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April 27, 2006

Eric Solomon  
Acting Deputy Assistant Secretary (Regulatory Affairs)  
Office of Tax Policy  
Department of the Treasury  
1500 Pennsylvania Avenue, NW  
Washington, DC 20220

Dear Mr. Solomon:

Thank you for meeting with representatives of the ISDA Tax Committee on February 17, 2006 to discuss Revenue Ruling 2006-1 (the "Ruling"). As we discussed, the position taken by the Internal Revenue Service (the "IRS") in the Ruling is inconsistent with the reasonable expectations of many industry participants and will require significant modifications to the portfolios of a number of regulated investment companies ("RICs") as well as prevent other RICs from implementing plans to invest in broad-based commodity index derivatives contracts. For these reasons, ISDA greatly appreciates the decision of the IRS and Treasury to delay the effective date of the Ruling to July 1, 2006. As discussed more fully in the following Appendices, however, the ISDA Tax Committee believes that, contrary to the position taken in the Ruling, broad-based commodity index derivatives should be treated as "qualifying income" under the RIC provisions of the Internal Revenue Code because (a) that is the correct result in terms of tax policy; (b) these derivatives are passive investments as envisioned by Congress in the legislative history of the Tax Reform Act of 1986 ("TRA 1986"); and (c) the acquisition of these derivatives does not constitute "trading in commodities", which Treasury indicated in the TRA 1986 legislative history was inappropriate for RICs.

For these reasons, we respectfully request that Treasury and the IRS reconsider the position taken in the Ruling and issue a supplemental ruling consistent with the conclusions expressed in this letter. If Treasury and the IRS are unable to do so before July 1, 2006, we respectfully request that the effective date of the Ruling be deferred until July 1, 2007 in order to provide Treasury, the IRS and other interested parties ample time to consider fully the important tax policy and interpretive issues presented by the Ruling.

In the Ruling, the IRS held that income received by a mutual fund under commodity index derivative contracts was not qualifying income under section 851 of the U.S. Internal Revenue Code, a category that includes “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” (*1940 Act*)).

In reaching its conclusion, the IRS determined that there was no “conclusive authority” whether derivatives contracts on commodities constituted “securities” under the 1940 Act. Based on this determination, the IRS examined the legislative history of the TRA 1986, which added the cross-reference to the 1940 Act, and concluded that exclusion of income from commodity index derivatives from the definition of “qualifying income” would be consistent with Congressional intent.

As we discussed in our meeting, the ISDA Tax Committee believes that there is strong support for concluding that the legislative history to the TRA 1986 is not inconsistent with treating income from broad based commodity index derivatives as qualifying income. Cash-settled commodity index derivatives did not exist in 1986, and the ISDA Tax Committee believes they do not represent the type of “trading in commodities” about which Congress was concerned at that time. There are also precedents in other tax authorities that distinguish between physical securities trading activity and derivatives transactions that reference broad based indices that support our conclusion. We have included a summary of these precedents in Appendix A to this note.

In addition to the technical support for treating broad based commodity index derivatives as different from trading in the underlying physical commodities, there are strong tax policy reasons for treating these derivatives as generating qualifying income. The primary reason for these commodity index mutual funds is that they allow small investors to gain access to professional money managers and invest their money in a cost efficient manner, which is also the fundamental premise behind the RIC rules. Wealthy, sophisticated individuals and institutions are able to buy commodity index derivatives directly (or through private investment funds), so they do not rely on these mutual funds as their sole investment vehicle. Given the ability of mutual funds to invest in structured notes that reference the same broad based commodity indices (as we understand was the conclusion reached by the IRS in a recent private letter ruling), the appropriate tax policy conclusion should be to allow mutual funds to buy commodity index derivatives directly so that individual investors are able to get commodity exposure in the most economically efficient manner. This conclusion is especially compelling in light of the above-mentioned private letter ruling and when one considers the fact these structured notes will generally be treated as derivatives, and not debt, for tax purposes, and consequently will be taxed in the same manner as commodity index derivatives.

As promised, we are including additional information for you with respect to commodity-linked structured notes, their underlying reference commodity indices and commodity 1940 Act funds (please refer to Appendices B, C and D).

I will follow up with you in a few days to see if you have any questions or want any additional information. However, in the meantime, please call me at (212) 325-7486 if you have any questions.

Sincerely,



Thomas Prevost  
ISDA, North American Tax Committee Chair

## APPENDIX A

### **Treatment of Income from Commodity Index Derivatives as Qualifying Income is Consistent with Congressional Intent**

The analysis in the Ruling reflects an inquiry into Congressional intent in 1986 when Internal Revenue Code (the *Code*) section 851 was amended to add the cross-reference to the 1940 Act in the definition of qualifying income. The discussion looks to statements made in 1986, when the Treasury Department commented that (i) RIC treatment should be available only to entities that hold property for investment and (ii) income from trading commodities should be excluded from qualifying income. Based on these concerns regarding commodity trading, the Ruling concludes that commodity index derivatives do not give rise to qualifying income.

With respect to the investment property requirement, the ISDA Tax Committee believes that these broad based commodity index derivatives are clearly investments. In fact, unlike trading in individual commodities, a broad based commodity index derivative is a financial contract that is an inherently passive investment. These indices are not actively managed; rather, they are only adjusted based on predetermined rules and objective information. The mutual fund investor has no “trading control” over the index. The cash settlement requirement in these contracts, together with the typical buy and hold investment strategy, further support the passive nature of these investments.

Treatment of commodity index derivatives as giving rise to investment income for purposes of the mutual fund rules is also consistent with the treatment of these instruments as passive investments in other areas of the tax law. For example, for purposes of the tax-exempt entity unrelated business taxable income rules of the Code sections 512-514, the exception for certain types of passive income covers income from notional principal contracts, including commodity swaps. In addition, proposed Code section 864 regulations on foreign persons engaged in business in the United States contain a safe harbor exception for passive activities that applies to trading in notional principal contracts (including commodity-based notional principal contracts). The exception from the publicly traded partnership rules of Code section 7704 for partnerships that derive at least 90 percent of their income from certain passive activities also includes income from commodity derivatives. Similarly, Code section 731(c)(3)(C)(i)(VI) treats commodity derivatives as a qualifying asset under the definition of an “investment partnership.”

With respect to the “trading in commodities” limitation in the TRA 1986 legislative history, the ISDA Tax Committee also believes that investing in these broad based commodity derivative investments does not constitute trading in commodities. Due to the limited discussion in the Congressional record and the Treasury letter, it is not clear to us what the term “trading in commodities” means. However, given the strong tax policy arguments for allowing this type of investment activity, we believe it is reasonable to interpret this language as referring to the commodities trading activities that existed at the time that TRA 1986 was enacted. Commodity index derivatives are a very different type of investment than the commodity trading activity that existed in 1986. Broad based commodity index derivative investments did not exist in 1986. Indeed, the commodity indices themselves were not developed until the 1990s.

As the graph below illustrates, the historic economic performance of an equally-weighted broad based commodity index is very different than the historic returns on commodities based on spot prices. So as an economic matter, investing in derivatives based on commodity indices is clearly different from trading in the underlying commodities.

## **Spot vs. Broad-Based Commodity Index Returns - Inflation Adjusted Performance\***



\*The equally-weighted collateralized futures index is constructed using data from the Commodity Research Bureau and the London Metals Exchange. The index includes every commodity futures contract (one contract per commodity) traded in the US and on the LME for which data is available in the databases maintained by CRB and LME. Contracts are included in the index when data becomes available. Each contract is given equal weight and the index is re-weighted monthly. Data from July 1959 to December 2004. 1959 = 100.

Furthermore, from a technical tax perspective, differentiating between an investment in a broad based commodity index derivative and the underlying commodities themselves is consistent with distinctions made elsewhere in the tax law. For example, the mark-to-market rules of Code section 1256 apply to options on a broad index of equity securities but do not apply to options on individual stocks or options on any narrow-based securities index. In addition, the regulations under Code section 246, relating to the treatment of positions that diminish risk of loss, distinguish between a position that reflects the value of one or a small group of stocks and a position that reflects the value of a broad portfolio of stocks. This tax technical differentiation is further supported by the actual economic differences between purchasing the underlying spot commodities and investing in the index.

In addition to the technical arguments above, there is a very compelling logical reason for this conclusion. It is clear that Congress and Treasury did not have commodity index derivatives in mind when they discussed the limitations in the legislative history to TRA 1986 (the commodity indices didn't even exist then), but had they known about this type of investment, we believe that Congress logically would have included income from these investments as qualifying income. To believe otherwise requires one to conclude that Congress would have thought it was acceptable for mutual funds to have investment exposure to commodities, but only in a structured note or other highly structured format that costs investors more money and encourages the mutual funds to invest in debt issued by a select group of investment banks, rather than debt issued by Corporate America and the U.S. Treasury. We are aware of no tax or other public policy reason that would support the imputation of such an intent to Congress.

## APPENDIX B

### Commodity-Linked Structured Notes

We have attempted to quantify the costs of a 1940 Act fund restructuring out of commodity index derivatives into commodity-linked structured notes, which are a more expensive way of getting commodity exposure.

Commodity index derivatives are entered into by two parties, namely, a fund and a dealer (subject to an ISDA Master Agreement), and are generally short-term in duration (between 1 month and 1 year). Commodity-linked structured notes involve three parties (fund, dealer and issuer) and are usually longer-term due to more extensive documentation requirements. We have identified three categories of additional costs for a 1940 Act fund restructuring into structured notes: (i) “alpha” opportunity costs; (ii) funding spreads and (iii) administrative and legal costs.

“Alpha” Opportunity Costs. “Alpha” opportunity costs reflect the fact that investor contributions used to purchase structured notes cannot be invested in other securities. That is, each dollar that a mutual fund, which purchases its commodity index exposure via derivatives, receives from investors can be actively managed by investing in securities. These funds usually target a spread over LIBOR of approximately 60 basis points (this is known as generating alpha). If the mutual fund invests in structured notes instead of derivatives, a significant percentage (usually 1/3<sup>rd</sup>) of the investor’s cash will not be available to invest in these higher yielding instruments.

Funding Spreads. Funding spreads reflect the fact that structured notes usually yield a spread under LIBOR (for example, 15-35 basis points). In fact, these notes are usually issued at a discount to the issuer’s funding spread for a comparable maturity due to their structured nature. The mutual fund investing in the structured note in these examples loses a total of 75-95 basis points on 1/3<sup>rd</sup> of the fund (60 basis points in alpha costs plus 15-35 basis points in funding spreads).

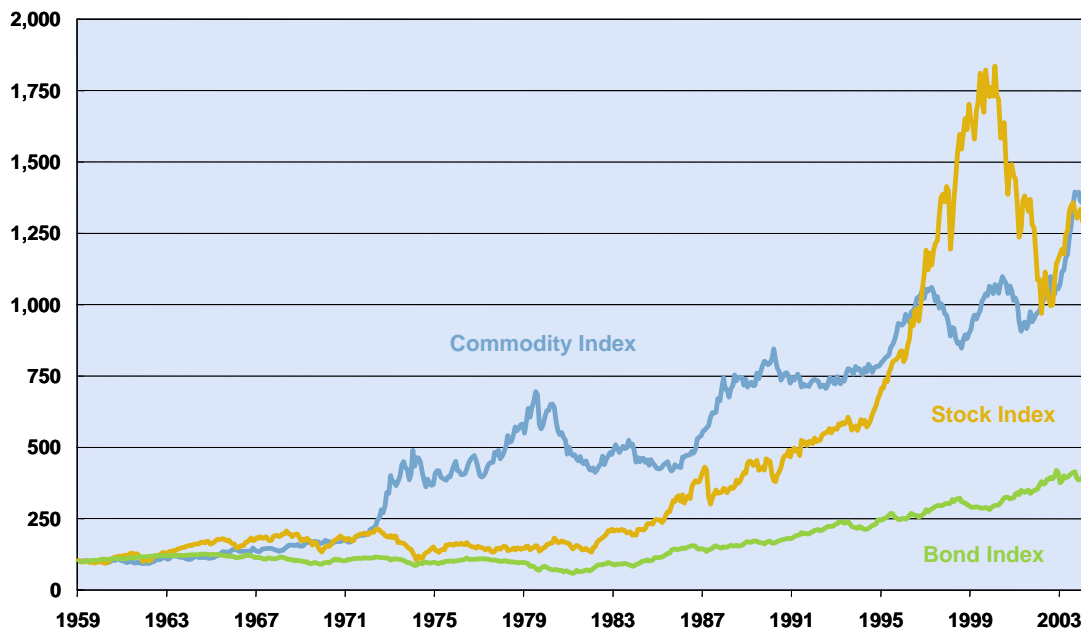
Legal and Administrative Costs. The three parties involved in a structured note incur additional legal and administrative costs. For example, if a dealer is providing the issuer with a commodity index derivative hedge, the dealer will have to ensure that the derivative is structured to provide an appropriate hedge to the issuance. If the dealer is acting as underwriter (as can be necessary if the issuer does not have a broker/dealer), then fairly extensive issuer due diligence and review of the structured note prospectus is required. The dealer may therefore charge the issuer a higher fee for the derivative; in turn, the issuer may charge the mutual fund more for the structured note. Signing up a new issuer would incur legal fees of somewhere between US\$50,000 and US\$100,000. If we assume US\$75,000 and approximately 17 structured note issuers, a one-time charge of US\$1.275 million would most likely be built into the various spreads.

An additional point to note is that due to RIC concentration limitation rules and restrictions imposed by a 1940 Act fund’s board of directors, structured notes require substantially more counterparties than derivative counterparties. There are relatively few issuers of structured notes at present and the impact of restructuring over US\$12 billion from commodity index derivatives into structured notes could be significant. OppenheimerFunds has recently closed its Oppenheimer Real Asset Fund, the first fund to offer commodity index exposure to retail investors, to new accounts and most new purchases. Morningstar reported on April 4, 2006 that “as more assets have rushed into [commodity-linked] structured notes, this fund has had some trouble putting new money to work”.

## APPENDIX C-1

### Long-Term Performance of a Broad Based Commodity Index\*

#### A. Indices: Commodities, Stocks and Bonds: Inflation Adjusted Performance From 1959 to 2004\*\*



The above graph compares the cumulative performance of the Ibbotson corporate bond total return index\* (“Bond Index”), the S&P500 total return index (“Stock Index”), and an equally-weighted commodity futures total return index (“Commodity Index”). The Bond and Stock indices are chosen as broad representatives of their asset classes. The Commodity Index was constructed to calculate long term commodity returns.\*\* Although individuals do not invest in indices, there are a variety of funds available to the individual investor which use these or similar indices. Some observations stand out:

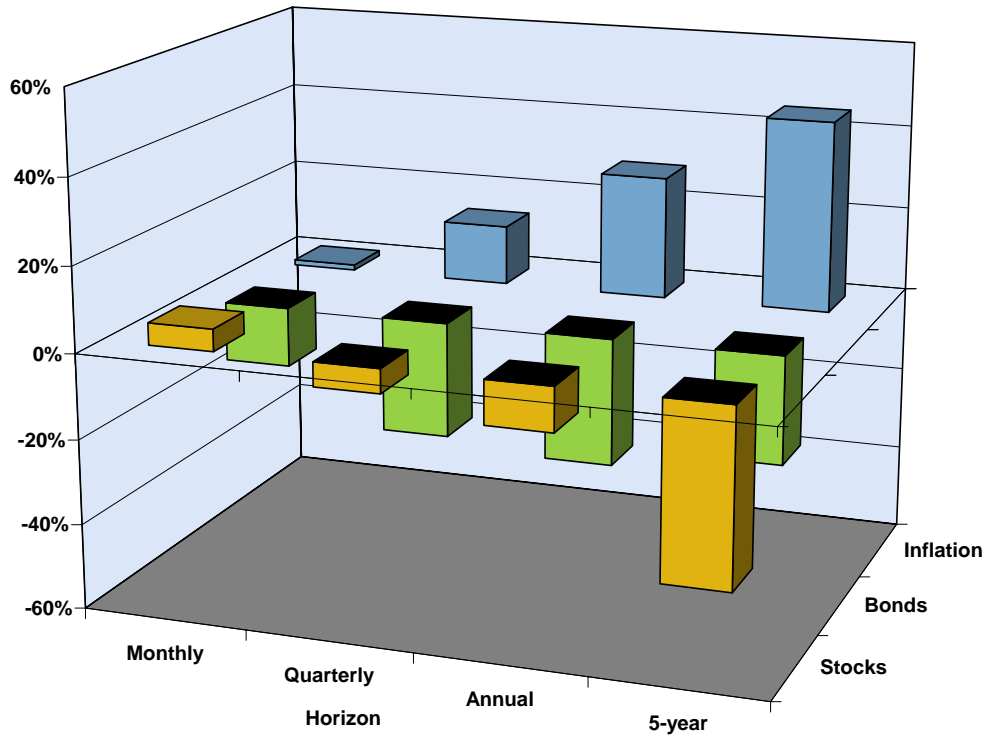
- Over the last 45 years, the average annualized return on the Commodity Index has been comparable to the return on the Stock Index. Both outperformed the Bond Index.
- The Commodity Index has experienced lower volatility than the Stock Index although both have experienced higher volatility than the Bond Index.
- The Commodity Index outperformed the Stock Index during the 1970s, but this performance was reversed during the 1990s.

\*Equally-weighted collateralized futures index, Ibbotson Large Company Stocks and Long-Term Corporate Bonds Indices. Data from July 1959 to December 2004. Source: Ibbotson Associates.

\*\*Data excerpted from a presentation entitled “Long-Term Performance of a Broad Based Commodity Index” by Gary Gorton, The Wharton School, University of Pennsylvania and K. Geert Rouwenhorst, School of Management, Yale University. (More detail is available in the research paper “Facts and Fantasies about Commodity Futures”) [http://papers.ssrn.com/sol3/cf\\_dev/AbsByAuth.cfm?per\\_id=17513](http://papers.ssrn.com/sol3/cf_dev/AbsByAuth.cfm?per_id=17513)

## APPENDIX C-2

### Correlation of Commodities With Other Financial Assets: Overlapping Monthly Return Data From 1959 to 2004\*



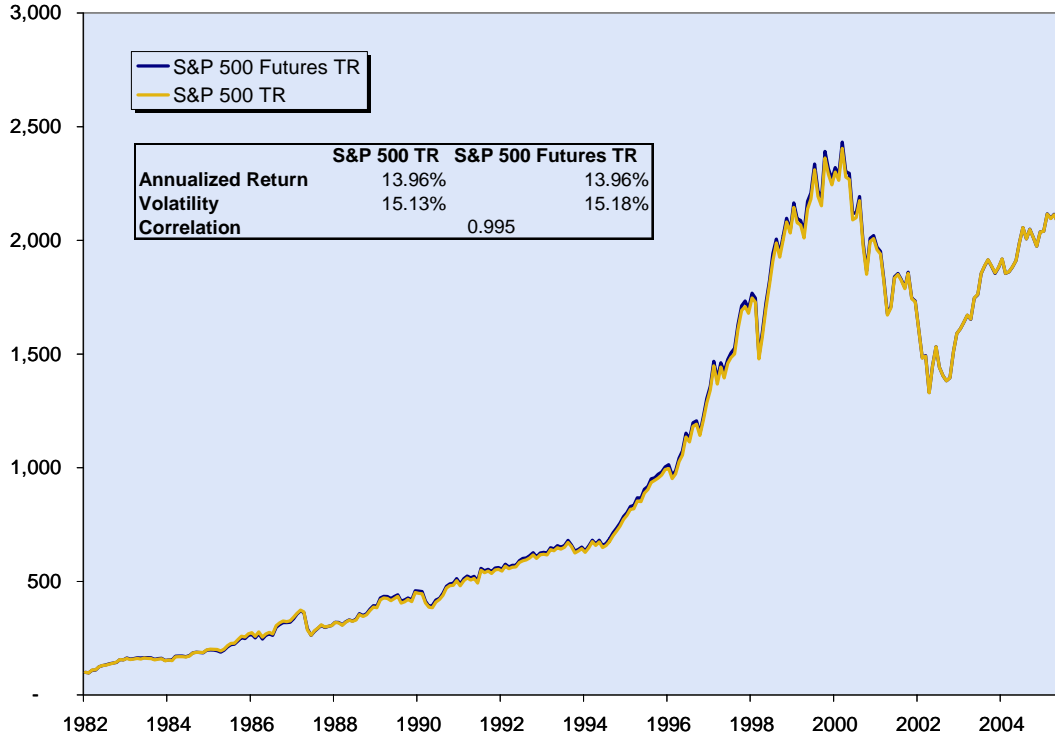
The above graph shows the correlation between the returns of the Commodity Index and those of the Stock Index, the Bond Index, and Inflation (CPI). Some observations stand out:

- Over all horizons – except monthly – returns on the Commodity Index are negatively correlated with those of the Stock and Bond Index. These findings suggest that Commodity Indices are effective in diversifying equity and bond portfolios.
- The negative correlation of Commodity Index returns with those of the Stock and Bond Indices tends to increase with the holding period. This suggests that the diversification benefits of Commodity Indices tend to be larger at longer horizons.
- Commodity Index returns are positively correlated with inflation and the correlation is larger at longer horizons.

\* Equally-weighted collateralized futures index, Ibbotson Large Company Stocks and Long-Term Corporate Bond Indices, CPI-U. Overlapping monthly return data from July 1959 to December 2004. Source: Ibbotson Associates.

**APPENDIX C-3**

**S&P 500 Total Return Index vs. S&P 500 Futures Total Return Index\***



One point that was raised in our meeting on February 17, 2006 concerns the fact that the Commodity Index is based on commodity futures while the Stock and Bond indices are based on “cash” (i.e. physical and not futures) stocks and bonds. The above graph compares the S&P Total Return Index to the S&P 500 Total Futures Return Index over time since the launch of the S&P 500 futures in 1982. As can be seen from the chart, the performance of the futures and cash indices are virtually identical.

\* S&P 500 Futures Total Return Index calculated based on the monthly return of the nearest to maturity S&P 500 Index Futures Contract (Trading symbol SP) that does not expire in that month plus interest earned and compounded monthly at the rate of 3 month Libor. Before December 1984 3month Libor was not available and interest rate on 3month US Treasuries was used instead. Source: Commodity Research Bureau, Bloomberg, AIG Financial Products Corp.

## APPENDIX D

### 1940 Act Funds with Exposure to Broad Based Commodity Indices

<b>1940 Act Funds (100% invested in commodities)</b>	<b>Commodity investment type</b>	<b>Total AUM at 2/28/06 (US\$)</b>	<b>Minimum investment (US\$)</b>
PIMCO Commodity Real Return Strategy Fund	Commodity index derivatives*	11.7 billion	5,000
Oppenheimer Real Asset Fund	Notes	1.772 billion	1,000
Credit Suisse Commodity Return Strategy Fund	Commodity index derivatives	184 million	2,500 / 500 for IRAs
Merrill Lynch Real Investment Fund	Notes	90 million	1,000
Rydex Commodities Fund	Notes**	42.5 million	25,000 (to open acct)
Potomac Commodity Bull Fund	Unknown***	9 million	10,000

\* In an April 11, 2006 Portfolio Manager Q&A, PIMCO stated that they had replaced US\$ 5.4 billion of commodity index derivatives with structured notes (for the entire Q&A, please refer to: [http://www.allianzinvestors.com/commentary/mkt\\_managerQA04112006.jsp](http://www.allianzinvestors.com/commentary/mkt_managerQA04112006.jsp))

\*\* In an April 11, 2006 Rydex Investments Press Release regarding the Rydex Commodities Fund, reference was made to a recently issued IRS private letter ruling that permits the manager to continue to meet the investment objective of the fund going forward using commodity-linked structured notes.

\*\*\* The fund's prospectus states that the fund will invest in "commodity-linked derivative investments including swap agreements, commodity options, futures, options on futures and commodity-linked notes".

<b>1940 Act Funds (Partially invested in commodities)</b>	<b>Commodity investment type</b>	<b>Total AUM at 2/28/06 (US\$)</b>	<b>Minimum investment (US\$)</b>
Bessemer Trust-Old Westbury Real Return Fund	Commodity index derivatives	1.022 billion	1,000
DWS Scudder Commodity Securities Fund	Notes	158 million	2,500 (or auto \$50 per mo.); 1,000 for AARP
DWS Global Commodity Stock Fund (closed-end fund)	Notes	442 million	Closed-end – per share investment
Fidelity Strategic Real Return Fund	Notes	609 million	2,500
The Investment Fund for Foundations*	Commodity index derivatives	1.2 billion	100,000
GMO Alternative Asset Opportunity Fund (master fund which owns shares in another fund)	Commodity index derivatives	309 million	

\* institutional investors only (foundations and non-profits)