United States Senate

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

March 19, 2012

VIA EMAIL (davisjz@sec.gov)

Ms. Elizabeth Murphy
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549

**RE: Concept Release on Use of Derivatives by Investment Companies
Release No. IC 29776, File No. S7-33-11**

Dear Ms. Murphy:

The purpose of this letter is to express support for the effort of the Securities and Exchange Commission ("SEC") to conduct a broad-based review of the use of derivatives by investment companies under the Investment Company Act of 1940 ("1940 Act").[1] The SEC's Concept Release is to be commended for focusing on issues related to risk management, leverage, liquidity, portfolio diversification, and valuation issues. The Concept Release also, however, invites comment on other issues. In response, this letter urges the SEC, during its review, to consider the use of derivatives by some investment companies to engage in commodity trading through the securities markets, in circumvention of certain legal restrictions in the tax code and in ways that minimize or eliminate oversight by the federal government's commodities expert, the Commodities Futures Trading Commission (CFTC). The letter also urges the SEC to consider how derivative use by some investment companies is diverting investment dollars away from stocks and bonds toward commodities, increasing speculation in the commodity markets, and contributing to greater commodity price volatility, price distortions, and a weaker economic recovery. The letter recommends that the SEC work with the CFTC and Internal Revenue Service (IRS) to address those concerns.

Subcommittee Work. Over the past ten years, the Permanent Subcommittee on Investigations has conducted a series of investigations into matters relating to complex financial matters, including a wide variety of issues involving derivatives and commodities. Most recently, the Subcommittee held a hearing examining actions taken by mutual funds to speculate in commodities using derivative instruments, including futures, commodity swaps, and commodity-linked notes, as well as actions taken to funnel some of those investments through

[1] The Concept Release defines derivatives as "instruments or contracts whose value is based upon, or derived from, some other asset or metric (referred to as the 'underlier,' 'underlying,' or 'reference asset.')." SEC Release at 4, citing *Board Oversight of Derivatives*, Independent Directors Council Task Force Report (July 2008), at 1, 3, available at http://www.ici.org/pdf/ppr_08_derivatives.pdf.

offshore shell corporations operating as unregistered commodity pools.[2] Earlier, the Subcommittee held a hearing which examined, in part, the growing use of exchange traded products to speculate in commodities through U.S. stock markets.[3] Both hearings are part of a larger, longstanding, and ongoing Subcommittee investigation into the role of excessive speculation in U.S. commodity markets, including the nature, extent, and origins of commodity speculation; its contribution to price distortions, price volatility, and hedging failures; and its detrimental impact on energy, food, and metal prices that affect every American business and household. Because commodity speculation is continuing to increase in ways that threaten the U.S. economic recovery and economy as a whole, this letter highlights derivative use by both mutual funds and exchange traded products to speculate in commodities; notes their increasing use of U.S. securities markets to trade in commodities; discusses their growing contributions to commodity speculation; and calls on the SEC, as part of its review, to examine troubling issues related to this activity.

Mutual Funds as an Engine of Investment. Mutual funds are the most common type of investment company under the 1940 Act. From their inception, mutual funds were made subject to dual sets of statutory restrictions under the 1940 Act and the Internal Revenue Code (IRC). Under IRC Section 851, mutual funds were given a preferential tax status which allowed them to avoid payment of any corporate income tax, so long as they adhered to certain requirements and restrictions. One of the key restrictions, under Section 851(b)(2), required mutual funds to derive at least 90% of their gross income from securities sales or loans, dividends, and interest, which meant they could derive no more than 10% of their gross income from alternative investments such as commodities.[4]

This tax provision created a favored tax status for mutual funds which has enabled the mutual fund industry to avoid payment of billions of dollars in taxes each year. At the same time, the 90% rule encouraged mutual funds to focus their investment dollars on corporate stocks, bonds, and similar securities, providing needed capital for corporate expansions, jobs, and economic growth. Because of the 90% rule, mutual funds became an engine of investment for corporate America.

Today, mutual funds are among the largest source of investment dollars in the U.S. economy. According to the Investment Company Institute (ICI), at the end of 2010, more than 8,500 mutual funds had net assets under management totaling more than $11 trillion dollars.[5] An estimated 90 million individuals, comprising 44% of all U.S. households, owned shares in a mutual fund.[6] ICI reported that mutual funds held a significant portion of the outstanding shares of U.S. issued stocks, bonds, and money market securities, and were among the largest investors

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[2] See "Compliance with Tax Limits on Mutual Fund Commodity Speculation," hearing before the U.S. Senate Permanent Subcommittee on Investigations (Jan. 26, 2012)(hereinafter "2012 Subcommittee Hearing").
[3] See "Excessive Speculation and Compliance with the Dodd-Frank Act," hearing before the U.S. Senate Permanent Subcommittee on Investigations (Nov. 3, 2011)(hereinafter "2011 Subcommittee Hearing"), in particular Hearing Exhibits 1b and 6.
[4] See 26 U.S.C. Section 851(b)(2). In 1986, this provision was amended to include within the 90% rule income from foreign currency investments, presumably to enable mutual funds to reduce foreign exchange risks.
[5] "2011 Investment Company Fact Book," issued by Investment Company Institute, available at http://www.ici.org/pdf/2011_factbook.pdf, (hereinafter "2011 Investment Company Fact Book"), at ii, 16.
[6] Id. at 80.

in U.S. commercial paper, which provides a critical source of financing for U.S. corporations.[7] ICI also reported that about 35% of mutual fund assets were invested in U.S. stock funds; 24% in money market funds; 22% in bond funds; 13% in international stock funds; and 6% in hybrid funds which invest in a mix of stocks and bonds.[8] It is this huge body of investment in America that justifies the annual loss of billions of dollars in tax revenues from the mutual fund industry.

Securities versus Derivative Investments. During its review of derivatives use by investment companies, it is critical that the Commission consider them in light of the 90% income source rule for mutual funds. This income source rule is one of the defining features of mutual funds and is responsible, in part, for the vigorous history of mutual fund investment in corporate America. As mutual funds begin to make increasing use of derivatives, not only to manage risks but also to make affirmative investments, mutual funds have begun to divert funds to commodity and swap markets and away from corporate stock and bond markets, in contravention of the 90% income source rule.

Investments in U.S. securities, such as an initial public offering, a corporate bond, commercial paper, or an asset backed security, often provide investment dollars directly to a business for use in its operations. They help finance corporate expansions, hiring, research, and other needs, sometimes characterized as investments in the "real economy." Buying and selling corporate stocks and bonds in the secondary markets also help ensure a vibrant capital formation process. In contrast, derivatives investments frequently amount to little more than bets on the performance of referenced assets or issuers and do not contribute to capital formation. For example, when a mutual fund trades in commodity futures, it is essentially placing a bet on a commodity price.

In evaluating derivative use by mutual funds, then, the SEC should review dollars spent on derivatives, not only in terms of risk or leverage, but also in terms of whether they meet the requirements of IRC Section 851(b)(2) which essentially requires mutual funds to direct the vast majority of their investment dollars to equities markets, rather than commodity or swap markets. It is those investments in the real economy that justify the tax exempt status of mutual funds when it comes to corporate income taxes. It is also those investments that help power the U.S. economy and provide needed capital for corporations.

Using Derivatives to Circumvent Investment Restrictions. As indicated earlier, in January 2012, the Subcommittee held a hearing which exposed how some mutual funds have become significant investors in commodities, despite the statutory restriction in IRC §851(b)(2) limiting mutual funds to deriving no more than 10% of their gross income from alternative investments such as commodities.[9] The hearing showed how mutual funds, which had not historically been involved in commodities markets, began petitioning for and receiving private letter rulings from the IRS allowing them to use a variety of tactics to invest in commodities, including through derivatives. In response, since 2006, the IRS has issued over 70 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

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[7] Id. at 12. Mutual funds are also among the largest holders of U.S. treasuries, municipal bonds, and other U.S. government agency securities. Id.

[8] Id. at 23.

[9] See 2012 Subcommittee Hearing.

income under Section 851(b)(2).[10] These letter rulings 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, to 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.[11]

The IRS private letter rulings opened the floodgates for mutual fund investments in commodities. A Subcommittee hearing exhibit identified, for example, 40 commodity-related mutual funds with accumulated assets in excess of $50 billion.[12] All of these funds have 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-related derivatives, from swaps to exchange traded notes to futures.[13] 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.[14] Despite these activities, for years, the commodity trading of these offshore shell corporations were explicitly exempted from direct CFTC oversight. Last month, however, the CFTC amended its rules to require investment advisers of these types of mutual funds to register as commodity pool operators subject to CFTC oversight.[15]

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

[10] Id., Subcommittee Hearing Exhibit 1c.

[11] For further information, see letter from Senators Levin and Coburn to the IRS on "Private Letter Rulings to Mutual Funds Seeking Commodities Exposure" (Dec. 20, 2011) (hereinafter "Levin-Coburn Letter on Private Letter Rulings to Mutual Funds")(urging IRS to "take immediate action to permanently halt" the issuance of such private letter rulings to mutual funds).

[12] 2012 Subcommittee Hearing, Hearing Exhibit 5a.

[13] See id., Hearing Exhibit 5b.

[14] Id., Hearing Exhibit 5b, materials related to PIMCO Commodity Real Return Strategy Fund.

[15] See "Final Rule Amending Registration and Compliance Obligations for Commodity Pool Operators and Commodity Trading Advisors" issued by the CFTC, February 9, 2012, available at http://www.cftc.gov/PressRoom/PressReleases/pr6176-12.

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. A mutual fund's investing in its own shell entity is not the type of securities investment that was contemplated by, or has traditionally qualified under, IRC Section 851(b)(2), nor is it the type of investment that justifies a mutual fund's tax exempt status. Furthermore, it is unclear how the $50 billion in commodity investments currently made by mutual funds through their offshore shells are taken into account for purposes of risk management, leverage and liquidity analysis, and diversification requirements.

In addition to allowing mutual funds to use offshore shell entities, the IRS private letter rulings have permitted mutual funds to use so-called "commodity-linked notes" to make investments in commodities. These structured notes can be used, for example, to create an investment based upon a specified commodity index. The private letters allow mutual funds to treat these structured notes as "securities" investments, despite the fact that the notes are designed and used solely for the purpose of investing in commodities. Again, a mutual fund's investing in a structured note in order to make commodity investments that would otherwise be prohibited by the income source rule is not the type of securities investment that was contemplated by, or has traditionally qualified under, IRC Section 851(b)(2), nor is it the type of investment that justifies a mutual fund's tax exempt status. In late 2011, the IRS placed a moratorium on the issuance of these types of private letter rulings for mutual funds, and is now conducting a review of the policy considerations.

When mutual funds invest in commodities, they not only divert investment dollars from corporate stock and bond markets, and endanger their tax exempt status, they also contribute to rising levels of speculation in the commodities markets. The Subcommittee has conducted a series of hearings examining excessive speculation in U.S. commodities markets, developing case histories involving the crude oil, natural gas, and wheat markets, and demonstrating the resulting harms to U.S. businesses and families.[16] Mutual funds have begun to exacerbate the problem by making billions of dollars in additional speculative bets each year on commodity prices.[17] CFTC Chairman Gary Gensler recently reported to the Subcommittee that speculators now hold over 80% of the outstanding futures contracts in U.S. crude oil markets and dominate other commodity markets as well.[18] These speculators contribute to escalating and unpredictable energy, metal, and food prices to the detriment of American families and businesses.[19] Unlike

[16] See, e.g., "The Role of Market Speculation in Rising Oil and Gas Prices: A Need to Put the Cop Back on the Beat," report issued by the Permanent Subcommittee on Investigations, S.Prt. 109-65 (June 27, 2006); "Excessive Speculation in the Natural Gas Market," Subcommittee hearing, S.Hrg. 110-235 (June 25 and July 9, 2007)(hereinafter "Subcommittee Hearing on Excessive Speculation in the Natural Gas Market"); "Excessive Speculation in the Wheat Market," Subcommittee hearing, S.Hrg. 111-155 (July 21, 2009)(hereinafter "Subcommittee Hearing on Excessive Speculation in the Wheat Market").

[17] See 2012 Subcommittee Hearing; Levin-Coburn Letter on Private Letter Rulings to Mutual Funds.

[18] 2011 Subcommittee Hearing, at 84.

[19] See, e.g., Subcommittee Hearing on Excessive Speculation in the Natural Gas Market (testimony of Arthur Corbin, President and CEO of the Municipal Gas Authority of Georgia on behalf of the American Public Gas Association; Paul Cicio, President of Industrial Energy Consumers of America; and Sean Cota, President of the New England Fuel Institute); Subcommittee Hearing on Excessive Speculation in the Wheat Market (testimony of Thomas Coyle, Chairman of the National Grain and Feed Association; Hayden Wands, Director of Procurement at the Sara Lee Corporation and Chairman of Commodity and Agricultural Policy for the American Bakers Association; and Mark Cooper, Director of Research for the Consumer Federation of America); 2011 Subcommittee

stock markets that are designed to attract investors, commodities markets exist primarily to enable commodity producers and consumers to set prices and hedge their pricing risks over time. Speculators traditionally made up only a minority of the market.[20] Unfortunately, this balance has been shattered by speculators placing bets on commodity price changes, with mutual funds as the latest entries.

As part of its review of the use of derivatives by investment companies, the SEC should consider, not just whether the derivatives create risk, leverage or diversification problems, but also whether they are being used by mutual funds to circumvent the law, including the income source restrictions intended to compel mutual funds to support the securities markets rather than the commodities or swap markets or other alternative investments. The SEC should also consult and coordinate with the IRS to help ensure that mutual funds do not and cannot use derivatives to make indirect commodity investments that they are legally barred from making directly.

Commodity-Related Exchange Traded Products. In addition to studying mutual funds, the Subcommittee has examined the role of exchange traded products (ETPs) in U.S. commodity markets. ETPs are a relatively new category of investment vehicle whose shares are traded through brokers on stock exchanges, in the same manner as corporate stocks.[21] ETPs encompass a wide variety of investment vehicles, including Exchange Traded Funds (ETFs) which function as investment companies; Exchange Traded Notes (ETNs) which provide debt securities backed by an issuer and often collateral; and Exchange Traded Commodities (ETCs) which are investment products backed by an inventory of physical commodities.[22] According to ICI, over the past decade, ETP net assets have grown from $66 billion to $992 billion in 2010, and ETFs have become the second most common type of registered investment company after mutual funds.[23]

ETPs, which continue to evolve in variety and complexity, can be used to make a wide range of investments, including in securities and commodities. At first, the SEC approved only ETPs that tracked a specified stock or commodity index, but in 2008, the SEC also began approving actively managed ETPs which offer a wide range of investments beyond index products.[24] Commodity-related ETPs, which began appearing in 2004, are a relatively small subset of ETPs overall, but offer many types of passive and active investments. According to ICI, by the end of 2010, there were less than 100 commodity-related ETPs, but their net assets had grown to $101 billion, almost triple their net assets over the prior two years.[25] At a hearing

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Hearing, Hearing Exhibit 9 (October 11, 2011 letter from 450 economists to the G20 Finance Ministers regarding impact of speculation on
food prices).

[20] See, e.g., 2011 Subcommittee hearing (testimony of Wallace Turbeville, Derivatives Specialist, at Better Markets, Inc., and Paul Cicio, President of Industrial Energy Consumers of America).

[21] See, e.g., 2011 Investment Company Fact Book, at 40.

[22] These terms are taken from the ETP classifications advocated by BlackRock, largest issuer of ETFs in the United States. See "ETFs: A Call for Greater Transparency and Consistent Regulation," Oct. 2011 (hereinafter "BlackRock Analysis"), at Exhibit 2, available at
https://www2.blackrock.com/webcore/litService/search/getDocument.seam?venue=PUB_IND&source=GLOBAL&contentId=1111150014.

[23] 2011 Investment Company Fact Book at viii, 41. Some ETPs are sponsored by mutual funds.

[24] Id. at 40.

[25] Id. at 48-49.

in November 2011, the Subcommittee identified over 65 commodity-related ETPs with assets exceeding $120 billion.[26]

Commodity-related ETPs, which use the securities markets to trade in commodities, are frequently heavy users of derivatives. Their investment strategies often include commodity index products as well as commodity-related futures, options, swaps, notes, or other derivatives.[27] Some ETPs provide returns which are leveraged or inverse to the commodity prices being tracked.[28] In a small number of cases, ETPs purchase and store physical commodities such as gold.[29] To secure their value, some ETPs hold a basket of futures or swaps; some maintain an inventory of physical commodities; some "synthetic" ETPs hold only swap instruments that reflect the returns of referenced assets or indices; and still others hold shares in other ETPs. Subcommittee research suggests that the most common type of commodity-related ETP is an exchange traded note that sells interests in its debt securities to investors.

Commodity-related ETPs merit particular attention during the SEC's review, not only for their heavy use of derivatives, but also for their potential impact on the U.S. economy. Commodity markets are much smaller than securities markets, and were not designed or intended to attract large-scale investment. Instead, commodity markets were designed and intended to enable commodity producers and consumers to use market mechanisms to price their goods and hedge their price risks, in response to traditional forces of supply and demand. As speculators have increased their role in commodity markets to record levels, however, price volatility has increased, commodity prices have often escalated, and hedging has become less effective and reliable. Today, U.S. businesses and families face the prospect of roller coaster prices for energy, metals, and food, including the $4-$5 per gallon gasoline that threatens the country's nascent economic recovery.

In 2009, my Subcommittee released a bipartisan 260-page staff report and held a hearing examining the role of commodity index traders in the wheat market, including traders acting on behalf of ETPs linked to agricultural indices.[30] The Subcommittee investigation found that the large number of wheat futures contracts being purchased by derivative dealers to support commodity index instruments had, in the aggregate, constituted excessive speculation in the Chicago wheat market, resulting in unwarranted price changes.[31] A portion of those wheat futures were purchased by derivative dealers selling shares in ETPs linked to commodity indices. Essentially, the report found that these index traders had created a new demand for wheat futures unrelated to physical use of the referenced commodities; had distorted wheat futures prices by overwhelming normal supply and demand factors; had interfered with the convergence of wheat futures and cash prices; and had hurt American businesses and consumers by causing unreliable

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[26] See 2011 Subcommittee Hearing, Exhibit 1b. The Subcommittee also determined that it is not uncommon for mutual funds to invest in commodity-related ETPs.

[27] See, e.g., 2011 Subcommittee Hearing; 2009 Subcommittee Hearing on Excessive Speculation in the Wheat Market.

[28] See BlackRock Analysis at 3.

[29] Id. See also "Request for Comment on Options for a Proposed Exemptive Order Relating to the Trading and Clearing of Precious Metal Commodity-Based ETFs; Concept Release," issued by the CFTC, 75 FR 189, at 60411 (Sept. 30, 2010)(hereinafter "CFTC Concept Release").

[30] See Subcommittee Hearing on Excessive Speculation in the Wheat Market, including at 255-59, 277-84.

[31] Id. at 180-181.

wheat prices and hedging failures. Since then, ETPs have only grown larger and increased their impact on commodity prices through their use of such derivatives as futures, swaps, and structured notes, as well as through the purchase of physical commodities.

The Concept Release currently focuses on derivative use by "investment companies," but derivative use by ETPs other than ETFs raise the same types of issues involving risk, leverage, liquidity, portfolio diversification, and valuation. They also raise the same types of concerns related to excessive speculation and commodity price distortions. Because all types of ETPs raise these same issues, the Concept Release should not artificially confine its review to ETFs, but include all types of ETPs, including ETNs involving commodities.

Using Derivatives to Dodge Commodity Oversights. In less than eight years, ETPs have diversified and grown to become a major source of investment in U.S. commodities, using exchange-traded securities to amass over $120 billion in assets. At the same time, commodity-related ETPs are subject to varying oversight by the SEC and may be exempt from CFTC oversight altogether, leaving the equity and commodity markets susceptible to undetected gaming and manipulation by participants trading across both markets.

Currently, a commodity-related ETP could be registered with the SEC as an investment company under the 1940 Act, overseen by the SEC as an affiliate of a registered investment company, or if it owns physical commodities, regulated by the SEC under the Securities Act of 1933.[32] In many cases, commodity-related ETPs take the form of exchange traded notes. ETNs are not subject to registration under the 1940 Act, are exempt from SEC regulations applicable to investment companies, and do not receive the same scrutiny as mutual funds.[33] Commodity-related ETNs also typically do not qualify as commodity pools, are not subject to CFTC regulations applicable to commodity pool operators or commodity futures, and investors who purchase shares in ETNs operate outside the CFTC's large trader reporting system.[34] To date, the CFTC has not even determined whether commodity-related ETNs and ETCs qualify as securities or commodities.[35]

Financial firms, including mutual funds, now routinely use ETPs in addition to futures and swaps to make commodity investments, subjecting themselves to limited SEC oversight while avoiding oversight by the CFTC. Commodity-related ETPs currently function as hybrid instruments, issuing securities whose sole purpose is to invest in commodities.[36] Commodity-related ETPs directly impact commodity supplies and spot and futures prices in both the regulated and over-the-counter commodity markets. They invite traders to engage in regulatory arbitrage over one class of transactions that is subject to CFTC oversight, such as futures, versus another, such as ETNs, that is economically similar but immune to CFTC regulation. In addition, they enable ETP managers and traders to take positions that are functionally equivalent to CFTC-regulated products, while escaping CFTC surveillance, large trader reporting, and

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[32] See, e.g., 2011 Investment Company Fact Book at 41; CFTC Concept Release at 60412 (noting that some commodity-related ETFs are barred by law from being regulated by the SEC under the 1940 Act).
[33] See, e.g., CFTC Concept Release.
[34] Id.
[35] See CFTC Concept Release.
[36] See, e.g., Prospectus for ETFS Platinum Trust (May 28, 2010) , at 20 ("The Shares are intended to offer investors an opportunity to participate in the platinum market through an investment in securities.").

market policing.[37] The result is that the CFTC and SEC are currently flying blind in their monitoring, analysis, and understanding of how billions of dollars in commodity-related ETP investments, individually and in the aggregate, affect commodity prices, supplies, and markets.

As part of its review of derivative use by investment companies, the SEC should consult and coordinate with the CFTC to take a hard look at the securities being used to invest in commodities, and acknowledge what the market has known for some time, that commodity-related ETPs, commodity-linked notes, and similar financial vehicles are hybrids that combine aspects of security and commodity instruments. These instruments should be subject to joint SEC-CFTC oversight, not only to protect investors, but also to protect commodity and equity markets from manipulation and excessive speculation that distorts prices and increases price volatility. Acknowledging these hybrid instruments would allow both agencies jointly to design appropriate disclosure, regulatory, and oversight procedures.

Conclusion. The SEC's proposed review of derivative use by investment companies is both timely and important. In conducting this review, the SEC should not only consider issues related to risk, leverage, liquidity, portfolio diversification and valuation, it should also take a hard look at the use of derivatives by mutual funds and ETPs to flood U.S. commodity markets with speculative bets, generate hybrid products that sidestep CFTC or SEC oversight, and fuel the excessive speculation that undermines the broader U.S. economy.

Right now, the SEC, IRS, and CFTC all have pending concept releases or policy reviews that provide a rare opportunity to consider these derivative issues. The SEC and IRS should use the opportunity to review mutual fund activities, prevent mutual funds from engaging in large amounts of indirect commodity investments that the law prohibits them from doing directly, and ensure mutual funds comply with the 90% rule in a way that justifies their continued tax-exempt status. The SEC and CFTC should acknowledge the widespread use of hybrid products that combine aspects of securities and commodities trading; consider joint registration of traders that use U.S. securities to trade in commodities; and the imposition of increased capital, margin, and liquidity requirements to protect investors and the markets against risky speculative bets. The SEC and CFTC should also acknowledge the importance of preventing manipulation and excessive commodity speculation and use their concept releases to tackle these problems.

Thank you for this opportunity to comment on the Concept Release.

Sincerely,

Carl Levin

Carl Levin
Chairman
Permanent Subcommittee on Investigations

[37] See, e.g., CFTC Concept Release.

cc: The Honorable Mary L. Schapiro, Chairman, Securities and Exchange Commission
The Honorable Elisse B. Walter, Commissioner, Securities and Exchange Commission
The Honorable Luis A. Aguilar, Commissioner, Securities and Exchange Commission
The Honorable Troy A. Paredes, Commissioner, Securities and Exchange Commission
The Honorable Daniel M. Gallagher, Commissioner, Securities and Exchange Commission
(Via Email to davisjz@sec.gov)

The Honorable Gary S. Gensler, Chairman, Commodity Futures Trading Commission
The Honorable Jill E. Sommers, Commissioner, Commodity Futures Trading Commission
The Honorable Bart Chilton, Commissioner, Commodity Futures Trading Commission
The Honorable Scott D. O'Malia, Commissioner, Commodity Futures Trading Commission
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