shall be considered at any date to be furnishing capital to any company whose securities it holds if within 10 years prior to such date it has acquired any of such securities, or any securities surrendered in exchange therefor, from such other company or predecessor thereof. For purposes of the certification under this subsection, the Securities and Exchange Commission shall have authority to issue such rules, regulations and orders, and to conduct such investigations and hearings, either public or private, as it may deem appropriate.

(4) Definitions

The terms used in this subsection shall have the same meaning as in subsections (b)(3) and (c) of this section.

(f) Certain unit investment trusts

For purposes of this title—

(1) A unit investment trust (as defined in the Investment Company Act of 1940)—

(A) which is registered under such Act and issues periodic payment plan certificates (as defined in such Act) in one or more series,

(B) substantially all of the assets of which, as to all such series, consist of (i) securities issued by a single management company (as defined in such Act) and securities acquired pursuant to subparagraph (C), or (ii) securities issued by a single other corporation, and

(C) which has no power to invest in any other securities except securities issued by a single other management company, when permitted by such Act or the rules and regu-

lations of the Securities and Exchange Commission,

shall not be treated as a person.

(2) In the case of a unit investment trust described in paragraph (1)—

(A) each holder of an interest in such trust shall, to the extent of such interest, be treated as owning a proportionate share of the assets of such trust;

(B) the basis of the assets of such trust which are treated under subparagraph (A) as being owned by a holder of an interest in such trust shall be the same as the basis of his interest in such trust; and

(C) in determining the period for which the holder of an interest in such trust has held the assets of the trust which are treated under subparagraph (A) as being owned by him, there shall be included the period for which such holder has held his interest in such trust.

This subsection shall not apply in the case of a unit investment trust which is a segregated asset account under the insurance laws or regulations of a State.

(g) Special rule for series funds

(1) In general

In the case of a regulated investment company (within the meaning of subsection (a)) having more than one fund, each fund of such regulated investment company shall be treated as a separate corporation for purposes of this title (except with respect to the definitional requirement of subsection (a)).

(2) Fund defined

For purposes of paragraph (1) the term "fund" means a segregated portfolio of assets, the beneficial interests in which are owned by the holders of a class or series of stock of the regulated investment company that is preferred over all other classes or series in respect of such portfolio of assets.

(h) Qualified publicly traded partnership

For purposes of this section, the term "qualified publicly traded partnership" means a publicly traded partnership described in section 7704(b) other than a partnership which would satisfy the gross income requirements of section 7704(c)(2) if qualifying income included only income described in subsection (b)(2)(A).

(i) Failure to satisfy gross income test

(1) Disclosure requirement

A corporation that fails to meet the requirement of paragraph (2) of subsection (b) for any taxable year shall nevertheless be considered to have satisfied the requirement of such paragraph for such taxable year if—

(A) following the corporation's identification of the failure to meet such requirement for such taxable year, a description of each item of its gross income described in such paragraph is set forth in a schedule for such taxable year filed in the manner provided by the Secretary, and

(B) the failure to meet such requirement is due to reasonable cause and not due to willful neglect.

(2) Imposition of tax on failures

If paragraph (1) applies to a regulated investment company for any taxable year, there is hereby imposed on such company a tax in an amount equal to the excess of—

(A) the gross income of such company which is not derived from sources referred to in subsection (b)(2), over

(B) ⅑ of the gross income of such company which is derived from such sources.

MENTZ LETTER

DEPARTMENT OF THE TREASURY

Washington, DC

February 5, 1986.

Hon. RONNIE G. FLIPPO,

House of Representatives, Washington, DC.

DEAR MR. FLIPPO:

Thank you for your September 25, 1985, letter to former Assistant Secretary Pearlman requesting the Treasury Department's views on H.R. 3397. I apologize for the delay in responding.

H.R. 3397 would amend the provisions of the Internal Revenue Code relating to regulated investment companies ("RICs"). The amendments would remove a limitation on the short-term trading activities of RICs, expand and clarify the types of income that may be earned by RIC's revise and clarify the treatment of RICs organized in series form, and make other minor changes. In general, the Treasury Department supports H.R. 3397. We believe, however, that revisions are needed to narrow the amendment of the income source rules and to provide certain transition rules. Our comments on the specific provisions of H.R. 3397 are described below.

****

Sources of income of RICS. Section 851(b)(2) of the Code requires a RIC to derive at least 90 percent of its gross income from dividends, interest, payments with respect to securities loans, and gains from the sale or other disposition of stock or securities. This listing of qualifying income fails to include many types of investment-related income commonly received by RICs.

The Internal Revenue Service has often gone beyond the literal terms of the statute in order to give a reasonable interpretation to *section 851(b)(2)*. For example, the IRS has ruled privately that certain investment products will be treated as securities, gains from the sale or disposition of which will be qualifying income under *section 851(b)(2). See G.C.M. 37233 (August 25, 1977) (options on securities); G.C.M. 38994 (January 21, 1983)* (futures contracts on *securities); and G.C.M. 39316 (July 31, 1984)* (stock index futures, options on stock indexes, and options on stock index futures). In addition, the IRS

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has ruled both publicly and privately that the receipt of certain other kinds of income, although not qualifying under *section 851(b)(2)*, will not result in loss of RIC status. See *Rev. Rul. 64-247, 1.964-2__ C.B. 1-79* (recovery of excess management fees); *Rev. Rul. 74-248 1.974-1 C.S. 167* (recovery of damages from investment advisor for breach of fiduciary duty); *Ltr. Rul. 8530016 (April 24, 1985)* (recovery of state taxes). Despite the flexibility that has been shown by the IRS, RICs often can be certain of the treatment of various income items only by obtaining a private ruling from the IRS.

H.R. 3397 would amend *section 851(b)(2)* to expand the list of qualifying income of a RIC to include gains from the disposition of "foreign currency, and other income (including but not limited to gains from options or futures contracts) derived with respect to its business of investing in such stock, securities, or currencies." If *section 851(b)(3)* is repealed, additional pressure is placed on *section 851(b)(2)* to limit the types of activities in which RICs may engage. We believe it is essential that two limits on the activities of RICs be retained. First, income qualifying under *section 851(b)(2)* should be limited to income from property held for investment, as opposed to property held for sale to customers in the ordinary course of business. Second, income qualifying under *section 851(b)(2)* should be limited to income from stocks and securities, as opposed to other property. (The reimbursement or recovery of expenses and similar items should be treated as falling within these limits since they generally represent amounts that were offset against such income in past years.) For example, under the second limit, we would generally not treat as qualifying income gains from trading in commodities, even if the purpose of that trading is to hedge a related stock investment.

H.R. 3397 would treat foreign currency gains as income qualifying under *section 851(b)(2)* . Foreign currency is a commodity and not a security. The purchase and sale of a stock or security denominated in a foreign currency cannot be accomplished, however, without the purchase and sale of foreign currency. Hence, foreign currency gains and losses are an inherent part of any investment in foreign-currency denominated securities.

We believe that investments in foreign-currency denominated securities are the type of passive investments that should be permissible for RICs. Moreover, foreign currency investments that are made to hedge investments in foreign-currency denominated securities also appear to be an appropriate, part of the passive investment activity of RICs. Accordingly, we believe that foreign currency gains from investments in foreign-currency denominated securities and from hedging activities with respect to such securities should be treated as qualifying income under section 851(b)(2).

We question whether other foreign currency gains should be treated as qualifying income under *section 851(b)(3)*. We recognize, however, that attempting to distinguish between qualifying and nonqualifying foreign currency gains would be difficult. We are not prepared at this time to propose statutory rules that would draw the appropriate distinction. Consequently, we suggest that foreign currency gains be added to the list of qualifying income under *section 851(b)(2)*, but that Treasury be provided with regulatory authority to exclude from qualifying income any foreign currency gains that are not derived with respect to investment in a foreign-currency denominated security or from hedging activity with respect to such a security.

****

We appreciate the opportunity to comment on the provisions of H.R. 3397 and look forward to working with Congress toward legislative improvements in this area.

Sincerely,

J. ROGER MENTZ,
Acting Assistant Secretary
(Tax Policy).

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Internal Revenue Bulletin: 2006-2
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Rev. Rul. 2006-1

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Regulated investment company (RIC). A RIC's income from a derivative contract with respect to a commodity index is not qualifying income for purposes of section 851(b)(2) of the Code if the income from the contract is not derived with respect to the RIC's business of investing in stocks, securities, or currencies Such a contract is not a security for purposes of section 851(b)(2)

ISSUE

If a corporation enters into a derivative contract that provides for a total-return exposure on a commodity index, does income from the derivative contract satisfy the test described in section 851(b)(2) of the Internal Revenue Code?

FACTS

R is a management company registered under the Investment Company Act of 1940 (the "'40 Act"), 15 U.S.C. section 80a-1 *et seq.*, as amended, and has elected under section 851(b)(1) of the Code to be a regulated investment company (RIC) taxable under subchapter M, part I, of the Code. *R* invests substantially all of the funds it receives from shareholders in debt instruments. *R* also enters into contracts ("Derivatives") with various counterparties pursuant to Master Agreements under which it will pay an amount equal to the 3-month U.S. Treasury bill rate plus a spread and pursuant to which it will receive (or pay) an amount based on the total return gain (or loss) on a commodity index The aggregate amount of the index on which the return on the Derivatives is based is approximately equal to the aggregate amount *R* has invested in its debt instruments The payment obligation on each Derivative is settled monthly by the receipt (in the event of a gain) or payment (in the event of a loss) of cash, in the net amount due under the contract, and each monthly measuring period constitutes a separate derivative contract under the Master Agreements

LAW

Section 851(b)(2) of the Code provides that a corporation shall not be considered a RIC for any taxable year unless it meets an income test (the "qualifying income requirement"). Under this test, at least 90 percent of its gross income must be derived from certain enumerated sources.

In addition, section 851(b)(3) of the Code provides that a corporation shall not be considered a RIC for any taxable year unless it meets an asset test (the "asset test"). Under this test, at least 50 percent of its total assets must be represented by cash, cash items, Government securities, securities of other RICs, and "other securities." The "other securities" are generally limited with respect to any one issuer to an amount not greater than 5 percent of the value of the RIC's total assets and to not more than 10 percent of the outstanding voting securities of the issuer.

Prior to the enactment of the Tax Reform Act of 1986 (the "1986 Act"), section 851(b)(2) identified qualifying income as "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." Section 851 did not contain its own definition of the term "securities," but section 851(c)(5) provided that, for purposes of the asset test, "all other terms shall have the same meaning as when used" in the '40 Act

The 1986 Act expanded the definition of RIC qualifying income in a number of ways: by adding a cross-reference to the definition of "securities" in the '40 Act, by adding gains from the sale or other disposition of foreign currencies; and by adding an "other income" provision. As so amended, section 851(b)(2) defines qualifying income, in relevant part, as—

> 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 [the '40 Act]) 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 . . . .

Section 851(b) further provides that, for this purpose, "the Secretary may by regulation exclude from qualifying income foreign currency gains which are not directly related to the company's principal business of investing in stock or securities (or options and futures with respect to stock or securities)."

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The '40 Act defines "security" as—

> 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.

15 U.S.C. § 80a-2(a)(36) (2000).

ANALYSIS

1. *Definition of "securities."*

The Derivatives that *R* enters into are not stock, debt instruments, or currency (or options, futures, or forward contracts with respect to stock, debt instruments, or currency). Nevertheless, *R*'s income from the Derivatives may be "other income" if the Derivatives are "securities" for purposes of section 851(b)(2). This determination depends on the effect of the 1986 Act amendments to section 851(b)(2), which added the cross-reference to the definition of securities in the '40 Act.

There is no conclusive authority, however, as to whether derivative contracts on commodities are included in the '40 Act's definition of "securities." Accordingly, consideration of Congressional intent in enacting that cross-reference is helpful in determining whether commodity derivative contracts are securities for purposes of section 851(b)(2). Evidence of that intent may be found in the background to amendments to section 851(b)(2) in the 1986 Act. The amendments were added as a Senate floor amendment to the bill that eventually became the 1986 Act. The House and Senate committee reports, therefore, do not discuss these provisions, and the relevant discussion of the cross-reference in the report of the Conference Committee is extremely brief *See* H.R. Rep. No. 99-426 (1985) (not discussed); S. Rep. No. 99-313 (1986) (not discussed); 2 H.R. Conf. Rep. No. 99-841, at II-243 (1986) ("The Senate amendment clarifies the definition of 'securities' by reference to the definition of securities in the Investment Company Act of 1940.") Thus the best evidence of Congressional intent is found in the floor statement when the provision was added to the Senate bill and in other floor statements and Administration comments concerning related legislation

The legislative antecedents to the 1986 Act amendments included H R. 3397, which was introduced on September 20, 1985, by Representatives Flippo, Kennelly, and McGrath, and S. 2155, which was introduced on March 7, 1986, by Senator Armstrong. These bills proposed the "other income" provision and the cross-reference to the definition of security in the '40 Act The former change was to codify a series of letter rulings, and the latter was to reflect then-current Treasury Regulations. *See* 131 Cong. Rec 24,570 (1985) (section-by section analysis of H.R. 3397)

With respect to the definition of qualifying income, Senator Armstrong's floor amendment to the bill that became the 1986 Act was identical to S. 2155. In introducing S. 2155, Senator Armstrong explained that his bill incorporated "minor changes" to H.R. 3397 "to comply with recommendations of the Treasury Department, which has given its support for the Bill." 132 Cong Rec. 4045 (1986) (remarks of Senator Armstrong). Senator Armstrong concluded his remarks by inserting into the Congressional Record the letter from the Treasury Department that had recommended changes to H R 3397. *See id.* at 4046, 4047-48 (inserting a letter from Acting Assistant Secretary of the Treasury (Tax Policy) J. Roger Mentz, dated February 5, 1986).

Mr Mentz's letter explained the fundamental policy served by the qualifying income requirement:

> [I]t is essential that two limits on the activities of RICs be retained. First, income qualifying under section 851(b)(2) should be limited to income from property held for investment, as opposed to property held for sale to customers in the ordinary course of business. Second, income qualifying under section 851(b)(2) should be limited to income from stocks and securities, as opposed to other property. . . . For example, under that second limit, we would generally not treat as qualifying income gains from trading in commodities, even if the purpose of that trading is to hedge a related stock investment.

Id. at 4048.

The letter pointed out that the Service had "often gone beyond the literal terms of the statute in order to give a reasonable interpretation to [then-current] section 851(b)(2)," for example by granting letter rulings that certain investment products were securities, gains on the sale or disposition of which resulted in qualifying income. (The products explicitly mentioned were options on securities, futures contracts on securities, stock index futures, options on stock indices, and options on stock index futures.) The letter noted that, despite this flexibility, each RIC could be certain of the treatment of various income items only by obtaining its own letter ruling. *See id* at 4047-48. Thus, one justification for the amendments in H.R. 3397 appeared to be providing the needed certainty.

With respect to foreign currency gains, the Treasury letter stated:

> We believe that investments in foreign-currency denominated securities are the type of passive investments that should be permissible for RICs. Moreover, foreign currency investments that are made to hedge investments in foreign-currency denominated securities also appear to be an appropriate[] part of the passive investment activity of RICs. Accordingly, we believe that foreign currency gains from investments in foreign-currency denominated securities and from hedging activities with respect to such securities should be treated as qualifying income under section 851(b)(2).

Id at 4048.

The Treasury Department, however, was not prepared at that time to propose statutory rules that would distinguish between currency gains relating to investments in stocks or securities denominated in a foreign currency and other currency gains that Treasury believed should not be qualifying income under section 851(b)(2). The letter, therefore, suggested that foreign currency gains be added to the list of qualifying income but that

investment in a foreign-currency denominated security or from hedging activity with respect to such a security." *Id.*

When Senator Armstrong offered the relevant provision as an amendment on the Senate floor, he asserted that it "enjoys the support of the Treasury Department" and that its purpose was "to permit the mutual fund industry to make better use of income from stock options, futures contracts and options on stock ind[ic]es, options and futures o[n] foreign currencies, and foreign currency transactions." 132 Cong. Rec. 14,991-92 (1986).

This discussion demonstrates that the amendments to section 851(b)(2) made by the 1986 Act had a very specific purpose, which was to provide certainty by expanding the statutory description of qualifying income to include income that the Service, in specific cases, had already treated administratively as qualifying income. This included income from derivative contracts on stocks and securities (as the term "security" is generally understood in the U S tax law), such as futures and options on stock indices, which create an economic exposure to stock or securities even though the property underlying the derivative may be a collection of stocks and securities, rather than a specific stock or security.

The new rule regarding gains from foreign currencies (and options, futures or forward contracts on foreign currencies) was distinct from both the "other income" provision and the cross-reference to the definition of "security" in the '40 Act. Thus a separate provision both established the general rule that foreign currency gain is qualifying income and created specific regulatory authority to exclude any foreign currency gains that are not "directly related" to a RIC's "principal business of investing in stock or securities (or options and futures with respect to stock or securities)." The reason was that these gains were income from property other than stock or securities.

The foregoing indicates that Congress did not intend for the cross-reference to the '40 Act to incorporate into section 851(b)(2) an expansive construction of the term "securities " Particularly important was the specific inclusion in the 1986 amendment of foreign-currency-related gains. If the '40 Act were read expansively, there would be no need for special mention of these gains, because they would be included in the provision for "other income . . derived with respect to [the RIC's] business of investing in securities." Moreover, the authority given to Treasury to exclude from qualifying income "foreign currency gains which are not directly related to the company's principal business of investing in stock or securities" indicates that the reason for the special treatment for foreign currency was to facilitate a RIC's principal activity, namely investing in qualifying stock or securities, when the stock or securities are denominated in a foreign currency.

A construction of the term "securities" that excludes derivative contracts providing for a total return exposure to a commodity index is consistent with Congress' intent in amending section 851(b)(2) in 1986. Accordingly, because the underlying property is a commodity (or commodity index), the Derivatives that *R* enters into are not securities for purposes of section 851(b)(2).

2. *Application of the "other income" provision.*

R invests substantially all of the funds it receives from shareholders in debt instruments, which are securities for purposes of section 851(b)(2). Even though *R*'s Derivatives are not themselves securities for purposes of section 851(b)(2), income from the Derivatives counts toward the 90-percent test if it is "other income (including but not limited to gains from options, futures, or forward contracts) derived with respect to [*R*'s] business of investing in" stock, securities, or currencies.

R, however, does not enter into the Derivatives in connection with a business of investing in stock, securities, or currencies. Nor does *R* enter into the Derivatives in order to reduce or hedge the level of risk in a business of investing in stock, securities, or currencies *R*'s business is to create investment exposure to changes in *commodity* prices, and the Derivatives are the primary vehicle for doing so. *R* owns the debt instruments to facilitate its business of providing this commodity-derivative exposure. Because *R*'s Derivatives are not themselves securities and because *R* does not enter into those contracts with respect to a business of investing in stock, securities, or currencies, income from the Derivatives is not qualifying income for purposes of section 851(b)(2).

HOLDING

A derivative contract with respect to a commodity index is not a security for purposes of section 851(b)(2). Under the facts above, *R*'s income from such a contract is not qualifying income for purposes of section 851(b)(2) because the income from the contract is not derived with respect to *R*'s business of investing in stocks, securities or currencies.

PROSPECTIVE APPLICATION

Under the authority of section 7805(b)(8), the holding of this revenue ruling will not be applied adversely with respect to amounts of income that a taxpayer recognizes on or before June 30, 2006

DRAFTING INFORMATION

The principal author of this revenue ruling is Dale S. Collinson of the Office of the Associate Chief Counsel (Financial Institutions & Products). For further information regarding this revenue ruling, contact him at (202) 622-3900 or Susan Thompson Baker at (202) 622-3930 (not toll-free calls).

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IRS Implicitly Rules on Economic Substance Doctrine and Blockers

By David H. Shapiro and Jeffrey W. Maddrey

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The authors note that the IRS has recently issued more than 40 private letter rulings (on identical facts) that sanction the use of tax-motivated blockers. They assert that the rulings implicitly hold that the economic substance doctrine does not apply to those blockers, and they consider the potential importance of that implicit holding, following the enactment of section 7701(o).

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A mutual fund cannot generate "good RIC income"[1] by trading in commodities. The IRS made that abundantly clear in Rev. Rul. 2006-1,[2] and Congress purposefully refused to change that result when it enacted the Regulated Investment Company Modernization Act of 2010 at the end of last year.[3] Notwithstanding the clear prohibition on direct commodity trading by a fund under current law, it would appear that a fund can generate good RIC income by trading commodities in a wholly owned controlled foreign corporation created for this purpose. So the thinking goes: (i) a fund employing this strategy is not, itself, generating any income from commodity trading; (ii) the fund is still taxed on 100 percent of the commodity trading income by reason of subpart F[4]; and (iii) the subpart F inclusions are, themselves, items of good RIC income. The IRS has recently confirmed that result in more than 40 private letter rulings,[5] which explicitly rule that subpart F inclusions resulting from

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[1]That is, income described in section 851 that enables the company to qualify as a regulated investment company for tax purposes.

[2]2006-1 C.B. 261, *Doc 2005-25446, 2005 TNT 242-15*. The ruling comprehensively details the legislative history of the prohibition on commodity trading within RICs, describing how a senator inserted a letter from the assistant secretary of the Treasury into the *Congressional Record* that "explained the fundamental policy served by the qualifying income requirement." That letter stated, "It is essential that limits on the activities of RICs be retained. . . . Income qualifying [as good RIC income] should be limited to income from stocks and securities, as opposed to other property. . . . For example, under [the] limit, we would generally not treat as qualifying income gains from trading in commodities, even if the purpose of that trading is to hedge a related stock investment." *See also* Rev. Rul. 2006-31, 2006-1 C.B. 1133, *Doc 2006-10637, 2006 TNT 107-20*.

[3]Early versions of the RIC Modernization Act contained a provision that would allow RICs to trade commodities. *See* H.R. (Footnote continued in next column.) 4337, section 201 as originally introduced in the House on Dec. 16, 2009 (*Doc 2009-27636, 2009 TNT 240-29*). However, the provision was removed by a voice vote in the Senate. *See also* Letter of the Commodity Markets Oversight Coalition, dated Nov. 24, 2010, regarding the RIC Modernization Act, *available at* http://www.commoditymarketsoversight.org (last checked Feb. 23, 2011); Joint Committee on Taxation, "Technical Explanation of H.R. 4337, the 'Regulated Investment Company Modernization Act of 2010,' for Consideration on the floor of the House of Representatives," JCX-49-10 (Sept. 28, 2010), at 6-7, *Doc 2010-21178, 2010 TNT 188-22*. (Interestingly, the JCT report explicitly acknowledges that "the IRS also has held that income of a RIC derived from investments in commodities by a wholly owned foreign subsidiary of the RIC is qualifying income for purposes of the gross income test.")

[4]*See* section 954(c)(1)(C) (commodity trading income is "foreign personal holding company income"). The CFC is not, itself, taxed in the United States by reason of the commodity trading safe harbor in section 864(c).

[5]As of March 3, the following 44 private letter rulings have been publicly released. (Readers will note that they began as a trickle in the 2006-2008 period and that the pace picks up considerably in 2009-2011.) *See* LTR 200647017, *Doc 2006-23717, 2006 TNT 227-24*; LTR 200741004, *Doc 2007-22919, 2007 TNT 199-25*; LTR 200743005, *Doc 2007-23886, 2007 TNT 209-39*; LTR 200822010, *Doc 2008-11948, 2008 TNT 106-39*; LTR 200840039, *Doc 2008-21294, 2008 TNT 194-44*; LTR 200842014, *Doc 2008-22256, 2008 TNT 203-56*; LTR 200912003, *Doc 2009-6214, 2009 TNT 53-21*; LTR 200922010, *Doc 2009-12098, 2009 TNT 102-26*; LTR 200923011, *Doc 2009-12734, 2009 TNT 107-35*; LTR 200931003, *Doc 2009-17407, 2009 TNT 146-33*; LTR 200931008, *Doc 2009-17412, 2009 TNT 146-34*; LTR 200932007, *Doc 2009-17959, 2009 TNT 151-37*; LTR 200936002, *Doc 2009-19886, 2009 TNT 171-50*; LTR 200939017, *Doc 2009-21334, 2009 TNT 185-39*; LTR 200946036, *Doc 2009-25045, 2009 TNT 218-45*; LTR 200947026, *Doc 2009-25640, 2009 TNT 223-37*; LTR 200947032, *Doc 2009-25646, 2009 TNT 223-38*; LTR 201005023, *Doc 2010-2804, 2010 TNT 25-41*; LTR 201007044, *Doc 2010-3702, 2010 TNT 35-41*; LTR 201024004, *Doc 2010-13543, 2010 TNT 118-43*; LTR 201024003, *Doc 2010-13542, 2010 TNT 118-42*; LTR 201025031, *Doc 2010-14148, 2010 TNT 123-36*; LTR 201030004, *Doc 2010-16986, 2010 TNT 147-41*; LTR 201034011, *Doc 2010-19012, 2010*

(Footnote continued on next page.)

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commodity trading activity constitute good RIC income for the fund (the explicit holding).[6] Significantly, the IRS did not condition the favorable letter rulings on the existence of a nontax business purpose for the interposition of the CFCs. From the face of the rulings, it appears that the sole purpose for the interposition of the CFCs was to achieve the conversion effect — in other words, the CFCs were created to achieve a tax purpose.

Although the rulings do not mention the economic substance doctrine or section 269, they contain an implicit holding that the economic substance doctrine and section 269 do not apply (the Implicit Holding). There is simply no way to reach the good RIC income result without getting comfortable with the view that neither applies. Read fairly, the rulings countenance the overtly tax-motivated use of a CFC to, for lack of a better term, convert bad income (income from commodity trading) into good RIC income (subpart F inclusions). Stated differently, the rulings allow a fund to use a foreign corporation to engage in activities which, if performed directly, would generate a bad U.S. tax result. The nonapplication of the economic substance doctrine and section 269 are integral to the result and therefore implicit in the ruling.

The Implicit Holding is significant for three reasons.

First, the Implicit Holding marks an important evolutionary point in the IRS's administrative view of the role of business purpose where a corporation is interposed between a taxpayer and an activity that, absent tax concerns, would be undertaken directly by the taxpayer. Earlier, in three important rulings addressing the interposition of a foreign corporation between a tax-exempt entity and an activity that would give rise to unrelated business taxable income, the IRS ruled that the interposed corporation worked as intended.[7] However, those private rulings (like some earlier cases[8]) were conditioned on the patina of a nontax business purpose. In each of the UBTI rulings, the taxpayer represented four purposes, three of which were not tax related: (1) that the interposed corporation provides flexibility in disposing of underlying investments; (2) that the interposed corporation provides "further insulation" from liabilities arising from the investments; (3) that the interposed corporation will be able to manage investments more efficiently; and (4) that the interposed corporation will enable the tax-exempt investor to avoid earning UBTI.

Viewed objectively, the articulated business purposes in the UBTI rulings ring hollow, especially when weighed against the significant tax advantages derived from interposing the corporation. In the recent commodity CFC rulings, the IRS appears to have jettisoned the need for the taxpayers to represent that they had a nontax business purpose. With one exception,[9] no mention is made of a

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TNT 167-29; LTR 201037012, *Doc 2010-20380, 2010 TNT 181-38*; LTR 201037014, *Doc 2010-20382, 2010 TNT 181-39*; LTR 201039002, *Doc 2010-21438, 2010 TNT 191-52*; LTR 201041033, *Doc 2010-22482, 2010 TNT 200-35*; LTR 201042015, *Doc 2010-22921, 2010 TNT 205-34*; LTR 201042001, *Doc 2010-22907, 2010 TNT 205-33*; LTR 201043017, *Doc 2010-23437, 2010 TNT 210-34*; LTR 201048021, *Doc 2010-25739, 2010 TNT 233-43*; LTR 201048022, *Doc 2010-25740, 2010 TNT 233-44*; LTR 201049015, *Doc 2010-26343, 2010 TNT 238-36*; LTR 201051014, *Doc 2010-27368, 2010 TNT 248-24*; LTR 201102047, *Doc 2011-948, 2011 TNT 11-34*; LTR 201102055, *Doc 2011-956, 2011 TNT 11-33*; LTR 201103017, *Doc 2011-1373, 2011 TNT 15-58*; LTR 201103009, *Doc 2011-1365, 2011 TNT 15-57*; LTR 201103033, *Doc 2011-1389, 2011 TNT 15-60*; LTR 201104013, *Doc 2011-1932, 2011 TNT 20-45*; LTR 201107012, *Doc 2011-3560, 2011 TNT 35-33*; LTR 201108008, *Doc 2011-4012, 2011 TNT 39-47*; LTR 201108018, *Doc 2011-4022, 2011 TNT 39-48*. We would note that most of the rulings were issued after the enactment of section 7701(o).

[6]Some of the rulings also directly address the highly technical issue of whether a subpart F inclusion constitutes good RIC income when it is not accompanied by a distribution from the CFC. Dale Collinson wrote a thoughtful piece explaining that aspect of the rulings (which is not immediately apparent, at least to us, without Collinson's insights guiding the way). *See* Dale S. Collinson, "Qualifying Income of a RIC From Investment in a CFC," *Tax Notes*, Feb. 12, 2007, p. 673, *Doc 2007-1721*, or *2007 TNT 30-49*.

[7]*See* LTR 200251016, *Doc 2002-27816, 2002 TNT 246-32*; LTR 200252096, *Doc 2003-96, 2002 TNT 250-78*; and LTR 200315028, *Doc 2003-9318, 2003 TNT 71-41*.

[8]In *Siegal v. Commissioner*, 45 T.C. 566 (1966), *acq.* 1966-2 C.B. 3, a U.S. individual seeking to invest in a foreign partnership structured the investment through a newly organized, foreign corporation. Because the transaction occurred in a year before the enactment of the subpart F regime, if the corporation's role was respected and if section 269 did not apply, the taxpayer would be entitled to significant deferral (when compared to holding the partnership investment directly). The Tax Court held for the taxpayer on both economic substance and section 269 grounds. Significantly, the taxpayer offered the best nontax reasons he could for interposing the corporation (limit personal liability and protect against damage to his reputation, credit, and personal government license). The Tax Court found that the taxpayer "was in fact moved by these [nontax] considerations in substantial part" in interposing the foreign corporation, and thus did not view itself as addressing a situation in which the interposed corporation was solely tax-motivated. The court was, of course, aware of the heavy influence tax considerations had on the structure: "To be sure, we are not so naive as to think that tax consequences were not taken into account in organizing [the corporation], and the record suggests that tax considerations did play a part." 45 T.C. at 576.

[9]LTR 200743005, *supra* note 5, indicates that the fund will form the CFC "to enhance the performance of its portfolios and to better reflect the pricing of the commodities markets." None of the other LTRs articulates a similar purpose for creating or using the CFC. (The other LTRs do mention, in passing, that the fund will have limited liability in respect of activities conducted by the CFC. However, the LTRs do not suggest that that is a reason or purpose for the creation of the CFC.)

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business purpose in any of the rulings (in contrast to the UBTI rulings), and it is hard to imagine that there could be a nontax purpose outweighing the tax purpose on the facts of the rulings. The IRS did not force the taxpayers to concoct nontax reasons for the interposition of the corporation in the rulings — we all know why it is there; there is no reason to hide it. This is a small step (given the insignificance of the nontax purposes in the earlier situations), but it is nevertheless noteworthy.

Second, the Implicit Holding is even more significant for what it might say about the economic substance doctrine after the enactment of section 7701(o). The IRS previously challenged (on economic substance grounds) transactions between taxpayers and corporate subsidiaries formed solely for tax avoidance. For example, in *Northern Indiana Public Service Corporation*,[10] the IRS challenged (as lacking economic substance) a financing arrangement between a domestic corporation and its foreign finance subsidiary (formed solely to obtain specific tax benefits under a treaty). The Seventh Circuit labeled the commissioner's economic substance argument as "creative" but viewed it as an assault on the existence (from a tax perspective) of the subsidiary itself. Stated differently, the court interpreted the economic substance argument as an attempt by the IRS to disregard the existence of the corporation. The court did not accept the IRS argument, and citing *Moline Properties*, explicitly articulated the principle that a corporation will be respected "for tax purposes, *despite any tax-avoidance motive*, so long as the corporation engages in bona fide economically-based business transactions" (emphasis added).

Is *Northern Indiana* fairly read as a case in which the economic substance doctrine was applied using a "one-prong" test (that is, no business purpose is required for a corporation to be recognized), or as a situation in which the economic substance doctrine was not relevant to the question at hand? Obviously, after the enactment of section 7701(o), this question is critical. If the case involves a one-prong application of the economic substance doctrine, section 7701(o) would change the result. If the economic substance doctrine was not relevant to the court's holding, section 7701(o) would change nothing. The Implicit Holding in the commodity CFC rulings suggests that the economic substance doctrine is simply not relevant to the question.[11] In that regard, the rulings are an important step to defining and applying the economic substance doctrine rationally. The rulings could be read as confirming that the codified version of the doctrine does not swallow the entire body of tax law.

Third, the Implicit Holding is also significant for what it says about the IRS's approach to guidance regarding economic substance after the enactment of section 7701(o). Many have complained that the IRS has not published an "angel list" of transactions immune to economic substance attack. While we might appreciate a list that clearly delineates good transactions from bad, we realize that those lists are not the natural way tax law evolves. Much more natural is for the IRS to look at a *few* transactions in context and render its view in private rulings (or other forms of guidance). The IRS has clearly done that here. The 44-and-counting rulings have added another data point to the body of economic substance authorities from which all can reason.

Unfortunately, the fact that the Implicit Holding was implied (and therefore not discussed) limits its usefulness as a data point outside the narrow fact situation to which the rulings were addressed.[12] Without discussion of the economic substance doctrine in the text of the rulings, we are left to speculate about the principles guiding the rulings' conclusion. Why is it acceptable for RICs (and tax exempts) to use blockers? One can only guess. Perhaps the utilization of a blocker to convert the character of income and thereby avoid entity-level tax is simply an acceptable tax planning technique to which the economic substance doctrine does not apply.[13] Perhaps the idea is that the relevant operative provision is so easily avoided by other means, that the utilization of an offshore blocker is not to be viewed as an incremental abuse.[14] Perhaps the

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[10] 115 F.3d 506 (7th Cir. 1997), *Doc 97-16951, 97 TNT 111-17.*

[11] Indeed, perhaps the IRS concluded that the economic substance doctrine is so irrelevant, it's not even worthy of being discussed. We would lament that as tax professionals in private practice, Circular 230 does not afford us the same luxury.

[12] Indeed, we suspect that taxpayers will continue to seek new rulings, because the existing rulings don't explicitly discuss the economic substance doctrine or section 269, and therefore do not provide a mooring on which private practitioners can comfortably dock their own analysis on the issue. That fact emphasizes the critical importance of the IRS continuing to issue the rulings in "real time" — to ensure taxpayers can engage in an activity with which the IRS has no objection, but regarding which taxpayers cannot otherwise get comfortable by themselves.

[13] *See* discussion above.

[14] For example, tax-exempt investors can gain leverage through mutual funds, swaps, and short sales — so allowing them to access leverage through an investment partnership (via a foreign blocker) does not meaningfully change anything. Similarly, RICs can obtain commodity exposure by investing in 1940 act "securities" — so allowing them to access the same commodity exposure via a CFC does not provide them with a practical result they could not already achieve. The latter strategy has given rise to a whole other series of rulings, in the rulings themselves (and in a raft of other rulings).

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identity of the taxpayers (RICs and tax exempts) makes a difference. Are they simply "good" (from a normative perspective), in contrast to other sorts of taxpayers (like hedge funds, perhaps)? Perhaps the government views the relevant rules[15] as inappropriate and therefore is willing to tolerate tax-motivated structures to avoid their literal scope.

The problem with those guesses, of course, is that they reflect subjective judgments that only the IRS is free to make. At some level, this is the problem with the economic substance doctrine as a whole. In practice, the doctrine feels more like an aesthetic response to one-off situations, rather than a coherent body of law.[16] With economic substance, we all know it when we see it, or think we do.[17] But how are we to know, *ex ante*, that the situation in the rulings is not problematic? One might step back and ask:

> Here's a domestic corporation that might have earned income from commodity trading. The corporation would not qualify as a RIC because of this activity, and so all of the corporation's income would be subject to U.S. tax (it would receive no deduction when it paid a dividend, as it might if it were a RIC). This is by design, because RICs are not allowed to trade commodities. However, if the corporation earns the same income, indirectly, through a wholly owned subsidiary and via subpart F inclusions, it need not pay any tax on the income. Does this comport with the economic substance doctrine and section 269 when this taxpayer's status as a RIC was not clearly intended by Congress?[18]

We suspect that that question sends taxpayers to the IRS for rulings because they have difficulty answering it definitively by themselves. Precisely because taxpayers can't know beforehand, a private ruling process (in which Implicit Holdings of the type seen in the commodity rulings are rendered) is an appropriate and indeed necessary step in the Sisyphean effort to administer the scope of the doctrine. We can't get an angel list, but we will take what we can get — and we would submit that if the IRS is willing to make favorable calls (obviously, where appropriate) in the private ruling process, it would go a long way to administering the economic substance doctrine in a rational way.

Having said that, we respectfully suggest that after more than 40 private rulings, it's time to publish a revenue ruling (or revenue procedure) on the topic, if for no other reason than to free up taxpayer and IRS resources. It would also ensure horizontal equity in the broader tax system (by ensuring that similarly situated taxpayers are treated the same). We recognize that the idea of an implicit holding embedded within a revenue ruling regarding sections 269 and 7701(o) may create some discomfort within the government.[19] If so, we respectfully suggest that the revenue ruling take a step toward making the Implicit Holding more explicit. By expressly articulating the rationale for the Implicit Holding, it would limit the potential that it can be used in ways the government finds objectionable. Furthermore, there seems little harm now that the administrative practice on this point has been set. Note that the JCT's explanation of section 7701(o) provides:

> The provision is not intended to alter the tax treatment of certain basic business 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. Among these basic transactions is . . . a U.S. person's choice between utilizing a foreign corporation or a domestic corporation to make a foreign investment.[20] [Emphasis added.]

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[15]That is, the rules prohibiting debt-financed investments by tax exempts and commodity trading by RICs.

[16]Joseph Isenberg, "Musing on Form and Substance in Taxation," 49 *U. Chi. L. Rev.* 859, 874 (1982) (criticizing early economic substance doctrine cases as "encapsulat[ing] in the end an essentially aesthetic response to attempts by taxpayers thought unworthy of success").

[17]*See* Monte A. Jackel, "The Dawn of a New Era: Congress Codifies Economic Substance," *Tax Notes*, Apr. 19, 2010, p. 289, *Doc 2010-6878*, or *2010 TNT 75-3*; and David P. Hariton, "The Frame Game: How Defining the 'Transaction' Decides the Case," 63 *Tax Law.* 1 (Fall 2009).

[18]*See supra* notes 2 and 3.

[19]Perhaps the IRS is imagining scenarios in which income that would otherwise be taxed in the United States is not taxed, by reason of conducting the same activity in a foreign corporation — a result that is, effectively, the same result sanctioned by the rulings. David S. Miller recently catalogued a number of those situations at the NYU Colloquium on Tax Policy and Public Finance. *See* David S. Miller, "Unintended Consequences: How U.S. Tax Law Encourages Investment in Offshore Tax Havens," Feb. 3, 2011. For example, an individual might avoid the 2 percent limitation on miscellaneous itemized deductions (and the AMT limit on those deductions) if he organizes a CFC to hold securities and pay the management fee. Miller also suggests foreign blockers might be used (among other things) to avoid the TMP rules, to avoid COD income, and to reduce "unearned income" subject to Medicare tax.

[20]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 (Mar. 21, 2010), at 152-153, *Doc 2010-6147*, *2010 TNT 55-23*. We would observe that the JCT report on the RIC Modernization Act (see footnote 3, *supra*) explicitly acknowledges that "the IRS also has held that income of a RIC derived from investments in

(Footnote continued on next page.)

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One may wonder if the volume of the rulings already represents the sort of "longstanding administrative practice" to which the JCT is referring.[21] Regardless of the answer, after more than 40 private letter rulings (and counting), would articulating the Implicit Holding in published guidance really be such a big step?

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commodities by a wholly owned foreign subsidiary of the RIC is qualifying income for purposes of the gross income test." That statement was made in the JCT's description of "present law" (after the enactment of section 7701(o)). That might suggest that the JCT agrees with the Implicit Holding.

[21]Can administrative practice become "long-standing" based on volume alone? If so, 40 separately considered rulings would appear to cement current administrative practice. Or can administrative practice only become longstanding through the passage of time? When the JCT used the word "long-standing," did it really mean "well settled"? Of course, tax motivated "blockers" have been used for a long time — a point often recognized on Capitol Hill (usually with regret) as legal. For a recent recognition of that, see, *e.g.*, Opening Statement of Senator Charles Grassley at the nomination hearing of Jeffrey Goldstein for Treasury Undersecretary, Mar. 2, 2010, *Doc 2010-4488, 2010 TNT 41-27*. ("This committee has held hearings on the use of offshore blocker corporations [on September 26, 2007]. We learned that . . . more than 12,000 businesses . . . in the Cayman Islands had *no purpose for being there other than tax avoidance*. Similarly, the private equity firm of which [the nominee] was a managing director set up blocker corporations . . . *While it is not illegal to utilize such corporations*, these arrangements have been the subject of much debate and discussion") (emphasis added).

Sequencing Tax Reform

By James Q. Riordan Sr.

James Q. Riordan Sr. is a former staff member of the House Ways and Means Committee, worked in the Justice Department's Tax Division, is the former chair of the Tax Foundation, and is a former vice chair of Mobil Oil.

Riordan suggests sequencing tax reform efforts in three parts: first, reforming the income tax base; second, reducing the bias against savings; and third, eliminating tax expenditures.

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Introduction

Sequencing the tax reform effort will be the key to success.

Congress should first reform the income tax base to simplify it, reduce its bias against savings, and eliminate tax expenditures. It should do that on a revenue neutral/progressivity neutral basis. Once the tax base is reformed, Congress should achieve its revenue targets and progressivity targets through the tax rate structure — not through tax base manipulation.

Adoption of a VAT will help Congress achieve its revenue target and will permit less reliance on the income tax (making it easier to reform the income tax base). Congress can achieve any progressivity target it chooses for the total system through the progressive rate structure of the income tax.

Discussion

There are three separate challenges that need to be addressed by Congress in the next two years:

1. agree on caps for spending and revenue as a percentage of GDP to get control of the deficit;

2. agree on how much progressivity it wants to achieve in the total tax system and how best to measure and achieve it; and

3. reform the tax system to make it simpler and less biased against savings, and to accomplish other needed improvements.

Most informed commentators agree that it will be more difficult to accomplish any of those three tasks if Congress attempts them as a part of a single effort. The work should be split into three segments.

The tax reform effort should begin now on a revenue-neutral, progressivity-neutral basis. The tax base needs to be reformed regardless of the targets Congress ultimately sets for total revenue and progressivity.

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TECHNICAL EXPLANATION OF H.R. 4337, THE "REGULATED INVESTMENT COMPANY MODERNIZATION ACT OF 2010," FOR CONSIDERATION ON THE FLOOR OF THE HOUSE OF REPRESENTATIVES

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION

September 28, 2010
JCX-49-10

Permanent Subcommittee on Investigations
EXHIBIT #4a

III. MODIFICATION OF GROSS INCOME AND ASSET TESTS OF RICS

A. Income From Commodities Counted Toward Gross Income Test of RICs (sec. 201 of the bill and sec. 851(b) of the Code)

Present Law

A RIC must derive 90 percent of its gross income for a taxable year from certain types of income.[16] These types of income ("qualifying income") are (1) 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)[17] or foreign currencies, or other income (including but not limited to gains from options, futures or forward contracts) derived with respect to the business of investing in such stock, securities, or currencies, and (2) net income derived from an interest in a qualified publicly traded partnership.[18]

In general, because direct investments in commodities are not "securities" under section 2(a)(36) of the Investment Company Act of 1940, they do not generate "qualifying income" for purposes of the 90 percent gross income test. Similarly, the IRS has ruled that derivative contracts with respect to commodity indexes are not securities for the purposes of the gross income tests.[19] On the other hand, in a series of private rulings, the IRS has held that certain notes, with payout formulas determined with reference to a commodities index, produce qualifying income for purposes of the gross income test.[20] The IRS also has held that income of a RIC derived from investments in commodities by a wholly owned foreign subsidiary of the RIC is qualifying income for purposes of the gross income test.[21]

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[16] Sec. 851(b)(2).

[17] Section 2(a)(36) of the Investment Company Act of 1940 defines a "security" as "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."

[18] A "qualified publicly traded partnership" means a publicly traded partnership (within the meaning of section 7704(b)), other than a publicly traded partnership whose gross income is qualifying income (other than income of another publicly traded partnership). Sec. 851(h).

[19] See Rev. Rul. 2006-31, 2006-1 C.B. 1133.

[20] See, e.g., PLRs 201031007, 200822012, 200705026, 200701020, 200647017, 200637018, 200628001.

[21] See, e.g., PLRs 200936002, 200932007.

The Secretary has the regulatory authority to exclude from qualifying income foreign currency gains which are not directly related to the RIC's principal business of investing in stock or securities (or options and futures with respect to stock or securities).[22]

Explanation of Provision

The provision modifies the qualifying income test to provide that (i) a RIC's gains from the sale or other disposition of commodities and (ii) other income of a RIC (including but not limited to gains from options, futures or forward contracts) derived with respect to its business of investing in commodities, are qualifying income for purposes of the gross income test. As a result, income earned by a RIC from derivative contracts with respect to commodity indices will be qualifying income for purposes of the gross income test.[23] In general, these changes are not intended to change the present law treatment of RICs' income from foreign currencies. However because the provision allows RICs to derive qualifying income from investments in commodities (including foreign currencies), the provision repeals the regulatory authority given to the Secretary to exclude certain foreign currency gains from qualifying income.[24]

Effective Date

The provision is effective for taxable years beginning after the date of enactment.

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[22] Sec. 851(b)(3).

[23] Cf. Rev. Rul. 2006-31, 2006-1 C.B. 1133 (holding that a RIC's income from a derivative contract with respect to a commodity index is not qualifying income for purposes of section 851(b)(2), because the income from the contract is not derived with respect to the RIC's business of investing in stocks, securities, or currencies.)

[24] The bill contains several conforming amendments to retain the present law definition of qualifying income for purposes of provisions relating to publicly traded partnerships.

(2) EFFECTIVE DATE.—The amendments made by paragraph (1) shall apply with respect to amounts allotted under section 1149 of the Social Security Act for payment for a fiscal year after fiscal year 2010.

The SPEAKER pro tempore. Pursuant to the rule, the gentleman from Tennessee (Mr. TANNER) and the gentleman from Texas (Mr. SAM JOHNSON) each will control 20 minutes.

The Chair recognizes the gentleman from Tennessee.

GENERAL LEAVE

Mr. TANNER. Madam Speaker, I ask unanimous consent that all Members have 5 legislative days in which to revise and extend their remarks on the bill under consideration.

The SPEAKER pro tempore. Is there objection to the request of the gentleman from Tennessee?

There was no objection.

Mr. TANNER. Madam Speaker, I yield myself as much time as I may consume.

This bill is an extension of two very important provisions of the Ticket to Work Act of 1999 which basically helps disabled Americans return to work when, and if, they can. This has been a bipartisan team effort I was pleased to work on with Mr. JOHNSON some time ago. The bill has no direct spending and complies with pay-as-you-go rules.

I am pleased to support this important extension of two programs from the bipartisan Ticket to Work Act of 1999, which was introduced by my colleagues EARL POMEROY, JIM MCDERMOTT, and SAM JOHNSON.

This has been a bipartisan, collaborative effort to ensure that two important programs that help disabled Americans return to work continue for another year, and I thank my colleagues for their good work on this issue.

The Work Incentives Planning and Assistance program (WIPA) provides $23 million for community-based organizations to provide personalized assistance to help Supplemental Security Income (SSI) and Social Security Disability Insurance (DI) recipients understand Social Security's complex work incentive policies and the effect that working will have on their benefits. In 2009, WIPA assisted over 37,000 SSI and DI beneficiaries who wanted to return to work.

The Protection and Advocacy for Beneficiaries of Social Security (PABSS) program provides $7 million in grants to designated Protection and Advocacy Systems to provide legal advocacy services that beneficiaries need to secure, maintain, or regain employment. In 2009, PABSS served nearly 9,000 beneficiaries.

If Congress does not extend these programs by the end of October, the Social Security Administration has told us there may be a lapse in service to beneficiaries, so it's important that we act now.

The bill also includes two commonsense, good-government changes to increase accountability and make the WIPA program more efficient.

First, we add a requirement that all WIPA grantees report data to the Social Security Administration about the beneficiaries they serve and the kinds of help they provided, the same requirement that current PABSS grantees have.

Good data is critical to our efforts to make sure that taxpayer funds to WIPAs are well-spent.

It also helps us learn more about what kind of help disabled beneficiaries may need if they are able to return to work, which will allow us to make other improvements in future legislation.

Second, this legislation would allow all WIPA grantees to carry over 10 percent of their funding into the next year, a change originally proposed by the Obama Administration. This change will allow for better and more consistent budgeting instead of encouraging end-of-year spending.

By extending WIPA and PABSS for a year, we reaffirm our commitment to these important work support programs while also acknowledging the need to consider policy and funding changes in the near future.

I urge my colleagues to support this bipartisan, commonsense legislation.

I reserve the balance of my time.

Mr. SAM JOHNSON of Texas. Madam Speaker, I yield myself such time as I may consume.

I rise today in support of the passage of this legislation, and I think the Supplemental Security Income and Social Security disability benefit programs provide an essential income safety net for people with disabilities.

Yet these programs face a real fiscal challenge. Waste, fraud and abuse continues to threaten public confidence. Most importantly the disability program will not be able to pay full benefits beginning just eight years from now in 2018.

Those who depend on these critical benefits are counting on us to act. They want answers and we must turn to these issues without delay.

With respect to the legislation we are considering today, just over 10 years ago Congress passed The Ticket to Work and Work Incentives Improvement Act to help those with disabilities get back to work.

The two grant programs we would reauthorize today were created as part of that landmark legislation.

One of the grant programs, The Work Incentives Planning Assistance Program funds community-based organizations to assist those receiving benefits to find work as well as understand Social Security's complex rules and the effect of working on their benefits, their health care and on other public benefits they may receive.

Today there are a total of 103 community-based cooperative agreements in all 50 States. Last year these programs served over 37,000 people.

One example is The Work Incentive Planning Assistance Program of Easter Seals North Texas which serves 19 counties in the north Texas area, including my district. Thanks to their hard work, so far this year over 20 percent of their caseload has jobs.

The other grant program, The Protection and Advocacy Program for Beneficiaries of Social Security Program funds 57 grant programs covering all 50 States. These programs served almost 9,000 people last year, helping those working or trying to work by assisting in the resolution of potential disputes, including those with their employer.

The authorized funding level included in the bill for these two programs is $30 million. This funding level has remained constant since these programs were created.

While I support a one-year extension of these two important programs, I am disappointed that our Subcommittee has not continued the work it began in May of last year when we learned that Social Security's Ticket to Work Program wasn't working as we would like.

Despite some signs of improvement since new rules were issued, now more than ever, we need to look at how every taxpayer dollar is spent. No matter how well intended these programs are, at the end of the day taxpayers deserve to know if they are getting their money's worth. Programs that don't work must be changed or must end.

I urge all my colleagues to vote yes.

I yield back the balance of my time.

Mr. TANNER. I yield back the balance of my time.

The SPEAKER pro tempore. The question is on the motion offered by the gentleman from Tennessee (Mr. TANNER) that the House suspend the rules and pass the bill, H.R. 6200.

The question was taken; and (two-thirds being in the affirmative) the rules were suspended and the bill was passed.

A motion to reconsider was laid on the table.

REGULATED INVESTMENT COMPANY MODERNIZATION ACT OF 2010

Mr. NEAL. Madam Speaker, I move to suspend the rules and pass the bill (H.R. 4337) to amend the Internal Revenue Code of 1986 to modify certain rules applicable to regulated investment companies, and for other purposes, as amended.

The Clerk read the title of the bill.

The text of the bill is as follows:

H.R. 4337

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE, ETC.

(a) SHORT TITLE.—This Act may be cited as the "Regulated Investment Company Modernization Act of 2010".

(b) REFERENCE.—Except as otherwise expressly provided, whenever in this Act an amendment or repeal is expressed in terms of an amendment to, or repeal of, a section or other provision, the reference shall be considered to be made to a section or other provision of the Internal Revenue Code of 1986.

(c) TABLE OF CONTENTS.—The table of contents for this Act is as follows:

Sec. 1. Short title, etc.

TITLE I—CAPITAL LOSS CARRYOVERS OF REGULATED INVESTMENT COMPANIES

Sec. 101. Capital loss carryovers of regulated investment companies.

TITLE II—MODIFICATION OF GROSS INCOME AND ASSET TESTS OF REGULATED INVESTMENT COMPANIES

Sec. 201. Income from commodities counted toward gross income test of regulated investment companies.

Sec. 202. Savings provisions for failures of regulated investment companies to satisfy gross income and asset tests.

Permanent Subcommittee on Investigations

EXHIBIT #4b

TITLE III—MODIFICATION OF RULES RELATED TO DIVIDENDS AND OTHER DISTRIBUTIONS

Sec. 301. Modification of dividend designation requirements and allocation rules for regulated investment companies.
Sec. 302. Earnings and profits of regulated investment companies.
Sec. 303. Pass-thru of exempt-interest dividends and foreign tax credits in fund of funds structure.
Sec. 304. Modification of rules for spillover dividends of regulated investment companies.
Sec. 305. Return of capital distributions of regulated investment companies.
Sec. 306. Distributions in redemption of stock of a regulated investment company.
Sec. 307. Repeal of preferential dividend rule for publicly offered regulated investment companies.
Sec. 308. Elective deferral of certain late-year losses of regulated investment companies.
Sec. 309. Exception to holding period requirement for certain regularly declared exempt-interest dividends.

TITLE IV—MODIFICATIONS RELATED TO EXCISE TAX APPLICABLE TO REGULATED INVESTMENT COMPANIES

Sec. 401. Excise tax exemption for certain regulated investment companies owned by tax exempt entities.
Sec. 402. Deferral of certain gains and losses of regulated investment companies for excise tax purposes.
Sec. 403. Distributed amount for excise tax purposes determined on basis of taxes paid by regulated investment company.
Sec. 404. Increase in required distribution of capital gain net income.

TITLE V—OTHER PROVISIONS

Sec. 501. Repeal of assessable penalty with respect to liability for tax of regulated investment companies.
Sec. 502. Modification of sales load basis deferral rule for regulated investment companies.

TITLE VI—PAYGO COMPLIANCE

Sec. 601. Paygo compliance.

TITLE I—CAPITAL LOSS CARRYOVERS OF REGULATED INVESTMENT COMPANIES

SEC. 101. CAPITAL LOSS CARRYOVERS OF REGULATED INVESTMENT COMPANIES.

(a) IN GENERAL.—Subsection (a) of section 1212 is amended by redesignating paragraph (3) as paragraph (4) and by inserting after paragraph (2) the following new paragraph:

"(3) REGULATED INVESTMENT COMPANIES.—

"(A) IN GENERAL.—If a regulated investment company has a net capital loss for any taxable year—

"(i) paragraph (1) shall not apply to such loss,

"(ii) the excess of the net short-term capital loss over the net long-term capital gain for such year shall be a short-term capital loss arising on the first day of the next taxable year, and

"(iii) the excess of the net long-term capital loss over the net short-term capital gain for such year shall be a long-term capital loss arising on the first day of the next taxable year.

"(B) COORDINATION WITH GENERAL RULE.—If a net capital loss to which paragraph (1) applies is carried over to a taxable year of a regulated investment company—

"(i) LOSSES TO WHICH THIS PARAGRAPH APPLIES.—Clauses (ii) and (iii) of subparagraph (A) shall be applied without regard to any amount treated as a short-term capital loss under paragraph (1).

"(ii) LOSSES TO WHICH GENERAL RULE APPLIES.—Paragraph (1) shall be applied by substituting 'net capital loss for the loss year or any taxable year thereafter (other than a net capital loss to which paragraph (3)(A) applies)' for 'net capital loss for the loss year or any taxable year thereafter'.".

(b) CONFORMING AMENDMENTS.—

(1) Subparagraph (C) of section 1212(a)(1) is amended to read as follows:

"(C) a capital loss carryover to each of the 10 taxable years succeeding the loss year, but only to the extent such loss is attributable to a foreign expropriation loss,".

(2) Paragraph (10) of section 1222 is amended by striking "section 1212" and inserting "section 1212(a)(1)".

(c) EFFECTIVE DATE.—

(1) IN GENERAL.—Except as provided in paragraph (2), the amendments made by this section shall apply to net capital losses for taxable years beginning after the date of the enactment of this Act.

(2) COORDINATION RULES.—Subparagraph (B) of section 1212(a)(3) of the Internal Revenue Code of 1986, as added by this section, shall apply to taxable years beginning after the date of the enactment of this Act.

TITLE II—MODIFICATION OF GROSS INCOME AND ASSET TESTS OF REGULATED INVESTMENT COMPANIES

SEC. 201. INCOME FROM COMMODITIES COUNTED TOWARD GROSS INCOME TEST OF REGULATED INVESTMENT COMPANIES.

(a) GROSS INCOME TEST.—Subparagraph (A) of section 851(b)(2) is amended—

(1) by striking "foreign currencies" and inserting "commodities", and

(2) by striking "or currencies" and inserting "or commodities".

(b) REPEAL OF REGULATORY AUTHORITY TO EXCLUDE CERTAIN FOREIGN CURRENCY GAINS FROM QUALIFYING INCOME.—Subsection (b) of section 851 is amended by striking "For purposes of paragraph (2), the Secretary may by regulation exclude from qualifying income foreign currency gains which are not directly related to the company's principal business of investing in stock or securities (or options and futures with respect to stock or securities)." in the flush matter after paragraph (3).

(c) CONFORMING AMENDMENTS.—

(1) Subsection (h) of section 851 is amended by inserting "(determined by substituting 'foreign currencies' for 'commodities' therein)" after "subsection (b)(2)(A)".

(2) Paragraph (4) of section 7704(d) is amended by inserting "(determined by substituting 'foreign currencies' for 'commodities' therein)" after "section 851(b)(2)(A)".

(d) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after the date of the enactment of this Act.

SEC. 202. SAVINGS PROVISIONS FOR FAILURES OF REGULATED INVESTMENT COMPANIES TO SATISFY GROSS INCOME AND ASSET TESTS.

(a) ASSET TEST.—Subsection (d) of section 851 is amended—

(1) by striking "A corporation which meets" and inserting the following:

"(1) IN GENERAL.—A corporation which meets", and

(2) by adding at the end the following new paragraph:

"(2) SPECIAL RULES REGARDING FAILURE TO SATISFY REQUIREMENTS.—If paragraph (1) does not preserve a corporation's status as a regulated investment company for any particular quarter—

"(A) IN GENERAL.—A corporation that fails to meet the requirements of subsection (b)(3) (other than a failure described in subparagraph (B)(i)) for such quarter shall nevertheless be considered to have satisfied the requirements of such subsection for such quarter if—

"(i) following the corporation's identification of the failure to satisfy the requirements of such subsection for such quarter, a description of each asset that causes the corporation to fail to satisfy the requirements of such subsection at the close of such quarter is set forth in a schedule for such quarter filed in the manner provided by the Secretary,

"(ii) the failure to meet the requirements of such subsection for such quarter is due to reasonable cause and not due to willful neglect, and

"(iii)(I) the corporation disposes of the assets set forth on the schedule specified in clause (i) within 6 months after the last day of the quarter in which the corporation's identification of the failure to satisfy the requirements of such subsection occurred or such other time period prescribed by the Secretary and in the manner prescribed by the Secretary, or

"(II) the requirements of such subsection are otherwise met within the time period specified in subclause (I).

"(B) RULE FOR CERTAIN DE MINIMIS FAILURES.—A corporation that fails to meet the requirements of subsection (b)(3) for such quarter shall nevertheless be considered to have satisfied the requirements of such subsection for such quarter if—

"(i) such failure is due to the ownership of assets the total value of which does not exceed the lesser of—

"(I) 1 percent of the total value of the corporation's assets at the end of the quarter for which such measurement is done, or

"(II) $10,000,000, and

"(ii)(I) the corporation, following the identification of such failure, disposes of assets in order to meet the requirements of such subsection within 6 months after the last day of the quarter in which the corporation's identification of the failure to satisfy the requirements of such subsection occurred or such other time period prescribed by the Secretary and in the manner prescribed by the Secretary, or

"(II) the requirements of such subsection are otherwise met within the time period specified in subclause (I).

"(C) TAX.—

"(i) TAX IMPOSED.—If subparagraph (A) applies to a corporation for any quarter, there is hereby imposed on such corporation a tax in an amount equal to the greater of—

"(I) $50,000, or

"(II) the amount determined (pursuant to regulations promulgated by the Secretary) by multiplying the net income generated by the assets described in the schedule specified in subparagraph (A)(i) for the period specified in clause (ii) by the highest rate of tax specified in section 11.

"(ii) PERIOD.—For purposes of clause (i)(II), the period described in this clause is the period beginning on the first date that the failure to satisfy the requirements of subsection (b)(3) occurs as a result of the ownership of such assets and ending on the earlier of the date on which the corporation disposes of such assets or the end of the first quarter when there is no longer a failure to satisfy such subsection.

"(iii) ADMINISTRATIVE PROVISIONS.—For purposes of subtitle F, a tax imposed by this subparagraph shall be treated as an excise tax with respect to which the deficiency procedures of such subtitle apply.".

SEC. 402. DEFERRAL OF CERTAIN GAINS AND LOSSES OF REGULATED INVESTMENT COMPANIES FOR EXCISE TAX PURPOSES.

(a) IN GENERAL.—Subsection (e) of section 4982 is amended by striking paragraphs (5) and (6) and inserting the following new paragraphs:

"(5) TREATMENT OF SPECIFIED GAINS AND LOSSES AFTER OCTOBER 31 OF CALENDAR YEAR.—

"(A) IN GENERAL.—Any specified gain or specified loss which (but for this paragraph) would be properly taken into account for the portion of the calendar year after October 31 shall be treated as arising on January 1 of the following calendar year.

"(B) SPECIFIED GAINS AND LOSSES.—For purposes of this paragraph—

"(i) SPECIFIED GAIN.—The term 'specified gain' means ordinary gain from the sale, exchange, or other disposition of property (including the termination of a position with respect to such property). Such term shall include any foreign currency gain attributable to a section 988 transaction (within the meaning of section 988) and any amount includible in gross income under section 1296(a)(1).

"(ii) SPECIFIED LOSS.—The term 'specified loss' means ordinary loss from the sale, exchange, or other disposition of property (including the termination of a position with respect to such property). Such term shall include any foreign currency loss attributable to a section 988 transaction (within the meaning of section 988) and any amount allowable as a deduction under section 1296(a)(2).

"(C) SPECIAL RULE FOR COMPANIES ELECTING TO USE THE TAXABLE YEAR.—In the case of any company making an election under paragraph (4), subparagraph (A) shall be applied by substituting the last day of the company's taxable year for October 31.

"(6) TREATMENT OF MARK TO MARKET GAIN.—

"(A) IN GENERAL.—For purposes of determining a regulated investment company's ordinary income, notwithstanding paragraph (1)(C), each specified mark to market provision shall be applied as if such company's taxable year ended on October 31. In the case of a company making an election under paragraph (4), the preceding sentence shall be applied by substituting the last day of the company's taxable year for October 31.

"(B) SPECIFIED MARK TO MARKET PROVISION.—For purposes of this paragraph, the term 'specified mark to market provision' means sections 1256 and 1296 and any other provision of this title (or regulations thereunder) which treats property as disposed of on the last day of the taxable year.

"(7) ELECTIVE DEFERRAL OF CERTAIN ORDINARY LOSSES.—Except as provided in regulations prescribed by the Secretary, in the case of a regulated investment company which has a taxable year other than the calendar year—

"(A) such company may elect to determine its ordinary income for the calendar year without regard to any net ordinary loss (determined without regard to specified gains and losses taken into account under paragraph (5)) which is attributable to the portion of such calendar year which is after the beginning of the taxable year which begins in such calendar year, and

"(B) any amount of net ordinary loss not taken into account for a calendar year by reason of subparagraph (A) shall be treated as arising on the 1st day of the following calendar year.".

(b) EFFECTIVE DATE.—The amendments made by this section shall apply to calendar years beginning after the date of the enactment of this Act.

SEC. 403. DISTRIBUTED AMOUNT FOR EXCISE TAX PURPOSES DETERMINED ON BASIS OF TAXES PAID BY REGULATED INVESTMENT COMPANY.

(a) IN GENERAL.—Subsection (c) of section 4982 is amended by adding at the end the following new paragraph:

"(4) SPECIAL RULE FOR ESTIMATED TAX PAYMENTS.—

"(A) IN GENERAL.—In the case of a regulated investment company which elects the application of this paragraph for any calendar year—

"(i) the distributed amount with respect to such company for such calendar year shall be increased by the amount on which qualified estimated tax payments are made by such company during such calendar year, and

"(ii) the distributed amount with respect to such company for the following calendar year shall be reduced by the amount of such increase.

"(B) QUALIFIED ESTIMATED TAX PAYMENTS.—For purposes of this paragraph, the term 'qualified estimated tax payments' means, with respect to any calendar year, payments of estimated tax of a tax described in paragraph (1)(B) for any taxable year which begins (but does not end) in such calendar year.".

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to calendar years beginning after the date of the enactment of this Act.

SEC. 404. INCREASE IN REQUIRED DISTRIBUTION OF CAPITAL GAIN NET INCOME.

(a) IN GENERAL.—Subparagraph (B) of section 4982(b)(1) is amended by striking "98 percent" and inserting "98.2 percent".

(b) EFFECTIVE DATE.—The amendments made by this section shall apply to calendar years beginning after the date of the enactment of this Act.

TITLE V—OTHER PROVISIONS

SEC. 501. REPEAL OF ASSESSABLE PENALTY WITH RESPECT TO LIABILITY FOR TAX OF REGULATED INVESTMENT COMPANIES.

(a) IN GENERAL.—Part I of subchapter B of chapter 68 is amended by striking section 6697 (and by striking the item relating to such section in the table of sections of such part).

(b) CONFORMING AMENDMENT.—Section 860 is amended by striking subsection (j).

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after the date of the enactment of this Act.

SEC. 502. MODIFICATION OF SALES LOAD BASIS DEFERRAL RULE FOR REGULATED INVESTMENT COMPANIES.

(a) IN GENERAL.—Subparagraph (C) of section 852(f)(1) is amended by striking "subsequently acquires" and inserting "acquires, during the period beginning on the date of the disposition referred to in subparagraph (B) and ending on January 31 of the calendar year following the calendar year that includes the date of such disposition,".

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to charges incurred in taxable years beginning after the date of the enactment of this Act.

TITLE VI—PAYGO COMPLIANCE

SEC. 601. PAYGO COMPLIANCE.

The budgetary effects of this Act, for the purpose of complying with the Statutory Pay-As-You-Go-Act of 2010, shall be determined by reference to the latest statement titled "Budgetary Effects of PAYGO Legislation" for this Act, submitted for printing in the Congressional Record by the Chairman of the House Budget Committee, provided that such statement has been submitted prior to the vote on passage.

The SPEAKER pro tempore. Pursuant to the rule, the gentleman from Massachusetts (Mr. NEAL) and the gentleman from Michigan (Mr. CAMP) each will control 20 minutes.

The Chair recognizes the gentleman from Massachusetts.

GENERAL LEAVE

Mr. NEAL. Madam Speaker, I ask unanimous consent that all Members may have 5 legislative days in which to revise and extend their remarks and to include extraneous material on the bill under consideration.

The SPEAKER pro tempore. Is there objection to the request of the gentleman from Massachusetts?

There was no objection.

Mr. NEAL. Madam Speaker, I yield myself such time as I might consume.

Madam Speaker, more than 100 years ago, the first U.S. mutual fund was started in Boston. Mutual funds have been a way of life for "everyman" to invest in the market, with the benefits of pooling and diversification. Indeed, it invites the term "mutualization." Today, more than 50 million households invest through mutual funds with a median household income of $80,000. More than 50 percent of 401(k) plan assets were invested in mutual funds at the end of 2009.

H.R. 4337 was introduced last year by Mr. RANGEL and me to modernize the tax laws regarding regulated investment companies, better known as mutual funds. A technical explanation and revenue table for this bill may be found on the Joint Tax Web site, www.jct.gov.

The tax rules that relate to mutual funds date back more than a half century. Although these rules have been updated from time to time, it has been over 20 years since they were last revisited. The bill before us today would make several changes to the Tax Code to address outdated provisions, such as rules that relate to preferential dividends and rules that require mutual funds to send separate annual dividend designation notices to shareholders and rules that prevent mutual funds from earning income from commodities.

In June, my subcommittee, the Select Revenue Measures Subcommittee, reviewed this legislation with a panel of experts who expressed support for these changes.

Today, I am pleased to be joined by my friend, the gentleman from Michigan (Mr. CAMP), in bringing this bill to the floor with a few technical changes and revenue offsets from within the industry. The Ways and Means Committee has the responsibility to review our tax rules from time to time, remove the dead wood, and update where necessary. This bill accomplishes that to the benefit of investors, taxpayers, and mutual fund companies. I urge its adoption.

I reserve the balance of my time.

Mr. CAMP. Madam Speaker, I yield myself such time as I may consume.

(Mr. CAMP asked and was given permission to revise and extend his remarks.)

Mr. CAMP. Madam Speaker, regulated investment companies, better

known in their most prevalent form as mutual funds, are intended to provide individual investors the ability to invest easily and with low costs in a diversified pool of professionally managed investments. According to the Investment Company Institute, ICI, the main trade association for mutual funds, more than 50 million American families currently invest in mutual funds.

Most of the current law mutual fund rules were last collectively updated more than two decades ago. H.R. 4337 would modify and update certain technical tax rules pertaining to mutual funds in order to make them better conform to, and interact with, other aspects of the Tax Code and applicable securities laws.

On June 15, 2010, the Ways and Means Subcommittee on Select Revenue Measures held a hearing on H.R. 4337. Invited witnesses, including a representative of ICI, were supportive of the bill, and we are not aware of any controversy or opposition to the legislation.

Let me close by making a broader point. It certainly is appropriate for Ways and Means to periodically review the tax law to ensure that targeted provisions of importance to particular segments of the economy, including the mutual fund industry and their investors, are kept up to date; and I certainly appreciate the majority's decision to hold a hearing on this bill before bringing it to the floor, because our committee works best when it works under regular order.

Having said that, I must say that I am deeply disappointed that our committee seems to have lost sight of its responsibility to address the single most significant tax issue facing Americans right now—preventing a massive $3.8 trillion tax increase at the end of this year. These looming tax hikes on families, seniors, investors, and small businesses not only threaten every American taxpayer with higher taxes, but they're also contributing significantly to the uncertainty we see in the economy as a whole. So while we should continue to work together to modernize the tax rules governing mutual funds, we also should be working together to prevent harmful tax increases, such as the tax hikes on capital gains and dividends that will dramatically affect the very same mutual fund investors we're focusing on here today.

With that, Madam Speaker, I urge support for the bill before us.

INVESTMENT COMPANY INSTITUTE,
Washington, DC, September 28, 2010.

Re: ICI Strongly Supports Mutual Fund Modernization Legislation.

Hon. NANCY PELOSI,
Speaker, House of Representatives,
U.S. Capitol, Washington, DC.
Hon. JOHN BOEHNER,
Republican Leader, House of Representatives,
U.S. Capitol, Washington, DC.

DEAR SPEAKER PELOSI AND REPUBLICAN LEADER BOEHNER: The Investment Company Institute strongly supports the bipartisan Regulated Investment Company ("RIC") Modernization Act (H.R. 4337). On behalf of the millions of mutual fund shareholders who would benefit from this bill, we urge all House members to vote favorably on this bill when it is considered on the Suspension Calendar.

This bill would modernize the tax laws that govern mutual funds. These laws have not been updated in any meaningful or comprehensive way since 1986, almost a quarter century ago; some of the provisions in current law date back more than 60 years. Numerous developments during the past 20-plus years—including the development of new fund structures and distribution channels—have placed considerable stress on the currently applicable tax rules.

The legislation's many benefits were discussed in detail during the bill's June 2010 hearing before the Committee on Ways and Means Select Revenue Measures Subcommittee. The three key areas in which the bill would benefit funds and their shareholders involve:

improving the efficiency of mutual fund investment structures,

reducing disproportionate tax consequences for inadvertent errors, and

minimizing the need for amended tax statements and amended tax returns.

As discussed in detail in our testimony before the Subcommittee, the bill would reduce the burden arising from amended year-end tax information statements, improve a fund's ability to meet its distribution requirements, create remedies for inadvertent mutual find qualification failures, improve the tax treatment of investing in a "fund-of-funds" structure, and update the tax treatment of fund capital losses.

This bill reflects the sponsors' conclusion, with which we strongly agree, that it is important to update, clarify, and streamline the mutual fund tax rules. By eliminating uncertainties and allowing appropriate innovations, funds will become more efficient The ICI supports the pay-fors included in H.R. 4337, which apply to regulated investment companies and fully offset the modest revenue costs of the legislation.

Enacting this legislation will allow our members to focus on what they do best—serving their shareholders.

We urge your support.

Sincerely,

PAUL SCHOTT STEVENS,
President and Chief Executive Officer.

I reserve the balance of my time.

Mr. NEAL. Madam Speaker, I yield myself such time as I might consume.

Madam Speaker, we held a hearing on this bill. It is well received by the investors; it is well received by the mutual fund companies, and it certainly received no negative commentary in the House. Why cannot we just come to this floor and speak to the issue at hand?

I worked hard on this piece of legislation with Mr. TIBERI for a long period of time. This is the legislation that's in front of this Congress at this particular time. It was well met because it was fully vetted in the committee with sufficient opportunity for any- and everyone to comment on it

This is a product that we should be proud of. For the first time in two decades, we are modernizing issues that relate to the industry that many, if not millions, of Americans come to depend upon for retirement. I don't understand why there would be any additional argument made on any other piece of legislation that was being considered when, in fact, this is the matter that's before us at this particular time.

I reserve the balance of my time.

□ 1710

Mr. CAMP. I have no further requests for time, and I yield back the balance of my time.

Mr. NEAL. Madam Speaker, I have no further requests for time, I urge adoption of the bill, and I yield back the balance of my time.

The SPEAKER pro tempore. The question is on the motion offered by the gentleman from Massachusetts (Mr. NEAL) that the House suspend the rules and pass the bill, H.R. 4337, as amended.

The question was taken; and (two-thirds being in the affirmative) the rules were suspended and the bill, as amended, was passed.

A motion to reconsider was laid on the table.

ALGAE-BASED RENEWABLE FUEL PROMOTION ACT OF 2010

Mr. VAN HOLLEN. Madam Speaker, I move to suspend the rules and pass the bill (H.R. 4168) to amend the Internal Revenue Code of 1986 to expand the definition of cellulosic biofuel to include algae-based biofuel for purposes of the cellulosic biofuel producer credit and the special allowance for cellulosic biofuel plant property, as amended.

The Clerk read the title of the bill.

The text of the bill is as follows:

H.R. 4168

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the "Algae-based Renewable Fuel Promotion Act of 2010".

SEC. 2. ALGAE TREATED AS A QUALIFIED FEEDSTOCK FOR PURPOSES OF THE CELLULOSIC BIOFUEL PRODUCER CREDIT, ETC.

(a) IN GENERAL.—Subclause (I) of section 40(b)(6)(E)(i) of the Internal Revenue Code of 1986 is amended to read as follows:

"(I) is derived solely from qualified feedstocks, and".

(b) QUALIFIED FEEDSTOCK; SPECIAL RULES FOR ALGAE.—Paragraph (6) of section 40(b) of such Code is amended by redesignating subparagraphs (F), (G), and (H) as subparagraphs (H), (I), and (J), respectively, and by inserting after subparagraph (E) the following new subparagraphs:

"(F) QUALIFIED FEEDSTOCK.—For purposes of this paragraph, the term 'qualified feedstock' means—

"(i) any lignocellulosic or hemicellulosic matter that is available on a renewable or recurring basis, and

"(ii) any cultivated algae, cyanobacteria, or lemna.

"(G) SPECIAL RULES FOR ALGAE.—In the case of fuel which is derived from feedstock described in subparagraph (F)(ii) and which is sold by the taxpayer to another person for refining by such other person into a fuel which meets the requirements of subparagraph (E)(i)(II)—

"(i) such sale shall be treated as described in subparagraph (C)(i),

"(ii) such fuel shall be treated as meeting the requirements of subparagraph (E)(i)(II) in the hands of such taxpayer, and

SEC. 404. INCREASE IN REQUIRED DISTRIBUTION OF CAPITAL GAIN NET INCOME.

(a) IN GENERAL.—Subparagraph (B) of section 4982(b)(1) is amended by striking "98 percent" and inserting "98.2 percent".

(b) EFFECTIVE DATE.—The amendments made by this section shall apply to calendar years beginning after the date of the enactment of this Act.

TITLE V—OTHER PROVISIONS

SEC. 501. REPEAL OF ASSESSABLE PENALTY WITH RESPECT TO LIABILITY FOR TAX OF REGULATED INVESTMENT COMPANIES.

(a) IN GENERAL.—Part I of subchapter B of chapter 68 is amended by striking section 6697 (and by striking the item relating to such section in the table of sections of such part).

(b) CONFORMING AMENDMENT.—Section 860 is amended by striking subsection (j).

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after the date of the enactment of this Act.

SEC. 502. MODIFICATION OF SALES LOAD BASIS DEFERRAL RULE FOR REGULATED INVESTMENT COMPANIES.

(a) IN GENERAL.—Subparagraph (C) of section 852(f)(1) is amended by striking "subsequently acquires" and inserting "acquires, during the period beginning on the date of the disposition referred to in subparagraph (B) and ending on January 31 of the calendar year following the calendar year that includes the date of such disposition,".

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to charges incurred in taxable years beginning after the date of the enactment of this Act.

SA 4745. Mr. REID (for Mr. CARPER) proposed an amendment to the bill S. 3167, to amend title 13 of the United States Code to provide for a 5-year term of office for the Director of the Census and to provide for authority and duties of the Director and Deputy Director of the Census, and for other purposes; as follows:

Beginning on page 5, strike line 1 and all that follows through page 6, line 13, and insert the following:

"(6) ADVISORY COMMITTEES.—

"(A) ADVISORY COMMITTEES GENERALLY.—

"(i) AUTHORITY TO ESTABLISH.—The Director may establish such advisory committees as the Director considers appropriate to provide advice with respect to any function of the Director.

"(ii) COMPENSATION AND EXPENSES.—Members of any advisory committee established under clause (i) shall serve without compensation, but shall be entitled to transportation expenses and per diem in lieu of subsistence in accordance with section 5703 of title 5.

"(B) TECHNOLOGY ADVISORY COMMITTEE.—

"(i) IN GENERAL.—Not later than 180 days after the date of the enactment of the Census Oversight Efficiency and Management Reform Act of 2010, the Director shall establish a technology advisory committee under subparagraph (A).

"(ii) MEMBERSHIP.—Members of the technology advisory committee shall be selected from the public, private, and academic sectors from among those who have experience in technologies and services relevant to the planning and execution of the census.

"(iii) DUTIES.—The technology advisory committee shall make recommendations to the Director and publish reports on the use of commercially available technologies and services to improve efficiencies and manage costs in the implementation of the census and census-related activities, including pilot projects.

"(7) REGULATIONS.—The Director may, in consultation with the Secretary, prescribe such rules and regulations as the Director considers necessary or appropriate to carry out the functions of the Director.

"(8) DELEGATIONS, ETC.—The Director may assign duties, and delegate, or authorize successive redelegations of, authority to act and to render decisions, to such officers and employees of the Bureau as the Director may find necessary. Within the limitations of such assignments, delegations, or redelegations, all official acts and decisions of such officers and employees shall have the same force and effect as though performed or rendered by the Director. An assignment, delegation, or redelegation under this paragraph may not take effect before the date on which notice of such assignment, delegation, or redelegation (as the case may be) is published in the Federal Register.

AUTHORITY FOR COMMITTEES TO MEET

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS AND THE COMMITTEE ON HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS

Mrs. MCCASKILL. Mr. President, I ask unanimous consent that the Committee on Banking, Housing, and Urban Affairs and the Committee on Homeland Security and Governmental Affairs be authorized to meet during the session of the Senate on December 8, 2010, at 3:30 p.m., to conduct a joint hearing entitled "Examining the Efficiency, Stability, and Integrity of the U.S. Capital Markets."

The PRESIDING OFFICER. Without objection, it is so ordered.

COMMITTEE ON THE JUDICIARY

Mrs. MCCASKILL. Mr. President, I ask unanimous consent that the Committee on the Judiciary be authorized to meet during the session of the Senate on December 8, 2010, at 10 a.m. in SD-226 of the Dirksen Senate Office Building, to conduct an executive business meeting.

The PRESIDING OFFICER. Without objection, it is so ordered.

ORDER OF PROCEDURE

Mr. REID. Mr. President, I ask unanimous consent that the cloture vote on the motion to proceed to Calendar No. 443, S. 3992, occur at 11 a.m. tomorrow, December 9, with the time following any leader time until 11 a.m. equally divided and controlled between the leaders or their designees; that following any leader statement, Senator DURBIN be recognized for up to 10 minutes, and the Senate then resume consideration of the motion to proceed to S. 3992; that during Thursday's session, Senator BENNETT be recognized to speak for up to 20 minutes for his farewell speech and also Senator DORGAN be recognized at 2 p.m. for up to 20 minutes for his farewell speech and that Senator BUNNING be recognized for up to 30 minutes for his farewell speech.

The PRESIDING OFFICER. Without objection, it is so ordered.

REGULATED INVESTMENT COMPANY MODERNIZATION ACT OF 2010

Mr. REID. I ask unanimous consent that the Senate proceed to the consideration of Calendar No. 640, H.R. 4337.

The PRESIDING OFFICER. The clerk will report the bill by title.

The legislative clerk read as follows:

A bill (H.R. 4337) to amend the Internal Revenue Code of 1986 to modify certain rules applicable to regulated investment companies, and for other purposes.

There being no objection, the Senate proceeded to consider the bill.

Mr. REID. I ask unanimous consent that the Bingaman substitute amendment which is at the desk be agreed to; the bill, as amended, be read three times, passed; the motion to reconsider be laid on the table; and any statements relating to this matter be printed in the RECORD.

The PRESIDING OFFICER. Without objection, it is so ordered.

The amendment (No. 4744) was agreed to.

(The amendment is printed in today's RECORD under "Text of Amendments.")

The amendment was ordered to be engrossed and the bill read a third time.

The bill (H.R. 4337), as amended, was read the third time and passed.

CENSUS OVERSIGHT EFFICIENCY AND MANAGEMENT REFORM ACT OF 2010

Mr. REID. Mr. President, I ask unanimous consent to proceed to Calendar No. 647, S. 3167.

The PRESIDING OFFICER. The clerk will report the bill by title.

The legislative clerk read as follows:

A bill (S. 3167) to amend title 13 of the United States Code to provide for a 5-year term of office for the Director of the Census and to provide for the authority and duties of the Director and Deputy Director of the Census, and for other purposes.

There being no objection, the Senate proceeded to consider the bill, which had been reported from the Committee on Homeland Security and Governmental Affairs, with amendments, as follows:

(The parts of the bill intended to be stricken are shown in boldface brackets and the parts of the bill intended to be inserted are shown in Italic.)

S. 3167

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the "Census Oversight Efficiency and Management Reform Act of 2010".

SEC. 2. AUTHORITY AND DUTIES OF DIRECTOR AND DEPUTY DIRECTOR OF THE CENSUS.

(a) IN GENERAL.—Section 21 of title 13, United States Code, is amended to read as follows:

"§21. Director of the Census; Deputy Director of the Census; authority and duties

"(a) DEFINITIONS.—As used in this section—

"(1) 'Director' means the Director of the Census;

Permanent Subcommittee on Investigations

EXHIBIT #4c

I am pleased that the bill has received strong support from the National Federation of the Blind and the Alliance of Automobile Manufacturers. I commend manufacturers of hybrid and electric vehicles that have already stepped forward to work with NHTSA to address this serious safety issue.

I also want to thank my chairman, Chairman RUSH, and my colleagues, the gentleman from New York (Mr. TOWNS) and the gentleman from Florida (Mr. STEARNS), for their leadership on this issue, which has a strong record of bipartisan awareness and support. I urge my colleagues to support this legislation.

I reserve the balance of my time.

Mr. PITTS. Madam Speaker, I yield myself such time as I may consume.

I rise in support of Senate 841. I commend Congressman TOWNS and Congressman STEARNS for their efforts to improve pedestrian safety as the champions of the House companion legislation to Senate 841. They have worked with all the stakeholders to champion the legislative compromise that the Senate passed and which is before us today.

The National Federation of the Blind and the auto industry support the compromise legislation that will ensure pedestrian safety is not compromised by evolving engine technology.

The success of hybrid cars represents technological progress, but the byproduct is a silent engine that has raised concerns they are not audible to pedestrians and can jeopardize their safety. Quiet technology makes it very difficult for the blind and other pedestrians, such as children, joggers, or bicyclists, to evaluate traffic they do not see. The concern is greatest for blind pedestrians that rely on audible attributes of cars to evaluate direction and speed of traffic to ensure their safety. New vehicles that employ hybrid or electric engine technology can be silent, rendering them extremely dangerous in situations where vehicles and pedestrians come into proximity with each other.

The changes required by the legislation will become more important as hybrid technology becomes more and more widely deployed, and so I urge support.

I reserve the balance of my time.

Mr. BARROW. Madam Speaker, I yield such time as he may consume to the gentleman from New York (Mr. TOWNS).

Mr. TOWNS. Madam Speaker, I would like to thank the gentleman from Georgia for yielding time, and of course the ranking member as well. I rise to urge my colleagues to vote in favor of S. 841, the Pedestrian Safety Enhancement Act.

Today, environmentally friendly vehicles are quickly becoming a staple in the lives of Americans who are attempting to go green. I applaud the use of technology that decreases air pollution and fossil fuel consumption; however, we must address an unforeseen consequence of such innovation.

Over the years, we have heard tragic stories involving pedestrians and hybrid or electric vehicles. Not too long ago, news accounts were the story of a young child hit by a hybrid car. This accident was not caused by a driver's negligence or a car's manufacturing defect. It occurred because the child never heard the approaching car. The hybrids: engines were simply too quiet. Environmentally friendly vehicles such as hybrids often fail to produce audible sounds when driven.

The silent nature of these vehicles, coupled with the growing popularity, presents a dilemma: How do we protect individuals dependent on sounds for their safety, such as unsuspecting pedestrians and the blind? The solution lies in the Pedestrian Safety Act.

This act requires the Secretary of Transportation to conduct a study of the minimum level of sound required for environmentally friendly vehicles. Once this safety standard is determined, it will be applied to all new automobiles manufactured or sold in the United States beginning 2 years after the standard is issued. This is an effective way, not only to prevent avoidable injuries to pedestrians, but to do so without impeding innovation with stringent regulations.

It is clear that environmentally friendly vehicles are growing in popularity. While it is important to embrace technology that benefits our environment, we must do so with the safety of all citizens in mind.

This bill successfully passed the Senate last week and has been a long time coming here in the House. Our Chamber's companion bill, H.R. 734, has 238 bipartisan cosponsors. The bill coming to us from the Senate is even stronger. It is completely deficit neutral and supported by the Alliance of Automobile Manufacturers, the National Federation of the Blind, the Association of International Automobile Manufacturers, and the American Council of the Blind.

Before I conclude, Madam Speaker, let me take a moment to thank my colleague and friend, Representative CLIFF STEARNS, who has worked over the years with me on this bill. I want to thank staff members James Thomas and Nicole Alexander for their tremendous assistance in helping us move this important legislation forward. I would also like to thank Emily Khoury and Dana Grayson and all other staff that have made this moment a reality. This bill has been a model of bipartisanship and will benefit pedestrians across the country for years to come.

I urge all of my colleagues here in the House of Representatives to join me in supporting this very important legislation.

□ 1740

Mr. PITTS. Madam Speaker, I yield back the balance of my time.

Mr. BARROW. Madam Speaker, I urge my colleagues to support this legislation, and I yield back the balance of my time.

The SPEAKER pro tempore. The question is on the motion offered by the gentleman from Georgia (Mr. BARROW) that the House suspend the rules and pass the bill, S. 841.

The question was taken.

The SPEAKER pro tempore. In the opinion of the Chair, two-thirds being in the affirmative, the ayes have it.

Mr. BARROW. Madam Speaker, on that I demand the yeas and nays.

The yeas and nays were ordered.

The SPEAKER pro tempore. Pursuant to clause 8 of rule XX and the Chair's prior announcement, further proceedings on this motion will be postponed.

REGULATED INVESTMENT COMPANY MODERNIZATION ACT OF 2010

Mr. LEVIN. Madam Speaker, I move to suspend the rules and concur in the Senate amendment to the bill (H.R. 4337) to amend the Internal Revenue Code of 1986 to modify certain rules applicable to regulated investment companies, and for other purposes.

The Clerk read the title of the bill.

The text of the Senate amendment is as follows:

Senate amendment:

Strike all after the enacting clause and insert the following:

SECTION 1. SHORT TITLE, ETC.

(a) SHORT TITLE.—This Act may be cited as the "Regulated Investment Company Modernization Act of 2010".

(b) REFERENCE.—Except as otherwise expressly provided, whenever in this Act an amendment or repeal is expressed in terms of an amendment to, or repeal of, a section or other provision, the reference shall be considered to be made to a section or other provision of the Internal Revenue Code of 1986.

(c) TABLE OF CONTENTS.—The table of contents for this Act is as follows:

Sec. 1. Short title, etc.

TITLE I—CAPITAL LOSS CARRYOVERS OF REGULATED INVESTMENT COMPANIES

Sec. 101. Capital loss carryovers of regulated investment companies.

TITLE II—MODIFICATION OF GROSS INCOME AND ASSET TESTS OF REGULATED INVESTMENT COMPANIES

Sec. 201. Savings provisions for failures of regulated investment companies to satisfy gross income and asset tests.

TITLE III—MODIFICATION OF RULES RELATED TO DIVIDENDS AND OTHER DISTRIBUTIONS

Sec. 301. Modification of dividend designation requirements and allocation rules for regulated investment companies.

Sec. 302. Earnings and profits of regulated investment companies.

Sec. 303. Pass-thru of exempt-interest dividends and foreign tax credits in fund of funds structure.

Sec. 304. Modification of rules for spillover dividends of regulated investment companies.

Sec. 305. Return of capital distributions of regulated investment companies.

Sec. 306. Distributions in redemption of stock of a regulated investment company.

Sec. 307. Repeal of preferential dividend rule for publicly offered regulated investment companies.

Permanent Subcommittee on Investigations

EXHIBIT #4d

Sec. 308. Elective deferral of certain late-year losses of regulated investment companies.
Sec. 309. Exception to holding period requirement for certain regularly declared exempt-interest dividends.
TITLE IV—MODIFICATIONS RELATED TO EXCISE TAX APPLICABLE TO REGULATED INVESTMENT COMPANIES
Sec. 401. Excise tax exemption for certain regulated investment companies owned by tax exempt entities.
Sec. 402. Deferral of certain gains and losses of regulated investment companies for excise tax purposes.
Sec. 403. Distributed amount for excise tax purposes determined on basis of taxes paid by regulated investment company.
Sec. 404. Increase in required distribution of capital gain net income.
TITLE V—OTHER PROVISIONS
Sec. 501. Repeal of assessable penalty with respect to liability for tax of regulated investment companies.
Sec. 502. Modification of sales load basis deferral rule for regulated investment companies.

TITLE I—CAPITAL LOSS CARRYOVERS OF REGULATED INVESTMENT COMPANIES

SEC. 101. CAPITAL LOSS CARRYOVERS OF REGULATED INVESTMENT COMPANIES.

(a) IN GENERAL.—Subsection (a) of section 1212 is amended by redesignating paragraph (3) as paragraph (4) and by inserting after paragraph (2) the following new paragraph:

"(3) REGULATED INVESTMENT COMPANIES.—

"(A) IN GENERAL.—If a regulated investment company has a net capital loss for any taxable year—

"(i) paragraph (1) shall not apply to such loss,

"(ii) the excess of the net short-term capital loss over the net long-term capital gain for such year shall be a short-term capital loss arising on the first day of the next taxable year, and

"(iii) the excess of the net long-term capital loss over the net short-term capital gain for such year shall be a long-term capital loss arising on the first day of the next taxable year.

"(B) COORDINATION WITH GENERAL RULE.—If a net capital loss to which paragraph (1) applies is carried over to a taxable year of a regulated investment company—

"(i) LOSSES TO WHICH THIS PARAGRAPH APPLIES.—Clauses (ii) and (iii) of subparagraph (A) shall be applied without regard to any amount treated as a short-term capital loss under paragraph (1).

"(ii) LOSSES TO WHICH GENERAL RULE APPLIES.—Paragraph (1) shall be applied by substituting 'net capital loss for the loss year or any taxable year thereafter (other than a net capital loss to which paragraph (3)(A) applies)' for 'net capital loss for the loss year or any taxable year thereafter'.".

(b) CONFORMING AMENDMENTS.—

(1) Subparagraph (C) of section 1212(a)(1) is amended to read as follows:

"(C) a capital loss carryover to each of the 10 taxable years succeeding the loss year, but only to the extent such loss is attributable to a foreign expropriation loss,".

(2) Paragraph (10) of section 1222 is amended by striking "section 1212" and inserting "section 1212(a)(1)".

(c) EFFECTIVE DATE.—

(1) IN GENERAL.—Except as provided in paragraph (2), the amendments made by this section shall apply to net capital losses for taxable years beginning after the date of the enactment of this Act.

(2) COORDINATION RULES.—Subparagraph (B) of section 1212(a)(3) of the Internal Revenue Code of 1986, as added by this section, shall apply to taxable years beginning after the date of the enactment of this Act.

TITLE II—MODIFICATION OF GROSS INCOME AND ASSET TESTS OF REGULATED INVESTMENT COMPANIES

SEC. 201. SAVINGS PROVISIONS FOR FAILURES OF REGULATED INVESTMENT COMPANIES TO SATISFY GROSS INCOME AND ASSET TESTS.

(a) ASSET TEST.—Subsection (d) of section 851 is amended—

(1) by striking "A corporation which meets" and inserting the following:

"(1) IN GENERAL.—A corporation which meets", and

(2) by adding at the end the following new paragraph:

"(2) SPECIAL RULES REGARDING FAILURE TO SATISFY REQUIREMENTS.—If paragraph (1) does not preserve a corporation's status as a regulated investment company for any particular quarter—

"(A) IN GENERAL.—A corporation that fails to meet the requirements of subsection (b)(3) (other than a failure described in subparagraph (B)(i)) for such quarter shall nevertheless be considered to have satisfied the requirements of such subsection for such quarter if—

"(i) following the corporation's identification of the failure to satisfy the requirements of such subsection for such quarter, a description of each asset that causes the corporation to fail to satisfy the requirements of such subsection at the close of such quarter is set forth in a schedule for such quarter filed in the manner provided by the Secretary,

"(ii) the failure to meet the requirements of such subsection for such quarter is due to reasonable cause and not due to willful neglect, and

"(iii)(I) the corporation disposes of the assets set forth on the schedule specified in clause (i) within 6 months after the last day of the quarter in which the corporation's identification of the failure to satisfy the requirements of such subsection occurred or such other time period prescribed by the Secretary and in the manner prescribed by the Secretary, or

"(II) the requirements of such subsection are otherwise met within the time period specified in subclause (I).

"(B) RULE FOR CERTAIN DE MINIMIS FAILURES.—A corporation that fails to meet the requirements of subsection (b)(3) for such quarter shall nevertheless be considered to have satisfied the requirements of such subsection for such quarter if—

"(i) such failure is due to the ownership of assets the total value of which does not exceed the lesser of—

"(I) 1 percent of the total value of the corporation's assets at the end of the quarter for which such measurement is done, or

"(II) $10,000,000, and

"(ii)(I) the corporation, following the identification of such failure, disposes of assets in order to meet the requirements of such subsection within 6 months after the last day of the quarter in which the corporation's identification of the failure to satisfy the requirements of such subsection occurred or such other time period prescribed by the Secretary and in the manner prescribed by the Secretary, or

"(II) the requirements of such subsection are otherwise met within the time period specified in subclause (I).

"(C) TAX.—

"(i) TAX IMPOSED.—If subparagraph (A) applies to a corporation for any quarter, there is hereby imposed on such corporation a tax in an amount equal to the greater of—

"(I) $50,000, or

"(II) the amount determined (pursuant to regulations promulgated by the Secretary) by multiplying the net income generated by the assets described in the schedule specified in subparagraph (A)(i) for the period specified in clause (ii) by the highest rate of tax specified in section 11.

"(ii) PERIOD.—For purposes of clause (i)(II), the period described in this clause is the period beginning on the first date that the failure to satisfy the requirements of subsection (b)(3) occurs as a result of the ownership of such assets and ending on the earlier of the date on which the corporation disposes of such assets or the end of the first quarter when there is no longer a failure to satisfy such subsection.

"(iii) ADMINISTRATIVE PROVISIONS.—For purposes of subtitle F, a tax imposed by this subparagraph shall be treated as an excise tax with respect to which the deficiency procedures of such subtitle apply.".

(b) GROSS INCOME TEST.—Section 851 is amended by adding at the end the following new subsection:

"(i) FAILURE TO SATISFY GROSS INCOME TEST.—

"(1) DISCLOSURE REQUIREMENT.—A corporation that fails to meet the requirement of paragraph (2) of subsection (b) for any taxable year shall nevertheless be considered to have satisfied the requirement of such paragraph for such taxable year if—

"(A) following the corporation's identification of the failure to meet such requirement for such taxable year, a description of each item of its gross income described in such paragraph is set forth in a schedule for such taxable year filed in the manner provided by the Secretary, and

"(B) the failure to meet such requirement is due to reasonable cause and not due to willful neglect.

"(2) IMPOSITION OF TAX ON FAILURES.—If paragraph (1) applies to a regulated investment company for any taxable year, there is hereby imposed on such company a tax in an amount equal to the excess of—

"(A) the gross income of such company which is not derived from sources referred to in subsection (b)(2), over

"(B) $\frac{1}{9}$ of the gross income of such company which is derived from such sources.".

(c) DEDUCTION OF TAXES PAID FROM INVESTMENT COMPANY TAXABLE INCOME.—Paragraph (2) of section 852(b) is amended by adding at the end the following new subparagraph:

"(G) There shall be deducted an amount equal to the tax imposed by subsections (d)(2) and (i) of section 851 for the taxable year.".

(d) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years with respect to which the due date (determined with regard to any extensions) of the return of tax for such taxable year is after the date of the enactment of this Act.

TITLE III—MODIFICATION OF RULES RELATED TO DIVIDENDS AND OTHER DISTRIBUTIONS

SEC. 301. MODIFICATION OF DIVIDEND DESIGNATION REQUIREMENTS AND ALLOCATION RULES FOR REGULATED INVESTMENT COMPANIES.

(a) CAPITAL GAIN DIVIDENDS.—

(1) IN GENERAL.—Subparagraph (C) of section 852(b)(3) is amended to read as follows:

"(C) DEFINITION OF CAPITAL GAIN DIVIDEND.—For purposes of this part—

"(i) IN GENERAL.—Except as provided in clause (ii), a capital gain dividend is any dividend, or part thereof, which is reported by the company as a capital gain dividend in written statements furnished to its shareholders.

"(ii) EXCESS REPORTED AMOUNTS.—If the aggregate reported amount with respect to the company for any taxable year exceeds the net capital gain of the company for such taxable year, a capital gain dividend is the excess of—

"(I) the reported capital gain dividend amount, over

"(II) the excess reported amount which is allocable to such reported capital gain dividend amount.

"(iii) ALLOCATION OF EXCESS REPORTED AMOUNT.—

"(I) IN GENERAL.—Except as provided in subclause (II), the excess reported amount (if any) which is allocable to the reported capital gain

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to calendar years beginning after the date of the enactment of this Act.

SEC. [illegible]04. INCREASE IN REQUIRED DISTRIBUTION OF CAPITAL GAIN NET INCOME.

(a) IN GENERAL.—Subparagraph (B) of section 4982(b)([illegible]) is amended by striking "9[illegible] percent" and inserting "98.2 percent".

(b) EFFECTIVE DATE.—The amendments made by this section shall apply to calendar years beginning after the date of the enactment of this Act.

TITLE [illegible]—OTHER PROVISIONS

SEC. 501. REPEAL OF ASSESSABLE PENALTY WITH RESPECT TO LIABILITY FOR TAX OF REGULATED INVESTMENT COMPANIES.

(a) IN GENERAL.—Part [illegible] of subchapter B of chapter 68 is amended by striking section 6697 (and by striking the item relating to such section in the table of sections of such part).

(b) CONFORMING AMENDMENT.—Section 860 is amended by striking subsection (j).

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after the date of the enactment of this Act.

SEC. 502. MODIFICATION OF SALES LOAD BASIS DEFERRAL RULE FOR REGULATED INVESTMENT COMPANIES.

(a) IN GENERAL.—Subparagraph ([illegible]) of section 852(f)(1) is amended by striking "subsequently acquires" and inserting "acquires, during the period beginning on the date of the disposition referred to in subparagraph (B) and ending on January 31 of the calendar year following the calendar year that includes the date of such disposition,".

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to charges incurred in taxable years beginning after the date of the enactment of this Act.

The SPEAKER pro tempore. Pursuant to the rule, the gentleman from Michigan (Mr. LEVIN) and the gentleman from Ohio (Mr. TIBERI) each will control 20 minutes.

The Chair recognizes the gentleman from Michigan.

GENERAL LEAVE

Mr. LEVIN. Madam Speaker, I ask unanimous consent that all Members have 5 legislative days to revise and extend their remarks and insert any extraneous material in the CONGRESSIONAL RECORD.

The SPEAKER pro tempore. Is there objection to the request of the gentleman from Michigan?

There was no objection.

Mr. LEVIN. I yield such time as he may consume to the gentleman from Massachusetts (Mr. NEAL), someone who has been working on this issue for—I don't know how long—a long time.

Mr. NEAL. I thank the chairman.

Madam Speaker, this legislation has already passed the House. It really was a bipartisan achievement this year, and much of the good work that went into this legislation has been years in coming.

More than 100 years ago, the first mutual fund was started in Boston, Massachusetts. Mutual funds have been a way for the "everyman" to invest in the market with benefits of pooling and diversification. Today, more than 50 million households invest through mutual funds with a median household income of $80,000. More than 50 percent of 401(k) plan assets were invested in mutual funds at the end of 2009.

H.R. 4337 was introduced last year by Mr. RANGEL and me to modernize the tax laws regarding regulated investment companies, better known as mutual funds. The tax rules that relate to mutual funds date back more than 50 years, and although these rules have been updated from time to time, it has been over 20 years since the rules were last revisited.

The bill before us today would make several changes to the Tax Code to address outdated provisions, such as rules that relate to preferential dividends, rules that require mutual funds to send separate annual dividend designation notices to shareholders, and rules that prevent mutual funds from earning income from commodities.

In June, my subcommittee, the Select Revenue Measures Subcommittee, reviewed this legislation with a panel of experts who expressed support for the changes. Simply put, the subcommittee held a hearing, and there was broad support on the Democratic side and on the Republican side for the accomplishment that sits in front of us.

I am pleased to support this modified legislation, which is also revenue neutral. The Ways and Means Committee has a responsibility to review our tax rules from time to time and to remove the deadwood and update where necessary. This bill accomplishes that to the benefit of the investors, taxpayers, and mutual fund companies.

I urge its adoption. I thank the chairman for yielding to me, and I thank our friends on the other side for their endorsement of this legislation as well.

Mr. TIBERI. I yield myself such time as I may consume.

Madam Speaker, as was just said, regulated investment companies, better known as mutual funds to most Americans and to us, are intended to provide individual investors the ability to invest easily and with low cost in a diversified pool of professionally managed investments, and they have worked. In fact, according to the Investment Company Institute, the largest trade association for mutual funds, as Chairman NEAL said, more than 50 million American families currently invest in mutual funds.

Most of the current laws that mutual funds have to deal with have not been comprehensively updated for more than two decades. In fact, H.R. 4337 would modify and update certain technical tax rules pertaining to mutual funds. These changes will allow mutual funds to better conform to and interact with other aspects of the Tax Code and security laws.

As Chairman NEAL said, we had a wonderful hearing where every single person who testified agreed to the changes in the underlying piece of legislation. It was passed in this House unanimously after that hearing this last summer. Every witness was supportive, and no opposition came before us with respect to the legislation. It was passed in the Senate last week by unanimous consent, with one change.

My hope is today, Chairman LEVIN, Chairman NEAL, Madam Speaker, that this House will once again vote for this underlying piece of legislation with the one change and send it on to the President. Let's make this change, and let's give American mutual fund investors some certainty into the future.

I yield back the balance of my time.

Mr. LEVIN. Madam Speaker, the bill before us right now makes important changes to the tax law rules that relate, as Mr. NEAL and Mr. TIBERI said, to regulated investment companies, more commonly known as mutual funds. They were described 80 years ago in testimony before the Ways and Means Committee as, "A group of small investors who have banded together for the purpose of obtaining diversity and supervision through the medium of pooling their investments."

While mutual funds continue to serve this important role, the tax rules that govern mutual funds have not been updated in over 20 years. In June of this year, the Select Revenue Measures Subcommittee, chaired by Mr. NEAL, heard testimony from a variety of industry experts stressing the importance of modifying our Nation's tax laws to ensure that the technical tax rules pertaining to mutual funds would better interact with other tax rules.

The Ways and Means Committee and the Congress have an obligation to ensure that our tax rules keep up with the times, so the bill before us would update and simplify the rules that apply to mutual funds to ensure that small investors are not disadvantaged simply because they band their investments together through a mutual fund rather than investing directly.

The bill enjoys strong bipartisan support. It passed the House by voice vote earlier this year and just last week was amended to pass the Senate by unanimous consent.

I want to thank all of my colleagues on Ways and Means and all others who joined for their contributions to ensure that these important changes to the mutual fund rules can be swiftly signed into law by the President of the United States. Passage today will do just that. So I urge strong support for this measure.

I yield back the balance of my time.

The SPEAKER pro tempore. The question is on the motion offered by the gentleman from Michigan (Mr. LEVIN) that the House suspend the rules and concur in the Senate amendment to the bill, H.R. 4337.

The question was taken; and (two-thirds being in the affirmative) the rules were suspended and the Senate amendment was concurred in.

A motion to reconsider was laid on the table.

Selected Commodity Related Mutual Funds

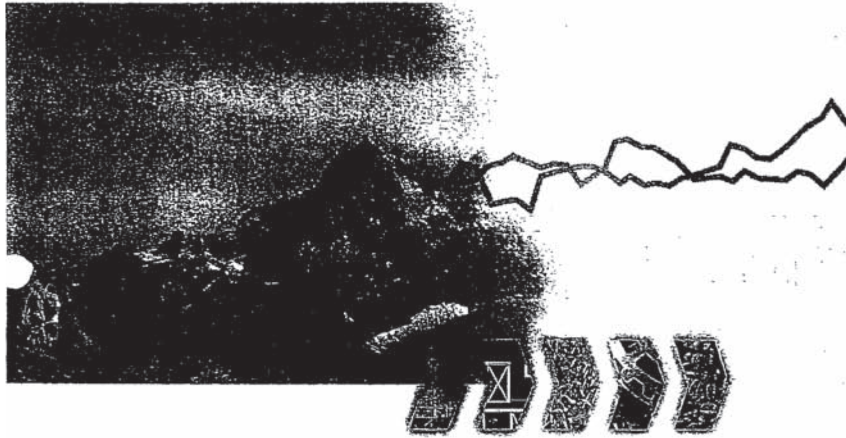
Name	2011 Net Assets
PIMCO Commodity Real Return Strategy Fund	$22,785,400,000
Fidelity Series Commodity Strategy Fund	$7,150,700,000
Credit Suisse Commodity Return Strategy	$5,407,400,000
Highbridge Dynamicc Commodities Strategy Fund	$2,413,200,000
PIMCO CommoditiesPLUS Strategy Fund	$1,976,900,000
Oppenheimer Commodity Strategy Total Return Fund	$1,212,400,000
Russell Commodity Strategies Fund	$1,146,200,000
DWS Enhanced Commodity Strategy Fund	$1,130,000,000
Rydex/SGI Managed Futures Strategy Fund	$1,130,000,000
Altegris Managed Futures Strategy Fund	$1,015,000,000
Grant Park Managed Futures Strategy Fund	$1,000,000,000
Goldman Sachs Commodity Strategy Fund	$898,600,000
Equinox MutualHedge Frontier Legends Fund	$556,600,000
Natixis ASG Managed Futures Strategy Fund	$530,400,000
Eaton Vance Commodity Strategy Fund	$508,700,000
Princeton Futures Strategy Fund	$385,100,000
Rydex|SGI Long/Short Commodities Strategy Fund	$380,400,000
Harbor Commodity Real Return Strategy Fund	$276,700,000
MFS Commodity Strategy Fund	$249,800,000
Ramius Trading Strategies Managed Futures Fund	$225,500,000
DFA Commodity Strategy Fund	$210,200,000
Transamerica Goldman Sachs Commodity Strategy Fund	$169,100,000
Altegris Macro Strategy Fund	$147,400,000
Invesco Balanced-Risk Commodity Strategy Fund	$145,400,000
Direxion Commodity Trends Strategy Fund	$131,700,000
Jefferies Asset Management Commodity Strategy Allocation Fund	$119,200,000
Credit Suisse Trust Commodity Return Strategy Fund	$114,200,000
Fidelity Commodity Strategy Fund	$112,000,000
ING Goldman Sachs Commodity Strategy Portfolio	$102,200,000
Invesco Commodities Strategy Fund	$87,000,000
LoCorr Managed Futures Strategy Fund	$77,300,000
Blackrock Commodities Strategy Fund	$48,200,000
Van Eck CM Commodity Index Fund	$41,200,000
Rydex Commodities Strategy Fund	$24,600,000
SCA Absolute Return Fund	$22,200,000
Eaton Vance Parametric Structured Commodity Strategy Fund	$18,200,000
Arrow Commodity Strategy Fund	$16,800,000
Columbia Commodity Strategy Fund	$8,700,000
TCW Enhanced Commodity Strategy I	$4,100,000
Mosaic Managed Futures Strategy Fund	$1,700,000
Total	$51,980,400,000

Data source: Morningstar, Inc. and various mutual fund materials
List prepared by Permanent Subcommittee on Investigations, Nov. 2011

Permanent Subcommittee on Investigations
EXHIBIT #5a

a managed tactical fund

the Commodity Trends Strategy Fund



A Diversified Long/Short Commodity Fund.

direxionfunds.

Think direction. Invest.

Permanent Subcommittee on Investigations
EXHIBIT #5b

Why commodities?

Financial professionals and their clients have found that commodities can:

- potentially provide additional risk-adjusted returns over time to a diversified portfolio;
- be an attractive investment option when global demand for commodities surge;
- offer low correlation to stocks and bonds;
- be an effective hedge against inflation; and
- be a diversification tool with the potential to enhance all asset allocation models.

Why consider long/short commodities?

Most traditional commodity funds only provide long exposure to commodities. However, these long-only commodity strategies have not proven to provide sustainable gains over time because:

- commodity returns are typically cyclical and sporadic,
- individual commodity sub-sectors tend to perform dissimilarly in different market environments, and
- significant drawdowns can be damaging to portfolios over time.

What does that mean for investors? ***Long-only exposure can tend to limit commodities' potential to contribute to a portfolio's long-term performance. For example, $1 invested in commodities in 1956 is worth 71 cents (inflation-adjusted) today[1].***

The following chart illustrates the Commodity Trends Indicator's (a long/short index) performance results from 2004 through 2010, as compared to the performance of two long only commodity indices, the S&P GSCI™ (Goldman Sachs Commodity Index) and the DJUBS CI (Dow Jones UBS Commodity Index).[2]

Commodity Trends Indicator (CTI) vs. the S&P GSCI and DJUBS CI: 2004-2010*

	CTI	S&P GSCI	DJUBS CI
Compound Annual Return	10.29%	1.35%	4.98%
Annualized Standard Deviation[3]	17.04%	27.45%	19.62%
Sharpe Ratio[4]	0.70	0.09	0.20
Maximum Drawdown[5]	38.97%	-71.40%	-56.89%

As demonstrated in the table, while the long-only indexes had periods of strong positive returns, the long/short index was able to maintain more favorable returns with a lower volatility measure for the seven year period.[2]

**The chart is meant to demonstrate the differences between long only and long/short indices and is not indicative of the funds performance.*

[1] *Based on data provided by the Chart Store for the Reuters/CRB Continuous Futures Index for the period 11/30/56 - 01/31/11.*

[2] *Past performance, especially statistical information, is not necessarily indicative of future results.*

[3] *Standard Deviation is a measure of the dispersion of a set of data from its mean.*

[4] *The expected return of that asset, less the rate of return on a risk-free asset. This rate is denominated by the risk of that asset, which is expressed as the standard deviation of returns.*

[5] *The greatest percent decline from a previous high.*

The Commodity Trends Strategy Fund

Investment objective

The Commodity Trends Strategy Fund seeks to match the performance of the Commodity Trends Indicator (CTI®), which offers pure commodity exposure that seeks to benefit in all market conditions, through its unique long/short exposure.

Principal investment strategy

Like the Commodity Trends Indicator, the Fund invests primarily in commodity futures, positions its investments in each sector and component either long or short depending upon price trends within that component, and rebalances each sector monthly.

How does the Commodity Trends Indicator work?

The CTI® is a managed futures index that tracks both rising and falling trends in the commodity markets. It offers exposure to 16 commodity markets (in six sectors) and will hold them long or short, based on price trends. The long/short decision involves monitoring the price of the sectors in relation to their respective seven-month moving average price, which allows investors to benefit from rising and falling commodity prices. The exception within the model is the Energy sector which, due to geopolitical issues, economic changes and other factors uniquely related to the sector, is positioned either long or neutral (flat).

Share Class	Index*	Investor Class	C Shares	Institutiona Class
Fees Gross/ Net	n/a	1.75/1.75	2.26/2.26	1.25/1.25
Symbol	CTITR	DXCTX	DXSCX	DXCIX
CUSIP	n/a	254939457	254939341	25493938

Principal Risks

The principal risks of investing in the Commodity Trends Strategy Fund are risks of investing in commodity-linked derivatives, risks of investing in wholly owned subsidiary, high portfolio turnover, tax risk, risk of tracking error, risks of aggressive investment techniques, leverage risk, derivatives risks, counterparty risks, risk of non-diversification, risks of investing in other investment companies and ETFs, adverse market conditions, risks of investing in equity securities, credit risk, derivatives risk, risks of shorting instruments, risks of volatile markets, risks of investing in Wholly Owned Subsidiary and concentration risk.

**One cannot invest directly in an index. This information is for illustrative purposes only.*

Concentration risks result from focusing the Commodity Trends Strategy Fund investments in a specific industry or sector.

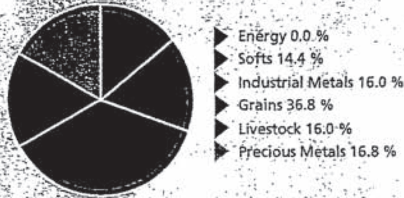
The performance of the fund may be more volatile than a fund that does not concentrate its investments.

The performance of the Fund is designed to correlate to the performance of its index. As a consequence, the fund's performance will suffer during conditions which are adverse to the investment goals.

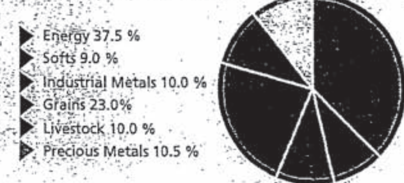
Diversification does not guarantee protection against market losses or ensure a gain.

CTI Index Compositions

When the Energy Sector is Flat



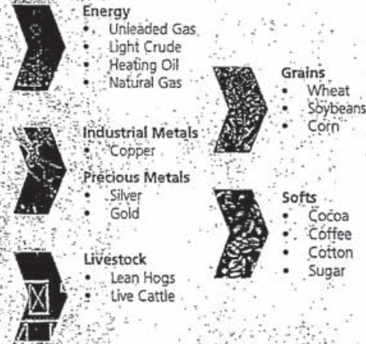
When the Energy Sector is Long



Leveraging the advantages of the CTI

By investing in the Commodity Trends Strategy Fund, offered by Direxion Funds, investors can take advantage of the benefits of a diversified, open-ended commodity mutual fund—without the inconvenience and high expenses ordinarily associated with other commodity options.

The six major sectors and components that the CTI track are:

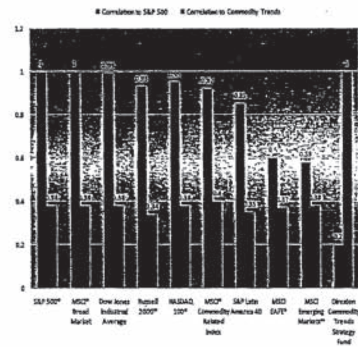


The importance of non-correlation

Non-correlating assets help reduce volatility, while providing diversification and risk-adjusted returns for your investors' portfolios. Whether market volatility is high or low, investors should consider incorporating alternative assets that have low correlation to traditional investment vehicles into their portfolios.

The graph (below) compares the correlation of traditional asset classes to that of both the S&P 500® Index and the Direxion Commodity Trends Strategy Fund.

6 Month Correlation through 12/31/10



As you can see, the Commodity Trends Strategy Fund has historically performed independently of traditional asset classes, such as stocks and bonds. This non-correlation could allow portfolio volatility to be reduced when the fund is included as part of a well balanced portfolio.

6 It is important to note that different time frames will result in different correlations.

The Russell Indexes noted herein are trademarks of Russell Investments and have been licensed for use by Direxion Shares. The fund is not sponsored, endorsed, sold or promoted by Russell Investments and Russell Investments makes no representation regarding the advisability of investing in the fund. The S&P indexes are trademarks of Standard and Poor's, a division of the McGraw Hill Companies, Inc. MSCI indexes are the exclusive property of MSCI and its affiliates. All rights reserved. Indexes are unmanaged and cannot be invested in directly.

Advantages of including the Commodity Trends Strategy Fund in your investment strategies

The Commodity Trends Strategy Fund, with its long and short exposure:

- may provide potentially solid returns over time;
- typically exhibits a low correlation to stocks and bonds;
- can potentially serve as an effective hedge against both inflation and deflation;
- potentially provides additional risk-adjusted returns over time to a well-balanced and diversified portfolio;
- provides investors with a means to capitalize on surges and declines in commodity demand and prices;
- allows for a buy and hold strategy while simultaneously acting upon short term market trends; and
- may be an effective complement to other alternative investments.

Diversification does not guarantee protection against market losses or ensure a gain.

To learn more about the Commodity Trends Strategy Fund and the role it can play in your clients' investment strategies, please contact Direxion Funds at 877-437-9363 or visit us at www.direxionfunds.com.

An investor should consider the investment objectives, risks, charges, and expenses of the Direxion funds carefully before investing. The prospectus contains this and other information about Direxion funds. To obtain a prospectus, please contact Direxion Funds at 800.851.0511. The prospectus should be read carefully before Investing. Investing in funds that invest in specific industries or geographic regions may be more volatile than investing in broadly diversified funds.

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Highbridge Dynamic Commodities Strategy Fund

A Shares (HDSAX)
C Shares (HDCCX)
Select Shares (HDCSX)

Data as of September 30, 2011

(Offered on a limited basis.)

Fund overview

Objective

The Fund seeks long-term total return.

Strategy/Investment process

- Invests in commodity-linked derivative instruments.
- Long-biased investment strategy combines a fundamental and systematic approach to commodities investing.
- Risk control process may reduce exposure to commodities in certain market environments.

Portfolio managers/industry experience

Sassan Alizadeh, 17 years
Mark Nodelman, 12 years
Christopher Tufts, 14 years

The fund invests in commodity-linked derivative instruments backed by a portfolio of high quality fixed income securities, such as commercial paper or other instruments that generally have a weighted average maturity of 90-days or less.

The fund's exposure to commodities may vary as a percentage of total fund net assets. The fund has flexibility to invest in long positions ranging from 0% to 200% of the value of the fund's net assets and short positions ranging from 0% to 100% of the value of the fund's net assets.

In the net commodity exposure table, the fund's net exposure as of 8/31/11 is equal to 86.8% of the fund's net assets and its gross exposure as of 8/31/11 is equal to 150.5% of the fund's net assets. The fund's net exposure equals the value of the fund's long positions minus the short positions. The fund's gross exposure equals the sum of the fund's long positions and short positions. Exposures are calculated as the notional value of the fund's derivative positions as a percentage of total net assets.

Portfolio characteristics	
Fund assets (in billions)	$2.41

Commodity maturity (%)[2,3]	
0 - 3 Months	65.0
3 - 6 Months	35.0
6+ Months	0.0

Fixed income maturity (%)[2,3]	
Less than one month	54.3
1 - 3 Months	33.6
3 - 6 Months	11.0
6+ Months	1.1

Net commodity exposure (%)[2,4]	
Precious Metals and Financial Commodities	77.1
Agriculture	14.9
Energy	-1.5
Industrial Metals	-3.8

Cash investments (%)[2,4]	
U.S. Government Agency Securities	63.9
Short-Term Investments	26.5
Repurchase Agreements	5.7
U.S. Treasury Securities	1.9
Certificates of Deposit	0.2

[2]Data as of 8/31/11
[3]Due to rounding, values may not total 100%
[4]Percent of total net assets

Fund performance*

Performance at NAV (%)	Total returns: Latest QTR	Total returns: YTD	Average annual total returns: 1 yr	3 yrs	5 yrs	Since inception
A Shares	-6.27	-4.87	14.40	N/A	N/A	13.92
C Shares	-6.42	-5.20	13.90	N/A	N/A	13.38
Select Shares	-6.24	-4.65	14.75	N/A	N/A	14.24
Dow Jones-UBS Commodity Index Total Return	-11.33	-13.62	0.02	N/A	N/A	10.49
Lipper Commodities General Funds Average	-10.87	-9.70	2.85	N/A	N/A	6.21
With sales charges (%)						
A Shares with 5.25% max. sales charge	-11.21	-9.86	8.39	N/A	N/A	10.39
C Shares with 1.00% max. CDSC	-7.42	-6.20	12.90	N/A	N/A	13.38

The Fund launched on 1/13/10 and was seeded with proprietary assets. Please note the performance shown does not take into consideration the inflow and outflows of cash which would have had an effect on performance. Also note, the limited performance track record is not a true indication of how this fund will perform in the long term.

**The performance quoted is past performance and is not a guarantee of future results. Mutual funds are subject to certain market risks. Investment returns and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than original cost. Current performance may be higher or lower than the performance data shown. For performance current to the most recent month-end please call 1-800-480-4111.*

Annual operating expenses	A Shares	C Shares	Select
Expense cap expiration date	2/29/2012	2/29/2012	2/29/2012
Expense cap (%)	1.65	2.15	1.40
Total annual Fund operating expenses (%)[1]	2.33	2.78	2.22
Fee waivers and/or expense reimbursements (%)[1]	(0.61)	(0.56)	(0.75)
Net expenses (%)[1]	1.72	2.22	1.47

[1]The Investment Advisor, Administrator and Distributor have contractually agreed to waive fees and/or reimburse expenses to the extent that Total Annual Operating Expenses (excluding Acquired Fund Fees and Expenses, dividend expenses relating to short sales, interest, taxes and extraordinary expenses and expenses related to the Board of Trustees' deferred compensation plan) exceed the expense cap of the average daily net assets through the expense cap expiration date. In addition, the Fund's service providers may voluntarily waive or reimburse certain of their fees, as they may determine, from time to time.

Portfolio statistics	A Shares	C Shares	Select
Inception date	1/13/2010	1/13/2010	1/13/2010
Investment minimum	$1,000	$1,000	$1M
Fund number	2013	2014	2015
CUSIP	48121A696	48121A688	48121A670

Insight + Process = Results™

Please refer to the back of the page for important disclosure information including risks associated with investing in the Fund.

J.P.Morgan
Asset Management

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Highbridge Dynamic Commodities Strategy Fund

A Shares (HDSAX)
C Shares (HDCCX)
Select Shares (HDCSX)
(Offered on a limited basis.)

Contact JPMorgan Distribution Services, Inc. at 1-800-480-4111 for a fund prospectus. You can also visit us at www.jpmorganfunds.com. Investors should carefully consider the investment objectives and risks as well as charges and expenses of the mutual fund before investing. The prospectus contains this and other information about the mutual fund. Read the prospectus carefully before investing.

RISKS ASSOCIATED WITH INVESTING IN THE FUND:

The Fund will gain exposure to commodity markets primarily by investing up to 25% of its total assets in the HCM Commodities Strategy Fund Ltd., a wholly owned subsidiary of the Fund organized under the laws of the Cayman Islands. By investing in the Subsidiary, the Fund is indirectly exposed to the risks associated with the Subsidiary's investments. The derivatives and other investments held by the Subsidiary are generally similar to those that are permitted to be held by the Fund and are subject to the same risks that apply to similar investments if held directly by the Fund. The Fund may use derivatives in connection with its investment strategies. Derivatives may be riskier than other types of investments because they may be more sensitive to changes in economic or market conditions than other types of investments and could result in losses that significantly exceed the Fund's original investment. The techniques and strategies contemplated by the Fund are expected to result in a high degree of portfolio turnover. Portfolio turnover may vary greatly from year to year as well as within a particular year. High portfolio turnover (e.g. over 100%) may involve correspondingly greater expenses to the Fund, including brokerage commissions or dealer mark-ups and other transaction costs on the sale of securities and reinvestments in other securities.

Assets not invested in commodity-linked derivatives, currency-linked derivatives or the Subsidiary will be invested in fixed income securities. The fixed income portion of the Fund is intended to provide liquidity and preserve capital. The Fund generally will only buy securities that have remaining maturities of 397 days or less. The dollar-weighted average maturity of the Fund's fixed income investments will generally be 90 days or less.

The Fund's investment in income securities is subject to interest rate risks. Bond prices generally fall when interest rates rise. The Fund will have a significant portion of its assets concentrated in commodity-linked securities. Developments affecting commodities will have a disproportionate impact on the Fund. The Fund's investment in commodity-linked derivative instruments may subject the Fund to greater volatility than investments in traditional securities, particularly if the instruments involve leverage. The value of commodity-linked derivative instruments may be affected by changes in overall market movements, commodity index volatility, changes in interest rates, or factors affecting a particular industry or commodity, such as drought, floods, weather, livestock disease, embargoes, tariffs and international economic, political and regulatory developments. Use of leveraged commodity-linked derivatives creates an opportunity for increased return but, at the same time, creates the possibility for greater loss (including the likelihood of greater volatility of the Fund's net asset value), and there can be no assurance that the Fund's use of leverage will be successful.

INDEXES DEFINED:

The Dow Jones-UBS Commodity Index Total Return is composed of futures contracts on 19 physical commodities. The performance of the index does not reflect the deduction of expenses associated with a fund, such as investment management fees. By contrast, the performance of the Fund reflects the deduction of the fund expenses, including sales charges if applicable. An individual cannot invest directly in an index.

The performance of the Lipper Commodities General Funds Average includes expenses associated with a mutual fund, such as investment management fees. These expenses are not identical to the expenses charged by the Fund.

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Total return assumes reinvestment of dividends and capital gains distributions and reflects the deduction of any sales charges, where applicable. Performance may reflect the waiver of a portion of the Fund's advisory or administrative fees for certain periods since the inception date. If fees had not been waived, performance would have been less favorable.

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J.P.Morgan
Asset Management

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MutualHedge Frontier Legends Fund

CLASS A AND CLASS C SHARES

Annual Report
September 30, 2010

1-888-643-3431
WWW.MUTUALHEDGE.COM

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Member FINRA

MutualHedge Frontier Legends Fund

Annual Letter to Shareholders for the period ended September 30, 2010

MutualHedge Frontier Legends Fund began trading on December 31, 2009 with an initial NAV of $10.00. For the period ending on September 30, 2010, Class A Shares returned 1.00% and Class C Shares returned 0.50%. For the same nine-month period, the CASAM CISDM CTA Asset Weighted Index* (the "Managed Futures Index") returned 4.93% and the S&P 500 Total Return Index** returned 3.89%.

Most of the Fund's underperformance versus the Managed Futures Index came in the first quarter of 2010, the Fund's very first quarter of operations, when the Fund was down about 1%. As discussed in our last letter, this was the period during which CTA Programs (defined below) were brought "on line" one at a time and were scaled into gradually. The Fund was down 1.3% during the second quarter, but there was a strong rebound in performance during the third quarter, when the Fund was up a healthy 3.3%. We discuss performance attribution at greater length later in this letter.

The Fund's investment objective and strategy is to achieve capital appreciation in both rising and falling equity markets with an annualized level of volatility similar to the historic level of volatility experienced by the S&P 500 Index. By analyzing the interrelationships among selected programs, the Fund seeks to combine them in a portfolio that offers more consistent performance potential with lower volatility than individual programs. The Fund gains exposure to managed futures programs of selected commodity trading advisors ("CTA Programs") through its investments in trading companies.[1] The Fund's allocation as of September 30, 2010 to the five currently selected CTA Programs is displayed below. These allocations will vary over time as a function of ongoing portfolio management and as new programs are identified and added to the mix.

MutualHedge Managed Futures Exposure as of September 30, 2010

	Allocation % (based on	Allocation changes from

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Trading Company Name	notional exposure levels)	3/31/2010 to 9/30/2010
Beach Horizon Trading - Horizon Program, LLC	22.3%	-2.7%
Cantab Trading Company - Aristarchus Program, LLC	21.4%	4.4%
QIM Trading Company - Global Program, LLC	20.7%	-3.9%
Tiverton Trading Company - Discretionary Program, LLC	17.6%	1.1%
WNTN Trading Company - Diversified Program, LLC	18.0%	1.1%

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[1] The Fund invests in the CTA Programs through its wholly-owned subsidiary.

The five programs differ in terms of primary trading characteristics. This is reflected in their long-term historical correlations, which are generally fairly low.

Correlation Coefficient of CTA Programs January 2005 to September 2010	Beach	Cantab	QIM	Tiverton	Winton
Beach Horizon, LLP	1.00	0.61	-0.04	0.63	0.73
Cantab Capital Partners, LLP	0.61	1.00	0.05	0.47	0.58
Quantitative Investment Management, LLC	-0.04	0.05	1.00	0.07	-0.10
Tiverton Trading, Inc.	0.63	0.47	0.07	1.00	0.42
Winton Capital Management	0.73	0.58	-0.10	0.42	1.00

Note that the Fund gains exposure to these CTA Programs through trading companies managed by the CTAs listed above. The correlation coefficients in the chart above are based upon each CTA's track record. Not all CTAs have track records for the full period of this analysis. Inception dates for these are: Beach Horizon: May 2005; Tiverton: April 2006; Cantab: March 2007. The track records, with the exception of Beach Horizon and Cantab which use a model account, are the composite track records of the respective CTAs, and do not include fees and expenses associated with an investment in the Fund including the indirect expenses of the Fund's subsidiary and the CTA Programs.

Correlation Coefficient: The correlation coefficient, r, indicates both the strength and direction of the relationship between the independent and pendent variables. Values of r range from -1.0, a strong negative relationship, to +1.0, a strong positive relationship. When r=0, there is no relationship between the S&P 500® and the other funds it is being compared to.

In reviewing the Fund's performance, it is important to recognize that CTA Programs can hold long, short or neutral positions, with the potential to earn profits in rising or falling markets across the six different sectors: metals, energy, agricultural, currencies, interest rates and stock indexes.

For the period from inception through September 30, 2010, three of our five CTA Programs posted positive returns of 9.6%, 2.9% and 1.5%, respectively, while the two negatively performing programs returned -4.1% and -5.7%. The underlying CTA Programs' month-by-month results also attest to the fact that the five programs have widely varying sources of returns: there was not a single month in which all five programs traded down, and two months in which they all earned positive returns. Further, their best and worst months of performance generally did not coincide. This pattern of monthly returns reflects the low correlations among the programs and illustrates the potential benefits of a diversified portfolio.

1678-NLD-11/12/2010

The drivers of performance also tend to differ across the programs. The best performing program, Winton, earned the bulk of its positive performance from trading interest rates, currencies and metals, while experiencing smaller losses in stock indexes, energy, and agriculturals. The worst performing program, QIM, incurred losses mainly in trading stock indexes, as well as in all other market sectors except interest rates, which were slightly profitable. The remaining three programs were all profitable in interest rates and metals; Beach Horizon and Cantab had meaningful losses in the other four sectors, while Tiverton's losses were smaller. On the whole, then, interest rates were the most significant positive contributor to Fund performance, followed by metals, while the losing sectors were led by stock indexes.

Other contributors to the Fund's underperformance versus the Managed Futures Index include: the fact that (i) the Fund's investments in the CTA Programs do not correspond with the components and weightings of the Managed Futures Index and some managed futures strategies may not be represented in the Fund, and (ii) the timing effects of the Fund's new investments into the trading companies may cause outperformance or underperformance against the Managed Futures Index.

A material portion of the Fund is invested in securities known as exchange traded funds (ETFs), which are designed to mimic the performance of pecific fixed-income indices. These investments may have material effects on the Fund's overall performance. For the period from inception through September 30, 2010, the CTA Programs out-performed the ETFs.

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Returns on the Fund's investment in the Subsidiary are net of the management fees and incentive fees of the trading companies. The aggregate weighted average management fee and weighted average incentive fee of the trading companies, in which the Subsidiary invested, were 0.64% of assets under management and 24.55% of trading profits, as of September 30, 2010.

‹ket Commentary

In May this year, the "flash crash" in U.S. stock markets raised some serious concerns in the minds of investors. It is worth noting that circuit breakers in the S&P index futures market were triggered and succeeded in slowing down trading, demonstrating the efficacy of some of the safety nets that have the potential to protect futures markets. The trading systems of our CTA Programs also appear to have been robust enough to withstand the shock. While four of our five programs did have negative performance during May, the Fund lost only about 1.5%. For comparison, the worst month during this year for the Managed Futures Index was January, when it fell as much as 3.0%.

The global economy continued to grow during the second and third quarters, although the outlook remains weak and policymakers face several tricky imbalances. The headline story during recent months has been the rally in bonds, catalyzed by the weak economy and expectations of further quantitative easing by the U.S. Federal Reserve. Interest rates are unusually low, especially in developed economies, reflecting both aggressive monetary policy as well as weak demand for credit. As money flows out of these countries and into emerging economies, where interest rates are higher, upward pressure develops on their currencies, potentially hurting exports. The higher rates of economic growth in these countries are also creating inflationary pressures, which may result in tighter monetary policies and further interventions in currency markets.

Meanwhile, the effects of the financial meltdown are still being felt mainly in developed economies as businesses and banks hoard cash and deleverage. In the U.S., manufacturing continues to increase at a very slow pace. Personal income and spending have increased modestly, while consumer confidence remains low. The housing market has not shown significant signs of recovery. The good news is that inflation appears to be under control, at least for the foreseeable future. Additionally, the outlook for emerging economies like China and India remains positive, albeit tempered by longer-term challenges and the need for structural changes.

The price of gold continues to climb, possibly a reflection of its status as a perceived safe haven. Energy markets have been fairly quiet, while agricultural prices have displayed an upward trend. Other significant market developments have included the sovereign debt crisis in Europe, the ›akness of the U.S. dollar, the strength of the Japanese yen. The high probability of gridlock in Washington after the U.S. elections appears to have ›ergized Wall Street and the equity markets. The prospect of lower taxes, lower deficits and a lower level of effort directed towards regulatory reform of the markets is appealing to many market participants.

Although we are pleased with the Fund's recent performance, because of the unpredictable nature in the short-term of financial markets and most asset classes, we encourage investors to focus on holding a portfolio that contains a mix of stocks, bonds, cash and alternative asset classes appropriate for their long-term goals. Such a well-balanced portfolio can provide protection from volatility while also affording opportunities for potential long-term growth. We believe that the Fund can play an important part in such a portfolio.

Thank you for investing in the MutualHedge Frontier Legends Fund.

* **The CASAM CISDM CTA Asset Weighted Index** reflects the dollar-weighted performance of Commodity Trading Advisors (CTAs) reporting to the CASAM CISDM Database. CTAs trade a wide variety of OTC and exchange-traded forward, futures and options markets (e.g., physicals, currency, financial), based on a wide variety of trading models. In order to be included in the Asset Weighted Index universe, a CTA must have at least $500,000 under management and at least a 12-month track record. The index goes back historically to January 1980. Source: casamhedge.com.

** **The S&P 500®Total Return Index** is widely regarded as the best single gauge of the U.S. equities market. This world-renowned Index includes 500 leading companies in leading industries of the U.S. economy. Although the S&P 500 focuses on the large cap segment of the market, with approximately 75% coverage of U.S. equities, it is also an ideal proxy for the total market. Total return provides investors with a price-plus-gross cash dividend return. Gross cash dividends are applied on the ex-date of the dividend. Source: standardandpoors.com.

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MutualHedge Frontier Legends Fund
PORTFOLIO REVIEW
September 30, 2010 (Unaudited)

The Fund's performance figures* for the period ending September 30, 2010, compared to its benchmarks:

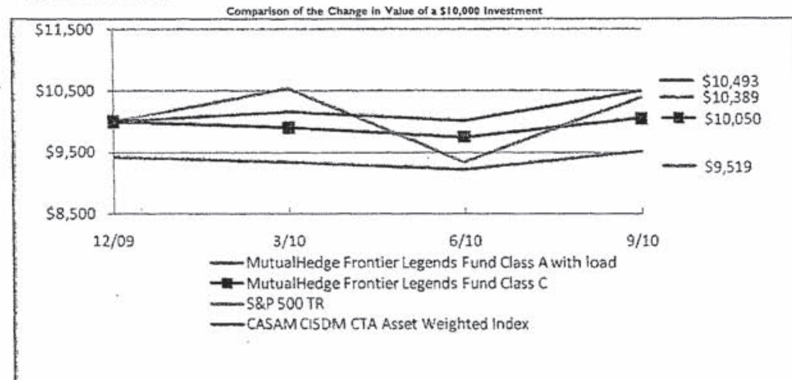
	Inception** – September 30, 2010
MutualHedge Frontier Legends Fund – Class A	1.00%
MutualHedge Frontier Legends Fund – Class A with load	-4.81%
MutualHedge Frontier Legends Fund – Class C	0.50%
CASAM CISDM CTA Asset Weighted Index	4.93%
S&P 500 Total Return Index	3.89%

* *The performance data quoted here represents past performance. The performance comparison includes reinvestment of all dividends and capital gains and has been adjusted for the Class A maximum applicable sales charge of 5.75%. Current performance may be lower or higher than the performance data quoted above. Past performance is no guarantee of future results. The investment return and principal value of an investment will fluctuate so that investor's shares, when redeemed, may be worth more or less than their original cost. The returns shown do not reflect the deduction of taxes that a shareholder would pay on Fund distributions or on the redemption of Fund shares. Performance figures for periods greater than 1 year are annualized. The Fund's total annual operating expenses are 2.20% for Class A shares, 2.95% for Class C shares per the January 1, 2010, prospectus. For performance information current to the most recent month-end, please call toll-free 1-888-643-3431.*

The CASAM CISDM CTA Asset Weighted Index reflects the dollar-weighted performance of Commodity Trading Advisors (CTAs) reporting to the CASAM CISDM Database. CTAs trade a wide variety of OTC and exchange-traded forward, futures and options markets (e.g., physicals, currency, financial), based on a wide variety of trading models. In order to be included in the Asset Weighted Index universe, a CTA must have at least $500,000 under management and at least a 12-month track record. The index goes back historically to January 1980.

** Inception date is December 31, 2009.

Comparison of the Change in Value of a $10,000 Investment



The Fund's Top Asset Classes are as follows:

Sectors	% of Net Assets
Exchange Traded Funds – Bonds	56.3%
Systematic Trading Companies	19.2%
Other, Cash & Cash Equivalents	24.5%
	100.00%

MutualHedge Frontier Legends Fund
CONSOLIDATED PORTFOLIO OF INVESTMENTS
September 30, 2010

Shares	Value

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	EXCHANGE TRADED FUNDS - 56.3%		
210,375	iShares Barclays 1-3 Year Credit Bond Fund	$	22,097,790
203,630	iShares Barclays Aggregate Bond Fund		22,124,399
22,490	iShares S&P/Citigroup 1-3 Year International Treasury Bond Fund		2,365,948
882,513	PowerShares VRDO Tax-Free Weekly Portfolio		22,058,412
	TOTAL EXCHANGE TRADED FUNDS (Cost $68,160,093)		68,646,549
	SYSTEMATIC TRADING COMPANIES - 19.2%		
8,581,423	Beach Horizon Trading Co. - Horizon Program, LLC * +		6,943,487
6,652,569	Cantab Trading Co. - Aristarchus Program, LLC * +		7,289,020
4,578,664	QIM Trading Co. - Global Program, LLC * +		3,860,776
1,782,534	Tiverton Trading Co. - Discretionary Program, LLC * +		2,201,537
1,727,763	WNTN Trading Co. - Diversified Program, LLC * +		3,109,507
	TOTAL SYSTEMATIC TRADING COMPANIES (Cost $19,986,110)		23,404,327
	TOTAL INVESTMENTS - 75.5% (Cost $88,146,203) (a)	$	92,050,876
	OTHER ASSETS AND LIABILITIES - 24.5%		29,962,446
	TOTAL NET ASSETS - 100.0%	$	122,013,322

(a) Represents cost for financial reporting purposes. Aggregate cost for federal tax purposes is $88,146,203 and differs from market value by net unrealized appreciation (depreciation) of securities as follows:

Unrealized Appreciation:	$	3,921,918
Unrealized Depreciation:		(17,245)
Net Unrealized Appreciation:	$	3,904,673

*Non-income producing investment.
+This investment is a holding of MutualHedge Fund Limited SPC.

See accompanying notes to financial statements.

MutualHedge Frontier Legends Fund
CONSOLIDATED STATEMENT OF ASSETS AND LIABILITIES
September 30, 2010

ASSETS		
Investment securities:		
At cost	$	88,146,203
At value	$	92,050,876
Cash		29,177,552
Receivable for Fund shares sold		1,019,195
Dividends and interest receivable		6,030
Prepaid expenses and other assets		269
TOTAL ASSETS		122,253,922
LIABILITIES		
Investment advisory fees payable		113,309
Distribution (12b-1) fees payable		26,788
Fees payable to other affiliates		18,716
Payable for Fund shares repurchased		1,850
Accrued expenses and other liabilities		79,937
TOTAL LIABILITIES		240,600
NET ASSETS	$	122,013,322
Composition of Net Assets:		
Paid in capital [$0 par value, unlimited shares authorized]	$	118,108,649
Net unrealized appreciation of investments		3,904,673
NET ASSETS	$	122,013,322
Net Asset Value Per Share:		
Class A Shares:		
Net Assets	$	113,177,204

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Shares of beneficial interest outstanding		11,203,024
Net asset value (Net Assets ÷ Shares Outstanding), offering price and redemption price per share (a)(b)	$	10.10
Maximum offering price per share (net asset value plus maximum sales charge of 5.75%) (c)	$	10.72
Class C Shares:		
Net Assets	$	8,836,118
Shares of beneficial interest outstanding		879,246
Net asset value (Net Assets ÷ Shares Outstanding), offering price and redemption price per share (b)	$	10.05

(a) For certain purchases of $1 million or more, a 1% contingent deferred sales charge may apply to redemptions made within twelve months of purchase.
(b) Redemptions made within 30 days of purchase may be assessed a redemption fee of 1.00%.
(c) On investments of $25,000 or more, the offering price is reduced.

See accompanying notes to financial statements.

MutualHedge Frontier Legends Fund
CONSOLIDATED STATEMENT OF OPERATIONS
For the Period Ended September 30, 2010(a)

INVESTMENT INCOME		
Dividends	$	207,150
Interest		20,587
TOTAL INVESTMENT INCOME		227,737
EXPENSES		
Investment advisory fees		388,406
Professional fees		102,903
Distribution (12b-1) fees:		
Class A		53,861
Class C		13,030
Transfer agent fees		44,112
Administrative services fees		40,517
Accounting services fees		22,171
Registration fees		12,488
Compliance officer fees		9,853
Printing and postage expenses		9,853
Custodian fees		8,129
Trustees fees and expenses		5,941
Insurance expense		464
Other expenses		3,972
TOTAL EXPENSES		715,700
Less: Fees waived by the Advisor		(206,650)
NET EXPENSES		509,050
NET INVESTMENT LOSS		(281,313)
REALIZED AND UNREALIZED GAIN ON INVESTMENTS		
Net realized gain from security transactions		1,442
Net change in unrealized appreciation (depreciation) of investments		3,904,673
NET REALIZED AND UNREALIZED GAIN ON INVESTMENTS		3,906,115
NET INCREASE IN NET ASSETS RESULTING FROM OPERATIONS	$	3,624,802

(a) The MutualHedge Frontier Legends Fund commenced operations on December 31, 2009.

See accompanying notes to financial statements.

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MutualHedge Frontier Legends Fund
CONSOLIDATED STATEMENT OF CHANGES IN NET ASSETS

	For the Period Ended September 30, 2010 (a)
FROM OPERATIONS	
Net investment loss	$ (281,313)
Net realized gain from security transactions	1,442
Net change in unrealized appreciation (depreciation) of investments	3,904,673
Net increase in net assets resulting from operations	3,624,802
FROM SHARES OF BENEFICIAL INTEREST	
Proceeds from shares sold:	
Class A	114,100,529
Class C	8,588,156
Redemption fee proceeds:	
Class A	1,434
Class C	91
Payments for shares redeemed:	
Class A	(4,287,819)
Class C	(13,871)
Net increase in net assets from shares of beneficial interest	118,388,520
TOTAL INCREASE IN NET ASSETS	122,013,322
NET ASSETS	
Beginning of Period	-
End of Period	$ 122,013,322
SHARE ACTIVITY	
Class A:	
Shares Sold	11,638,891
Shares Redeemed	(435,867)
Net increase in shares of beneficial interest outstanding	11,203,024
Class C:	
Shares Sold	880,644
Shares Redeemed	(1,398)
Net increase in shares of beneficial interest outstanding	879,246

(a) The MutualHedge Frontier Legends Fund commenced operations on December 31, 2009.

See accompanying notes to financial statements.

MutualHedge Frontier Legends Fund
CONSOLIDATED FINANCIAL HIGHLIGHTS

Per Share Data and Ratios for a Share of Beneficial Interest Outstanding Throughout the Period

	Class A Period Ended September 30, 2010 (1)	Class C Period Ended September 30, 2010 (1)
Net asset value, beginning of period	$ 10.00	$ 10.00
Activity from investment operations:		

http://globaldocuments.morningstar.com/documentlibrary/document/5f8ce96e43448750862ea2730ef0a7c.msdoc/original[10/27/2011 10:52:47 AM]

Net investment loss (2)	(0.09)	(0.14)
Net realized and unrealized gain on investments	0.19	0.19
Total from investment operations	0.10	0.05
Net asset value, end of period	$ 10.10	$ 10.05
Total return (3)(8)	1.00%	0.50%
Net assets, at end of period (000s)	$ 113,177	$ 8,836
Ratio of gross expenses to average net assets (4)(5)(6)	2.98%	5.97%
Ratio of net expenses to average net assets (5)(6)	2.20%	2.95%
Ratio of net investment loss to average net assets (5)(7)	(1.19)%	(1.99)%
Portfolio Turnover Rate (8)	0%	0%

(1) The MutualHedge Frontier Legends Fund's Class A and Class C shares commenced operations December 31, 2009.
(2) Per share amounts calculated using the average shares method, which more appropriately presents the per share data for the period.
(3) Total returns shown exclude the effect of applicable sales charges and redemption fees.
(4) Represents the ratio of expenses to average net assets absent fee waivers and/or expense reimbursements by the Advisor.
(5) Annualized for periods less than one full year.
(6) Does not include the expenses of other investment companies in which the Fund invests.
(7) Recognition of net investment income by the Fund is affected by the timing of the declaration of dividends by the underlying investment companies in which the Fund invests.
(8) Not annualized.

See accompanying notes to financial statements.

MutualHedge Frontier Legends Fund
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
September 30, 2010

1. ORGANIZATION

The MutualHedge Frontier Legends Fund (the "Fund") is a non-diversified series of shares of beneficial interest of Northern Lights Fund Trust (the "Trust"), a statutory trust organized under the laws of the State of Delaware on January 19, 2005, and is registered under the Investment Company Act of 1940, as amended (the "1940 Act"), as an open-end management investment company. The Fund currently offers two distinct share classes; Class A and Class C shares. The Fund seeks to achieve capital appreciation in both rising and falling (bull and bear) equity markets with an annual volatility that is generally lower than the volatility experienced by the S&P 500 Index. The investment objective of the Fund is non-fundamental and may be changed without shareholder approval.

The Fund currently offers Class A and Class C shares. Class C shares are offered at net asset value. Class A shares are offered at net asset value plus a maximum sales charge of 5.75%. Each class represents an interest in the same assets of the Fund and classes are identical except for differences in their sales charge structures and ongoing service and distribution charges. All classes of shares have equal voting privileges except that each class has exclusive voting rights with respect to its service and/or distribution plans. The Fund's income, expenses (other than class specific distribution fees) and realized and unrealized gains and losses are allocated proportionately each day based upon the relative net assets of each class.

2. SIGNIFICANT ACCOUNTING POLICIES

The following is a summary of significant accounting policies followed by the Fund in preparation of its consolidated financial statements. The policies are in conformity with accounting principles generally accepted in the United States of America ("GAAP"). The preparation of the consolidated financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of income and expenses for the period. Actual results could differ from those estimates.

Security Valuation – Securities, including exchange traded funds, listed on an exchange are valued at the last reported sale price at the close of the regular trading session of the exchange on the business day the value is being determined, or in the case of securities listed on NASDAQ at the NASDAQ Official Closing Price ("NOCP"). In the absence of a sale such securities shall be valued at the last bid price on the day of valuation. If market quotations are not readily available or if the Advisor believes the market quotations

are not reflective of market value, securities will be valued at their fair market value as determined in good faith by the Trust's Fair Value Committee and in accordance with the Trust's Portfolio Securities Valuation Procedures (the "Procedures"). The Board of Trustees (the "Board") will review the fair value method in use for securities requiring a fair market value determination at least quarterly. The Procedures consider, among others, the following factors to determine a security's fair value: the nature and pricing history (if any) of the security; whether any dealer quotations for the security are available; and possible valuation methodologies that could be used to determine the fair value of the security. Investments in Systematic Trading Companies are valued at a fair value based on the net asset value as reported by underlying trading companies. Short-term debt obligations having 60 days or less remaining until maturity, at time of purchase, are valued at amortized cost. Investments in open-end investment companies are valued at net asset value.

MutualHedge Frontier Legends Fund
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
September 30, 2010

The Fund utilizes various methods to measure the fair value of most of its investments on a recurring basis. GAAP establishes a hierarchy that prioritizes inputs to valuation methods. The three levels of input are:

Level 1 – Unadjusted quoted prices in active markets for identical assets and liabilities that the Fund has the ability to access.

Level 2 – Observable inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly. These inputs may include quoted prices for the identical instrument in an inactive market, prices for similar instruments, interest rates, prepayment speeds, credit risk, yield curves, default rates and similar data.

Level 3 – Unobservable inputs for the asset or liability, to the extent relevant observable inputs are not available, representing the Fund's own assumptions about the assumptions a market participant would use in valuing the asset or liability, and would be based on the best information available.

The availability of observable inputs can vary from security to security and is affected by a wide variety of factors, including, for example, the type of security, whether the security is new and not yet established in the marketplace, the liquidity of markets, and other characteristics particular to the security. To the extent that valuation is based on models or inputs that are less observable or unobservable in the market, the determination of fair value requires more judgment. Accordingly, the degree of judgment exercised in determining fair value is greatest for instruments categorized in Level 3.

The inputs used to measure fair value may fall into different levels of the fair value hierarchy. In such cases, for disclosure purposes, the level in the fair value hierarchy within which the fair value measurement falls in its entirety, is determined based on the lowest level input that is significant to the fair value measurement in its entirety.

The inputs or methodology used for valuing securities are not necessarily an indication of the risk associated with investing in those securities. The following tables summarize the inputs used as of September 30, 2010 for the Fund's assets and liabilities measured at fair value:

MutualHedge Frontier Legends Fund
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
September 30, 2010

Assets	Level 1	Level 2	Level 3	Total
Exchange Traded Funds	$ 68,646,549	$ -	$ -	$ 68,646,549
Systematic Trading Companies	-	23,404,327	-	$ 23,404,327
Total	$ 68,646,549	$ 23,404,327	$ -	$ 92,050,876

The Fund did not hold any Level 3 securities during the period.

MutualHedge Fund Limited SPC (MFL-SPC) – The consolidated financial statements of the Fund include MFL-SPC, a wholly-owned and controlled subsidiary. All inter-company accounts and transactions have been eliminated in consolidation.

The Fund may invest up to 25% of its total assets in a segregated portfolio company ("SPC"), which acts as an investment vehicle in order to effect certain investments consistent with the Fund's investment objectives and policies.

MFL-SPC invests in the global derivatives markets through the use of one or more proprietary global macro trading programs ("global macro programs"), which are often labeled "managed futures" programs. Global macro programs attempt to earn profits in a variety of markets by employing long and short trading algorithms applied to futures, options, forward contracts, and other derivative instruments. It is anticipated that the global macro programs used by MFL-SPC will be tied to a variety of global markets for currencies, interest rates, stock market indices, energy resources, metals and agricultural products. MFL-SPC's investment in a global

macro program may be through investment in one or more unaffiliated private investment vehicles or unaffiliated commodity pools ("unaffiliated trading companies") advised by one or more commodity trading advisors or "CTAs" registered with the U.S. Commodity Futures Trading Commission. The Fund or MFL-SPC do not consolidate the assets, liabilities, capital or operations of the trading companies into their financial statements. Rather, the unaffiliated trading companies are separately presented as an investment in the Fund's consolidated portfolio of investments. Income, gains and unrealized appreciation or depreciation on the investments in the trading companies are recorded in the Fund's consolidated statement of assets and liabilities and the Fund's consolidated statement of operations.

In accordance with its investment objectives and through its exposure to the aforementioned global macro programs, the Fund may have increased or decreased exposure to one or more of the following risk factors defined below:

Commodity Risk. Commodity risk relates to the change in value of commodities or commodity indexes as they relate to increases or decreases in the commodities market. Commodities are physical assets that have tangible properties. Examples of these types of assets are crude oil, heating oil, metals, livestock, and agricultural products.

Credit Risk. Credit risk relates to the ability of the issuer to meet interest and principal payments, or both, as they come due. In general, lower-grade, higher-yield bonds are subject to credit risk to a greater extent than lower-yield, higher-quality bonds.

Equity Risk. Equity risk relates to the change in value of equity securities as they relate to increases or decreases in the general market.

MutualHedge Frontier Legends Fund
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
September 30, 2010

Foreign Exchange Rate Risk. Foreign exchange rate risk relates to the change in the U.S. dollar value of a security held that is denominated in a foreign currency. The U.S. dollar value of a foreign currency denominated security will decrease as the dollar appreciates against the currency, while the U.S. dollar value will increase as the dollar depreciates against the currency.

Interest Rate Risk. Interest rate risk refers to the fluctuations in value of fixed-income securities resulting from the inverse relationship between price and yield. For example, an increase in general interest rates will tend to reduce the market value of already issued fixed-income investments, and a decline in general interest rates will tend to increase their value. In addition, debt securities with longer
maturities, which tend to have higher yields, are subject to potentially greater fluctuations in value from changes in interest rates than obligations with shorter maturities.

Volatility Risk. Volatility risk refers to the magnitude of the movement, but not the direction of the movement, in a financial instrument's price over a defined time period. Large increases or decreases in a financial instrument's price over a relative time period typically indicate greater volatility risk, while small increases or decreases in its price typically indicate lower volatility risk.

Please refer to the Fund's prospectus for a full listing of risks associated with these investments.

A summary of the Fund's investments in the MFL-SPC is as follows:

MutualHedge Fund Limited SPC (MFL-SPC) * September 30, 2010		
Fair Value of Systematic Trading Companies	$	23,404,327
Other Assets	$	49,955
Total Net Assets	$	23,454,282
Percentage of the Fund's Total Net Assets		19.22%

* MFL-SPC commenced operations on January 12, 2010

For tax purposes, MFL-SPC is an exempted Cayman investment company. MFL-SPC has received an undertaking from the Government of the Cayman Islands exempting it from all local income, profits and capital gains taxes. No such taxes are levied in the Cayman Islands at the present time. For U.S. income tax purposes, MFL-SPC is a Controlled Foreign Corporation and as such is not subject to U.S. income tax. However, as a wholly-owned Controlled Foreign Corporation, MFL-SPC's net income and capital gain, to the extent of its earnings and profits, will be included each year in the Fund's investment company taxable income.

Security Transactions and Related Income – Security transactions are accounted for on trade date basis. Interest income is recognized on an accrual basis. Discounts are accreted and premiums are amortized on securities purchased over the lives of the respective securities. Dividend income is recorded on the ex-dividend date. Realized gains or losses from sales of securities are determined by comparing the identified cost of the security lot sold with the net sales proceeds.

MutualHedge Frontier Legends Fund
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
September 30, 2010

Dividends and Distributions to Shareholders – Dividends from net investment income, if any, are declared and paid at least annually. Distributable net realized capital gains, if any, are declared and distributed annually. Dividends from net investment income and distributions from net realized gains are determined in accordance with federal income tax regulations, which may differ from GAAP. These "book/tax" differences are considered either temporary (i.e., deferred losses, capital loss carry forwards) or permanent in nature. To the extent these differences are permanent in nature, such amounts are reclassified within the composition of net assets based on their federal tax-basis treatment; temporary differences do not require reclassification. Dividends and distributions to shareholders are recorded on ex-dividend date.

Cash and Cash Equivalents – Cash and cash equivalents include cash and overnight investments in interest-bearing demand deposits with a financial institution with maturities of three months or less. The Fund maintains deposits with a high quality financial institution in an amount that is in excess of federally insured limits.

Federal Income Taxes – The Fund intends to continue to comply with the requirements of the Internal Revenue Code applicable to regulated investment companies and to distribute all of its taxable income to its shareholders. Therefore, no provision for Federal income tax is required. The Fund recognizes the tax benefits of uncertain tax positions only where the position is "more likely than not" to be sustained assuming examination by tax authorities. The Fund identifies its major tax jurisdictions as U.S. Federal, Nebraska and foreign jurisdictions where the Fund makes significant investments; however the Fund is not aware of any tax positions for which it is reasonably possible that the total amounts of unrecognized tax benefits will change materially in the next twelve months.

Indemnification – The Trust indemnifies its officers and trustees for certain liabilities that may arise from the performance of their duties to the Trust. Additionally, in the normal course of business, the Fund enters into contracts that contain a variety of representations and warranties and which provide general indemnities. The Fund's maximum exposure under these arrangements is unknown, as this would involve future claims that may be made against the Fund that have not yet occurred. However, based on experience, the risk of loss due to these warranties and indemnities appears to be remote.

3. INVESTMENT TRANSACTIONS

For the period ended September 30, 2010, cost of purchases and proceeds from sales of portfolio securities, other than short-term investments and U.S. Government securities, amounted to $88,146,203 and $0, respectively.

4. INVESTMENT ADVISORY AGREEMENT AND TRANSACTIONS WITH AFFILIATES

The business activities of the Fund are overseen by the Board, which is responsible for the overall management of the Fund. Equinox Fund Management, LLC serves as the Fund's Investment Advisor (the "Advisor"). The Fund has employed Gemini Fund Services, LLC ("GFS") to provide administration, fund accounting, and transfer agent services. A Trustee and certain officers of the Fund are also officers of GFS, and are not paid any fees directly by the Fund for serving in such capacities.

Pursuant to an Advisory Agreement with the Fund, the Advisor, under the oversight of the Board, directs the daily operations of the Fund and supervises the performance of administrative and professional services provided by others. As compensation for its services and the related expenses borne by the Advisor, the Fund pays the Advisor a management fee, computed and accrued daily and paid monthly, at an annual rate of 1.70% of the Fund's average daily net assets.

Pursuant to a written contract (the "Waiver Agreement"), the Advisor has agreed, at least until January 31, 2012, to waive a portion of its advisory fee and has agreed to reimburse the Fund for other expenses to the extent necessary so that the total expenses incurred by the Fund (excluding front-end or contingent deferred loads, brokerage fees and commissions, acquired fund fees and expenses, borrowing costs such as interest and dividend expenses on securities sold short, or extraordinary expenses, such as litigation, not incurred in the ordinary course of the Fund's business) do not exceed 2.20% and 2.95% per annum of the Fund's average daily net assets for Class A and Class C shares, respectively. For the period ended September 30, 2010, the Advisor waived fees in the amount of $206,650.

If the Advisor waives any fee or reimburses any expense pursuant to the Waiver Agreement, and the Fund's Operating Expenses are subsequently less than 2.20% and 2.95% of average daily net assets attributable to Class A and Class C shares, respectively, the Advisor shall be entitled to reimbursement by the Fund for such waived fees or reimbursed expenses provided that such reimbursement does not cause the Fund's expenses to exceed 2.20% and 2.95% of average daily net assets for each share class. If

Fund Operating Expenses attributable to Class A and Class C shares subsequently exceed 2.20% and 2.95%, respectively per annum of the average daily net assets, the reimbursements shall be suspended.

The Advisor may seek reimbursement only for expenses waived or paid by it during the three fiscal years prior to such reimbursement; provided, however, that such expenses may only be reimbursed to the extent they were waived or paid after the date of the Waiver Agreement (or any similar agreement). The Board may terminate this expense reimbursement arrangement at any time.

As of September 30, 2010, the Advisor has $206,650 of waived expenses that may be recovered no later than September 30, 2013.

The Board has adopted a Distribution Plan and Agreement (the "Plan") pursuant to Rule 12b-1 under the 1940 Act. The Plan provides that a monthly service and/or distribution fee is calculated by the Fund at an annual rate of 0.25% of the average daily net assets attributable to the Class A shares and 1.00% of the average daily net assets attributable to Class C shares and is paid to Northern Lights Distributors, LLC (the "Distributor"), to provide compensation for ongoing distribution-related activities or services and/or maintenance of the Fund's shareholder accounts, not otherwise required to be provided by the Advisor. The Plan is a compensation plan, which means that compensation is provided regardless of 12b-1 expenses incurred.

MutualHedge Frontier Legends Fund
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
September 30, 2010

The Distributor acts as the Fund's principal underwriter in a continuous public offering of the Fund's Class A and Class C shares. The Distributor is an affiliate of GFS. For the period ended September 30, 2010, the Distributor received $433,975 in underwriting commissions for sales of Class A shares, of which $61,789 was retained by the principal underwriter or other affiliated broker-dealers.

The Fund pays its pro rata share of a total fee of $12,500 per quarter for the Northern Lights Fund Trust to each Trustee who is not affiliated with the Trust or Advisor. The Fund pays the chairperson of the audit committee its pro rata share of an additional $2,500 per quarter. The "interested persons" who serve as Trustees of the Trust receive no compensation for their services as Trustees. None of the executive officers receive compensation from the Trust.

Pursuant to separate servicing agreements, GFS is compensated for providing *administration, fund accounting and transfer agency* services to the Fund as follows:

Administration. The Fund pays GFS an asset-based fee in decreasing amounts as Fund assets reach certain breakpoints. The Fund is subject to a minimum annual fee. The Fund also pays GFS for any out-of-pocket expenses. Fees are billed monthly as follows:

The greater of:
A minimum annual fee of $40,000 per annum or
- 10 basis points or 0.10% per annum on the first $100 million in net assets
- 6 basis points or 0.06% per annum on the next $150 million in net assets
- 5 basis points or 0.05% per annum on net assets greater than $250 million

Fund Accounting. Total charges for Fund Accounting services include asset-based fees and out-of-pocket expenses. Fees are calculated based upon the average net assets of the Fund for the previous month. The Fund pays GFS a base annual fee of $24,000 plus $6,000 for each additional share class above one plus a basis point fee in decreasing amounts as Fund assets reach certain breakpoints, as follows:

- 2 basis points or 0.02% on net assets of $25 million to $100 million
- 1 basis point or 0.01% on net assets greater than $100 million

Transfer Agency. For the services rendered by GFS in its capacity as transfer agent, the Fund pays GFS transfer agent fees, out-of-pocket expenses, activity charges, and special report charges. The fees are billed monthly as follows:

- The greater of the annual minimum or per account charges. The annual minimum is $15,000 per class and the per account charge is $14.00 for open accounts and $2.00 for closed accounts.

In addition, certain affiliates of GFS provide ancillary services to the Fund(s) as follows:

MutualHedge Frontier Legends Fund
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
September 30, 2010

Northern Lights Compliance Services, LLC ("NLCS")
NLCS, an affiliate of GFS, provides a Chief Compliance Officer ("CCO") to the Trust, as well as related compliance services, pursuant to a consulting agreement between NLCS and the Trust. Under the terms of such agreement, NLCS receives from the Fund an annual fee, payable quarterly, and is reimbursed for out-of-pocket expenses. For the period ended September 30, 2010, the Fund incurred expenses of $9,853 for compliance services pursuant to the Trust's Agreement with NLCS. Such fees are included in the line item marked "Compliance Officer Fees" on the Statement of Operations in this shareholder report.

GemCom, LLC ("GemCom")
GemCom, an affiliate of GFS, provides EDGAR conversion and filing services as well as print management services for the Fund on an ad-hoc basis. For EDGAR services, GemCom charges a per-page conversion fee and a flat filing fee. For the period ended September 30, 2010, GemCom collected amounts totaling $2,914 for EDGAR and printing services performed. Such fees are included in the line item marked "Printing and Postage Expenses" on the Statement of Operations in this shareholder report.

5. TAX COMPONENTS OF CAPITAL

As of September 30, 2010, the components of accumulated earnings/(deficit) on a tax basis were as follows:

Undistributed Ordinary Income	Undistributed Long-Term Gains	Capital Loss Carry Forwards	Post October Losses	Unrealized Appreciation/ (Depreciation)	Total Accumulated Earnings/(Deficits)
$ -	$ -	$ -	$ -	$ 3,534,673	$ [illegible]

Permanent book and tax differences primarily attributable to net operating losses, tax treatment of short-term capital gains and adjustments resulting from the Fund's investment in a controlled foreign corporation, resulted in reclassification for the Fund for the period ended September 30, 2010 was follows: a decrease in paid in capital of $279,871; a decrease in accumulated net investment loss of $281,313; and a decrease in accumulated net realized gain from security transactions of $1,442.

6. NEW ACCOUNTING PRONOUNCEMENT

In January 2010, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2010-06 "Improving Disclosures about Fair Value Measurements." ASU No. 2010-06 amends FASB Accounting Standards Codification Topic 820, Fair Value Measurements and Disclosures, to require additional disclosures regarding fair value measurements. Certain disclosures required by ASU No. 2010-06 are effective for interim and annual periods beginning after December 15, 2009, and other required disclosures are effective for fiscal years beginning after December 15, 2010, and for interim periods within those fiscal years. Management is currently evaluating the impact ASU No. 2010-06 will have on the Fund's financial statement disclosures.

7. SUBSEQUENT EVENTS

The Fund is required to recognize in the financial statements the effects of all subsequent events that provide additional evidence about conditions that existed at the date of the Statement of Assets and Liabilities. For non-recognized subsequent events that must be disclosed to keep the financial statements from being misleading, the Fund is required to disclose the nature of the event as well as an estimate of its financial effect, or a statement that such an estimate cannot be made. In addition, the Fund is required to disclose the date through which subsequent events have been evaluated. Management has evaluated subsequent events through the issuance of these financial statements and has noted no such events.

Report of Independent Registered Public Accounting Firm

**To the Board of Trustees of Northern Lights Fund Trust
and the Shareholders of MutualHedge Frontier Legends Fund**

We have audited the accompanying consolidated statement of assets and liabilities of MutualHedge Frontier Legends Fund (Fund), including the consolidated portfolio of investments, as of September 30, 2010, and the related consolidated statements of operations, changes in net assets and financial highlights for the period from December 31, 2009 (commencement of operations) through September 30, 2010. These consolidated financial statements and consolidated financial highlights are the responsibility of the Fund's management. Our responsibility is to express an opinion on these consolidated financial statements and consolidated financial highlights based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements and consolidated financial highlights are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in consolidated financial statements. Our procedures included confirmation of securities owned as of September 30, 2010, by correspondence with custodian. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the consolidated financial statements and consolidated financial highlights referred to above present fairly, in all material respects, the financial position of the Fund as of September 30, 2010, the results of its operations, changes in its net assets and the financial highlights for the period from December 31, 2009 (commencement of operations) through September 30, 2010, in conformity with accounting principles generally accepted in the United States of America.

/s/ McGladrey & Pullen, LLP

Denver, Colorado
November 30, 2010

MutualHedge Frontier Legends Fund
EXPENSE EXAMPLES
September 30, 2010 (Unaudited)

As a shareholder of the MutualHedge Frontier Legends Fund, you incur two types of costs: (1) transaction costs, including sales charges (loads) on purchases of Class A shares; (2) ongoing costs, including management fees; distribution and/or service (12b-1) fees; and other Fund expenses. This example is intended to help you understand your ongoing costs (in dollars) of investing in the MutualHedge Frontier Legends Fund and to compare these costs with the ongoing costs of investing in other mutual funds.

The example is based on an investment of $1,000 invested at the beginning of the period and held for the entire period from April 1, 2010 through September 30, 2010.

Actual Expenses

The "Actual Expenses" line in the table below provides information about actual account values and actual expenses. You may use the information below, together with the amount you invested, to estimate the expenses that you paid over the period. Simply divide your account value by $1,000 (for example, an $8,600 account value divided by $1,000 = 8.6), then multiply the result by the number in the table under the heading entitled "Expenses Paid During Period" to estimate the expenses you paid on your account during this period.

Hypothetical Example for Comparison Purposes

The "Hypothetical" line in the table below provides information about hypothetical account values and hypothetical expenses based on the MutualHedge Frontier Legends Fund's actual expense ratio and an assumed rate of return of 5% per year before expenses, which is not the Fund's actual return. The hypothetical account values and expenses may not be used to estimate the actual ending account balances or expenses you paid for the period. You may use this information to compare this 5% hypothetical example with the 5% hypothetical examples that appear in the shareholder reports of other funds.

Please note that the expenses shown in the table are meant to highlight your ongoing costs only and do not reflect any transactional costs, such as sales charges (loads), or redemption fees. Therefore, the table is useful in comparing ongoing costs only, and will not help you determine the relative total costs of owning different funds. In addition, if these transactional costs were included, your costs would have been higher.

Actual	Beginning Account Value 4/1/10	Ending Account Value 9/30/10	Expenses Paid During Period 4/1/10 – 9/30/10	Expense Ratio During Period** 4/1/10 – 9/30/10
Class A	$1,000.00	$1,019.20	$11.14*	2.20%
Class C	1,000.00	1,015.20	14.90*	2.95

Hypothetical (5% return before expenses)	Beginning Account Value 4/1/10	Ending Account Value 9/30/10	Expenses Paid During Period 4/1/10 – 9/30/10	Expense Ratio During Period** 4/1/10 – 9/30/10
Class A	$1,000.00	$1,014.04	$ 11.11*	2.20%
Class C	1,000.00	1,010.28	14.87*	2.95

*Expenses are equal to the average account value over the period, multiplied by the Fund's annualized expense ratio, multiplied by the number of days in the period (183) divided by the number of days in the fiscal year (365).
**Annualized.

MutualHedge Frontier Legends Fund
SUPPLEMENTAL INFORMATION (Continued)

OPPENHEIMER

Commodity Strategy Total Return Fund

Summary Prospectus March 30, 2011

NYSE Ticker Symbols

Class A QRAAX
Class B QRABX
Class C QRACX
Class N QRANX
Class Y QRAYX

Before you invest, you may want to review the Fund's prospectus, which contains more information about the Fund and its risks. You can find the Fund's prospectus, Statement of Additional Information, Annual Report and other information about the Fund online at https://www.oppenheimerfunds.com/fund/investors/overview/CommodityStrategyTotalReturnFund. You can also get this information at no cost by calling 1.800.225.5677 or by sending an email request to: info@oppenheimerfunds.com.

The Fund's prospectus and Statement of Additional Information ("SAI"), both dated March 30, 2011, and pages 7 through 78 of its most recent Annual Report, dated December 31, 2010, are incorporated by reference into this Summary Prospectus. You can access the Fund's prospectus and SAI at https://www.oppenheimerfunds.com/fund/investors/overview/CommodityStrategyTotalReturnFund. The Fund's prospectus is also available from financial intermediaries who are authorized to sell Fund shares.

Investment Objective. The Fund seeks total return.

Fees and Expenses of the Fund. This table describes the fees and expenses that you may pay if you buy and hold or redeem shares of the Fund. You may qualify for sales charge discounts if you (or you and your spouse) invest, or agree to invest in the future, at least $25,000 in certain funds in the Oppenheimer family of funds. More information about these and other discounts is available from your financial professional and in the section "About Your Account" beginning on page 14 of the prospectus and in the sections "How to Buy Shares" beginning on page 64 and "Appendix A" in the Fund's Statement of Additional Information.

Shareholder Fees (fees paid directly from your investment)

	Class A	Class B	Class C	Class N	Class Y
Maximum Sales Charge (Load) imposed on purchases (as % of offering price)	5.75%	None	None	None	None
Maximum Deferred Sales Charge (Load) (as % of the lower of original offering price or redemption proceeds)	None	5%	1%	1%	None

Annual Fund Operating Expenses (expenses that you pay each year as a percentage of the value of your investment)

	Class A	Class B	Class C	Class N	Class Y
Management Fees of the Fund and Subsidiary[1]	1.04%	1.04%	1.04%	1.04%	1.04%
Distribution and/or Service (12b-1) Fees	0.25%	1.00%	1.00%	0.50%	None
Other Expenses					
Other Expenses of the Fund	0.50%	1.13%	0.63%	0.74%	0.26%
Other Expenses of the Subsidiary	0.00%	0.00%	0.00%	0.00%	0.00%
Total Other Expenses	0.50%	1.13%	0.63%	0.74%	0.26%
Acquired Fund Fees and Expenses	0.05%	0.05%	0.05%	0.05%	0.05%
Total Annual Fund Operating Expenses	1.84%	3.22%	2.72%	2.33%	1.35%
Fee Waiver and Expense Reimbursement[2]	(0.38%)	(0.95%)	(0.49%)	(0.61%)	(0.27%)
Total Annual Fund Operating Expenses After Fee Waiver and Expense Reimbursement	1.46%	2.27%	2.23%	1.72%	1.08%

1. "Management Fees of the Fund and Subsidiary" reflects the gross management fees paid to the Manager by the Fund and the Subsidiary during the Fund's most recent fiscal year.
2. The Manager has contractually agreed to waive the management fee it receives from the Fund in an amount equal to the management fee paid to the Manager by the Subsidiary. This waiver will continue in effect for so long as the Fund invests in the Subsidiary, and may not be terminated by the Manager unless termination is approved by the Fund's Board of Trustees. The Fund's investment adviser has voluntarily agreed to waive fees and/or reimburse Fund expenses in an amount equal to the indirect management fees incurred through the Fund's investment in Oppenheimer Institutional Money Market Fund. The Fund's transfer agent has voluntarily agreed to limit its fees for all classes to 0.35% of average annual net assets per class. These expense limitations may be amended or withdrawn no earlier than one year from the date of this prospectus.

Example. The following Example is intended to help you compare the cost of investing in the Fund with the cost of investing in other mutual funds. The Example assumes that you invest $10,000 in a class of shares of the Fund for the time periods indicated. The Example also assumes that your investment has a 5% return each year and that the Fund's operating expenses remain the same. Although your actual costs may be higher or lower, based on these assumptions your expenses would be as follows:

	If shares are redeemed				If shares are not redeemed			
	1 Year	3 Years	5 Years	10 Years	1 Year	3 Years	5 Years	10 Years
Class A	$ 716	$ 1,090	$ 1,488	$ 2,598	$ 716	$ 1,090	$ 1,488	$ 2,598
Class B	$ 733	$ 1,212	$ 1,826	$ 2,877	$ 233	$ 917	$ 1,626	$ 2,877
Class C	$ 329	$ 808	$ 1,414	$ 3,055	$ 229	$ 808	$ 1,414	$ 3,055
Class N	$ 276	$ 676	$ 1,203	$ 2,649	$ 176	$ 676	$ 1,203	$ 2,649
Class Y	$ 111	$ 404	$ 718	$ 1,611	$ 111	$ 404	$ 718	$ 1,611

Portfolio Turnover. The Fund pays transaction costs, such as commissions, when it buys and sells securities (or "turns over" its portfolio). A higher portfolio turnover rate may indicate higher transaction costs and may result in higher taxes when Fund shares are held in a taxable account. These costs, which are not reflected in the annual fund operating expenses or in the example, affect the Fund's performance. During the most recent fiscal year, the Fund's portfolio turnover rate was 38% of the average value of its portfolio.

Principal Investment Strategies. The Fund mainly invests in a combination of commodity-linked derivatives, corporate and governmental fixed-income securities and certain other types of derivative investments.

- **Commodity-Linked Derivatives.** A derivative is an investment whose value depends on (or is derived from) the value of an underlying security, asset, interest rate, index or currency. A commodity-linked derivative is a derivative instrument whose value is linked to the price movement of a commodity, commodity index, or commodity option or futures contract. Commodity-linked derivatives may include commodity-linked notes, swaps, futures and options. The value of some commodity-linked derivatives may be based on a multiple of those price movements.
  Physical commodities are assets that have tangible properties. The Fund's commodity-linked investments provide exposure to the investment returns of commodities markets without investing directly in physical commodities. The commodity-linked instruments that the Fund invests in may be linked to the price movements of: a physical commodity such as heating oil, livestock, or agricultural products; a commodity option or futures contract; a commodity index such as the S&P GSCI® ("S&P GSCI," formerly the "Goldman Sachs Commodity Index"); or some other readily measurable variable that reflects changes in the value of particular commodities or commodities markets. The Fund does not intend to invest more than 10% of its total assets, determined at the time of investment, in commodity-linked notes that mature in more than 19 months.
- **Fixed-Income Securities.** The fixed-income securities the Fund may invest in may be of any maturity and include U.S. Government securities, repurchase agreements, money market securities and affiliated money market funds. The Fund may buy debt securities for liquidity purposes, for collateral management or to seek income.
- **Other Derivative Investments.** The Fund may also invest in other derivative instruments such as forwards, options, futures and swaps relating to debt securities, interest rates or currencies. It may do so to seek to increase its investment returns or to hedge against declines in the value of the Fund's other investments.

The Fund can purchase investment-grade and below investment-grade securities (also referred to as "junk bonds"). The Fund can invest up to 10% of its assets in lower-grade securities. The Fund may invest in U.S. or foreign securities, including derivative instruments that trade in U.S. or foreign exchanges or in the "over-the-counter" ("OTC") market.

The Fund can also invest up to 25% of its total assets in its wholly-owned and controlled subsidiary (the "Subsidiary"). The Subsidiary primarily invests in commodity-linked derivatives (including commodity futures, options and swap contracts) and fixed income securities and other investments that serve as collateral for its derivatives positions. Investments in the Subsidiary are intended to provide the Fund with exposure to commodities market returns within the limitations of the federal tax requirements that apply to the Fund. The Subsidiary will be subject to the same investment restrictions and limitations, and follow the same compliance policies and procedures as the Fund.

In selecting investments for the Fund's portfolio, the portfolio managers generally allocate the Fund's commodity-linked investments among a variety of different commodity sectors, based on the weightings of the components of the Fund's benchmark index, the S&P GSCI. The Fund is not an "index" fund, however, and its investment allocations and performance will usually differ from the weightings and performance of the S&P GSCI. The portfolio managers currently focus on the following inter-related components, which may vary in particular cases and may change over time:

- **Commodities Selection.** The portfolio managers use a model-driven approach and their own analysis and judgment to try to identify differences in quality between two commodities or contracts with the intent of exploiting temporary market inefficiencies. The Fund's proprietary models also incorporate fundamental and technical factors intended to identify extreme market pricing imbalances for individual commodities or sectors and catalysts that may potentially eliminate the particular imbalances.
- **Form of Investment.** The portfolio managers also consider which instrument or form of investment is best suited to provide the desired commodities exposure. If the portfolio managers determine that a commodity-linked note is appropriate, the Fund would generally invest directly in the commodity-linked note. If the portfolio managers decide that a commodity futures contract, swap, or option on a futures contract is appropriate, the Fund might enter into the futures or swap contract or purchase the option directly or it might invest in that instrument indirectly through its Subsidiary.
- **Collateral Management.** The portfolio managers use a team approach to construct a portfolio of fixed-income securities that includes U.S. Government securities, repurchase agreements, money market securities and affiliated money market funds to provide collateral, liquidity and income.
- **Performance and Portfolio Risk Monitoring.** The portfolio managers monitor the performance and risks of the Fund's investments on an ongoing basis.

The Fund's investment in the Subsidiary will vary based on the portfolio managers' use of different types of commodity-linked derivatives. If the Fund increases its use of commodity linked notes, that would typically result in a lower level of investment in the Subsidiary. If the Fund increases its use of commodity futures, swaps, or options on futures, that would typically result in a higher level of investment in the Subsidiary.

Industry Concentration. The Fund will maintain exposure of 25% or more of its total assets in securities and derivatives linked to the energy and natural resources, agriculture, livestock, industrial metals, and precious metals sectors as a group. However, the Fund will not concentrate more than 25% of its total assets in issuers in any one industry. At times the Fund may emphasize investments in some industries more than others. The individual components of an index will be considered as separate industries for this purpose.

Principal Risks. The price of the Fund's shares can go up and down substantially. The value of the Fund's investments may change because of broad changes in the markets in which the Fund invests or from poor security selection, which could cause the Fund to underperform other funds with similar investment objectives. There is no assurance that the Fund will achieve its investment objective. When you redeem your shares, they may be worth more or less than what you paid for them. *These risks mean that you can lose money by investing in the Fund.*

Risks of Commodity-Linked Investments. Investments linked to the prices of commodities are considered speculative. The values of commodities and commodity-linked investments are affected by events that might have less impact on the values of stocks and bonds. Prices of commodities and related contracts may fluctuate significantly over short periods due to a variety of factors, including changes in supply and demand relationships, weather, agriculture, fiscal, and exchange control programs, disease, pestilence, and international economic, political, military and regulatory developments. These risks may make commodity-linked investments more volatile than other types of investments. The commodity-linked instruments in which the Fund invests have substantial risks, including risk of loss of a significant portion of their principal value.

The commodity markets are subject to temporary distortions and other disruptions due to, among other factors, lack of liquidity, the participation of speculators, and government regulation and other actions. U.S. futures exchanges and some foreign exchanges limit the amount of fluctuation in futures contract prices which may occur in a single business day (generally referred to as "daily price fluctuation limits"). The maximum or minimum price of a contract as a result of these limits is referred to as a "limit price." If the limit price has been reached in a particular contract, no trades may be made beyond the limit price. Limit prices have the effect of precluding trading in a particular contract or forcing the liquidation of contracts at disadvantageous times or prices. These circumstances could adversely affect the value of the commodity-linked investments.

Risks of Derivative Investments. Derivatives may be volatile and may involve significant risks. The underlying security or other instrument on which a derivative is based, or the derivative itself, may not perform as expected. Some derivatives have the potential for unlimited loss, regardless of the size of the Fund's initial investment. The Fund may also lose money on a derivative investment if the issuer fails to pay the amount due. Certain derivative investments held by the Fund may be illiquid, making it difficult to close out an unfavorable position. Derivative transactions may require the payment of premiums and can increase portfolio turnover. As a result of these risks, the Fund could realize little or no income or lose money from its investment, or a hedge might be unsuccessful.

- **Special Risks of Options.** If the Fund sells a put option, there is a risk that the Fund may be required to buy the underlying investment at a disadvantageous price. If the Fund sells a call option, there is a risk that the Fund may be required to sell the underlying investment at a disadvantageous price. If the Fund sells a call option on an investment that the Fund owns (a "covered call") and the investment has increased in value when the call option is exercised, the Fund will be required to sell the investment at the call price and will not be able to realize any of the investment's value above the call price. Options may involve economic leverage, which could result in greater price volatility than other investments.
- **Special Risks of Futures Contracts.** The volatility of futures contracts prices has been historically greater than the volatility of stocks and bonds. The liquidity of the futures market depends on participants entering into offsetting transactions rather than making or taking delivery. To the extent participants decide to make or take delivery, liquidity in the futures market could be reduced. In addition, futures exchanges often impose a maximum permissible price movement on each futures contract for each trading session. The Fund may be disadvantaged if it is prohibited from executing a trade outside the daily permissible price movement.
- **Special Risks of Swap Transactions.** There is no central exchange or market for swap transactions and therefore they are less liquid than exchange-traded instruments. If the Fund were to sell a swap it owned to a third party, the Fund would still remain primarily liable for the obligations under the swap contract.
- **Total Return Swaps.** In a total return swap transaction, one party agrees to pay the other party an amount equal to the total return on a defined underlying asset or a non-asset reference during a specified period of time. The underlying asset might be a security, commodity contract or basket of securities or commodity contracts or a non-asset reference might be a securities or commodities index. In return, the other party would make periodic payments based on a fixed or variable interest rate or on the total return from a different underlying asset or non-asset reference.

  Total return swaps could result in losses if the underlying asset or reference does not perform as anticipated. Total return swaps can have the potential for unlimited losses. They are also subject to counterparty risk. If the counterparty fails to meet its obligations, the Fund may lose money.

Special Risks Of Commodity-Linked Notes. The Fund may invest in commodity-linked notes to gain exposure to commodities markets. Commodity-linked notes may be subject to special risks that do not affect traditional equity and debt securities:

- **Risk of loss of interest.** If the interest rate on a commodity-linked note is based on the value of a particular commodity, commodity index or other economic variable, the Fund might receive lower interest payments (or not receive any interest) if the value of the underlying investment falls.
- **Risk of loss of principal.** To the extent that the amount of the principal to be repaid upon maturity is linked to the value of a particular commodity, commodity index or other economic variable, the value of the commodity, commodity index or other economic variable may not increase sufficiently so that the Fund might not receive a portion (or any) of the principal when the investment matures or upon earlier exchange.
- **Credit Risk.** Commodity-linked notes are subject to credit risks on the underlying investment and to counterparty credit risk. If the counterparty fails to meet its obligations, the Fund may lose money.
- **Valuation risk.** The value of commodity-linked notes may be influenced by several factors, including: value of the commodity, commodity index or other economic variable, volatility, interest and yield rates in the market, the time remaining to maturity and the credit worthiness of the issuer of the commodity-linked note.
- **Liquidity risk.** A liquid secondary market may not exist for certain commodity-linked notes the Fund buys, which may make it difficult for the Fund to sell them at an acceptable price or to accurately value them.
- **Volatility risk.** The value of the commodity-linked derivatives the Fund buys may fluctuate significantly because the values of the underlying investments to which they are linked are extremely volatile. Additionally, the particular terms of a commodity-linked note may create economic leverage by requiring payment by the issuer of an amount that is a multiple of the price increase or decrease of the underlying commodity, commodity index, or other economic variable. Economic leverage increases the volatility of the value of commodity-linked notes and their value may increase or decrease more quickly than the underlying commodity, commodity index or other economic variable.

Risks of Investments in Leverage. Certain derivatives and other investments of the Fund may involve leverage. Leverage may be created when an investment exposes the Fund to a risk of loss that exceeds the amount invested. Certain derivatives and other investments provide the potential for investment gain or loss that may be several times greater than the change in the value of an underlying security, asset, interest rate, index or currency, resulting in the potential for a loss that may be substantially greater than the amount invested.

Some derivatives and other leveraged investments have the potential for unlimited loss, regardless of the size of the initial investment. Because leverage can magnify the effects of changes in the value of the Fund and make the Fund's share price more volatile, a shareholder's investment in the Fund will tend to be more volatile, resulting in larger gains or losses in response to the fluctuating prices of the Fund's investments.

The Fund has limits on the leverage ratio of each commodity-linked note it buys and on its overall portfolio. The Fund is also subject to legal requirements designed to reduce the effects of any leverage created by the use of certain investments. Under these requirements, the Fund must earmark or segregate liquid assets or engage in other asset coverage measures with regard to the Fund's potential obligations with respect to those investments. The Fund, including the Subsidiary, will comply with these requirements.

Risks Of Investments In The Fund's Wholly-Owned Subsidiary. The Subsidiary is not registered under the Investment Company Act and is not subject to its investor protections (except as otherwise noted in this prospectus). As an investor in the Subsidiary, the Fund does not have all of the protections offered to investors by the Investment Company Act, however the Fund wholly owns and controls the Subsidiary, and the Fund and the Subsidiary are both managed by the Manager and the Sub-Adviser. The Fund's ownership and control make it unlikely that the Subsidiary will take actions contrary to the interests of the Fund or its shareholders. The Fund's Board has oversight responsibility for the Fund's investment activities, including its investments in the Subsidiary and its role as the Subsidiary's sole shareholder. The Manager and Sub-Adviser also apply the same investment restrictions and operational guidelines in managing the Subsidiary's portfolio that are applied to managing the Fund.

Changes in the laws of the Cayman Islands, under which the Subsidiary is incorporated, could prevent the Subsidiary from operating as described in this prospectus and could negatively affect the Fund and its shareholders. For example, the Cayman Islands currently does not impose any income, corporate or capital gains tax, estate duty, inheritance tax, gift tax or withholding tax on the Subsidiary. If Cayman Islands law were changed and the Subsidiary was required to pay Cayman Islands taxes, the investment returns of the Fund would likely decrease.

Main Risks of Debt Securities. Debt securities may be subject to credit risk, interest rate risk, prepayment risk and extension risk. Credit risk is the risk that the issuer of a security might not make interest and principal payments on the security as they become due. If an issuer fails to pay interest or repay principal, the Fund's income or share value might be reduced. Adverse news about an issuer or a downgrade in an issuer's credit rating, for any reason, can also reduce the market value of the issuer's securities. Interest rate risk is the risk that when prevailing interest rates fall, the values of already-issued debt securities generally rise; and when prevailing interest rates rise, the values of already-issued debt securities generally fall, and they may be worth less than the amount the Fund paid for them. When interest rates change, the values of longer-term debt securities usually change more than the values of shorter-term debt securities. When interest rates fall, debt securities may be repaid more quickly than expected and the Fund may be required to reinvest the proceeds at a lower interest rate. This is referred to as "prepayment risk." When interest rates rise, debt securities may be repaid more slowly than expected and the value of the Fund's holdings may fall sharply. This is referred to as "extension risk." Interest rate changes normally have different effects on variable or floating rate securities than they do on securities with fixed interest rates.

Because the Fund can invest up to 10% of its assets in lower-grade securities, the Fund's credit risks are greater than those of funds that buy only investment-grade securities.

Fixed-Income Market Risks. Economic and other market developments can adversely affect fixed-income securities markets in the United States, Europe and elsewhere. At times, participants in debt securities markets may develop concerns about the ability of certain issuers of debt securities to make timely principal and interest payments, or they may develop concerns about the ability of financial institutions that make markets in certain debt securities to facilitate an orderly market. Those concerns can cause increased volatility in those debt securities or debt securities markets. Under some circumstances, as was the case during the latter half of 2008 and early 2009, those concerns could cause reduced liquidity in certain debt securities markets. A lack of liquidity or other adverse credit market conditions may hamper the Fund's ability to sell the debt securities in which it invests or to find and purchase suitable debt instruments.

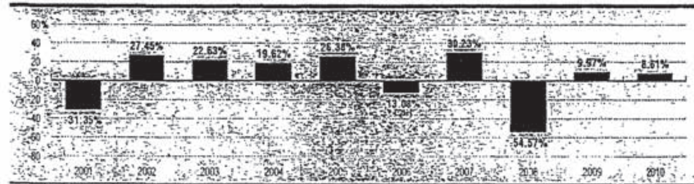
Main Risks of Foreign Investing. Foreign securities are subject to special risks. Foreign issuers are usually not subject to the same accounting and disclosure requirements that U.S. companies are subject to, which may make it difficult for the Fund to evaluate a foreign company's operations or financial condition. A change in the value of a foreign currency against the U.S. dollar will result in a change in the U.S. dollar value of securities denominated in that foreign currency and in the value of any income or distributions the Fund may receive on those securities. The value of foreign investments may be affected by exchange control regulations, foreign taxes, higher transaction and other costs, delays in the settlement of transactions, changes in economic or monetary policy in the United States or abroad, expropriation or nationalization of a company's assets, or other political and economic factors. These risks may be greater for investments in developing or emerging market countries.

Time-Zone Arbitrage. The Fund may invest in securities of foreign issuers that are traded in U.S. or foreign markets. If the Fund invests a significant amount of its assets in foreign markets, it may be exposed to "time-zone arbitrage" attempts by investors seeking to take advantage of differences in the values of foreign securities that might result from events that occur after the close of the foreign securities market on which a security is traded and before the Fund's net asset value is calculated. If such time-zone arbitrage were successful, it might dilute the interests of other shareholders. The Fund's use of "fair value pricing" to adjust certain market prices of foreign securities may help deter those activities.

Who Is the Fund Designed For? The Fund is designed for aggressive investors seeking total return over the long term, mainly from commodity-linked derivatives. Those investors should be willing to assume the risks of potentially significant short-term share price fluctuations and losses because of the Fund's investments in commodity-linked instruments. The Fund is not designed for investors seeking current income or preservation of capital. Investors should consider buying shares of the Fund as part of an overall portfolio strategy that includes other asset classes, such as fixed-income and equity investments. The Fund is not a complete investment program and may not be appropriate for all investors. You should carefully consider your own investment goals and risk tolerance before investing in the Fund.

An investment in the Fund is not a deposit of any bank and is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency.

The Fund's Past Performance. The bar chart and table below provide some indication of the risks of investing in the Fund by showing changes in the Fund's performance from year to year and by showing how the Fund's average annual returns for 1, 5 and 10 years compare with those of a broad measure of market performance. The Fund's past investment performance (before and after taxes) is not necessarily an indication of how the Fund will perform in the future. More recent performance information is available by calling the toll-free number on the back of this prospectus and on the Fund's website:
https://www.oppenheimerfunds.com/fund/investors/overview/CommodityStrategyTotalReturnFund



Sales charges and taxes are not included and the returns would be lower if they were. During the period shown, the highest return for a calendar quarter was 30.80% (2nd Qtr 08) and the lowest return was -52.35% (4th Qtr 08).

The following table shows the average annual total returns for each class of the Fund's shares. After-tax returns are calculated using the highest individual federal marginal income tax rates and do not reflect the impact of state or local taxes. Your actual after-tax returns, depending on your individual tax situation, may differ from those shown and after-tax returns shown are not relevant to investors who hold their Fund shares through tax-deferred arrangements, such as 401(k) plans or individual retirement accounts. After-tax returns are shown for only one class and after-tax returns for other classes will vary.

Average Annual Total Returns for the periods ended December 31, 2010

	1 Year	5 Years	10 Years (or life of class, if less)
Class A Shares (inception 03-31-1997)			
Return Before Taxes	2.36%	(10.36%)	(0.63%)
Return After Taxes on Distributions	1.84%	(11.98%)	(2.85%)
Return After Taxes on Distributions and Sale of Fund Shares	1.54%	(9.16%)	(1.34%)
Class B Shares (inception 03-31-1997)	2.48%	(10.35%)	(0.54%)
Class C Shares (inception 03-31-1997)	6.74%	(10.03%)	(0.86%)
Class N Shares (inception 03-01-2001)	7.21%	(9.58%)	0.46%
Class Y Shares (inception 03-31-1997)	8.99%	(8.84%)	0.40%
S&P GSCI	9.03%	(5.70%)	1.77%
(reflects no deduction for fees, expenses or taxes)			2.51%[1]

1. From 02/28/01

Investment Adviser. OppenheimerFunds, Inc. is the Fund's investment adviser (the "Manager") and Oppenheimer Real Asset Management, Inc. (the "Sub-Adviser"), a wholly-owned subsidiary of the Manager, is its sub-adviser.

Portfolio Managers. Kevin Baum, CFA, CAIA, has been a Vice President of the Fund since October 2000, and a portfolio manager of the Fund since May 1999. Robert Baker, CFA, has been a Vice President and portfolio manager of the Fund since May 2007. Carol Wolf has been a Vice President and portfolio manager of the Fund since December 2008.

Purchase and Sale of Fund Shares. In most cases, you can buy Fund shares with a minimum initial investment of $1,000 and make additional investments with as little as $50. For certain investment plans and retirement accounts, the minimum initial investment is $500 and, for some, the minimum additional investment is $25. For certain fee based programs the minimum initial investment is $250.

Shares may be purchased through a financial intermediary or the Distributor and redeemed through a financial intermediary or the Transfer Agent on days the New York Stock Exchange is open for trading. Shareholders may purchase or redeem shares by mail, through the website at www.oppenheimerfunds.com or by calling 1.800.225.5677. Share transactions may be paid by check, by Federal Funds wire or directly from or into your bank account.

Taxes. If your shares are not held in a tax-deferred account, Fund distributions are subject to Federal income tax as ordinary income or as capital gains and they may also be subject to state or local taxes.

Payments to Broker-Dealers and Other Financial Intermediaries. If you purchase Fund shares through a broker-dealer or other financial intermediary (such as a bank), the Fund, the Manager, or their related companies may pay the intermediary for the sale of Fund shares and related services. These payments may create a conflict of interest by influencing the broker-dealer or other intermediary and your salesperson to recommend the Fund over another investment. Ask your salesperson or visit your financial intermediary's website for more information.

For More Information About Oppenheimer Commodity Strategy Total Return Fund

You can access the Fund's prospectus and SAI at https://www.oppenheimerfunds.com/fund/investors/overview/CommodityStrategyTotalReturnFund. You can also request additional information about the Fund or your account:

By Telephone:	Call OppenheimerFunds Services toll-free: 1.800.CALL OPP (225.5677)	
By Mail:	For requests by mail: OppenheimerFunds Services P.O. Box 5270 Denver, Colorado 80217-5270	For courier or express mail requests: OppenheimerFunds Services 12100 East Iliff Avenue, Suite 300 Aurora, Colorado 80014
On the Internet:	You can read or download information on the OppenheimerFunds website at: **www.oppenheimerfunds.com**	

PR0735.001.0311

PIMCO

Your Global Investment Authority

CommodityRealReturn Strategy Fund®
CommoditiesPLUS™ Strategy Fund

Accessing the Diversification and Inflation-Hedging Potential of Commodities

Fund Overview

Portfolio managers

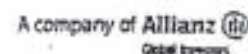
Mihir Worah, Ph.D.
Managing Director,
Head of Real Return
Portfolio Management Team,
Portfolio Manager

Nicholas Johnson
Senior Vice President,
Portfolio Manager

Protecting against inflation by preserving the purchasing power of one's assets is a key element in achieving long-term financial security. However, long-term inflation rates will always be highly uncertain, and as a result it is difficult to preserve the real value of one's assets by using traditional stock and bond investments alone. PIMCO, a global commodity manager, has long believed that the selective use of commodities within one's investment strategy can prove highly effective as a portfolio diversifier and a hedge against inflation, albeit with additional risk. Our actively managed commodity index mandates include two PIMCO funds— PIMCO CommodityRealReturn Strategy Fund and the PIMCO CommoditiesPLUS Strategy Fund. Both Funds employ our enhanced-index approach to commodity investing. This involves combining positions in commodity index-linked derivatives that capture the price return of the commodities futures market with a fixed income collateral portfolio that is actively managed with the objective of adding incremental return above those markets.

Why invest in commodities?

Commodities are assets that have tangible properties, such as oil, metals and agricultural products. Historically, commodity investments have had a positive correlation (tendency to move in tandem) with changes in inflation and a low correlation to stock and bond returns. That is why commodities can be used to hedge against inflation as well as to enhance portfolio diversification. Further,



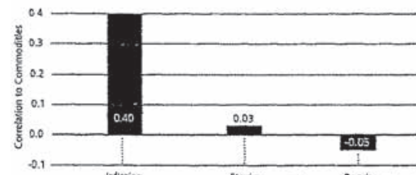
underlying economic fundamentals suggest that commodities will almost certainly trend upward over the long term. This is largely due to growing demand from emerging markets and underinvestment in infrastructure. Investors should be aware, however, that commodities are volatile investments, should only form a small part of a diversified portfolio and may not be suitable for all investors.

How do these funds gain exposure?

The funds do not invest in physical commodities. Instead, they use an "enhanced index" strategy. This exposes the funds to commodities through investments in commodity-index-linked derivative instruments. PIMCO CommodityRealReturn Strategy Fund is linked to the Dow Jones UBS Commodity Total Return Index. PIMCO CommoditiesPLUS Strategy Fund is linked to the Credit Suisse Commodity Benchmark. Also, the funds may invest in derivatives linked to the value of a particular commodity or commodity futures contracts (or in subsets). PIMCO CommodityRealReturn Strategy Fund then "collateralizes" these derivative instruments by investing the remaining portfolio assets in an actively managed portfolio of inflation-indexed bonds and other fixed income securities. In this way, the fund seeks to capitalize on the inflation-hedging properties of both commodities and inflation-indexed bonds.

Inflation hedging and diversification

Commodities have historically had a positive correlation with inflation and a noncorrelation with stock and bond returns, making them an attractive vehicle to enhance portfolio diversification and guard against inflation. Of course, diversification does not guarantee a profit or protect against a loss.



Past performance is no guarantee of future results. Above data reflects quarterly returns for the period 12/31/91–12/31/09. Commodities, stocks, bonds and inflation represented by the Dow Jones UBS Commodity Total Return Index, S&P 500 Index, Barclays Capital U.S. Aggregate Index and Consumer Price Index-All Urban Consumers, respectively.

PIMCO CommoditiesPLUS Strategy Fund "collateralizes" these derivative instruments by investing the assets in an actively managed portfolio of high-quality short-term bonds. PIMCO has extensive experience managing both index-linked securities and the collateral backing this exposure.

What are some of the advantages of this enhanced-index approach?

Our approach to the commodity index markets relies on our core strengths as a derivatives manager and creates the potential for the portfolios to outperform the benchmarks. Rather than purchase individual commodities, we use derivatives to obtain exposure to changes in a broad index of commodity futures prices without committing a substantial amount of capital, leaving the remaining portfolio assets to serve as collateral. We seek to invest the portfolio assets that serve as collateral in a portfolio of fixed income securities. If these fixed income investments provide a higher return than the T-bill rate embedded in the returns of the commodity index, then the total return of the overall portfolio should be enhanced by the difference between these two rates.

What are the active commodities strategies the funds employ?

Structural alpha strategies seek to add value by taking advantage of identifiable economic factors that create patterns of risk upon which the funds can capitalize and other factors that might generate returns. These are distinguished from traditional active commodities strategies, which are based on outright technical and fundamental views that directly over- and underweight individual commodities or commodity sectors.

Why did PIMCO choose the Dow Jones UBS Commodity Total Return Index and the Credit Suisse Commodity Benchmark as our benchmarks?

Commodity indices calculate the returns to a hypothetical portfolio that contains only long positions in commodity futures contracts, passively managed, on a fully collateralized basis. Only long positions are considered, so that the portfolio will consistently benefit if commodity futures prices rise. Only commodity (and not financial) futures are considered, so that

Real Return Portfolio Management Team. He joined PIMCO in 2001 as a member of the analytics team and worked on term structure modeling and options pricing. He has a Ph.D. in theoretical physics from the University of Chicago and is the author of numerous scientific papers. PIMCO CommoditiesPLUS Strategy Fund is managed by Nicholas Johnson, a senior vice president and portfolio manager. He joined PIMCO in 2004 and previously managed the portfolio analyst group. Prior to joining PIMCO, he worked at NASA's Jet Propulsion Laboratory, developing Mars missions and new methods of autonomous navigation. He holds a master's degree in financial mathematics from the University of Chicago and an undergraduate degree from California Polytechnic State University.

How can I learn more?

Ask your financial advisor for more information, including a copy of the prospectus. You can also visit our website at **pimco.com/investments** or call us at **1.888.87.PIMCO**.

Investors should consider the investment objectives, risks, charges and expenses of the funds carefully before investing. This and other information is contained in the funds' prospectuses and summary prospectuses, if available, which may be obtained by contacting your financial advisor or by visiting pimco.com/investments or by calling 1-888-87-PIMCO. Please read them carefully before you invest or send money.

A word about risk: The funds invest in commodity-linked derivative instruments, including commodity index-linked notes, swap agreements, commodity options, futures and options on futures. These instruments and commodities in general may subject the funds to greater volatility than investments in traditional securities. The value of a commodity-linked derivative is generally based on: price movements of a commodity, a commodity futures contract, a commodity index or other economic variables based on changes in the commodities markets. Use of derivative instruments may involve certain costs and risks such as liquidity risk, interest rate risk, market risk, credit risk, management risk and the risk that a fund could not close out a position when it would be most advantageous to do so. The funds' commodity exposures are backed by a portfolio of inflation-indexed securities and other fixed income instruments. Inflation-indexed bonds issued by the U.S. Government, known as TIPS, are fixed income securities whose principal value is periodically adjusted according to the rate of inflation, which will affect the interest payable on them. Repayment upon maturity of the adjusted principal value is guaranteed by the U.S. Government. Neither the current market value of inflation-indexed bonds nor the share value of a fund that invests in them is guaranteed, and either or both may fluctuate. These funds may invest in non-U.S. securities, non-U.S. currency-denominated securities, which may entail greater risk due to foreign economic and political developments, a small percentage in high yield securities and may invest in mortgage-related securities. High yield bonds typically have a lower credit rating than other bonds. Lower-rated bonds generally involve a greater risk to principal than higher-rated bonds. The funds are non-diversified, which means they may incur greater risk by concentrating assets in a smaller number of issuers than a diversified fund. The funds may also invest in common and preferred stocks as well as convertible securities of issuers in commodity-related industries.

Past performance is no guarantee of future results. This material contains the current opinions of PIMCO, which are subject to change without notice. Statements concerning financial market trends are based on current market conditions, which will fluctuate. There is no guarantee that these investment strategies will work under all market conditions, and each investor should evaluate their ability to invest for the long term, especially during periods of downturn in the market.

Alpha measures a portfolio's risk-adjusted performance, which is the difference between a portfolio's actual and expected returns, given the level of market risk as measured by beta. The Consumer Price Index (CPI) is an unmanaged index representing the rate of inflation in U.S. consumer prices as determined by the U.S. Department of Labor Statistics.

The Dow Jones UBS Commodity Total Return Index is composed of futures contracts on 19 physical commodities. The Standard & Poor's 500 Composite Index (S&P 500) is an unmanaged index generally representative of the U.S. stock market. The Barclays Capital U.S. Aggregate Index is composed of securities from the Barclays Capital Government/Credit Bond Index, Mortgage-Backed Securities Index and Asset-Backed Securities Index. It is generally considered to be representative of the domestic, investment-grade, fixed-rate, taxable bond market. The Credit Suisse Commodity Benchmark is an unmanaged index composed of futures contracts on 30 physical commodities. The objective of the benchmark is to gain exposure to the broad commodity universe while maintaining sufficient liquidity. Commodities were chosen based on world production levels, sufficient open interest and volume of trading. The index is designed to be a highly liquid and diversified benchmark for commodities as an asset class. It is not possible to invest directly in an index.

PIMCO advised funds are distributed by **PIMCO Investments LLC**.

Investment Products

Not FDIC Insured	May Lose Value	Not Bank Guaranteed

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About PIMCO

PIMCO is a leading global investment management firm, with offices in 10 countries throughout North America, Europe and Asia. Founded in 1971, PIMCO offers a wide range of innovative solutions to help millions of investors worldwide meet their needs. Our goal is to provide attractive returns while maintaining a strong culture of risk management and long-term discipline.

pimco.com/investments

PIMCO

Mutual Funds

All data as of 09/30/11, unless otherwise indicated

Mutual Funds

PIMCO CommodityRealReturn Strategy Fund INSTL (PCRIX)

Performance quoted represents past performance. Past performance is no guarantee of future results. Investment return and the principal value of an investment will fluctuate. Shares may be worth more or less than original cost when redeemed. Current performance may be lower or higher than performance shown. Performance quoted does not reflect any sales charges, if applicable, and performance would be lower if it did. Click Performance tab for performance current to the most recent month-end.

PIMCO

Print-friendly

About this Fund | Performance | Portfolio | Documents

Class INSTL

All data as of 10/19/11

Objective

Seeks maximum real return consistent with prudent investment management

Daily Price

NAV	CHG($)	1 Day Return	YTD Return
$7.66	-$0.11	-1.42%	-6.29%

Primary Portfolio

Commodity Index-linked derivative instruments backed by a portfolio of inflation-indexed bonds and other fixed income securities

Historical Prices

$7.79	$7.76	$7.77
10/14/11	10/17/11	10/18/11

Historical data

At a Glance

Symbol
PCRIX

CUSIP Number
722005667

Total Fund Assets (in millions)
$22,785.4

Share Class Inception Date
06/28/2002

Dividend Frequency
QUARTERLY

Maximum Sales Charge
-

Net Operating Expenses
0.740 %

Total Annual Operating Expenses
0.890 %

Core Documents

- PDF Annual Report
- PDF Dividends and Capital Gains
- PDF Fund Card
- PDF Fund Overview
- XLS Holdings Report
- XLS Portfolio Statistics
- PDF Prospectus
- PDF Semi Annual Report
- PDF Statement of Additional Information
- PDF Summary Prospectus

Fund Overview

Summary

Capturing the diversification and inflation-hedging potential of commodities

With its innovative Double Real™ strategy, this unique Fund seeks to capture the performance potential of a commodities index backed with Treasury Inflation-Protected Securities (TIPS). The resulting portfolio potentially offers a double hedge against inflation and a powerful diversification tool.

Managers

Mihir Worah

Mr. Worah is a managing director in the Newport Beach office, a portfolio manager, and head of the Real Return portfolio management team. He was previously a member of the analytics team and worked on real and nominal term structure modeling and options pricing. Prior to joining PIMCO in 2001, he was a postdoctoral research associate at the University of California, Berkeley, and the Stanford Linear Accelerator Center, where he built models to explain

Why Invest in this Fund

A Double Real™ inflation-hedging strategy

Instead of investing in physical commodities, the Fund purchases derivatives linked to a broad index, helping it diversify without committing substantial capital. The Fund then "collateralizes" these derivatives with an actively managed TIPS portfolio. This dual approach seeks to capitalize on real (after-inflation) returns from commodities and real returns from TIPS. TIPS may decline in value if interest rates rise, and may be particularly sensitive if real interest rates rise rapidly.

A carefully chosen index

The Fund offers exposure to the performance potential of the Dow Jones–UBS Commodity Total Return Index, which provides broad diversification across 19 physical commodities. The Index also offers an annual rebalancing feature, which may enhance potential returns, and relies on clearly defined rules to ensure that no single commodity or sector dominates the Index, which may help reduce volatility.

The diversification potential of commodities

Commodities are real assets like oil, metal or grain, as opposed to "paper" assets like stocks or bonds. As a result, they are sensitive to different economic factors and tend to perform differently, as evidenced by their low or negative correlation (tendency to move in tandem) with stocks and bonds. Adding commodities to a balanced portfolio may enhance overall diversification, though diversification does not guarantee a profit or protect against loss.

Investment Process

Rather than invest directly in physical commodities, the Fund employs an "enhanced-index" strategy. Specifically, the Fund gains exposure to the commodity markets through investments in commodity-index-linked derivative instruments and through investments in the PIMCO Cayman Commodity Fund I Ltd., a wholly owned subsidiary of the Fund organized under the laws of the Cayman Islands (the "Subsidiary"). The derivative instruments in which the Fund and the Subsidiary primarily intend to invest are instruments linked to certain commodity indices, specifically the Dow Jones–UBS Commodity Total Return Index. Additionally, the Fund or the Subsidiary may invest in derivative instruments linked to the value of a particular commodity or commodity futures contract, or a subset of commodities or commodity futures contracts. The Fund collateralizes the commodity-index-linked derivative instruments by investing its assets in an actively managed portfolio of inflation-indexed bonds and other fixed-income securities. Inflation-indexed bonds offer a return that is linked to changes in the rate of inflation. As a result, the Fund attempts to employ a Double Real™ strategy, seeking to capitalize on the inflation-hedging properties of both commodities and inflation-indexed bonds. PIMCO has extensive experience in managing both index-linked securities and the collateral backing this type of exposure.

About Commodity-Index-Linked Instruments

Commodities are assets that have tangible properties, such as oil, metals and agricultural products. Rather than invest directly in these physical commodities, the Fund may use a range of index-linked instruments to gain exposure to the commodities market. As with any commodity-index-linked instruments, the value of these instruments may be affected by overall market movements and other factors that affect the value of a particular industry or commodity, such as weather, disease, embargoes or political and regulatory developments. The market for these instruments has evolved and become more sophisticated, offering risk management solutions and often acting as a substitute for direct securities ownership.

the difference between matter and anti-matter. He has nine years of investment experience and holds a Ph.D. in theoretical physics from the University of Chicago.

Investors should consider the investment objectives, risks, charges and expenses of the funds carefully before investing. This and other information are contained in the fund's prospectus and summary prospectus, if available, which may be obtained by contacting your financial advisor or PIMCO representative. Click here for a complete list of the PIMCO Funds prospectuses and summary prospectuses. Please read them carefully before you invest or send money.

A word about risk:
Fixed income investments are subject to interest rate risk; their value will normally decline as interest rates rise. Commodities are assets that have tangible properties, such as oil, metals, and agricultural products. Commodities and commodity–index–linked securities may be affected by overall market movements and other factors that affect the value of a particular industry or commodity, such as weather, disease, embargoes, or political and regulatory developments. The value of a commodity–linked derivative is generally based on price movements of a commodity, a commodity futures contract, a commodity index, or other economic variables based on changes in the commodities markets. Use of derivative instruments may involve certain costs and risks such as liquidity risk, interest rate risk, market risk, credit risk, management risk and the risk that a fund could not close out a position when it would be most advantageous to do so. Portfolios investing in derivatives could lose more than the principal amount invested in those instruments.

Mortgage–backed securities are subject to prepayment risk and may be sensitive to changes in prevailing interest rates. The value of some mortgage–related or asset–backed securities may be particularly sensitive to interest rate changes, and there is no assurance that private insurers of the underlying mortgages or assets will meet their obligations. The Fund's commodity exposure is backed by a portfolio of inflation-indexed securities and other fixed-income instruments. Inflation–indexed bonds issued by the U.S. Government, known as TIPS, are fixed–income securities whose principal value is periodically adjusted according to the rate of inflation, which will affect the interest payable on them. Repayment upon maturity of the adjusted principal value is guaranteed by the U.S. Government. Neither the current market value of inflation–indexed bonds nor the share value of a fund that invests in them is guaranteed, and either or both may fluctuate. This Fund may invest in non–U.S. securities, which may entail greater risk due to foreign economic and political developments; these risks may be enhanced in emerging markets. This Fund is non–diversified, which means it may incur greater risk by concentrating its assets in a smaller number of issuers than a diversified fund.

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RYDEX|SGI LONG SHORT COMMODITIES STRATEGY FUND

A FUND PROVIDING LONG/SHORT EXPOSURE TO THE COMMODITIES MARKET — **SECOND QUARTER 2011**

FUND HIGHLIGHTS & APPLICATIONS

- Offers broad exposure to the commodities markets, which has traditionally served as a way to participate in the growth of the global economy and as an inflation hedge
- Long/short strategies may help mitigate commodities portfolio drawdowns
- Potential low noncorrelation to equity and fixed income markets

INVESTMENT STRATEGY

The fund seeks to achieve positive total returns with less volatility than the broad commodity markets

INCOME DISTRIBUTION FREQUENCY

Annual, if applicable

FUND TYPE

Commodities

PORTFOLIO MANAGERS

Team managed

BENCHMARK COMPARISONS

- JPMorgan Core Commodity-Investable Global Asset Rotator Sigma Long-Short Total Return Index
- S&P GSCI
- DJ UBS Commodity Index

SYMBOL & CUSIP NUMBER

	Symbol	CUSIP #
A-Class	RYLBX	78356A244
C-Class	RYLEX	78356A236
H-Class	RYLFX	78356A251
Institutional Class	RYITX	78356A152

For information, call 800.820.0888 or visit www.rydex-sgi.com

RYDEX|SGI LONG SHORT COMMODITIES STRATEGY FUND offers broad exposure to the commodities markets through a systematic trend-identifying strategy that seeks to exploit both rising and falling price trends.

The fund may be up to 100% long and 100% short (200% gross exposure) at times in energy, metals and agricultural commodities. The long short approach may mitigate the volatility and drawdowns often experienced in long-only commodities investing, while attempting to preserve other characteristics often found in commodity investments, such as the potential for a low correlation to equity markets and use as an inflation hedge.

INVESTMENT PROCESS

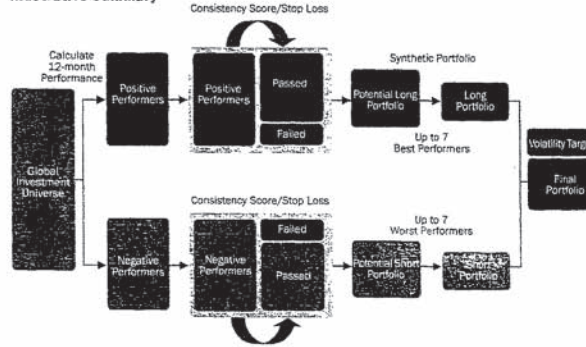
The fund follows a transparent investment methodology that:

- Seeks to identify longer-term price trends in 14 commodities futures
- Tests recent price movements for consistency relative to the longer-term trend
- Weights positions equally
- Attempts to control for expected portfolio volatility

Investment Universe

Energy	Industrial Metals	Precious Metals	Agriculture
Natural Gas	Nickel	Silver	Wheat
Gasoline	Lead	Gold	Soybeans
Heating Oil	Copper		Corn
Brent Crude	Aluminium		
WTI Crude			

Illustrative Summary



Rydex|SGI Long Short Commodities Strategy Fund is subject to a number of risks and may not be suitable for all investors. • The fund's use of derivatives such as futures, options, structured notes and swap agreements may expose the fund to additional risks that it would not be subject to if it invested directly in the securities underlying those derivatives. • A highly liquid secondary market may not exist for the commodity-linked structured notes the fund invests in, and there can be no assurance that a highly liquid secondary market will develop. The fund's exposure to the commodity markets may subject the fund to greater volatility as commodity-linked investments may be affected by changes in overall market movements, commodity index volatility, changes in interest rates or factors affecting a particular industry or commodity—such as droughts, floods, weather, embargos, tariffs and international economic, political and regulatory developments. • The fund's use of short selling involves increased risk and costs. The fund risks paying more for a security than it received from its sale. Theoretically, securities sold short have the risk of unlimited losses. The more the fund invests in leveraged instruments, the more the leverage will magnify any gains or losses on those investments. • The fund's investment in other investment companies, including ETFs, subjects the fund to those risks affecting the investment company, including the possibility that the value of the underlying securities held by the investment company could decrease. Moreover, the fund will incur its pro rata share of the expenses of the underlying investment companies' expenses. • Securities are not deposits or obligations of any bank, are not guaranteed by any bank, are not insured by the FDIC or any other agency, and involve investment risk, including the possible loss of the principal amount invested. • See the prospectus for more details. • The fund is considered nondiversified and can invest a greater portion of its assets in securities of individual issuers than a diversified fund. As a result, changes in the market value of a single security could cause greater fluctuations in the value of fund shares than would occur in a more diversified fund.

RYDEX|SGI ALTERNATIVE MUTUAL FUNDS OFFER:

- Daily liquidity.
- Daily performance in addition to semi-annual and annual reports.
- Convenience of 1099s for tax reporting.
- Availability to all investors*, depending on investment minimums and investor suitability. (Not subject to investor accreditation.)
- SEC-registered and-regulated. Although registration with the SEC is a requirement for a 1940 Act mutual fund, neither the SEC nor any other regulatory organization endorses, indemnifies or guarantees the fund's performance.

*Excluding non-resident aliens.

AVERAGE ANNUAL TOTAL RETURNS (AS OF 6/30/2011)

	YTD[1]	1-Year	3-Year	5-Year	10-Year	SI	Gross/Net Expense Ratio[3]	Inception Date
A-Share Class (w/load)	-1.55%	15.98%	n/a	n/a	n/a	4.60%	2.09%/1.93%	6/25/09
A-Share Class (NAV)	3.37%	21.78%	n/a	n/a	n/a	7.17%	2.09%/1.93%	6/25/09
C-Share Class (w/load)	1.99%	19.90%	n/a	n/a	n/a	6.35%	2.83%/2.67%	6/25/09
C-Share Class (NAV)	2.99%	20.90%	n/a	n/a	n/a	6.35%	2.83%/2.67%	6/25/09
H-Share Class	3.38%	21.79%	n/a	n/a	n/a	7.15%	2.07%/1.91%	6/25/09
Institutional Class	3.53%	22.15%	n/a	n/a	n/a	7.88%	1.88%/1.70%	5/03/10
C-IGAR Sigma Index[4]	3.56%	25.30%	n/a	n/a	n/a	11.59%[2]	n/a	—
S&P GSCI[4]	2.71%	26.11%	-21.66%	-6.16%	3.69%	9.10%[2]	n/a	—
DJ UBS Commodity Index[4]	-2.58%	25.80%	-11.82%	-0.05%	6.59%	13.21%[2]	n/a	—

Performance displayed represents past performance, which is no guarantee of future results. Investment return and principal value will fluctuate so that when shares are redeemed, they may be worth more or less than original cost. Returns reflect the reinvestment of all dividends. Current performance may be lower or higher than the performance data quoted. For up-to-date fund performance, including performance current to the most recent month-end, visit our web site at www.rydex-sgi.com. *Class A-Share with load performance reflects a maximum sales charge of 4.75%. A-Share investors may be eligible for a reduction in sales charges. Under certain circumstances, there may be a CDSC of 1% for redemptions within 12 months of purchase. Class C-Share with load performance reflects a maximum contingent deferred sales charge (CDSC) of 1% for shares redeemed within 12 months of purchase. For additional information, see the fund's prospectus.*

Effective July 11, 2011, the fund's investment objective changed from seeking to track the performance of a benchmark to seeking to achieve positive absolute returns. The fund's principal investment strategy was also revised to reflect the new objective.

[1] Partial-year returns are cumulative, not annualized. Performance results are short-term and may not provide an adequate basis for evaluating the performance potential of the fund over varying market conditions or economic cycles.[2] Returns are for the period 6/25/09–6/30/2011 (since inception of Rydex|SGI Long Short Commodities Strategy Fund H-Class). [3] The net expense ratio reflects the advisor's agreement to waive the management fee it receives from the fund in an amount equal to the management fee paid to the advisor by the subsidiary. This undertaking will continue in effect for so long as the fund invests in the subsidiary, and may be terminated only with the approval of the fund's board of trustees. In any event, this undertaking will continue through April 30, 2012. See the prospectus for more information. [4]C-IGAR Sigma, S&P GSCI and DJ UBS Commodity Indices are shown as performance comparisons. The referenced indices are unmanaged and not available for direct investment. Index performance does not reflect transaction costs, fees or expenses.

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For more complete information regarding the fund, call 800.820.0888 or visit www.rydex-sgi.com for a prospectus and a summary prospectus (if available). Investors should carefully consider the investment objectives, risks, charges and expenses of a fund before investing. The fund's prospectus and its summary prospectus (if available) contains this and other information about the fund. Please read the prospectus and summary prospectus (if available) carefully before you invest or send money.

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THE INTELLIGENT PURSUIT OF WEALTH™

For information, call 800.820.0888 or visit **www.rydex-sgi.com**

RYDEX|SGI MANAGED FUTURES STRATEGY FUND

RYDEX SGI
THE INTELLIGENT PURSUIT OF WEALTH

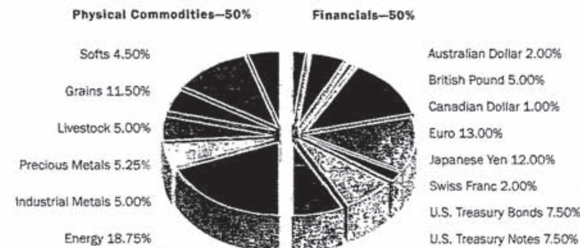
A FUND OFFERING BROAD EXPOSURE TO THE COMMODITIES AND FINANCIAL MARKETS AND SEEKING TO CAPTURE PRICE TRENDS IN BOTH RISING AND FALLING MARKETS

SECOND QUARTER 2011

RYDEX|SGI MANAGED FUTURES STRATEGY FUND seeks to achieve positive absolute returns using a rules-based trend-following strategy. It represents a composite of commodity and financial futures designed to provide exposure to both up and down major global market price trends. Positions may be either long or short based on current prices relative to their moving averages.

SECTOR WEIGHTINGS

The fund gains exposure to 14 sectors, with 50% allocated to financial futures and 50% to commodity futures. Each month, the fund's sector exposure is rebalanced to the weightings identified below, and sectors may be positioned either long or short, depending on current prices relative to their medium-term moving averages. The one exception is the energy sector, which cannot be held short because of political issues, economic changes and other risk factors unique to that sector. Should the energy sector take a neutral position, its weighting will be allocated proportionately to the other sectors.



Composition is subject to change.

FUND HIGHLIGHTS & APPLICATIONS[1]

- A medium-term-trend-following managed futures strategy
- Balanced exposure between commodities and financial markets (but does not take short positions in energy)
- Investment methodology is primarily based on the S&P Diversified Trends Indicator

INVESTMENT PROCESS
Rydex|SGI Managed Futures Strategy Fund seeks to achieve positive absolute returns.

TOTAL ASSETS
$2,592,373,196
(As of 6/30/2011)

INCOME DISTRIBUTION FREQUENCY
Annual, if applicable

FUND TYPE
Alternative Investment Fund

PORTFOLIO MANAGER
Team managed

BENCHMARK COMPARISONS

- S&P Diversified Trends Indicator
- Bank of America Merrill Lynch 3 Month Treasury Bill

SYMBOL & CUSIP NUMBER

	Symbol	CUSIP #
A-Class	RYMTX	78356A517
H-Class	RYMFX	78356A491
C-Class	RYMZX	78356A525
Institutional Class	RYIFX	78356A145

For information, call 800.258.4332 or visit **www.rydex-sgi.com**

[1] **Rydex|SGI Managed Futures Strategy Fund is subject to a number of risks and may not be suitable for all investors. Investing in mutual funds involves risk and does not assure a profit.** • The fund's use of derivatives such as futures, options, structured notes and swap agreements may expose the fund to additional risks that it would not be subject to if it invested directly in the securities underlying those derivatives. A highly liquid secondary market may not exist for the commodity-linked structured notes the fund invests in, and there can be no assurance that a highly liquid secondary market will develop. • The fund's exposure to the commodity and currency markets may subject the fund to greater volatility as commodity- and currency-linked derivative investments may be affected by changes in overall market movements, commodity index volatility, changes in interest rates or factors affecting a particular industry, commodity or currency, such as droughts, floods, weather, livestock disease, embargos, tariffs and international economic, political and regulatory developments. The fund may also incur transaction costs with the conversion between various currencies. • The fund's use of short selling involves increased risk and costs. The fund risks paying more for a security than it received from its sale. Theoretically, securities sold short have the risk of unlimited losses. • The fund's investment in other investment companies, including ETFs, subjects the fund to those risks affecting the investment company, including the possibility that the value of the underlying securities held by the investment company could decrease. Moreover, the fund will incur its pro rata share of the expenses of the underlying investment companies' expenses. • This fund is considered nondiversified and can invest a greater portion of its assets in securities of individual issuers than a diversified fund. As a result, changes in the market value of a single security could cause greater fluctuations in the value of fund shares than would occur in a more diversified fund. • Securities are not deposits or obligations of any bank; are not guaranteed by any bank, are not insured by the FDIC or any other agency, and involve investment risk, including the possible loss of the principal amount invested. • See the prospectus for more details.

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RYDEX|SGI ALTERNATIVE MUTUAL FUNDS OFFER:

- Daily liquidity.
- Daily performance in addition to semi-annual and annual reports.
- Convenience of 1099s for tax reporting.
- Availability to all investors*, depending on investment minimums and investor suitability (Not subject to investor accreditation).
- SEC registered and regulated. Although registration with the SEC is a requirement for a 1940 Act mutual fund, neither the SEC nor any other regulatory organization endorses, indemnifies or guarantees the fund's performance.

*Excluding non-resident aliens.

PORTFOLIO RISK/RETURN METRICS

Since Fund Inception (3/02/2007–6/30/2011)

	RYMFX	S&P DTI	ML 3M T-Bills
Annualized Standard Deviation[6]	11.41	11.45	0.37
Beta[7]	1.38	1.52	1.00
Annualized Alpha[8]	-0.35	0.51	0.00
Sharpe Ratio[9]	-0.02	0.05	0.00
Correlation[10] to S&P 500	-0.13	-0.10	-0.12
Correlation[10] to ML 3M T-Bills	0.04	0.05	1.00

Source: FactSet. Calculations performed using daily data points.

AVERAGE ANNUAL TOTAL RETURNS (AS OF 6/30/2011)

	YTD[2]	1-Year	3-Year	5-Year	10-Year	SI	Gross Expense Ratio[3]	Net Expense Ratio[3]	Inception Date
A-Class (w/load)	-5.80%	-4.28%	-4.26%	n/a	n/a	0.19%	2.04%	1.97%	03/02/2007
A-Class (NAV)	-1.09%	0.51%	-2.69%	n/a	n/a	1.32%	2.04%	1.97%	03/02/2007
C-Class (w/load)	-2.42%	-1.24%	-3.42%	n/a	n/a	0.57%	2.79%	2.72%	03/02/2007
C-Class (NAV)	-1.44%	-0.24%	-3.42%	n/a	n/a	0.57%	2.79%	2.72%	03/02/2007
H-Class	-1.09%	0.51%	-2.69%	n/a	n/a	1.32%	2.04%	1.97%	03/02/2007
Institutional Class	-0.93%	0.83%	n/a	n/a	n/a	0.03%	1.78%	1.72%	05/03/2010
S&P DTI[4]	0.69%	2.99%	-2.72%	n/a	n/a	2.18%[5]	—	—	—
Bank of America Merrill Lynch 3-Month Treasury Bill[4]	0.08%	0.16%	0.42%	n/a	n/a	1.52%[5]	—	—	—

Performance displayed represents past performance, which is no guarantee of future results. Investment return and principal value will fluctuate so that when shares are redeemed, they may be worth more or less than original cost. Returns reflect the reinvestment of all dividends. Current performance may be lower or higher than the performance data quoted. For up-to-date fund performance, including performance current to the most recent month-end, visit our web site at www.rydex-sgi.com. *Class A-Share with load performance reflects a maximum sales charge of 4.75%. A-Share investors may be eligible for a reduction in sales charges. Under certain circumstances, there may be a CDSC of 1% for redemptions within 12 months of purchase. Class C-Share with load performance reflects a maximum contingent deferred sales charge (CDSC) of 1% for shares redeemed within 12 months of purchase. For additional information, see the fund's prospectus.*

Effective July 11, 2011, the fund's investment objective changed from seeking to track the performance of a benchmark to seeking to achieve positive absolute returns. The fund's principal investment strategy was also revised to reflect the new objective.

[2] Partial-year returns are cumulative, not annualized. Performance results are short-term and may not provide an adequate basis for evaluating the performance potential of the fund over varying market conditions or economic cycles. [3] The net expense ratio reflects the advisor's agreement to waive the management fee it receives from the fund in an amount equal to the management fee paid to the advisor by the subsidiary. This undertaking will continue in effect for so long as the fund invests in the subsidiary, and may be terminated only with the approval of the fund's board of trustees. In any event, this undertaking will continue through April 30, 2012. See the prospectus for more information. [4] The S&P DTI and Bank of America Merrill Lynch 3-Month Treasury Bill are shown as performance comparisons. The referenced indices are unmanaged and not available for direct investment. Index performance does not reflect transaction costs, fees or expenses. [5] Returns are for the period 03/02/2007–6/30/2011 (since inception of Rydex|SGI Managed Futures Strategy Fund H-Class). [6] **Standard deviation** is a statistical measure of the historical volatility of an investment. More generally, a measure of the extent to which numbers are spread around their averages. The higher the number, the more volatility is to be expected. [7] **Beta:** A measure of a fund's sensitivity to market movements. The beta of the market is 1.00 by definition. Morningstar calculates beta by comparing a fund's excess return over Treasury bills to the market's excess return over Treasury bills, so a beta of 1.10 shows that the fund has performed 10% better than its benchmark index in up markets and 10% worse in down markets, assuming all other factors remain constant. Conversely, a beta of 0.85 indicates that the fund's excess return is expected to perform 15% worse than the market's excess return during up markets and 15% better during down markets. [8] **Alpha:** A coefficient, which measures risk-adjusted performance, factoring in the risk due to the specific security, rather than the overall market. A high value for alpha implies that the stock or mutual fund has performed better than would have been expected given its beta (volatility). [9] **Sharpe ratio** is a risk-adjusted measure developed by William F. Sharpe, calculated using standard deviation and excess return to determine reward per unit of risk. The higher the Sharpe ratio, the better the fund's risk-adjusted performance. The 3% represents the risk-free rate of return, usually based on the three-month U.S. Treasury Bill. [10] **Correlation** is a statistical measure of how two securities move in relation to each other. This measure ranges from -1 to +1, where -1 indicates perfect negative correlation and +1 indicates perfect positive correlation.

Read the fund's prospectus and summary prospectus (if available) carefully before investing. It contains the fund's investment objectives, risks, charges, expenses and other information, which should be considered carefully before investing. Obtain a prospectus and summary prospectus (if available) at www.rydex-sgi.com or call 800.258.4332.

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Van Eck CM Commodity Index Fund

August 2011

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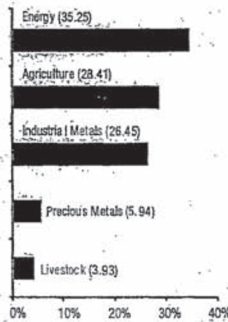
CMCAX | COMIX | CMCYX

The Van Eck CM Commodity Index Fund is a passively-managed mutual fund that seeks to track, before fees and expenses, the performance of the UBS Bloomberg Constant Maturity Commodity Total Return Index ("CMCI"). The CMCI employs a methodology that seeks to minimize exposure to the front end of the futures curve and diversify across maturities. By spreading its exposure across multiple maturities, the index can potentially mitigate the impacts of contango and negative roll yield.

CMCI Target Weightings (%): 2H 2011



Expenses: Class A: Gross 1.52%; Net 0.95%; Class I: Gross 0.98%; Net 0.65% and Class Y: Gross 1.27%; Net 0.70%. Expenses are capped contractually until 05/01/12 at 0.95% for Class A, 0.65% for Class I and 0.70% for Class Y. Caps exclude certain expenses, such as interest.

The tables present past performance which is no guarantee of future results and which may be lower or higher than current performance. Returns reflect applicable fee waivers and/or expense reimbursements. Had the Fund incurred all expenses and fees, investment returns would have been reduced. Investment returns and Fund share values will fluctuate so that investor's shares, when redeemed, may be worth more or less than their original cost. Fund returns assume that dividends and capital gains distributions have been reinvested in the Fund at NAV. Index returns assume that dividends of the Index constituents in the Index have been reinvested.

This Fund is newly offered and has a limited operating history. The performance shown for the indices does not reflect fees and charges, which are assessed with the purchase and ownership of the Fund. Indices are not securities in which investments can be made.

Investment Approach

- The Fund seeks to track the performance of the CMCI by primarily investing in commodity-linked derivative instruments and more conservative fixed income securities, such as U.S. Treasury Bills
- The Fund may invest in instruments linked to the value of a particular commodity or commodity futures contract through a wholly owned subsidiary of the Fund formed in the Cayman Islands

UBS Bloomberg CMCI Highlights

- Diversified across 27 commodity components and up to five maturities
- Potential for higher risk-adjusted returns than traditional commodity indices
- Constant maturity approach: daily rolling of a small proportion of underlying contracts
- Monthly rebalancing: limited concentration risk to any one underlying commodity

Fund Facts as of 08/31/11

Net Assets (Class A, I, Y)	$43.8M	Number of Commodity Sectors	5
Average Weighted Contract Maturity	7.7 Months	Number of Commodity Components	27

Average Annual Total Returns (%) as of 08/31/11

	1 Mo[1]	3 Mo[1]	YTD[1]	1 Yr	3 Yr	5 Yr	10 Yr	Life[2]
Class A: NAV (Inception 12/31/10)	-0.74	0.00	5.07	--	--	--	--	--
Class A: Maximum 5.75% load	-6.42	-5.76	-0.96	--	--	--	--	--
Class I: NAV (Inception 12/31/10)	-0.64	0.21	5.41	--	--	--	--	--
Class Y: NAV (Inception 12/31/10)	-0.64	0.11	5.29	--	--	--	--	--
UBS Bloomberg CMCI	-0.66	0.27	5.99	31.35	-0.39	--	--	7.06

Average Annual Total Returns (%) as of 06/30/11

	1 Mo[1]	3 Mo[1]	YTD[1]	1 Yr	3 Yr	5 Yr	10 Yr	Life[2]
Class A: NAV (Inception 12/31/10)	-2.68	-4.42	2.25	--	--	--	--	--
Class A: Maximum 5.75% load	-8.28	-9.92	-3.61	--	--	--	--	--
Class I: NAV (Inception 12/31/10)	-2.57	-4.31	2.48	--	--	--	--	--
Class Y: NAV (Inception 12/31/10)	-2.57	-4.31	2.48	--	--	--	--	--
UBS Bloomberg CMCI	-2.56	-4.12	3.00	35.36	-5.97	--	--	6.64

NAV History (Class A)

	12-Month High	12-Month Low	Month-End
	--	--	$9.33

[1]One-month and year-to-date returns are not annualized.
[2]UBS Bloomberg CMCI live track record (inception) begins on January 1, 2007.

Van Eck CM Commodity Index Fund

August 2011

CMCAX | COMIX | CMCYX

2011 Monthly Returns (%)

	Jan	Feb	March	April	May	June	August	August	Sept	Oct	Nov	Dec	Year
Class A: NAV	3.27	2.62	0.96	2.00	-3.72	-2.68	3.52	-0.74					
UBS Bloomberg CMCI	3.52	2.73	1.01	2.13	-3.66	-2.56	3.59	-0.66					

Returns reflect capital appreciation and the reinvestment of dividends and capital gains, if any, as well as all fees and expenses but do not reflect any sales load. All indices are unmanaged and include the reinvestment of all dividends, but do not reflect the payment of transaction costs, advisory fees or expenses that are associated with an investment in the Fund. An index's performance is not illustrative of the Fund's performance. Indices are not securities in which investments can be made. Results reflect past performance and do not guarantee future results. See the reverse side for complete performance information.

Three-Year Max Drawdown (%) as of 08/31/11	
UBS Bloomberg CMCI	-44.44
S&P GSCI Index	-60.32
DJUBS Index	-44.03
S&P® 500 Index	-41.82

Three-Year Volatility (%) as of 08/31/11	
UBS Bloomberg CMCI	22.29
S&P GSCI Index	29.46
DJUBS Index	21.69
S&P® 500 Index	21.50

CMCI Three-Year Correlation as of 08/31/11	
BarCap Agg Bond Index	0.14
S&P® 500 Index	0.82

Maximum drawdown is the largest negative change in fund value over a given period of time. Volatility is the annualized standard deviation of monthly returns. Correlation describes a complementary or parallel relationship between two investments. The correlation coefficient is a measure that determines the degree to which two variables' movements are associated and will vary from -1.0 to 1.0. -1.0 indicates perfect negative correlation, and 1.0 indicates perfect positive correlation.

Know Your Terms: Contango occurs when the price of a futures contract is above the expected future spot price at the time the contract expires. Negative roll yield is the amount of return lost in a contango market.

Know Your Indices: The Dow Jones-UBS Commodity Index (DJUBS) is composed of futures contracts on 20 physical commodities covering seven sectors, specifically energy, petroleum, precious metals, industrial metals, grains, livestock and softs. Energy exposure is limited to no more than 33%; manager cannot invest above that level no matter how favorable the energy market. The S&P® Goldman Sachs Commodity Index (S&P GSCI) is a composite index of commodity sector returns, representing an unleveraged, long-only investment in commodity futures. High energy concentration; limited diversification. The index benefits when energy is strong, and suffers when energy is weak. Lastly, the S&P® 500 Index consists of 500 widely held common stocks covering industrial, utility, financial and transportation sectors. The Barclays Capital Global Aggregate Bond Index is composed of the mortgage-backed and asset-backed securities and government/credit bonds. All indices are unmanaged and include the reinvestment of all dividends, but do not reflect the payment of transaction costs, advisory fees or expenses that are associated with an investment in the Fund. An index's performance is not illustrative of the Fund's performance. Indices are not securities in which investments can be made.

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You can lose money by investing in the Fund. Any investment in the Fund should be part of an overall investment program, not a complete program. Commodities are assets that have tangible properties, such as oil, metals, and agriculture. Commodities and commodity-linked derivatives may be affected by overall market movements and other factors that affect the value of a particular industry or commodity such as weather, disease, embargoes or political or regulatory developments. The value of a commodity-linked derivative is generally based on price movements of a commodity, a commodity futures contract, a commodity index or other economic variables based on the commodity markets. Derivatives use leverage, which may exaggerate a loss. The Fund is subject to the risks associated with its investments in commodity-linked derivatives, risks of investing in wholly owned subsidiary, risk of tracking error, risks of aggressive investment techniques, leverage risk, derivatives risks, counterparty risks, non-diversification risk, credit risk, concentration risk and market risk. The use of commodity-linked derivatives such as swaps, commodity-linked structured notes and futures entails substantial risks, including risk of loss of a significant portion of their principal value, lack of a secondary market, increased volatility, correlation risk, liquidity risk, interest-rate risk, market risk, credit risk, valuation risk and tax risk. Gains and losses from speculative positions in derivatives may be much greater than the derivative's cost. At any time, the risk of loss of any individual security held by the Fund could be significantly higher than 50% of the security's value. Investment in commodity markets may not be suitable for all investors. The Fund's investment in commodity-linked derivative instruments may subject the fund to greater volatility than investment in traditional securities. For a description of these and other risk considerations, please refer to the Fund's prospectuses, which should be read carefully before you invest. Again, the Fund offers investors exposure to the broad commodity markets, currently, by investing in commodity-linked swaps.

Please call 800.826.2333 or visit vaneck.com for performance information current to the most recent month end and for a free prospectus and summary prospectus. An investor should consider the Fund's investment objective, risks, and charges and expenses carefully before investing. The prospectus and summary prospectus contain this and other information. Please read them carefully before investing.

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United States Senate
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Committee on Homeland Security and Governmental Affairs

Carl Levin, Chairman
Norm Coleman, Ranking Minority Member

EXCESSIVE SPECULATION IN THE NATURAL GAS MARKET

STAFF REPORT

WITH ADDITIONAL MINORITY STAFF VIEWS

PERMANENT SUBCOMMITTEE ON INVESTIGATIONS

UNITED STATES SENATE

RELEASED IN CONJUNCTION WITH THE PERMANENT SUBCOMMITTEE ON INVESTIGATIONS JUNE 25 AND JULY 9, 2007 HEARINGS

Permanent Subcommittee on Investigations
EXHIBIT #6a

EXCESSIVE SPECULATION IN THE NATURAL GAS MARKET

JUNE 25, 2007

I. EXECUTIVE SUMMARY

Since 2001, the U.S. Senate Permanent Subcommittee on Investigations ("the Subcommittee") has been examining the structure and operation of U.S. energy markets. In June 2006, the Subcommittee issued a bipartisan staff report, *The Role of Market Speculation in Rising Oil and Gas Prices: A Need to Put the Cop Back on the Beat,*[1] analyzing the extent to which the increasing amount of financial speculation in energy markets has contributed to the steep rise in energy prices over the past few years. The report concluded: "Speculation has contributed to rising U.S. energy prices," but also that "gaps in available market data" made quantification of the speculative component problematic.[2] The report endorsed the estimate of various analysts that the influx of speculative investments into crude oil futures accounted for approximately $20 of the then-prevailing crude oil price of approximately $70 per barrel. The report's analysis was based entirely on publicly available data about the overall level of financial investments in energy markets and publicly available data on energy prices and supplies.

The Subcommittee's staff report recommended that the Commodity Futures Trading Commission ("CFTC") be provided with the same authority to regulate and monitor electronic energy exchanges, such as the Intercontinental Exchange ("ICE"), as it has with respect to the fully regulated futures markets, such as the New York Mercantile Exchange ("NYMEX"), to ensure that excessive speculation did not adversely affect the availability and affordability of vital energy commodities through unwarranted price increases. Congress has not taken any action since then to authorize CFTC oversight of unregulated energy markets like ICE.

Shortly after the Subcommittee issued the report in 2006, the natural gas market entered a period of extreme price volatility punctuated by the collapse in September 2006 of Amaranth Advisors LLC ("Amaranth"), one of the largest hedge funds in the natural gas market. From the last week in August until the middle of September 2006, Amaranth's natural gas positions lost over $2 billion in value, precipitating the liquidation of the entire portfolio of the $8 billion fund.

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[1] S. Prt. 109-65, 109th Congress, 2nd Session (June 27, 2006).
[2] *Id.*, at p. 6.

In late summer, natural gas prices began falling. For example, the price of the NYMEX futures contract to deliver natural gas in October 2006 fell from a high of $8.45 per MMBtu in late July to just under $4.80 per MMBtu in September, the lowest level for that contract in two and one-half years. The difference in price between the NYMEX natural gas futures contract for March 2007 and for April 2007 – called the price spread – fell from a high of nearly $2.50 per MMBtu in July to less than 60 cents in September, a drop of 75 percent. The price for the immediate delivery of natural gas, called the spot price, fell from $7.49 per MMBtu in late August to $3.66 per MMBtu in early October, the lowest level in four years.[3] The Electric Power Research Institute described this price collapse as "stunning . . . one of the steepest declines ever."[4]

Throughout this period, the market fundamentals of supply and demand were largely unchanged. Natural gas supplies were plentiful, and the amount of natural gas in storage remained higher than average throughout the summer and into the early fall. The large price variations in the face of steady supply and demand trends raises several questions: If the underlying supply and demand factors were unchanged, what was causing the large price swings? To what extent was the collapse of Amaranth related to the fall in prices? If Amaranth's collapse either caused or accelerated the price drops, then were Amaranth's positions responsible for the higher prices and large spreads that prevailed throughout the summer? Was there adequate market oversight to ensure that large hedge funds were not distorting natural gas prices?

In October 2006, the Subcommittee began its investigation into the behavior of natural gas prices earlier in the year. The Subcommittee analyzed millions of natural gas transactions from trading records obtained from NYMEX and ICE, the two principal exchanges for energy commodities, and from Amaranth and other traders. In addition, the Subcommittee conducted numerous interviews of natural gas market participants, including natural gas traders, producers, suppliers, and hedge fund managers, as well as exchange officials, regulators, and energy market experts. NYMEX, ICE, Amaranth, and many traders cooperated with detailed inquiries. The Subcommittee also reviewed commodity market statutes and regulations, and researched a variety of legal issues.

The trading records examined by the Subcommittee disclosed that from early 2006 until its September collapse, Amaranth dominated trading in the U.S. natural gas financial markets. Amaranth bought and

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[3] Federal Energy Regulatory Commission (FERC), Winter 2006-07 Energy Market Assessment, Item No.: A-3, October 19, 2006, at p. 2.

[4] Electric Power Research Institute, Natural Gas Issues: Turnaround Prospects, Energy Markets and Generation Response, October 2006, at p. 1.

sold thousands of natural gas contracts on a daily basis, and tens of thousands of contracts on certain days. It accumulated tens of thousands of natural gas holdings, or "positions," on both NYMEX and ICE. The CFTC defines a "large trader" for reporting purposes in the natural gas market as a trader who holds at least 200 contracts; NYMEX examines a trader's position if it exceeds 12,000 natural gas contracts in any one month. Amaranth held as many as 100,000 natural gas contracts in a single month, representing 1 trillion cubic feet of natural gas, or 5 percent of the natural gas used in the entire United States in a year. At times Amaranth controlled 40 percent of all of the outstanding contracts on NYMEX for natural gas in the winter season (October 2006 through March 2007), including as much as 75 percent of the outstanding contracts to deliver natural gas in November 2006.

Amaranth's large positions and trades caused significant price movements in key natural gas futures prices and price relationships. For example, Amaranth's purchases of contracts to deliver natural gas in the winter months, in conjunction with Amaranth's sales of natural gas contracts for delivery in the summer months, drove winter prices far above summer prices. These differences between winter and summer prices, called "price spreads," were far higher in 2006 than in previous years - until the collapse of Amaranth, when the price spreads returned to more normal levels. On several specific dates, Amaranth's massive trades were responsible for large jumps in the price differences between the futures contracts for March and April 2007. Traders interviewed by the Subcommittee said that during the spring and summer of 2006 the differences between winter and summer prices were "clearly out-of-whack," at "ridiculous" levels, and unjustified by supply or demand.

Purchasers of natural gas during the summer of 2006 for delivery in the following winter months paid inflated prices due to Amaranth's large-scale speculative trading. Businesses such as utilities had to either absorb this added expense or pass the higher costs onto the ultimate consumer, such as residential users who paid higher home heating bills.

The current regulatory system was unable to prevent Amaranth's excessive speculation in the 2006 natural gas market. Under current law, NYMEX is required to monitor the positions of its traders to determine whether a trader's positions are too large. If a trader's position exceeds pre-set "accountability levels," the exchange may require a trader to reduce its positions. The Amaranth case history demonstrates two critical flaws. First, NYMEX has no routine access to information about a trader's positions on ICE in determining whether a trader's positions are too large. It is therefore impossible under the current system for NYMEX to have a complete and accurate view of a trader's position in determining whether it is too large.

Second, even if NYMEX orders a trader to reduce its positions on NYMEX, the trader can simply shift its positions to ICE where no limits apply. This is precisely what Amaranth did after NYMEX finally told Amaranth, in August 2006, to reduce its positions in two contracts nearing expiration, contracts to deliver gas in September and October 2006. In response, Amaranth reduced its positions on NYMEX and increased them on ICE, maintaining the same overall positions in the market. Within a few days, Amaranth resumed increasing its positions, mostly on ICE. By the end of August, Amaranth held nearly 100,000 short positions in the September contract, mostly on ICE, and a total of nearly 90,000 short positions for the October contract on both ICE and NYMEX. These were huge positions - each variation of one cent in a position of 100,000 contracts changes a trader's profit or loss by $10 million. As a result, NYMEX's instructions to Amaranth did nothing to reduce Amaranth's size, but simply caused Amaranth's trading to move from a regulated market to an unregulated one.

The data analyzed by the Subcommittee, together with trader interviews, show that NYMEX and ICE are functionally equivalent markets. Natural gas traders use both markets, employing coordinated trading strategies. In many instances the volumes on ICE are comparable to or greater than the volumes on NYMEX. Traders use the natural gas contract on NYMEX, called a futures contract, in the same way they use the natural gas contract on ICE, called a swap, for risk management and economic purposes. The data show that prices on one exchange affect the prices on the other. Given their equivalence, there is no sound basis for one exchange to be regulated and the other not.

The disparity in regulation between NYMEX and ICE results from the so-called "Enron loophole" in the Commodity Exchange Act. The Enron loophole, which was inserted into the law in 2000 at the request of Enron and others, exempts electronic energy exchanges such as ICE from CFTC oversight and regulation. Unlike NYMEX, there are no limits on the trading on ICE, and no routine government oversight. The Amaranth case history demonstrates that the disparity in regulation of the two markets prevents the CFTC and the exchanges from fully analyzing market transactions, understanding trading patterns, and compiling accurate pictures of trader positions and market concentration; it requires them to make regulatory judgments on the basis of incomplete and inaccurate information; and it impedes their authority to detect, prevent, and punish market manipulation and excessive speculation.

Natural gas traders are well aware of the consequences of this limitation. For example, when Amaranth's lead energy trader predicted in an email that "boy I bet you see some CFTC inquiries" into a price

spike that affected the final price of the September 2006 futures contract, another trader reminded him that most of the trades had taken place on ICE using swaps. The trader wrote: "Until they monitor swaps no big deal." His comment captures the problem – current law requires our regulators to oversee U.S. energy markets with incomplete information and inadequate authority.

To repair the broken regulatory system, Congress needs to require currently unregulated exchanges, such as ICE, to comply with the same statutory obligations as regulated markets, such as NYMEX, and operate under the same rules to prevent market manipulation and excessive speculation from affecting the price of vital energy commodities.

Some market observers contend that Amaranth's collapse proved the energy markets are functioning well because an overly risky trader met its demise without harming other traders or the natural gas market as a whole. In fact, however, many other market participants were harmed by Amaranth's massive speculative trading. For example, utilities that provide gas-powered electricity or heating to homes, schools, hospitals, and industries that use natural gas in manufacturing paid inflated prices. Many of their costs were passed onto consumers. Some companies told the Subcommittee that extreme price swings in the natural gas futures market make it more difficult and expensive to use the futures market for hedging. Still others told the Subcommittee that they have lost confidence in the natural gas market, viewing it not as a mechanism to set prices reflecting supply and demand, but as a market increasingly responsive to a few dominant traders with sufficient capital to affect prices.

If given authority to police all U.S. energy commodity markets, the CFTC should use this authority to monitor aggregate positions taken by traders on both NYMEX and ICE, and to analyze trading data from both exchanges. Regulators should also strengthen their monitoring and oversight to prevent excessive speculation for all of the months in which contracts are traded, not just contracts near expiration. The Amaranth experience demonstrates how excessive speculation can distort prices of futures contracts that are many months from expiration, with serious consequences for other market participants. To prevent excessive speculation from causing unwarranted price changes, commodity regulators need to conduct oversight over both a broader market and for a longer time horizon than the next few months.

A final major problem is the inadequate oversight capabilities of the CFTC. The CFTC suffers from antiquated technology systems, a shrinking staff, and flat budgets. In part, these budgetary woes have occurred because Congress has never authorized the CFTC, as it has

virtually every other federal financial regulator, to collect user fees from the markets it oversees. Congress needs to provide the CFTC with adequate resources to do its job, and authorize user fees to pay for the additional expense.

Energy is a critical factor in the future of the U.S. economy. How it is priced is of vital concern. The Amaranth case history is not just the story of a single hedge fund dominating the market, but of a broken regulatory system that has left our energy markets vulnerable to any trader with sufficient resources to alter energy prices for all market participants.

The remainder of this Report details the Amaranth case history. Section II presents the staff findings and recommendations from the Subcommittee's investigation. Section III provides general information on the importance of natural gas to the U.S. economy, its production, economic uses, and the fundamentals of natural gas supply and demand. Section IV provides general information on the cash and financial markets for natural gas, and an overview of the regulatory structure for the various types of energy exchanges. Section V describes the unusual and extreme behavior of natural gas prices in the spring and summer of 2006, and analyzes the role of Amaranth and other hedge funds in forming those prices. Section V also describes the impact of Amaranth's trading on other market participants. Sections VI and VII offer recommendations to restore the integrity of energy commodity markets in the United States and protect them against market manipulation and excessive speculation. Section VIII contains additional Minority Staff views on the Report.

II. FINDINGS AND RECOMMENDATIONS

A. FINDINGS

(1) A single hedge fund, Amaranth Advisors LLC, dominated the U.S. natural gas market in 2006.

(a) Amaranth accumulated massive natural gas holdings on NYMEX and ICE spanning five years, from 2006-2010.

(b) Amaranth accumulated such large positions and traded such large volumes of natural gas in 2006, on both NYMEX and ICE, that it had a direct effect on U.S. natural gas prices and increased price volatility in the natural gas market. The larger than usual differences between winter and summer futures prices that prevailed during the spring and summer of 2006 were largely the result of Amaranth's large-scale trades rather than the normal market interaction of many buyers and sellers.

(c) Amaranth's 2006 positions in the natural gas market constituted excessive speculation.

(2) In August 2006, Amaranth traded natural gas contracts on ICE rather than on NYMEX so that it could trade without any restrictions on the size of its positions.

(a) When NYMEX directed Amaranth to reduce its positions in September 2006 and October 2006 natural gas futures contracts, Amaranth simply transferred those positions to ICE, an unregulated market, thereby maintaining its overall speculative position in the natural gas market.

(b) NYMEX's attempt to limit speculative trading during the last day of trading on the September 2006 natural gas futures contract failed, because neither NYMEX nor the CFTC had any authority, mandate, or ability to limit trading on ICE that affected the pricing of the NYMEX futures contract.

(3) Amaranth's actions in causing significant price movements in the natural gas market demonstrate that excessive speculation distorts prices, increases volatility, and increases costs and risks for natural gas consumers, such as utilities, who ultimately pass on inflated costs to their customers.

(a) Purchasers of natural gas during the summer of 2006 for delivery in the following winter months paid inflated prices due to Amaranth's speculative trading.

(b) Many of these inflated costs were passed on to consumers, including residential users who paid higher home heating bills.

(4) The two major U.S. exchanges that trade natural gas – NYMEX and ICE – affect each other's prices.

(a) Significant volumes of natural gas are traded on both NYMEX and ICE, and both markets play a key role in setting U.S. natural gas prices.
(b) The contracts used on NYMEX and ICE to trade natural gas, called futures contracts on NYMEX and swaps on ICE, are equivalent financial products that serve the same risk-management purposes.
(c) Traders routinely buy and sell natural gas contracts on both NYMEX and ICE, and hold positions in both markets.
(d) The price of NYMEX futures and ICE swaps are virtually identical up until the final half hour of the last trading day of the NYMEX contract, when NYMEX and ICE prices typically differ by a few cents at most.

(5) Current restraints on speculative trading to prevent manipulation and price distortions are inadequate.

(a) The CFTC lacks statutory authority to establish or enforce speculative position limits on the trading of natural gas on ICE or other Exempt Commercial Markets.
(b) When large traders choose to trade on ICE rather than NYMEX, it is difficult, if not impossible, for NYMEX to prevent price manipulation or excessive speculation from distorting NYMEX prices, because NYMEX does not have information regarding, or the jurisdiction to limit, trading on ICE even though ICE trades affect NYMEX futures prices.
(c) The CFTC's primary strategy to stop excessive speculation has been to prevent manipulation of the final price of a futures contract that is about to expire, rather than to generally review speculative trades affecting a range of futures contract prices.

(6) The CFTC is unable to meet its statutory mandate to prevent market manipulation and excessive speculation from causing sudden, unreasonable, or unwarranted energy prices.

(a) The CFTC lacks statutory authority to effectively oversee U.S. energy commodity markets, because the "Enron Loophole" prevents the CFTC from overseeing ICE.
(b) The CFTC lacks budgetary, staff, and technological resources to effectively monitor energy commodity markets.

(c) As a result of the lack of legal authority and budgetary resources, the CFTC was unable to prevent excessive speculation in the natural gas market in 2006.
(d) If the CFTC is not provided with additional legal authority and resources, the CFTC will remain unable to accomplish its statutory mission.
(e) The inability of the CFTC to accomplish its statutory mission with respect to the trading of energy commodities presents a threat to the energy and economic security of the United States.

B. RECOMMENDATIONS

(1) Congress should eliminate the "Enron Loophole" that exempts electronic energy exchanges from regulatory oversight. Experience since passage of the Commodity Futures Modernization Act of 2000, demonstrates there is no sound rationale for exempting electronic energy exchanges from regulatory oversight. Excessive speculation that occurred on electronic exchanges in 2006 contributed to the overall distortion of energy prices in the natural gas market, to the detriment of American consumers, businesses, industry, and utilities. Exempt Commercial Markets, such as ICE, should be required to comply with the same statutory obligations as Designated Contract Markets, such as NYMEX, and should be regulated in the same manner by the CFTC to prevent market manipulation and excessive speculation. To ensure fair energy pricing, it is time to put the cop back on the beat in all U.S. energy commodity markets.

(2) If given additional legal authority, the CFTC should monitor aggregate positions on NYMEX and ICE. The CFTC and exchanges should strengthen their monitoring and oversight to prevent excessive speculation for all of the months in which contracts are traded, not just for contracts near expiration.

(3) Congress should increase the CFTC budget and authorize CFTC user fees to help pay for the additional cost. The CFTC's budget should be increased to provide the staff and technology needed to monitor, integrate, and analyze real-time transactional data from all U.S. commodity exchanges, including NYMEX and ICE. Needed funding should be obtained from user fees imposed on commodity markets.

United States Senate
PERMANENT SUBCOMMITTEE ON INVESTIGATIONS
Committee on Homeland Security and Governmental Affairs
Carl Levin, Chairman
Tom Coburn, Acting Ranking Minority Member

EXCESSIVE SPECULATION IN THE WHEAT MARKET

MAJORITY AND MINORITY STAFF REPORT

PERMANENT SUBCOMMITTEE ON INVESTIGATIONS

UNITED STATES SENATE

JUNE 24, 2009

Permanent Subcommittee on Investigations

EXHIBIT #6b

EXCESSIVE SPECULATION IN THE WHEAT MARKET

I. EXECUTIVE SUMMARY

For several years, the U.S. Senate Permanent Subcommittee on Investigations has been examining the role of speculation in the commodity markets and failures of the federal regulatory structure to prevent excessive speculation from causing unwarranted changes in commodity prices and an undue burden on interstate commerce.

In 2006, the Subcommittee released a report showing how the injection of billions of dollars from speculation into the commodity futures markets had contributed to rising energy prices.[1] In 2007, the Subcommittee released a report and held a hearing showing how excessive speculation by a single hedge fund named Amaranth had distorted natural gas prices and contributed to higher costs for natural gas consumers.[2] These and other reports offered a number of recommendations for legislative and regulatory actions to enable the Commodity Futures Trading Commission (CFTC) to fulfill its mission under the Commodity Exchange Act to prevent excessive speculation from "causing unreasonable or unwarranted fluctuations in the price of commodities in interstate commerce."

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[1] In its 2006 Report, "*The Role of Market Speculation in Rising Oil and Gas Prices: A Need to Put the Cop Back on the Beat,*" S. Prt. 109-65 (June 27, 2006), the Subcommittee investigation found that influx of billions of dollars into the U.S energy markets through commodity index funds had contributed to the rise in energy prices, and that the large influx of speculative investments in these markets had altered the traditional relationships between futures prices and supplies of energy commodities, particularly crude oil. The Report recommended that Congress enact legislation to "close the Enron loophole," the provision in the Commodity Futures Modernization Act of 2000 (CFMA), which exempted from regulation the trading of futures contracts and swaps for energy and metals commodities on electronic exchanges. It also recommended legislation to ensure the CFTC had sufficient authority to monitor U.S. traders trading in U S commodities on foreign exchanges. See the 2006 Subcommittee Report at http //hsgac senate gov/public/_files/SenatePrint10965MarketSpecReportFINAL pdf

[2] In its 2007 Report, "*Excessive Speculation in the Natural Gas Market,*" reprinted in S. Hrg. 110-235 (June 25 and July 9, 2007), at pp. 196-710, the Subcommittee investigation found that Amaranth had distorted the price of natural gas futures contracts as a result of its large purchases of contracts on the regulated New York Mercantile Exchange (NYMEX) and "look-alike" swap contracts on the then-unregulated Intercontinental Exchange (ICE). As a result of several provisions in the CFMA, the CFTC did not have authority to limit the positions of traders using ICE rather than NYMEX. Based on this finding, the Report recommended that Congress enact legislation to close the Enron loophole in order to fully regulate electronic exchanges, like ICE, that are the functional equivalent of futures markets. In the 2008 Farm Bill, Congress enacted legislation to close the Enron loophole by providing that commodity contracts traded on over-the-counter electronic exchanges that perform a significant price discovery function be regulated in the same manner as futures contracts. As a result of this legislation, the CFTC now has the authority – and responsibility – to regulate and monitor these electronic markets to prevent excessive speculation. See the 2007 Subcommittee Report at http //hsgac senate.gov/public/_files/REPORTExcessiveSpeculationintheNaturalGasMarket pdf

In the Amaranth investigation, the Subcommittee examined how the activities of a single trader making large trades on both a regulated futures exchange and an unregulated electronic energy exchange constituted excessive speculation in the natural gas market. To prevent this type of excessive speculation, the Subcommittee Report recommended that limits on the number of contracts that a trader can hold at one time, known as position limits, be applied consistently to both markets in which the same type of natural gas contracts are traded.

In the current investigation, the Subcommittee has examined how the activities of many traders, in the aggregate, have constituted excessive speculation in the wheat market. To prevent this type of excessive speculation, this Report recommends that the CFTC phase out waivers and exemptions from position limits that were granted to commodity index traders purchasing wheat contracts to help offset their sales of speculative financial instruments tied to commodity indexes.

A commodity index, like an index for the stock market, such as the Dow Jones Industrial Average or the S&P 500, is calculated according to the prices of selected commodity futures contracts which make up the index. Commodity index traders sell financial instruments whose values rise and fall in tune with the value of the commodity index upon which they are based. Index traders sell these index instruments to hedge funds, pension funds, other large institutions, and wealthy individuals who want to invest or speculate in the commodity market without actually buying any commodities. To offset their financial exposure to changes in commodity prices that make up the index and the value of the index-related instruments they sell, index traders typically buy the futures contracts on which the index-related instruments are based. It is through the purchase of these futures contracts that commodity index traders directly affect the futures markets.

The Subcommittee investigation examined in detail how commodity index traders affected the price of wheat contracts traded on the Chicago Mercantile Exchange. CFTC data shows that, over the past three years, between one-third and one-half of all of the outstanding wheat futures contracts purchased ("long open interest") on the Chicago exchange are the result of purchases by index traders offsetting part of their exposure to commodity index instruments sold to third parties. The Subcommittee investigation evaluated the impact that the many purchases made by index traders had on prices in the Chicago wheat futures market. This Report finds that there is significant and persuasive evidence to conclude that these commodity index traders, in the aggregate, were one of the major causes of "unwarranted changes" – here, increases – in the price of wheat futures contracts relative to the price of wheat in the cash market. The resulting unusual, persistent, and large disparities between wheat futures and cash prices impaired the ability of participants in the grain market to use the futures market to

price their crops and hedge their price risks over time, and therefore constituted an undue burden on interstate commerce. Accordingly, the Report finds that the activities of commodity index traders, in the aggregate, constituted "excessive speculation" in the wheat market under the Commodity Exchange Act.

The futures market for a commodity provides potential buyers and sellers of the commodity with prices for the delivery of that commodity at specified times in the future. In contrast, the cash market provides potential buyers and sellers with the price for that commodity if it is delivered immediately. Normally, the prices in the futures market follow a predictable pattern with respect to the cash price for a commodity. Typically, as a contract for future delivery of a commodity gets closer to the time when the commodity is to be delivered under the contract (the expiration of the contract), the price of the futures contract gets closer to the price of the commodity in the cash market. The prices are said to "converge." In recent years in the wheat market, however, the futures prices for wheat have remained abnormally high compared to the cash prices for wheat, and the relationship between the futures and cash prices for wheat has become unpredictable. Oftentimes the price of wheat in the Chicago futures market has failed to converge with the cash price as the futures contracts have neared expiration.

The result has been turmoil in the wheat markets. At a time when wheat farmers were already being hit by soaring energy and fertilizer costs, the relatively high price of wheat futures contracts compared to the cash price, together with the breakdown in the relationship between the two prices and their failure to converge at contract expiration, have severely impaired the ability of farmers and others in the grain business to use the futures markets as a reliable guide to wheat prices and to manage price risks over time.

Participants in the grain industry have complained loudly about the soaring prices and breakdowns in the market. "Anyone who tells you they've seen something like this is a liar," said an official of the Farmers Trading Company of South Dakota. An official at cereal-maker Kellogg observed, "The costs for commodities including grains and energy used to manufacture and distribute our products continues to increase dramatically." "I can't honestly sit here and tell who is determining the price of grain," said one Illinois farmer, "I've lost confidence in the Chicago Board of Trade." "I don't know how anyone goes about hedging in markets as volatile as this," said the president of MGP Ingredients which provides flour, wheat protein, and other grain products to food producers. "These markets are behaving in ways we have never seen," said a senior official from Sara Lee. A grain elevator manager warned, "Eventually, those costs are going to come out of the pockets of the American consumer."

The inability of farmers, grain elevators, grain merchants, grain processors, grain consumers, and others to use the futures market as a reliable guide to wheat prices and to manage their price risks over time has significantly aggravated their economic difficulties and placed an undue burden on the grain industry as a whole.

This Report concludes there is significant and persuasive evidence that one of the major reasons for the recent market problems is the unusually high level of speculation in the Chicago wheat futures market due to purchases of futures contracts by index traders offsetting sales of commodity index instruments. To diminish and prevent this type of excessive speculation in the Chicago wheat futures market, the Report recommends that the CFTC phase out existing exemptions and waivers that allow some index traders to operate outside of the trading limits designed to prevent excessive speculation.

A. Subcommittee Investigation

To prepare this Report, the Subcommittee conducted a year-long, bipartisan investigation. As a first step, the Subcommittee obtained and analyzed price and trading data from a variety of agricultural futures and cash markets. The Subcommittee obtained, for example, daily and monthly wheat futures and cash price data from the CFTC, U.S. Department of Agriculture, Chicago Mercantile Exchange, Kansas City Board of Trade, and Minneapolis Grain Exchange. The Subcommittee also examined numerous historical materials on the operations and performance of the grain futures markets, and on the development and application of relevant statutes, regulations, and guidance. The CFTC provided extensive data on index trading, as well as information on the application of position limits and the granting of exemptions. The Subcommittee appreciates the cooperation and responsiveness of the exchanges and federal agencies.

To understand the issues, the Subcommittee interviewed numerous experts and persons familiar with the wheat markets, agricultural commodity markets as a whole, and commodity indexes. The interviews included persons familiar with grain trading and actual traders from a wide range of organizations in the grain industry: farm organizations, grain elevator operators, grain merchants, grain processors, food manufacturers, and agricultural trade groups. The Subcommittee also interviewed farmers, market analysts, agricultural economists, academic experts, financial institutions, and exchange officials. The Subcommittee also benefited from a number of meetings and presentations provided by the CFTC. The Subcommittee appreciates the cooperation and assistance of these individuals, organizations, and agencies.

B. The Cash and Futures Markets for Wheat

Wheat crops change hands primarily through cash transactions. There is no centralized cash market for wheat or other grains; the cash market exists wherever a grain elevator, grain merchant, grain consumer, or other participant in the grain industry posts a price to purchase or sell grain. Cash transactions take place all over the country, at all times of the day, either with or without the use of standardized contracts. In a common transaction, a grain elevator purchases wheat from a farmer for cash and then stores the wheat for sales throughout the year to grain processors.

Wheat futures are sold on three regulated exchanges: the Chicago Mercantile Exchange (CME), the Kansas City Board of Trade (KCBOT), and the Minneapolis Grain Exchange (MGEX). Wheat traded on the Chicago exchange, known as "soft red winter" wheat, is used mainly for crackers, pie crusts, cakes, and biscuits. Wheat traded in Kansas City, known as "hard red winter" wheat, is primarily used to make flour for bread. The Minneapolis exchange trades "hard red spring" wheat, which also is used to make bread, biscuits, and rolls.

All three of these futures exchanges offer standardized contracts to buy or sell standard amounts and types of wheat for which the only negotiated variable is the price. In the vast majority of cases, traders of wheat futures contracts do not take physical delivery of the wheat being bought or sold on the futures market. Rather, the primary purpose of the futures market is to enable market participants to "discover" the price of wheat for delivery at specified times in the future, to purchase or sell such contracts for future delivery at such prices, and thereby to enable wheat market participants to protect their business activities against the risk of future price changes.

C. Increasing Commodity Index Speculation

A commodity index is calculated using the prices of the futures contracts for the commodities that make up the index. Each commodity within a commodity index is assigned a "weight," and the contribution of each commodity toward the value of the index is calculated by multiplying the current price of the specified futures contract for that commodity by the assigned weight. All of the major, broad-based commodity indexes include soft red winter wheat futures contracts traded on the Chicago exchange as one of their component commodities.

The purchase of a financial instrument whose value is linked to a commodity index offers the buyer the potential opportunity to profit from the price changes in futures contracts for a broad spectrum of commodities, without having to actually purchase the referenced commodities. Typically, hedge funds, pension funds, and other large

institutions purchase these financial instruments with the aim of diversifying their portfolios, obtaining some protection against inflation, and profiting when commodity prices are rising. Since they are not involved in selling or buying actual commodities, and do not use these instruments to hedge or offset price risks regarding the actual use of the underlying commodities, the purchasers of commodity index instruments are making a speculative investment.

The large growth in commodity index speculation is a recent phenomenon. It is only over the past six years that financial institutions have heavily marketed commodity index instruments as a way to diversify portfolios and profit from rising commodity prices. The total value of the speculative investments in commodity indexes has increased an estimated tenfold in five years, from an estimated $15 billion in 2003, to around $200 billion by mid-2008.[3]

The amount of speculation in the wheat market due to sales of commodity index instruments has, correspondingly, grown significantly over the past five years. CFTC data indicates that purchases by index traders in the largest wheat futures market, the Chicago Mercantile Exchange, grew sevenfold from about 30,000 daily outstanding contracts in early 2004, to a peak of about 220,000 contracts in mid-2008, before dropping off at year's end to about 150,000 contracts. (Figure ES-1). The data shows that, during the period from 2006 through 2008, index traders held between 35 and 50% of the outstanding wheat contracts (open long interest) on the Chicago exchange and between 20 and 30% of the outstanding wheat contracts on the smaller Kansas City Board of Trade.

The presence of index traders is greatest on the Chicago exchange compared to the other two wheat exchanges, and is among the highest in all agriculture markets. In addition, neither of the other two wheat markets, nor any other grain market, has experienced the same degree of breakdown in the relationship between the futures and cash markets as has occurred in the Chicago wheat market. Accordingly, the Subcommittee focused its investigation on the role of index trading on the Chicago exchange and the breakdown in the relationship between Chicago wheat futures and cash prices.

[3] This estimate reflects both the actual amounts invested in commodity index related instruments and the appreciation in value of those investments due to increasing commodity prices.

Figure ES-1. Growth in index fund purchases of Chicago wheat futures contracts. Chart prepared by Permanent Subcommittee on Investigations. Data source: CFTC.

D. Impact of Index Instruments on the Wheat Futures Market

Commodity indexes have an indirect but significant impact on ıtures markets. A commodity index standing alone is a computational evice unsupported by any actual assets such as futures or commodity oldings. Financial institutions that sell index investments, however, ave created three basic types of financial instruments tied to ommodity indexes: commodity index swaps, exchange traded funds ETFs), and exchange traded notes (ETNs). Commodity index swaps re sold by swap dealers and are the most common index instrument; TFs and ETNs offer index-related shares for sale on a stock exchange. 'he value of commodity index swaps, index-related ETFs, and index-elated ETNs rises and falls with the value of the commodity index upon /hich each is based.

Speculators who buy index instruments do not themselves urchase futures contracts. But the financial institutions who sell them he index instruments typically do. In the case of commodity index waps, for example, swap dealers typically purchase futures contracts for ll commodities on which an index is based to offset their financial xposure from selling swaps linked to those futures contracts. CFTC lata shows that, over the past five years, financial institutions selling ommodity index instruments have together purchased billions of dollars vorth of futures contracts on the Chicago Mercantile Exchange.

The Subcommittee investigation has found that the large number of wheat futures contracts purchased by swap dealers and other index traders is a prime reason for higher prices in the wheat futures market relative to the cash market. Commodity traders call the difference between the futures prices and the cash price "the basis." Index traders typically do not operate in the cash market, since they have no interest in taking delivery or making use of a wheat crop. Instead, index traders operate in the futures markets, where they buy futures contracts to offset the index instruments they have sold. The additional demand for wheat futures resulting from these index traders is unrelated to the supply of and demand for wheat in the cash market.

In the Chicago wheat market, the result has been wheat futures prices that are increasingly disconnected from wheat cash prices. Data compiled by the Subcommittee shows that, since 2006, the daily gap between Chicago wheat futures prices and wheat cash prices (the basis) has been unusually large and persistent. Figure ES-2 presents this data for the last eight years.

Figure ES-2. Increase in daily difference between futures and cash prices for Chicago wheat. Chart prepared by Permanent Subcommittee on Investigations. Data sources: CME (daily futures prices); MGEX (average daily cash prices).

From 2000 through 2005, the average daily difference between the average cash and the futures price for soft red winter wheat traded on the Chicago exchange was about 25 cents. During the second half of 2008, in contrast, the price of the nearest wheat futures contract on the Chicago exchange was between $1.50 and $2.00 per bushel higher than the

average cash price, an unprecedented price gap (basis).[4] During that period, the average cash price for soft red winter wheat ranged from $3.12 to $7.31 per bushel, while the futures price ranged from $4.57 to $9.24. The fundamentals of supply and demand in the cash market alone cannot explain this unprecedented disparity in pricing between the futures and cash markets for the same commodity at the same time.

In addition, increasingly, the wheat futures prices on the Chicago exchange have not converged with the cash prices at the expiration of the futures contracts. Figure ES-3 shows the extent of this price gap (basis).

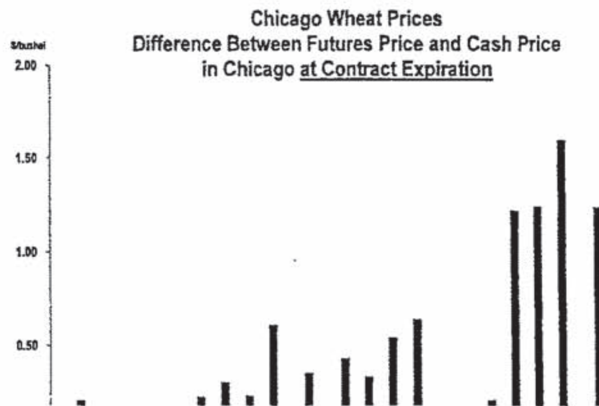

Figure ES-3. Increase in difference between futures and cash prices for Chicago wheat at futures contract expiration. Chart prepared by Permanent Subcommittee on Investigations. Data sources: CME (daily futures prices) and USDA (cash prices at Chicago).

The data underlying this chart shows that the average difference between the cash and futures price at contract expiration at the delivery location in Chicago for the Chicago wheat futures contract rose from an average of about 13 cents per bushel in 2005 to 34 cents in 2006, to 60 cents in 2007, to $1.53 in 2008, a tenfold increase in four years.

In the same period during which these pricing disparities occurred, CFTC data shows a very large presence of index traders in the Chicago wheat market. Since 2006, index traders have held between one-third and one-half of all of the outstanding purchased futures contracts ("long open interest") for wheat on the Chicago exchange. For most of 2008, the demand for Chicago wheat futures contracts from these index

[4] Typically, traders define basis as the difference between the cash and futures price (basis = cash – futures). In this Report, the basis is defined as the difference between the futures and cash price (basis = futures – cash) in order to give a positive value to the basis when the futures price is higher than the cash price, as it typically is in the wheat market.

investors was greater than the supply of wheat futures contracts from commercial firms selling grain for future delivery. During July 2008, for instance, index traders buying wheat futures contracts held, in total, futures contracts calling for the delivery of over 1 billion bushels of wheat, while farmers, grain elevators, grain merchants, and other commercial sellers of wheat had outstanding futures contracts providing for the delivery of a total of only about 800 million bushels of wheat. Under these circumstances, the additional demand from index traders for contracts for future delivery of wheat bid up the futures prices until prices were high enough to attract additional speculators willing to sell the desired futures contracts at the higher prices.

The investigation found that, in 2008, the greater demand for Chicago wheat futures contracts generated by index traders was a significant factor in the relative increase in the wheat futures price compared to the cash price (the basis) during that period. In addition, a significant cause of the resulting price disparity between the futures and cash markets, which was far greater than the normal gap between futures and cash prices, was the purchases of Chicago wheat futures by index traders.

E. Undue Burden on Interstate Commerce

The ongoing pricing discrepancy between wheat futures and cash market prices has exacerbated many of the recent economic difficulties facing farmers, grain elevators, grain merchants, and grain end-users.

Over the past few years, the prices of many agricultural commodities – like the prices of commodities in general – experienced an unprecedented spike and subsequent collapse. For example, the cash price of wheat rose from just over $3 per bushel in mid-2006, to over $11 per bushel in early 2008, before collapsing to about $3.50 per bushel at the end of 2008. Figure ES-4 shows the average daily cash price of wheat from 2000 to 2008, including the spike in the price of wheat during 2007 and 2008.

Figure ES-4. The average daily cash price of soft red winter wheat, the type of wheat traded on the Chicago Mercantile Exchange. Chart prepared by Permanent Subcommittee on Investigations. Data source: MGEX (daily cash index price).

A wide variety of factors contributed to the price volatility in the cash market for wheat, including poor weather, changes in agricultural productivity, an increasing demand for commodities in developing countries, changing dietary habits, increasing energy prices, and changes in the value of the dollar compared to other currencies.

Wheat prices in the cash market rose steadily from 2004 to 2008, in part due to steep increases in the price of energy, particularly oil, gasoline, natural gas, and diesel fuel, which sharply increased the costs of farming, transporting grain to markets, and grain processing. Although grain prices in the cash market eventually rose to record highs, farmers and grain merchants often were unable to realize the benefits of those higher prices due to the higher costs. In March 2009, for example, USDA reported that although wheat was selling for very high prices by historical standards, the increase in fuel and fertilizer costs had "offset this unprecedented runup in wheat prices for producers."

During this same period, futures prices also rose. The steep increases in cash and futures prices severely affected the grain industry in several ways. First, higher futures prices resulted in higher margin calls for wheat farmers, grain elevators, and other sellers of wheat that had hedged in the futures markets, requiring them to make much larger cash outlays than normal. The National Grain and Feed Association estimated, for example, that a typical grain elevator faced a 300% increase in hedging costs in 2008, compared to 2006. It stated that "recent commodity price increases have led to unprecedented borrowing

by elevators – and unprecedented lending by their bankers – to finance inventory and maintain hedge margins." According to the Federal Reserve Bank of Kansas City, in the first quarter of 2008, the Farm Credit System "raised $10 billion in funds through the sale of debt securities to meet increasing demand from elevators and other processing and marketing entities." In April 2008, the Federal Reserve Bank of Kansas City reported that nearly one-quarter of all grain elevators it surveyed were struggling to acquire the cash needed to manage margin calls; about 40% stated they had "enough cash to just manage current margin calls."

The cash flow problems confronting many grain elevators directly affected farmers, as those elevators began to reduce their cash purchases, pull back on forward contracts offered to farmers, and lower the cash prices offered for crops. Some began to require farmers to pre-pay for seed and fertilizer, causing cash flow problems for farming operations. Farmers participating directly in the futures market also were subject to rising margin calls. One wheat farmer explained, "If you've got 50,000 bushels hedged and the market moves up 20 cents, that would be a $10,000 day. If you only had $10,000 in your margin account, you'd have to sit down and write a check. You can see $10,000 disappear overnight. . . . Everybody has a story about a guy they know getting blown out of his hedge."

Other problems arose from the unusually large and persistent gap between the futures and cash prices for wheat and the failure of the two prices to converge as futures contracts expired. This persistent pricing difference and lack of convergence meant that farmers, grain elevators, grain merchants, and others who had used the futures market to hedge their future sales found that when they went to sell their wheat, the cash prices were much lower than they had anticipated based upon the futures market. This persistent price gap significantly impaired the ability of farmers and others to protect themselves from declining prices during the dramatic price decreases experienced during the second half of 2008. It also meant that wheat industry participants could no longer rely on the futures markets to reliably price their crops and effectively manage their price risks over time.

In a properly functioning futures market, futures and cash prices converge as futures contracts near expiration. Otherwise, if one price were higher, a trader could buy the commodity in the lesser-priced market and immediately sell it in the higher-priced market for a quick profit. Those types of transactions would soon equalize the two prices. But on many occasions during the last few years in the Chicago wheat market, the two prices have not converged.

One key reason is that the large price disparity between the cash and futures price makes it much more profitable for grain merchants to

buy grain in the cash market, hold onto it, and then sell it later – at the price of the higher-priced futures contracts – than engage in the type of transactions described above between the cash and futures market that would make the two prices converge. In addition, the large price disparity means that merchants who already have grain in storage and have hedged that grain by selling futures contracts could suffer a loss if they decided to actually sell their grain in the cash market, because they also would have to buy back the futures contract at a higher price than they could get for selling their grain in the cash market.

Virtually all of the traders interviewed by the Subcommittee, from all perspectives within the grain business, identified the large presence of index traders in the Chicago market as a major cause of the price convergence problem. This ongoing problem indicates that at a fundamental level the Chicago wheat futures market no longer effectively serves the needs of many wheat growers or commercial wheat users.

Still another set of problems caused by excessive speculation in the wheat market and the disconnect between wheat futures and cash prices affects the federal crop insurance program. Federal crop insurance, which is supported with taxpayer dollars, is available to farmers who want to cover potential financial losses due to bad weather or crop disease. Several types of federal crop insurance use futures prices to determine how much money should be paid to a farmer who has purchased coverage and suffered a loss in crop income. Futures prices are used in the formulas that calculate both the insurance premiums to be paid by farmers and the indemnity payments made to farmers after an insurance claim. Because they are included in the calculations, futures market prices that are significantly higher than actual cash prices impair the accuracy of the insurance formulas and can inflate the final figures. Futures prices that are much higher than the prices in the cash market and that do not closely follow the prices in the cash market can increase both the crop insurance premiums paid in part by farmers and can either increase or decrease the ultimate insurance payout to the farmer – thereby either resulting in too large a payout from a taxpayer-funded program or too small a payout to the farmer who has paid for the insurance. Either scenario undermines the effectiveness of the crop insurance program.

The ongoing large gap between wheat futures prices and cash prices is a problem of intense concern to the wheat industry, the exchanges, and the CFTC. The CFTC has conducted several public hearings and recently formed a special advisory subcommittee to make recommendations on how best to address the problem. The Chicago exchange has amended its wheat contract in several respects – to provide for additional delivery locations, to increase the storage rate for wheat, and to change certain specifications for deliverable wheat – in an effort

to improve trading and create a more active cash market that will force cash and futures prices to converge.

These actions to date, however, do not address one of the fundamental causes of the problem – the large presence of index traders in the Chicago wheat market. These index traders, who buy wheat futures contracts and hold them without regard to the fundamentals of supply and demand in the cash market for wheat, have created a significant additional demand for wheat futures contracts that has as much as doubled the overall demand for wheat futures contracts. Because this significant increase in demand in the futures market is unrelated to any corresponding supply or demand in the cash market, the price of wheat futures contracts has risen relative to the price of wheat in the cash market. The very large number of index traders on the Chicago exchange has, thus, contributed to "unwarranted changes" in the prices of wheat futures relative to the price of wheat in the cash market. These "unwarranted changes" have, in turn, significantly impaired the ability of farmers and other grain businesses to price crops and manage price risks over time, thus creating an undue burden on interstate commerce. The activities of these index traders constitute the type of excessive speculation that the CFTC should diminish or prevent through the imposition and enforcement of position limits as intended by the Commodity Exchange Act.

F. Trading Limits on Index Traders

The Commodity Exchange Act (CEA) directs the CFTC to prevent excessive speculation in the futures markets. Specifically, Section 4a(a) of the CEA requires the CFTC to establish and maintain "position limits" on commodity traders to prevent the undue burden on interstate commerce that results from "sudden or unreasonable fluctuations or unwarranted changes" in the price of a commodity caused by excessive speculation. Pursuant to this statutory mandate, the CFTC has established position limits for the agricultural commodities traded on futures markets such as wheat, corn, oats, and soybeans. These position limits specify the maximum number of outstanding futures contracts that any single trader can hold at any particular time. For example, the CFTC has generally prohibited any single trader from holding more than 6,500 wheat futures contracts at any one time. Prior to 2005, the maximum number of contracts that could be held at any one time was 5,000 contracts.

Over the course of many years, the CFTC has made a number of decisions that have enabled certain index traders to hold more than the current limit of 6,500 wheat futures contracts. The first set of decisions resulted in the CFTC's granting position limit exemptions to swap dealers selling commodity index swaps. Although the CEA directs the

CFTC to impose trading limits to prevent excessive speculation, section 4a(c) of the Act also states that these limits are not to be applied to "transactions or positions which are shown to be bona fide hedging transactions or positions." The CEA provides the CFTC with the discretion to define the term "bona fide hedging transaction" in order to "permit producers, purchasers, sellers, middlemen, and users of a commodity or a product derived therefrom to hedge their legitimate anticipated business needs for that period of time into the future for which an appropriate futures contract is open and available on an exchange."

Initially, the CFTC limited the concept of a bona fide hedging transaction to transactions directly linked to the business needs of the producers, marketers, and users of a physical commodity in the cash market. But after Congress directed the CFTC, in 1986, to consider expanding its definition to include persons using the futures markets to manage risks associated with financial investment portfolios, the CFTC issued a series of clarifications and interpretations which, in effect, expanded the definition to include trading strategies to reduce financial risks, regardless of whether a matching transaction ever took place in a cash market for a physical commodity.

In 1991, using this expanded definition, the CFTC granted the first exemption from speculative trading limits to a swap dealer seeking to buy futures contracts to hedge its financial exposure to commodity index swaps it had sold to third parties. According to CFTC data provided to the Subcommittee, the CFTC has currently issued four hedge exemptions to swap dealers seeking to buy wheat futures. Those exemptions permit the swap dealers to exceed the 6,500 position limit and hold up to 10,000, 17,500, 26,000, and 53,000 wheat futures contracts to hedge their exposures to commodity index swaps that reference wheat futures prices. In addition, in 2006, the CFTC staff took another step by issuing two "no-action" letters permitting the manager of one index-related exchange traded fund (ETF) to hold up to 11,000 wheat futures contracts and another fund manager to hold up to 13,000 wheat futures contracts.

Together, these hedge exemptions and no-action letters permit six index traders to hold a total of up to almost 130,000 wheat futures contracts at any one time. Absent these waivers from the position limits, these six index traders would have been limited to a total of about 39,000 wheat futures contracts at a time, or less than one-third of the contracts that they are now permitted to hold.

CFTC data indicates that, from 2006 to mid-2008, the total number of outstanding contracts (long open interest) attributable to commodity index traders in the wheat market was about 200,000 contracts. That means that the six index traders granted waivers

from the trading limits may have held up to about 60% of all the outstanding wheat contracts held by index traders.

In directing the CFTC to consider granting position limit exemptions to firms using the futures markets to manage price risks associated with financial portfolios, Congress emphasized that the Commission's actions should remain consistent with its mandate to prevent excessive speculation from causing unreasonable or unwarranted changes in the prices of commodities traded on the futures exchanges. Because the large amount of index investments in the Chicago wheat futures market have been one of the major causes of "unreasonable or unwarranted" changes in wheat futures prices relative to cash prices, the granting of exemptions and waivers to index traders is inconsistent with the CFTC's statutory mandate to prevent excessive speculation on futures exchanges. Accordingly, the Report recommends that the CFTC no longer waive position limits for index traders and, in addition, begin an orderly phase-out of the existing waivers.

If the CFTC were to phase out the exemptions and waivers granted to index traders in the wheat market, those traders would become subject to the position limits for wheat futures contracts that generally apply and would be unable to hold more than 6,500 wheat contracts at any one time. The strict enforcement of the 6,500 contract limit should reduce the presence of index traders in the Chicago wheat futures market and help bring the futures market into better alignment with the cash market.

Restoring the 6,500 position limit to index traders may not, however, fully solve the pricing problems in the Chicago wheat futures market and eliminate the problems in the market exacerbated by excessive speculation. CFTC data indicates that at most 60% of the total outstanding wheat contracts (long open interest) which can be attributed to index investors would be affected by restoring the 6,500 limit. If pricing problems persist in the wheat market after the phase-out of these waivers, and after implementation of other actions being taken by the Chicago exchange, the CFTC should consider imposing additional restrictions on index traders to reduce their presence, such as by restoring the pre-2005 position limit of 5,000 wheat contracts per index trader to reduce their aggregate impact on wheat futures prices.

G. Other Commodities

The wheat market illustrates how a large amount of index trading on a futures exchange can significantly impair the ability of the futures market to perform its primary purposes – to enable commercial market participants, including farmers, grain elevators, grain merchants, and consumers, to efficiently price their commodities and manage their price risks over time. The Subcommittee investigation was made possible in

large part by the availability of data compiled by the CFTC on index trading in the wheat market. Comparable data on index trading in non-agricultural markets, including for crude oil, natural gas, and other energy commodities, is not presently available. The data problem is due in part to the complexity of the over-the-counter (OTC) energy market, the associated difficulty in tracing index trading in that market, and the difficulty in assessing the impact of OTC energy trades on regulated energy futures exchanges. To understand the role of index trading in energy and other non-agricultural commodity markets, the CFTC will need to improve its data collection and analysis efforts for both the OTC markets and index trading. Given the importance of this issue, despite the difficulties, the CFTC should undertake this effort to bring additional transparency to the impact of index trading on energy futures markets.

H. Findings and Recommendations

Based upon the Subcommittee's investigation, the Report makes the following findings of fact and recommendations to diminish or prevent excessive speculation in the wheat market.

Findings of Fact.

(1) **Excessive Speculation in Wheat.** The large number of wheat futures contracts purchased and held by commodity index traders on the Chicago futures exchange over the last five years constituted excessive speculation.

  (a) **Index Traders Increased Futures Prices Relative to Cash Prices.** The large number of wheat futures contracts purchased by index traders on the Chicago exchange created additional demand for those contracts and was a major contributing factor in the increasing difference between wheat futures prices and cash prices from 2006 to 2008.

  (b) **Index Traders Impeded Price Convergence.** Over the past few years, the large number of Chicago wheat futures contracts purchased by index traders has been a major cause of the frequent failure of wheat futures and cash prices to converge upon contract expiration.

  (c) **Unwarranted Price Changes.** The additional demand for Chicago wheat futures contracts attributable to commodity index traders contributed to "unreasonable fluctuations or unwarranted changes" in wheat futures prices, resulting in an abnormally large and persistent gap between wheat futures and cash prices (the basis). Largely as a result of index trading, the average

difference between the cash and futures price at contract expiration rose from 13 cents per bushel in 2005, to 34 cents in 2006, to 60 cents in 2007, to $1.53 in 2008, a tenfold increase in four years.

(d) **Undue Burden on Commerce.** The unwarranted changes in wheat prices resulting from the large amount of index trading in the Chicago wheat futures market created an undue burden on interstate commerce. This undue burden was imposed on farmers, grain elevators, grain merchants, grain processors, and others by impeding useful hedging strategies, imposing significant unanticipated costs, and providing inaccurate indications of expected prices in the wheat markets.

(2) **CFTC Waivers Facilitated Excessive Speculation.** CFTC actions to waive position limits for commodity index traders facilitated excessive speculation in the Chicago wheat futures market. Waiving position limits for these index traders is inconsistent with the CFTC's statutory mandate to maintain position limits to prevent excessive speculation.

(3) **Inflated Futures Prices Affect Crop Insurance.** Because federal crop insurance, which is backed with taxpayer dollars, uses futures prices in its calculations, inflated futures prices can inflate insurance premiums, whose cost is shared by farmers and taxpayers, and impair the accuracy of the formulas used to determine the payouts to farmers, resulting in either overpayments or underpayments.

(4) **Poor Data Impedes Analysis.** There is a lack of adequate data on the number of futures contracts purchased by commodity index traders for non-agricultural commodities like crude oil. Improved data is essential to analyze the extent to which index traders may be contributing to higher futures prices and excessive speculation in crude oil and other markets.

Recommendations.

(1) **Phase Out Existing Wheat Waivers for Index Traders.** The CFTC should phase out existing waivers, granted through exemptions or no-action letters, which permit commodity index traders to exceed the standard limit of 6,500 wheat contracts per trader at any one time, and re-apply the standard position limit designed to prevent excessive speculation in the wheat market.

(2) **Take Further Action If Necessary.** If pricing problems in the Chicago exchange persist after the phase-out of index trader waivers and after implementation of other actions being taken by the Chicago exchange, the CFTC should consider imposing additional restrictions on commodity index traders to reduce excessive speculation, such as by imposing a position limit of 5,000 wheat contracts per index trader.

(3) **Analyze Other Agricultural Commodities.** The CFTC should undertake an analysis of other agricultural commodities to determine whether commodity index traders have increased futures prices compared to cash prices or caused price convergence problems, and whether position limit waivers for index traders should be phased out to eliminate excessive speculation.

(4) **Strengthen Data Collection for Non-Agricultural Commodities.** The CFTC should develop reliable data on the extent to which commodity index traders purchase non-agricultural commodity futures contracts, especially crude oil and other energy commodities. Once this data is collected, the CFTC should evaluate the impact of index trading in these markets, and whether position limits for index traders should be phased in to eliminate excessive speculation.

The following sections of this Report present detailed information on how, in recent years, the high level of commodity index trading in the wheat market constituted excessive speculation. Section II describes the wheat futures and cash markets, and recent pricing trends that have caused turmoil among wheat producers, merchants, and consumers. Section III provides general information about hedging and speculation in the commodity markets, and why price convergence is important to commercial users of the wheat market. Section IV explains how commodity index trading works, its impact on the futures markets, and how the CFTC has facilitated index trading by waiving position limits for wheat and other agricultural commodities. Section V details the evidence indicating how commodity index trading has been one of the major causes of unwarranted price fluctuations and an undue burden on interstate commerce, and thereby constituted excessive speculation in the wheat market. Section VI describes how inflated futures prices affect the federal crop insurance program.

FOOD SPECULATION

http://www.wdm.org.uk/stop-bankers-betting-food/hundreds-economists-tell-g20-regulate-speculation-food-prices

450 economists tell the G20: regulate speculation on food prices

11 October 2011

Dear G20 Finance Ministers,

We write to you ahead of the October meeting of the G20 Finance Ministers to urge you to commit with your counterparts to take effective action to curb excessive speculation on food commodities Excessive financial speculation is contributing to increasing volatility and record high food prices, exacerbating global hunger and poverty.

While there are many pressures on food prices, fundamental changes in supply and demand cannot fully account for the dramatic price fluctuations that have occurred in recent years.

In June, a report for the G20 by international organisations including the IMF and the OECD noted that "too much speculation can cause frequent and erratic price changes" in futures markets. Evidence suggests that financial speculators are less likely to make trading decisions based on information regarding supply and demand and are more prone to herding behaviours than commercial traders. Excessive speculation undermines the price discovery function of futures markets, driving real prices away from levels determined by supply and demand.

The High Level Panel of Experts on food security for the Committee on World Food Security at the FAO reported in July that "tighter regulation of speculation is necessary." The panel suggested that "Increasing transparency, by requiring exchange trading and clearing of most agricultural commodity contracts, and setting lower limits for noncommercial actors could be the first set of measures taken by the countries that house major commodity exchanges."

Increasing market transparency is vital, but will not go far enough to tackle excessive financial speculation. We therefore urge you to support the establishment of position limits to cap the proportion of agricultural commodity derivatives markets that can be held by financial speculators. Limits could be set at a level that would maintain sufficient liquidity in the markets while preventing an excessive concentration of purely financial actors. The US has already passed legislation including provisions to introduce such limits and the G20 should act to prevent regulatory arbitrage between exchanges.

Position limits would be more effective in tackling excessive speculation than position management powers, which rely on the use of judgement by exchanges and provide little assurance that powers will be exercised effectively Clear limits would provide regulatory certainty, promoting stable and sustainable derivatives markets to the benefit of food producers, consumers and broader economic stability.

Permanent Subcommittee on Investigations
EXHIBIT #6c

With around 1 billion people enduring chronic hunger worldwide, action is urgently needed to curb excessive speculation and its effects on global food prices.

Yours sincerely,

cc: Michel Barnier, European commissioner for internal market and services

Signed

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BETTER MARKETS

TRANSPARENCY · ACCOUNTABILITY · OVERSIGHT

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NEW BETTER MARKETS RESEARCH REPORT SHOWS WALL STREET DRIVING UP FOOD, FUEL PRICES; DATA SHOWS THAT COMMODITY INDEX FUNDS SHOULD BE BANNED

Better Markets today released a new research report showing speculative commodity trading pushed by Wall Street is causing market disruptions that have increased prices for American families and farmers.

The analysis reviews commodity markets data over the last 27 years and shows that, since 2005, so-called commodity index funds have triggered an upward price curve in the futures markets when they trade out of an expiring month contract and into a new future month (referred to as the "roll"). This has resulted in rising prices and costs as well as a boom-and-bust cycle by changing the incentives of producers and consumers of commodities. It also has sent misleading and non-fundamental price signals to the market, which have disrupted the futures and physical commodity markets.

"This research report analyzes commodity market activity for more than 25 years and specifically analyzed speculative commodity index fund trading," said Dennis Kelleher, president and CEO of Better Markets. "This is the first study to directly isolate the impact of the speculative index fund roll trading. The data shows the trading those funds do every month has severely disrupted and dramatically changed those markets, causing food and fuel prices to increase, hedging costs for businesses to rise, and prices to swing erratically up and down, which also raises everyone's costs."

"When this research and data is considered with Better Markets' prior research on speculation, the need to ban commodity index funds is overwhelming," said Mr. Kelleher.

The Dodd-Frank law requires the Commodity Futures Trading Commission to "diminish, eliminate, or prevent excessive speculation." In its March 28 comment letter to the Commission, Better Markets called for banning commodity index funds because they are the

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EXHIBIT #6d

primary drivers of such speculation, triggering dramatic increases in the price of vital commodities such as food and energy. The CFTC will rule on that matter on Oct. 18.

As detailed in the report, the research found that during this "roll" period, the price spread increases between the expiring contract and the new longer-dated contract, creating an upward price curve known as "contango." The data shows that this bias toward contango is generally absent during the rest of the trading month.

The analysis also found that this contango bias did not exist prior to the rapid expansion of commodity index funds in 2004. In prior years, the historical price curve norm for longer-dated contracts was actually priced lower than near-term contracts – a structure known as "backwardation. But this has changed since $200 billion to $300 billion in these speculative index funds poured into the futures markets, pushed by the Wall Street firms that have heavily marketed and profited from them.

The research specifically analyzed the same trading dates on which the roll now occurs, going back 27 years. But no contango bias was present prior to creation of the commodity index fund. The study looked primarily at NYMEX WTI Crude Oil and CBOT Wheat. The analysis was also extended to NYMEX Heating Oil, CBOT Corn, NYMEX Natural Gas, and CME Live Cattle.

The data and analysis shows commodity index funds' speculative trading is causing market distortions, disrupting price discovery, increasing the costs for commercial hedgers and pushing prices needlessly higher.

Better Markets, Inc., is a nonpartisan, nonprofit organization that promotes the public interest in the international and domestic capital and commodity markets.

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BETTER MARKETS

TRANSPARENCY · ACCOUNTABILITY · OVERSIGHT

New Research Shows That Wall Street Speculators Are Driving Up Food and Fuel Prices and That Commodity Index Funds Should Be Banned

Research analyzing commodity markets for the last 27 years shows that Wall Street's speculative trading through commodity index funds is causing market disruptions, interfering with price discovery, increasing the costs for businesses to hedge, and needlessly pushing prices higher for all Americans. It shows how the biggest banks, all bailed out by the taxpayers in 2008, are lining their pockets at the expense of America's families and farmers.

Since 2005, there has been historically high commodity price volatility, with prices swinging up and down at persistent levels that are not justified by supply and demand. That wasn't always the case. Prior to 2005, big price swings, when they happened, were typically the result of a supply or demand event like a war or a hurricane.

Importantly, as commodity price volatility has increased, there has also been a massive inflow of new funds into these markets, particularly from so-called commodity index funds, which is all speculative trading, as opposed to buying and selling by actual producers and consumers. While the precise amounts invested are hard to determine, there is at least $200 to $300 billion invested in various speculative trading funds.

We do know, however, that these speculative trading funds, while a relatively new type of market player, now collectively make up the single largest group of non-commercial traders in the commodities futures markets. These speculative trading funds, which represent giant pools of capital, have in recent times been the single largest group of traders, outweighing both commercial business hedgers (producers and consumers of commodities) and traditional "speculators," who take short-term directional bets and provide liquidity.

Given both the very large size and the common trading strategies of these speculative trading funds, many market observers have concluded that there is a high likelihood that they are distorting price formation in commodities markets. It has been suggested that this distortion has directly led to the more recent "boom and bust" price cycles and higher prices for many food and energy commodities in markets around the world.

Historically, under typical trading activities in the commodity markets, price curves in the commodities futures markets have been predominantly "backwardated." That is just a fancy way of saying longer-dated contracts are most often priced *lower* than shorter-dated contracts. This traditional price curve structure is commonly explained in terms of

"convenience yield" i.e. price volatility can make it hard to produce sufficient product at short notice. Therefore, if you want your commodity sooner, you must pay a premium.

Therefore, the further out in time a contract is, the lower the premium. Put another way, futures prices should slope downwards. Everyone in the market knows this doesn't necessarily mean prices are actually going to decline over time. Rather, the traditional pricing signal in a backwardated market is that prices over time will stay fairly steady, all else being equal.

However, this changes once speculative trading funds start pouring hundreds of billions of dollars into the futures markets. In fact, the price curve is basically turned upside down. The traditionally backwardated price curves become upward sloping. This is known as "contango," where the longer-dated contract prices are relatively *higher* and continue to go up.

This shouldn't happen as a routine matter given the premium built into the price of near-dated futures contracts. When buyers and sellers see a price curve in contango, it tells them that *even with the convenience yield built into today's price, tomorrow's price will almost certainly be higher.* That tells producers to delay production, and consumers to buy more now (even if this doesn't necessarily show up in patchy data on inventories). This causes exaggerated scarcity in the short run, which pushes prices up sharply. In the long run, when the delayed production comes on to the market while at the same time demand declines because consumers have already stocked up or cut back, the bubble bursts, and prices come crashing down.

Although there were some fundamental supply and demand events that appeared to give a partial explanation of the change in the price curves (e.g. crude oil delivery bottlenecks at Cushing, OK), their occurrence did not seem to match accurately either the timing or magnitude of the shift. Therefore, we decided to use a new set of analytic approaches to look at what the speculative trading funds were doing. The dramatic change in price curves seemed to coincide with their trading, but was it coincidence or causation? Our research and analysis was all directed at trying to answer this question.

Specifically, we examined the behavior of futures price spreads before, during and after the time each month that the speculative trading funds closed out their expiring futures contracts and purchased new futures contracts. [1] This is referred to as "rolling" contracts into the future and we call the period in question the "Roll," "Roll Period," or "Roll Cycle."[2] For example, the largest group of speculative trading funds is based on the Standard & Poor's Goldman Sachs Commodity Index (GSCI), which must roll forward their expiring futures contracts during a set period of each month, from the 5th to 9th business day.

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1 Futures contracts expire at regular periods. Traditional hedgers simply close out their contracts for cash at expiration, or make or take delivery. However, speculative commodity index funds are designed to keep bets on the table for long periods of time. That is what gives rise to the necessity of "rolling" those expiring contracts into new futures contracts every month. This requires massive trading every month as these funds liquidate all expiring contracts and replace them, swamping the market repeatedly.

2 These speculative trading funds are misleadingly labeled "commodity index funds," presumably intentionally to make people think of benign, passive, low cost stock index funds. The commodity funds bear little resemblance to the stock index funds. Crucially, one cannot buy and hold a futures contract forever like a stock, so every month hundreds of transactions are required simply to keep a commodity index fund invested.

Our analysis found overwhelming evidence that the GSCI Roll Cycle systematically distorts forward commodities futures price curves towards a contango state. As explained above, this causes speculative "boom-bust" cycles by changing the incentives of producers and consumers of storable commodities, and also by sending misleading and non-fundamental price signals to the market.

The analysis looked very closely at the behavior of prices during the monthly GSCI Roll Period. The primary commodities studied were NYMEX WTI Crude Oil and CBOT Wheat. The analysis was also extended to NYMEX Heating Oil, CBOT Corn, NYMEX Natural Gas, and CME Live Cattle.

The research found that during the Roll, the price spread between the expiring contract and the new longer-dated contract (which the speculative trading fund must buy) increases, creating a "contango" price curve. The data also show that this bias towards contango is generally absent during the rest of the trading month, clearly suggesting that the persistent contango that has been witnessed in many commodities over the last several years is generated by the speculative trading funds activity rather than supply and demand conditions.

The analysis also found that the contango bias during the Roll period did not exist prior to the rapid expansion of Commodity Index Funds in 2004. The research specifically analyzed the same trading dates on which the Roll now occurs, going back more than 25 years. Bias towards contango simply was not present prior to the creation of the commodity index fund.

This clearly indicates that there is indeed a hugely misleading price signal generated by the activities of the commodity index funds and other speculators who may be trading around the Roll. The persistent contango of recent years is not the result of some pre-existing phenomenon, whether fundamentals- or market-based. Since this price signal is not related to actual supply and demand fundamentals, the consequence is to drive prices away from their true value. Because the phenomenon is persistent, and is not arbitraged away, it has significant long-term implications, and tends to promote boom-and-bust price cycles.

In conclusion, speculative trading through commodity index funds is causing market disruptions, interfering with price discovery, increasing the costs for businesses to hedge, and needlessly pushing prices higher for all Americans. The way to prevent these market damaging events is to ban commodity index funds.

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News Analysis: IRS Suspends RIC Commodities Investments Rulings

by Lee A. Sheppard

Full Text Published by taxanalysts

The IRS has stopped issuing rulings allowing regulated investment companies to indirectly invest in commodities through controlled subsidiaries and structured notes. The IRS is still accepting ruling requests; it's just not acting on them while it studies the issue.

Although RICs are regulated by the SEC under the Investment Company Act of 1940, the code is where the restrictions on their investments are lodged. The qualifying income requirement of section 851(b)(2) requires that 90 percent of a RIC's income be derived from equities, securities and currencies. By exclusion, it prohibits extensive investments in commodities and commodities futures.

Mutual funds turned to structured notes to be able to hold commodity-linked investments, which the IRS gave them permission to hold. (See, e.g., LTR 200720011.) The IRS has been given rulings allowing RICs to invest in commodities through controlled foreign subsidiaries that elect to be treated as separate corporations, on the reasoning that distributions are dividends under section 951(a)(1)(A)(i). (See, e.g., LTR 201129002.) (For LTR 200720011, see *Doc 2007-12201* or *2007 TNT 98-34*. For LTR 201129002, see *Doc 2011-15971* or *2011 TNT 142-33*.)

The IRS has been merrily issuing these rulings for years. In the current state of affairs, however, some funds have rulings and some funds don't. Every fund needs its own ruling, even if its sponsor is a fund management firm with a large family of funds. (For prior coverage, see *Doc 2011-4752* or *2011 TNT 55-6*.)

Issuance of the rulings was suspended after Steve Larson, IRS associate chief counsel (financial institutions and products), attended a CFTC roundtable on rule 4.5 (17 C.F.R. 4.5). The IRS has been in communication with the CFTC about RICs investing in commodities.

The IRS says that it was not ordered to stop giving rulings, but is just taking a pause to rethink the rulings it has been giving. "Although we and the CFTC staff are communicating, the CFTC neither suggested nor demanded that we suspend our rulings," said an IRS spokesman.

CFTC Exclusion

Rule 4.5(a)(1) excludes RICs registered with the SEC under the 1940 Act from having to register with the CFTC as commodity pool operators when they invest in commodities. There is no such thing as dual registration, which would require cooperation between the two agencies, which use different methods of calculating fund performance.

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The CFTC is being lobbied to restrict rule 4.5(a)(1). The National Futures Association wants the CFTC to restrict the RIC exclusion. In its petition to the CFTC, the NFA complained about IRS ruling practices. (For the NFA's CFTC petition, see http://www.nfa.futures.org/news/newsPetition.asp?ArticleID=2491.)

"We were not directly aware of the complaints received by the CFTC, but the increase in activity by that agency was certainly a factor in our deciding to look more carefully at the policies and analysis behind our letter ruling policy," said an IRS spokesman.

The NFA's beef is that mutual funds went hog wild with their exclusion and are competing unfairly (cheesy puns fully intended). Rule 4.5(c) used to require that RICs restrict their commodities activity to hedging, restrict commodities holdings to 5 percent of the liquidation value of the portfolio, and not hold themselves out as commodities trading vehicles.

The NFA wants these restrictions, which were removed in 2003, restored. This would mean that a lot of RIC subsidiaries would have to either unwind or register with the CFTC as commodities pool operators.

The NFA complains that some mutual funds are marketing leveraged commodities funds loaded with derivatives, futures, and options to unsophisticated retail customers. The petition notes that RIC subsidiaries that invest in commodities are not subject to 1940 Act regulation and customer protection rules. Oh, and the parent RICs hold a lot of liquid investments to collateralize the commodities subsidiaries' derivatives positions.

The NFA frets that others will take advantage of the wide-open exemption. Of course, the same unsophisticated investors are going directly into exchange-traded funds (ETFs), the most popular of which is GLD, which holds gold bullion. The NFA complained about ETFs as well.

Another factor in the IRS suspension was the recent enactment of the RIC Modernization Act (P.L. 111-325). As originally introduced in 2009, H.R. 4337 would have explicitly permitted RICS to invest in commodities and commodities futures under section 851(b)(2). (For the original bill, see *Doc 2009-27636* or *2009 TNT 240-39*.)

This provision was stripped out when the bill was passed into law, apparently on the insistence of one of the congressional agriculture committees. In the minds of some, the congressional failure to explicitly permit unlimited commodities investments creates a negative inference that the IRS should not be permitting them administratively.

"It is fair to say that we had hoped that the RIC Modernization Act would bring clarity on this point, and that the failure to bring that clarity was also a factor in our decision to look into the issue more closely," said an IRS spokesman.

Similarly Situated?

RICs have ruling requests currently lodged with the IRS, whose personnel are telling applicants that the requests cannot be granted. This creates a situation in which it could be said that similarly situated taxpayers are being treated differently.

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In *Schering-Plough Corp. v. United States*, the taxpayer argued that it had been unfairly treated because a competitor got a ruling for the same scheme. The government prevailed on a motion for summary judgment that the two taxpayers were not similarly situated because the taxpayer had never requested a ruling. (For the opinion in *Schering-Plough*, No. 05-2575 (D.N.J. Dec. 3, 2007), see Doc 2007-26557 or 2007 TNT 234-8.)

Schering-Plough relied on *International Business Machines Corp. v. United States*, 343 F.2d 914 (Ct. Cl. 1965), *cert. denied* 382 U.S. 1028 (1966) for its disparate treatment argument. In that case, an IBM competitor got a favorable excise tax ruling. Upon learning of this, IBM sought a similar ruling for the same equipment, and the IRS sat on its request for two years. The IRS then revoked the competitor's ruling prospectively, while telling IBM it owed excise tax retroactively.

The Court of Claims found a tax policy of equal treatment to ensure fulfillment of congressionally intended uniform taxation within business sectors. The court rejected the argument that the IRS had a universal power to tax regardless of the impact on other taxpayers. Finding an abuse of section 7805(b) discretion, the court awarded IBM a refund for the same period that its competitor was not required to pay excise taxes.

Can RICs with ruling requests on file get their rulings if the IRS decides to change its policy because the CFTC may be changing its policy? The seminal gift loan case, *Dickman v. Commissioner*, 465 U.S. 330 (1985), established that taxpayers may not rely on previous administrative stupidity after the agency's practice has changed. The IRS cannot be barred from collecting a tax because it corrected an erroneous interpretation of law.

RICs filing requests for the same rulings that others (even within their own fund families) have are certainly similarly situated to each other, and arguably within *IBM*. But what if the rulings were wrongly granted? On the regulatory side, there is a question whether the IRS went too far in opening the door to commodities investments by RICs. Perhaps the IRS was not aware of RICs' aggressive use of rulings to get around CFTC rules.

Fairness to similarly situated taxpayers may ultimately be out of the hands of the IRS. If the CFTC changes its policy along the lines suggested by the NFA, the lucky RICs that have commodities rulings will have to unwind their commodities affiliates if they do not want to register them as commodities pool operators.

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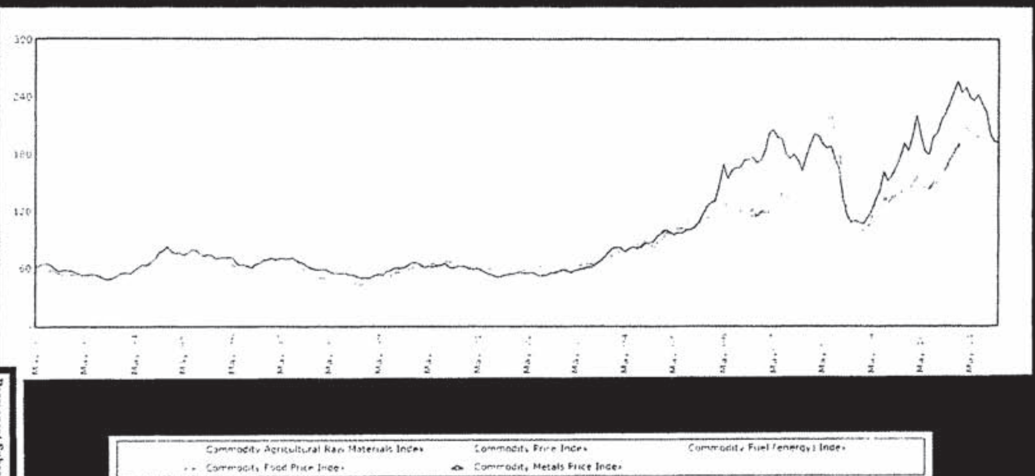
SELECT COMMODITY PRICE INDICES



Source: Chart appearing at http://www.indexmundi.com/commodities/, attributing data to International Monetary Fund Primary Commodity Price Indices

Permanent Subcommittee on Investigations
EXHIBIT #8

RESPONSES TO SUPPLEMENTAL QUESTIONS FOR THE RECORD
from
SENATOR CARL LEVIN
Chairman, Permanent Subcommittee on Investigations
to
THE HONORABLE DOUGLAS H. SHULMAN
Commissioner, Internal Revenue Service

Hearing On
"Compliance with Tax Limits on Mutual Fund Commodity Speculation"
January 26, 2012

1. **In connection with its approval of the 72 private letter rulings, did the IRS request or receive from the mutual funds information concerning one or more substantial nontax purposes for creating or using an offshore corporation or commodity-linked note to make commodity investments versus the mutual funds making those same types of commodity investments directly? If so, please describe the substantial non-tax purposes identified by the mutual funds.**

   Answer:
   The IRS analyzed the 72 private letter rulings under section 851 and the tax law principles relevant to applying that statute. In the case of the private letter rulings involving controlled foreign corporations (CFCs), the IRS requested and received information sufficient to analyze whether the relevant CFCs should be respected for tax purposes. In performing this analysis, the IRS relied on long-standing principles in the tax law which generally respect a taxpayer's choice of entity, but require a taxpayer that has chosen the corporate form to comply with the normal requirements of corporate law. For example, one such consideration is whether the CFC is adequately capitalized to conduct its business. In connection with these private letter rulings, the IRS required and received representation that the CFC would be adequately capitalized, and more specifically that the CFC would comply with the requirements of section 18(f) of the Investment Company Act of 1940 and related SEC guidance pertaining to asset coverage. As discussed in my written testimony, IRS lawyers then analyzed the CFC structures in light of section 851 to determine the proper treatment of the CFC income for the parent regulated investment company (RIC).

   In the case of the private letter rulings involving commodity-linked notes, the IRS requested and received information related to whether the relevant note should be treated as a security, including the structure and terms of the note (such as principal pay-back features), and other counterparty arrangements. As also discussed in my written testimony, IRS lawyers then analyzed these notes in light of section 851 to determine the proper treatment of investments in the notes.

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2. **Given codification of the economic substance doctrine in Internal Revenue Code Section 7701(o) in 2010, please explain why the IRS does not plan to apply the economic substance doctrine when analyzing policy issues related to the 72 private letter rulings allowing mutual funds to use wholly owned offshore shell corporations and structured notes to invest in commodities in apparent circumvention of the income restrictions of Section 851(b)(2).**

   Answer:
   The economic substance doctrine, as codified in section 7701(o) of the Internal Revenue Code, is a powerful tool which the IRS has used very successfully in attacking tax shelters and similar abusive transactions. The court cases in which the IRS has successfully litigated the economic substance doctrine contain fact patterns different from the fact pattern presented by the RIC CFC and structured note ruling requests.

   Your question asks why we would not assert the economic substance doctrine against the taxpayers who have been issued favorable private letter rulings. The IRS believes that it would be unnecessary to invoke the economic substance doctrine against conduct that has taken place in express reliance on the taxpayer's private letter ruling. Other tax law doctrines or principles are better suited to these transactions and, as discussed in question 1, were considered in issuing the private letter rulings. If it were determined that RIC investments in structured notes, CFC stock, or both, are inappropriate, the IRS believes that the conduct could be curtailed by the issuance of appropriate guidance, withdrawal of the private letter rulings, or other similar administrative steps.

3. **In principles set out in the 1972 Aiken Industries case and subsequent IRS regulations, the IRS is allowed to disregard any entity which functions as an intermediary for a taxpayer and treat its income as income attributable to the taxpayer itself. As one 2002 IRS private letter ruling explains: "where the parent corporation so controls the affairs of the subsidiary that it is merely an instrumentality of the parent, the corporate entity of the subsidiary may be disregarded."**

   Please explain whether the IRS plans to use the conduit analysis under Aiken Industries case and the subsequent IRS regulations to treat the CFCs conducting commodity investments as conduits, agents, or instrumentalities for the mutual funds that own them and attribute the CFC income to the mutual funds for purposes of Section 851(b)(2) and, if not, why not.

   Answer:
   While Aiken Industries is an important case for the IRS in attacking certain types of conduit structures, the IRS does not view the conduit theory applied in Aiken Industries as applicable to the CFC subsidiaries in which RICs have invested. The facts of Aiken Industries are instructive on this point: In that case, the taxpayer was the payor of a \$2.25 million note issued originally to a related Bahamian corporation, and, as such, would have been responsible for foreign withholding tax on any interest paid. To avoid this withholding tax, the Bahamian corporation transferred its note to a subsidiary incorporated in Honduras, which had a treaty with the U.S. eliminating withholding on

interest paid to a Honduras corporation. The note was exchanged for a matching series of notes also aggregating $2.25 million, such that all of the note payments received in Honduras were immediately paid over to the Bahamian corporation. The court held that the taxpayer was required to pay the withholding tax because the Honduras subsidiary received the interest only as a collection agent for the Bahamian corporation, and did not itself have any beneficial interest in the payments.

Unlike the situation in Aiken Industries, the CFCs engage on their own account and in their own name in the business of investing in instruments providing exposure to commodity price movements. Each CFC would have income and loss at the subsidiary level, even though that income or loss may effectively be included in the income or loss of its parent under the subpart F rules. Cases such as Moline Properties, 319 U.S. 436 (1943), support the recognition of such subsidiaries, provided normal corporate law requirements are satisfied, including adequate capitalization.

Your question asks whether we plan to assert the conduit theory against the taxpayers who have been issued favorable private letter rulings. As we noted in our response to Question 2, pertaining to the economic substance doctrine, that there is no need to resort to doctrines like the conduit theory to address CFC investments. If a determination were made that CFC investments are inappropriate, compliance with that view could be obtained through published guidance or withdrawal of the private letter rulings.

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RESPONSE TO SUPPLEMENTAL QUESTION FOR THE RECORD
from
SENATOR CARL LEVIN
Chairman, Permanent Subcommittee on Investigations
to
EMILY McMAHON
Acting Assistant Secretary for Tax Policy
U. S. Department of the Treasury

Hearing On
"Compliance with Tax Limits on Mutual Fund Commodity Speculation"
January 26, 2012

Q. From 2006 to 2010, the IRS issued 72 private letter rulings allowing the mutual funds to whom the letters were addressed to use either wholly-owned offshore corporations or financial instruments called "commodity linked notes" to make unrestricted commodity investments, notwithstanding the 10% limit in Section 851.

In your written statement submitted on January 26, 2012 to the Subcommittee, you stated, "the extent which investors should be able to obtain exposure to commodity price fluctuations through investment in RICs [mutual funds] is not fundamentally a tax policy issue." Please explain why the IRS' approval of the use of offshore shell corporations and commodity linked notes permitting mutual funds to gain unrestricted exposure to commodities, allowing them to do indirectly what the law doesn't let them do directly, is not fundamentally a tax policy issue.

Answer:
The hearing on "Compliance with Tax Limits on Mutual Fund Commodity Speculation," which took place on January 26, 2012 addressed two types of private letter rulings that the Internal Revenue Service (IRS) had been issuing to regulated investment companies (RICs) that invested in securities, giving them indirect commodity exposure. The first type treated certain structured notes linked to commodities prices or a commodities price index as "securities" that produce qualifying income for purposes of section 851(b)(2) of the Internal Revenue Code (Code). The second type treated subpart F income attributable to a RIC parent from the stock of certain wholly owned foreign subsidiaries as qualifying income for purposes of section 851(b)(2). (The subsidiary stock also satisfied the security ownership requirements of section 851(b)(3)).

As an initial matter, to elaborate on the statement I made in my testimony, Congress conceivably could amend the Code to provide that income derived from commodity-related securities is not qualifying income for purposes of section 851(b)(2). However, we do not see any particular reason relating to tax policy to further limit the extent to which RICs are permitted to obtain indirect commodity exposure through investments in commodity-related securities. Rather, we believe that this question is better addressed by the Securities and Exchange Commission (SEC) or the Commodity Futures Trading

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Commission (CFTC), and if Congress chooses to impose additional limitations through the Code on the extent to which RICs can make commodity-related investments, that such a decision be informed by their views.

With regard to the specific question you raise in your letter, the private letter rulings in question simply interpret section 851 as written. The private letter rulings involving commodity-linked notes address whether income from those notes is described in section 851(b)(2)(A). That section requires a RIC to derive at least 90 percent of its gross income from securities, as defined in section 2(a)(36) of the Investment Company Act of 1940 (1940 Act). Although the Treasury Department did not participate in the issuance of these private letter rulings, the rulings necessarily apply section 2(a)(36) of the 1940 Act. Section 851(b)(2)(A) does not impose any further limitations on the types of securities that produce qualifying income, and we are not aware of any guidance issued by the SEC that would imply that commodity-linked notes should not be treated as securities for 1940 Act purposes. Therefore, notwithstanding that income derived from a direct investment in commodities is not qualifying income for a RIC, it is difficult to find any statutory basis to conclude that a commodity-linked note, to the extent that it constitutes a "security" under the 1940 Act, cannot produce qualifying income.

Similarly, the private letter rulings involving an investment by a RIC in a wholly owned corporate subsidiary are consistent with the rule of section 851(b) that subpart F income is generally treated as a dividend, and thus as qualifying income for purposes of section 851(b)(2). The statute imposes no limitations on the activities that can be conducted by the issuer of the securities in which the RIC invests. Consequently, it is difficult to find a statutory basis to conclude that a wholly-owned subsidiary of a RIC cannot invest in commodities, or cannot carry on any other type of business, whether or not such business could be conducted directly by the RIC.

Your question seems to imply that the Treasury Department should be applying certain judicial doctrines (such as sham transaction, conduit, and economic substance) to prohibit the use by RICs of commodity-linked notes or controlled foreign corporations to obtain commodity exposure. These are enforcement tools that the IRS has successfully used on numerous occasions. However, these doctrines require factual inquiries that must be done on a case-by-case basis. Therefore, it is not appropriate to apply these doctrines as a blanket prohibition on the use of commodity-linked notes or controlled foreign corporations by all RICs, when the statute does not otherwise prohibit them. Instead, those doctrines may be relevant depending on the facts of a particular case. Although the Treasury Department was not involved in the private letter rulings at issue, we believe it is unlikely that the IRS would have issued favorable rulings if it believed the relevant facts warranted invoking those doctrines.

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