Office of Chief Counsel
Internal Revenue Service
Memorandum

Number: **201827011**
Release Date: 7/6/2018

CC:FIP:B02: SRTetelman
POSTF-117308-17

UILC: 246.05-02

date: March 28, 2018

to: Associate Area Counsel
(Large Business and International)

from: Special Counsel to the Associate Chief Counsel
(Financial Institutions and Products)

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subject: Dividends Received Deduction for Exchange-Traded Fund Dividends

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Parent	=
X	=
Y	=
Z	=
PS	=
Index	=
ETF Trust	=
j percent	=
k percent	=
Year 1	=
Year 2	=
Year 3	=
Year 4	=

Issue

Whether a taxpayer's short positions in swaps reflecting the value of a stock index ("Index") are "substantially similar or related property" within the meaning of § 246 of the Internal Revenue Code with respect to shares of an exchange-traded fund that tracks the performance of the same index.

Facts

Parent is the common parent of an affiliated group of corporations (the "Group" or the "Taxpayer") that filed consolidated federal income tax returns for tax years Year 1 through Year 2, the years under examination. Group Member X is a customer-facing equity-swap dealer. Group member Y is the Group's primary broker/dealer. At all relevant times, X was a dealer within the meaning of § 475. Beginning in Year 3 and through the present, X's business included entering into both long positions and short positions with respect to the Index, using a combination of stocks, futures, and exchange-traded funds ("ETF's").

Prior to converting to an LLC in Year 4, X acquired short positions with respect to the Index using numerous notional principal contracts (hereinafter collectively referred to as the "Swaps"). The maturities of the Swaps varied, with being the most common maturity. The terms of the Swaps required X to pay or otherwise credit the appreciation in the Index and any dividends. Conversely, under the Swaps the third-party customer counterparties made payments to X equal to the sum of any depreciation in value of the Index and a financing payment.

Prior to converting to an LLC in Year 4, X also acquired shares in the ETF Trust.[1] According to its prospectus, the ETF Trust was organized through a trust agreement and was a unit investment trust that sought to provide investment results that, before minimal estimated annual expenses of j percent of its average net assets, corresponded as closely as possible to the price and yield performance of the Index. The ETF Trust held a portfolio of all the common stocks that were included in the Index, with the weight of each stock in the portfolio closely corresponding to the weight of such stock in the Index. Thus, the ETF Trust and the Index produced nearly identical economic returns. The ETF Trust rebalanced its portfolio from time to time to conform to periodic changes in the identity and relative weightings of securities in the Index. Holders of the ETF Trust's shares received quarterly dividends in an amount corresponding to the amount of any cash dividends declared with respect to the common stocks actually held by the ETF Trust during the applicable period, net of minimal fees and expenses associated with operation of the ETF Trust, and taxes, if applicable.

For federal income tax purposes, the ETF Trust was a regulated investment company ("RIC") under subchapter M of the Code. Individual shares were generally available for

[1] Although each share in the ETF Trust was a security called a "Trust Unit" or "Unit," the ETF Trust was a domestic corporation for federal income tax purposes and such securities are referred to herein as shares.

purchase and sale on an exchange and through broker/dealers at market prices. In addition, certain institutional investors were "Authorized Participants" with respect to the ETF Trust and were permitted to purchase or redeem shares directly with the ETF Trust, but could do so only in large blocks of 50,000 shares known as "Creation Units." Creation Unit transactions were conducted in exchange for the deposit or delivery of in-kind securities constituting a substantial replication of the securities included in the Index, cash, or both. Y was an Authorized Participant of the ETF Trust and in the ordinary course of its business regularly exercised its rights to create or redeem Creation Units in-kind. X was not an Authorized Participant of the ETF Trust.

The divergence between the ETF Trust's holdings and the components of the Index was minimal, and the Taxpayer expected such divergence to be minimal in its economic analyses of its Swap hedging transactions. To manage its risk, X ensured that it held short Swaps that were sized to offset risks associated with holding the ETF Trust shares that it purchased from the market.

In Year 4, X converted into an LLC and a different Group member, Z, acquired the ETF Trust shares. X continued to enter into Swaps with third-party customers, and also entered into a back-to-back swap with Z. Similar to the Swaps with third-party customers, under the terms of the back-to-back swap, Z was required to pay or otherwise credit to X the appreciation in the Index and any dividends. Conversely, X was required to pay or otherwise credit to Z an amount equal to the sum of any depreciation in the Index plus a financing fee. Thus, Z's short position in the back-to-back swap was similar economically to X's short position in the Swaps, as previously defined. Accordingly, hereinafter the term "Swaps" refers to both the back-to-back swap and the previously defined Swaps.[2]

To finance the purchase of the ETF Trust shares at the lowest possible cost, X and Z[3] lent the ETF Trust shares to Y. Y then, in the normal course of its brokerage business, lent the shares to its third-party customers to cover those customers' short positions on the ETF Trust shares.[4] To ensure that X or Z received actual dividends on the ETF Trust shares rather than substitute dividends (which would not qualify for the dividends received deduction ("DRD")), during the period around each dividend date, X and Z required Y to return the same number of ETF Trust shares that were borrowed. Y did not require its customers to return the shares they had borrowed; instead, Y borrowed shares from the market to return to X or Z.

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[2] During a brief period prior to completing the restructuring, a partnership (PS) owned by two Group members was used to acquire the ETF Trust shares from the market and enter into a back-to-back swap with X.

[3] PS owned the ETF Trust shares briefly in Year 4 and Z owned the shares after X converted to an LLC in Year 4.

[4] The Service is not challenging the Taxpayer's claim that X's loan of the ETF Trust shares to Y qualified under § 1058.

X and Z placed the returned shares in a separate account over the dividend record dates so that the shares could not be used for any purpose other than in repurchase transactions. During the period around the dividend date when Y returned the shares to X or Z, in some cases the returned shares were used as collateral under a repurchase agreement ("Repo"). X and Z considered ETF Trust shares that were financed with a Repo to be debt-financed portfolio stock for which each entity reduced the DRD under § 246A.

X and Z generally hedged in the most profitable manner, and financing the acquisition of ETF Trust shares with a Repo was more expensive than financing by lending the ETF Trust shares to Y to cover third-party client short sales. In order to maximize profit, X and Z sought to finance transactions by lending shares to cover third-party customers' short sales as often as possible, and to use Repo financing as seldom as possible. X and Z entered into Swaps and acquired the ETF Trust shares contemporaneously as paired transactions.

Historically, the demand in prime brokerage for ETF Trust shares to cover customer short positions has been robust, making the use of ETF Trust shares to hedge the Swaps desirable throughout the years under examination. The Taxpayer stated that it could have offset the Swaps by acquiring the individual components of the Index instead of the ETF Trust shares, but that demand for the various components of the Index is generally not as consistent as the demand for ETF Trust shares. Thus, according to the Taxpayer, offsetting the Swaps by acquiring the individual components of the Index instead of the ETF Trust shares would have reduced or even eliminated its economic profit from the transactions. The Taxpayer stated that it was most profitable to enter into offsetting ETF Trust share purchases together with the short Swap, even absent the DRD benefit.

The economics of holding the offsetting Swaps and ETF Trust Shares were materially enhanced by the claimed 70 percent DRD. Effectively, X and Z were in economically neutral positions with respect to the dividends because the dividends earned on the ETF Trust shares funded the obligation to pay or credit the same dividends on the Swaps. X and Z were also in economically neutral positions with respect to the Index because the Swaps granted X and Z the right to be paid or otherwise credited an amount equal to the sum of any depreciation in the Index plus a financing fee. However, despite the offsetting dividend flows, and the offsetting of overall risk of holding the ETF Trust shares, X and Z claimed a deduction for the dividends that X and Z credited to counterparties on the Swaps and deducted almost 70 percent of the dividend flow again as a DRD. As discussed above, X and Z did not claim the DRD with respect to a small amount of dividends received with respect to ETF Trust shares that it considered to be debt-financed portfolio stock subject to § 246A.

Law & Analysis

Under § 243(a), a corporation is generally allowed a 70 percent DRD on most dividends received from a domestic corporation subject to income tax.

Section 246 provides various rules limiting the DRD allowed under § 243. In particular, § 246(c)(1)(A) disallows the DRD for any dividend on a share of stock that is held by the taxpayer for 45 days or less during the 91-day period beginning on the date which is 45 days before the date on which the share becomes ex-dividend with respect to the dividend. For this purpose, under § 246(c)(4)(C), a taxpayer's holding period in a dividend-paying stock is reduced (in the manner provided in regulations prescribed by the Secretary) for any period (during the 91-day period referred to in § 246(c)(1)) in which, under regulations prescribed by the Secretary, the taxpayer has diminished his or her risk of loss by holding one or more other positions with respect to substantially similar or related property ("SSRP").[5]

Section 1.246-5 of the Income Tax Regulations provides rules for applying § 246(c)(4)(C). Section 1.246-5(a) provides that the holding period of stock for purposes of the DRD is appropriately reduced for any period in which a taxpayer has diminished its risk of loss by holding one or more other positions with respect to SSRP. Section 1.246-5(b)(1) provides that the term SSRP is applied according to the facts and circumstances of each case. In general, property is SSRP to stock when (i) the fair market values of the stock and the property primarily reflect the performance of (A) a single firm or enterprise, (B) the same industry or industries, or (C) the same economic factor or factors such as (but not limited to) interest rates, commodity prices, or foreign-currency exchange rates; and (ii) changes in the fair market value of the stock are reasonably expected to approximate, directly or indirectly, changes in the fair market value of the property, a fraction of the fair market value of the property, or a multiple of the fair market value of the property.

Section 1.246-5(b)(2) provides that a taxpayer has diminished its risk of loss on dividend-paying stock by holding positions with respect to SSRP if changes in the fair market values of the stock and the positions are reasonably expected to vary inversely. Section 1.246-5(b)(3) provides that a position with respect to property is an interest (including a futures or forward contract or an option) in property or any contractual right to a payment, whether or not severable from stock or other property.

Section 1.246-5(c)(7) provides that rights and obligations under notional principal contracts such as swaps are considered separately even though payments with regard to those rights and obligations are generally netted for other purposes. Therefore, if a taxpayer is treated as receiving payments under a swap when the fair market value of

[5] In addition, § 246(c)(1)(B) disallows the DRD for any dividend on a share of stock to the extent that the corporate shareholder is under an obligation (whether pursuant to a short sale or otherwise) to make related payments with respect to positions in SSRP. Since the analysis of whether the Swaps are SSRP with respect to the ETF Shares is the same, the conclusions expressed herein apply equally for purposes of § 246(c)(1)(B).

the underlying security declines, the taxpayer has diminished its risk of loss by holding a position in SSRP regardless of the netting of payments under the contract for other purposes.

Section 1.246-5(c)(1) provides special rules (often referred to as the portfolio rules) that apply when a position reflects the value of more than one stock. In general, if a position reflects the value of a portfolio of stocks, the position is determined to be SSRP with respect to the stocks held by the taxpayer under the rules of paragraphs (c)(1)(ii) through (iv) of § 1.246-5.[6] Section 1.246-5(c)(1)(ii) provides that, notwithstanding paragraph (b)(1) of § 1.246-5, a position reflecting the value of a portfolio of stocks is SSRP to the stocks held by the taxpayer only if the position and the taxpayer's holdings substantially overlap as of the most recent testing date. A position may be substantially similar or related to a taxpayer's entire stock holdings or a portion of a taxpayer's stock holdings.

Section 1.246-5(c)(1)(iii) contains a three-step procedure for determining whether a position reflecting the value of a portfolio of stocks is SSRP with respect to a dividend-paying stock. In general, Step One requires the taxpayer to construct a subportfolio (the "Subportfolio") that consists of stock in an amount equal to the lesser of the fair market value of each stock represented in the position and the fair market value of the stock in the taxpayer's stock holdings. (The Subportfolio may contain fewer than 20 stocks.) Then, under Step Two, if the fair market value of the Subportfolio is equal to or greater than 70 percent of the fair market value of the stocks represented in the position, the position and the Subportfolio substantially overlap. Finally, under Step Three, if the position does not substantially overlap with the Subportfolio, the taxpayer must reduce the size of the position and repeat Steps One and Two. The largest percentage of the position that results in a substantial overlap is substantially similar or related to the Subportfolio determined with respect to that percentage of the position. Section 1.246-5(c)(1)(vi) contains an anti-abuse rule providing that, notwithstanding paragraphs (c)(1)(i) through (v) of § 1.246-5(c)(1), a position that reflects the value of more than one stock is a position in SSRP with respect to the appropriate portion of the taxpayer's stock holdings if (A) changes in the value of the position or the stocks reflected in the position are reasonably expected to virtually track (directly or inversely) changes in the value of the taxpayer's stock holdings, or any portion of the taxpayer's stock holdings and other positions of the taxpayer; and (B) the position is acquired or held as part of a plan a principal purpose of which is to obtain tax savings (including by deferring tax) the value of which is significantly in excess of the expected pre-tax economic profits from the plan.

[6] For this purpose a portfolio of stock is stock of more than 20 unrelated issuers. Section 1.246-5(c)(1). If a position reflects the value of more than one stock, but less than a portfolio of stock, the position is treated as a separate position with respect to each of the stocks the value of which the position reflects. Section 1.246-5(c)(1)(v).

Section 1.246-5(c)(6) provides two anti-abuse rules for transactions involving the use of related persons or pass-through entities. The first provides that positions held by a party related to the taxpayer within the meaning of § 267(b) or 707(b)(1) are treated as positions held by the taxpayer if the positions are held with a view to avoiding the application of § 1.246-5 or § 1.1092(d)-2. The second anti-abuse rule under § 1.246-5(c)(6) provides that a taxpayer is treated as diminishing its risk of loss by holding substantially similar or related property if the taxpayer holds an interest in, or is the beneficiary of, a pass-through entity, intermediary, or other arrangement with a view to avoiding the application of § 1.246-5 or § 1.1092(d)-2. The terms "pass-through entity" and "intermediary" are undefined in the regulations.

In the instant case, the Swaps are a position with respect to property within the meaning of § 1.246-5(b)(3). The Taxpayer argues that, because the Swaps represent the value of all of the stocks included in the Index, whether the Swaps are SSRP with respect to X's and Z's stock holdings must be determined under the portfolio rules. According to the Taxpayer, because X's and Z's stock holdings do not include the individual stocks included in the Index, there is no substantial overlap under the portfolio rules and, therefore, § 246(c)(4)(C) does not apply to reduce X's and Z's holding period in the dividend-paying stock (the ETF Trust shares).

The Taxpayer misapplies the rules in § 1.246-5 to arrive at a result that is plainly contrary to the purpose of § 246(c)(4)(C). Section 1.246-5(b)(1) expressly states that the meaning of SSRP is determined according to the facts and circumstances of each case. In this case, the individual stocks in the Index, in the aggregate, reflect not only the performance of the Index, but also the performance of a single company's stock – the shares of the ETF Trust. Thus, the Swaps may be positions with respect to SSRP under either the general rule in § 1.246-5(b)(1) or the portfolio rules of § 1.246-5(c).

The dividend-paying entity, the ETF Trust, held the stocks that comprised the Index, and was designed and managed so that the ETF Trust's price and yield corresponded as closely as possible to the price and yield performance of the Index. The position, the Swaps, also reflected the performance of all of the stocks underlying the Index. Accordingly, the Swaps not only reflected the performance of all of the individual stocks in the Index, but also reflected the performance of the ETF Trust. As a result, the fair market values of the position and the dividend-paying stock reflected the performance of a single firm or enterprise, the ETF Trust, as required by § 1.246-5(b)(1)(i)(A). Moreover, changes in the fair market value of the ETF Trust shares are reasonably expected to closely match changes in the fair market value of the basket of stocks comprising the Index. Therefore, under § 1.246-5(b)(1), the Swaps are positions in SSRP with respect to the ETF Trust shares.

The Taxpayer argues that because § 1.246-5(c)(1)(ii) states that "notwithstanding paragraph (b)(1) of this section," a position that reflects the value of more than one stock is SSRP only if the substantial overlap test is met, and, therefore, the Swaps and the ETF Trust shares may only be tested under the portfolio rules in § 1.246-5(c)(1)(ii)

through (iv). We believe the Taxpayer's reading of this phrase is incorrect. The portfolio rules of § 1.246-5(c)(1) are intended to apply in situations in which the taxpayer holds a portfolio of stocks and the question is whether the position is a position in SSRP with respect to all or a portion of the taxpayer's stock holdings. The existence of these rules does not preclude a position referencing a portfolio of stocks from being a position in SSRP with respect to a stock of a single corporation (such as an ETF) when the ETF and the position reflect the performance of the same index. Accordingly, under § 246(c)(4)(C), because X and Z, under regulations prescribed by the Secretary, have diminished their risk of loss by holding one or more positions with respect to substantially similar or related property, the holding period in the ETF Trust shares is reduced by excluding the period during which the risk of loss was diminished by holding SSRP. X and Z acquired the Swaps and the ETF Trust shares contemporaneously. Thus, their holding periods for the ETF Trust shares do not meet the requisite time period for X and Z to be eligible for the DRD under the statute.

As a result of our conclusion under the general rule in § 1.246-5(b)(1), we need not address the application of the portfolio rules, or the anti-abuse rule under § 1.246-5(c)(1)(vi), to the ETF Trust dividends.[7] In addition, the first anti-abuse rule under § 1.246-5(c)(6) is not implicated in the instant case because, at all times, the party owning the ETF shares also held Swaps with respect to the Index.

We note, however, that the second anti-abuse rule in § 1.246-5(c)(6) also may be applied to the ETF Trust dividends. Under the second anti-abuse rule of § 1.246-5(c)(6), if X or Z, as appropriate, holds the interest in the ETF Trust with a view to avoiding the application of § 1.246-5, and the ETF Trust, which is a RIC for Federal income tax purposes, is considered a pass-through entity, intermediary, or other arrangement, then X or Z, as appropriate, is treated as holding substantially similar or related property.

The term "pass-through entity" is commonly understood to include partnerships and S corporations.[8] In some instances, however, the term also includes hybrid entities such as RICs. For example, RICs, real estate investment trusts, trusts, partnerships, and S corporations are all considered "pass-through entities" for purposes of § 1260, relating to gain from constructive ownership transactions. Section 1260(c)(2). In general, § 1260 prevents taxpayers from obtaining tax benefits (both deferral and character) from holding a derivative position through an entity rather than direct ownership. RICs are also generally considered pass-through entities under § 67(c)(1). Moreover, RICs, like partnerships and S corporations, are generally designed and operated to avoid an entity-level tax under subchapter M of the Code (§§ 851-855), as a RIC is entitled to a deduction for dividends paid and adverse tax consequences result if dividends received

[7] In addition, application of the anti-abuse rule under § 1.246-5(c)(1)(vi), would require a detailed analysis of the pre-tax economic profits from "the plan," including a determination of which aspects of Taxpayer's operations are properly considered part of "the plan."
[8] See, e.g., § 267(e).

by a RIC are not distributed to RIC shareholders (and deducted as a dividend paid) for the taxable year. Certain favorable tax attributes associated with various types of income and gain of a RIC pass through to the RIC shareholders when the RIC distributes dividends attributable to such income and gain to its shareholders. Significantly, dividends eligible for the DRD pass through RICs in this manner.

We conclude, therefore, that a RIC is properly considered a pass-through entity for purposes of the § 1.246-5(c)(6) anti-abuse rule.[9] The ETF Trust provided X and Z a means of indirectly owning the shares underlying the Index and obtaining returns that closely matched the returns on the Index. Treating the ETF Trust as a pass-through entity is consistent with the purpose of the § 1.246-5(c)(6) anti-abuse rule.

By its plain language, the term "with a view to" indicates that the taxpayer must be motivated to some degree to structure a transaction or series of transactions in a particular manner so as to avoid disallowance of the DRD. It is also clear that such a motivation need not be a "primary" or "principal" determinant. In our opinion, the Taxpayer's inclusion of the DRD as one of many factors in its planning and structuring of the transactions as a whole and the Taxpayer's statements regarding its motivations for the transactions satisfy the "with a view to" standard of the § 1.246-5(c)(6) anti-abuse rule.

For example, X and Z took steps to seek to ensure that they would be entitled to a DRD with respect to the ETF Trust shares by structuring their transactions so that they would receive actual dividends rather than substitute dividends, which would not qualify for the DRD. As set forth above, to finance the purchase of the ETF Trust shares at the lowest possible cost, X and Z lent the ETF Trust shares to Y. Then, in the normal course of its brokerage business, Y lent the shares to its third-party customers to cover those customers' short positions on the ETF Trust shares. To ensure that X and Z received actual dividends on the ETF Trust shares rather than substitute dividends, X and Z required Y to return the same number of ETF Trust shares that were borrowed and X and Z placed the returned shares in a separate account over the dividend record dates so that the shares could not be used for any purpose other than in repurchase transactions.

In addition to taking proactive steps to seek to ensure that they received the DRD, X and Z also structured their transactions so that they would essentially eliminate their risk

[9] In addition, a RIC properly may be treated as an "intermediary" or "other arrangement" under the § 1.246-5(c)(6) anti-abuse rule. Given that RIC dividends originate with the individual stock held by the RIC, the RIC itself may be viewed as merely an intermediary between the original dividend-paying stock and the RIC shareholder. Moreover, because RICs resemble partnerships and S corporations by typically not incurring an entity-level tax, a RIC is generally comparable to traditional pass-through entities and, therefore, also may be considered an "other arrangement." Under the *ejusdem generis* canon of statutory construction, where a general term follows the specific enumeration of a particular class of thing, the general term is construed as applying to things of the same general class. See, e.g., *Coleman v. Commissioner*, 76 T.C. 580, 589 (1981) (interpreting "other casualty" for purposes of § 165(c)(3)).

with respect to the ETF Trust shares by entering into the Swaps contemporaneously with the purchase of the ETF Trust shares. As discussed above, the ETF Trust was organized to provide investment results that, before minimal expenses, corresponded as closely as possible to the price and yield performance of the Index. The ETF Trust held all of the common stocks that were included in the Index, with the weight of each stock closely corresponding to the weight of such stock in the Index. The ETF Trust also rebalanced its holdings from time to time to conform to periodic changes in the identity and relative weightings of securities in the Index. Further, holders of the ETF Trust's shares received quarterly dividends in an amount corresponding to the amount of any cash dividends paid with respect to the common stocks actually held by the ETF Trust during the applicable period, net of fees and expenses associated with operation of the ETF Trust, and taxes, if applicable.

The forgoing, in addition to the fact that the position would have satisfied the substantial overlap test of the portfolio rules had X or Z, as appropriate, directly held the stocks held by the ETF Trust, provides sufficient evidence to demonstrate that the ETF Trust shares were held with a view to avoiding the application of § 246(c)(4)(C) and § 1.246-5. In planning and structuring the transactions each entity proactively sought to ensure that it would be entitled to a DRD, while simultaneously ensuring that it essentially eliminated its risk of loss. Even if each entity had other business reasons for structuring its transactions in this manner, those business reasons would not alter the conclusion that the ETF Trust shares were held with a view to avoiding the application § 246(c)(4)(C) and § 1.246-5. Thus, X and Z are treated as diminishing their risk of loss by holding a position with respect to SSRP because each held the ETF Trust shares, an interest in a pass-through entity within the meaning of § 1.246-5(c)(6), with a view to avoiding the application § 246(c)(4)(C) and § 1.246-5.

The application of § 1.246-5(b)(1)(i)(A) and the second anti-abuse rule in § 1.246-5(c)(6) to the facts of the instant case is consistent with the legislative history to § 246, which provides that regulations under § 246(c)(4)(C) are intended to apply to a transaction involving the acquisition of a short position on an index while holding stock of an investment company whose principal holdings mimic the performance of the stocks included in the stock index. See H.R. Conf. Rep. No. 861, 98th Cong., 2d Sess. 818 (1984). Thus, Congress intended that the regulations disallow the DRD in situations like the instant case in which security or portfolio-specific risk, in contrast to general market risk, is eliminated through the use of short positions in SSRP. Here, the Swaps reference the same basket of stocks held by the ETF Trust and effectively eliminated all risk associated with ownership of the ETF Trust shares.

Based on the foregoing, we conclude that the Swaps held by X or Z, as appropriate, are positions in SSRP with respect to each entity's corresponding ETF Trust shares under both § 1.246-5(b)(1) and the second anti-abuse rule of § 1.246-5(c)(6), resulting in a reduction in each entity's holding period with respect to the ETF Trust shares and the disallowance of the DRD claimed by each entity with respect to dividends it received on the ETF Trust shares.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted]

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Please call (202) 317-7053 if you have any further questions.

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