

OTC Options as Qualified Covered Call Options

This paper is submitted by the International Swaps and Derivatives Association, Inc. (ISDA). ISDA is the global trade association representing participants in the over-the-counter (OTC) derivatives industry. ISDA has over 600 member institutions which include most of the world's major institutions that deal in, as well as leading end-users of, OTC derivatives, including OTC options. For the reasons set forth below, ISDA is opposed to the provision of S. 1637, as passed by the Senate, to deny qualified covered call treatment for OTC options while maintaining that treatment for listed options.

Covered Call Writing

Covered call writing is simply an investor selling call options on stock that the investor owns, and is a well established, widely used strategy for investors to enhance the cash yield on their shares — particularly in respect of shares that pay little or no dividends. Cash is generated from the receipt of option premium upon the sale of the call option (thus the strategy is sometimes referred to as providing “synthetic dividends”).¹ The objective is to earn the cash option premium — not to sell the underlying shares — so the call options sold are out-of-the-money. Using options pricing models, an investor (or his or her financial advisor) can select a series of covered call options to sell with the appropriate strike prices and expiration dates that optimize the trade-off between maximizing option premium and minimizing the risk of the options being exercised (which may require the investor to sell his or her underlying shares). Covered call writing is thus not a strategy to hedge an investor’s risk in respect of his or her shares. In fact, the call options sold do not provide any meaningful protection against risk of loss on the underlying shares held by the investor. Moreover, covered call writing is not a “tax-advantaged” strategy, because the option premium received by the investor is taxed at ordinary income rates (not reduced long-term capital gains or qualified dividend rates) when it is includable in income (that is, if the option expires unexercised, which is the objective of covered call writing).

As described above, covered call writing does not meaningfully hedge the shares held by the investor. The shares held by the investor, however, fully hedges the risk of loss to the investor from selling the call options (which is why such call options are described as “covered”). Because the shares hedge the written call options, but for the “qualified covered call option” (QCC) exception, the two positions would be treated as a straddle for tax purposes. In short, if covered call options were straddles, the adverse tax consequences for the investor would be (i) capitalization (rather than deduction) of any interest expense incurred to finance the shares (such as a margin loan), (ii) deferral of any loss upon cash settling the call options (which is often the manner in which OTC options are settled), and (iii) elimination of holding period for the

¹ The covered call writing strategy discussed herein refers to the yield enhancement version of the strategy. Covered call writing can also serve as an “exit” strategy to sell the underlying shares at a price above the current stock price (in hopes that the stock price in fact will appreciate above the strike price of the call option). Although all of the points made herein apply to covered call writing pursued as an exit strategy, they generally apply with greater force to covered call writing pursued as a yield enhancement strategy, because a wider array of call options is required to execute the strategy successfully over time.

underlying shares, if such holding period did not exceed one year when the covered call option was sold.

Congress recognized covered call writing as a legitimate investment strategy that should be excluded from the straddle rules, which is precisely why the QCC rules were enacted. In its committee reports on the 1984 amendments to the straddle rules that included the QCC exception, Congress stated that:

One widely used investment strategy that would be affected by the extension of the straddle rules to stock options involves writing call options on stock owned by the taxpayer. The committee believes that it may be appropriate to exempt these transactions where they are undertaken primarily to enhance the taxpayer's investment return on the stock and not to reduce the taxpayer's risk of loss on the stock. . . . The granting of a covered call option does not substantially reduce a taxpayer's risk of loss with respect to the underlying stock unless the option is deep-in-the-money. The bill contemplates that taxpayers can continue to write at-the-money and non-deep-in-the-money covered calls, without running afoul of the straddle rules.²

OTC versus Listed Equity Options Generally

Investors pursuing a covered call writing strategy currently have the ability to sell listed equity options and OTC equity options, as both types of options are eligible for QCC treatment under the current tax rules.³ For the reasons given below, OTC equity options fill a large gap that is left by the limited listed equity options that are currently available. In this regard, OTC options complement listed options in providing the widest array of equity options for pursuing a covered call writing strategy.

Listed equity options are financial contracts that are traded on certain exchanges — in a manner similar to the way stocks are traded on the stock exchanges. For the most part, the exchanges bring together buyers and sellers of options, acting through brokers, and quotes for current prices of listed options are publicly available. Listed options are available for many publicly traded common stocks, but not for all of them.

To facilitate their liquidity and trading, listed options are standardized to a large extent. In particular, with the exception of “flex” options (described below), listed options are available only (i) as American-style options (exercisable at any time before expiration), (ii) with one expiration date per calendar month (the Saturday following the third Friday), and (iii) with strike prices in minimum increments of \$2.50 and in many cases \$5.⁴ It is precisely this standardization and limitation on the range of listed options that facilitates their liquidity. Even for a public

² S. Rep. No. 98-169, 98th Cong., 2d Sess. at 289-91; H.R. Rep. No. 98-432, 98th Cong. 2d Sess. at 1266-68.

³ Internal Revenue Code section 1092(c)(4); Treasury regulation section 1.1092(c).

⁴ The increment is \$2.50 if the strike price is below \$25, and in some cases if the strike price is between \$25 and \$50. The increment is \$5 in all cases if the strike price is \$50 or above, and in many cases if the strike price is \$25 or above.

company that has only one class of stock outstanding, the types of options on that company's common stock could be innumerable, and it would be difficult for an exchange to list all possible options on a particular common stock to suit the needs of all investors.

Flex options are listed options with somewhat more flexibility in respect of certain option terms. Flex options may (i) be American or European style (exercisable on the expiration date only), (ii) expire on most days of any month, and (iii) can have strike prices in much smaller increments (generally \$0.125). Because, however, of their customized terms, listed flex options are far less liquid than listed standardized options. If an investor wanted to sell a flex option with terms customized to suit his or her needs (such as a covered call writing strategy), that investor may very well be the only seller of that flex option, and there may be no buyer seeking that exact flex option. In that case, the sole potential buyer for that flex option will be a designated options market maker that will bid for the flex option for its own account. The bid price for flex options thus will reflect a significant discount, because the price is set by the market maker and not by the supply and demand dynamics of an actively traded market. Similarly, if an investor who sold a flex call option later wants to buy back (and thus terminate) the flex option, he or she generally will be able to buy it only from the market maker at a premium offer price. In other words, the bid-offer price spreads for flex options are several times greater than such spreads for standardized options, which reflects the illiquid nature of flex options. As a result, flex options are rarely, if ever, used by investors pursuing a covered call writing strategy.

OTC equity options, by contrast, are private option contracts negotiated and entered into directly by the principals, one of which is a dealer in OTC options. OTC options are not listed on an exchange or traded in a dealer market, and their current market values are not quoted in any public medium. By contrast to listed equity options, OTC equity options offer greater flexibility. An OTC option can be American or European-style in respect of any underlying stock, with any strike price and any expiration date that is mutually acceptable to the parties. Other more generic terms governing the rights and obligations of the parties are standardized, because OTC options are usually documented pursuant to an ISDA Master Agreement or other standardized model agreement. Moreover, although OTC call options are generally sold directly to an OTC options dealer, and not through an exchange or market that brings many buyers and sellers together, there are many OTC equity options dealers to choose from and their business is a very competitive one. It is standard practice for an investor wishing to sell an OTC option to seek bids from several competing OTC options dealers and thereby ensure a competitive price for his or her covered call option.

The Importance of OTC Options for Covered Call Writing

Listed equity options and OTC equity options neatly complement each other when it comes to covered call writing. For example, assume that an investor held 1000 shares of publicly traded ABC stock on January 9, 2004 that paid little or no dividends. Also assume that each share is trading for \$50. The investor decides to engage in covered call writing to increase the cash yield in respect of his or her ABC shares. If the investor wishes to sell American-style call options on his or her 1000 ABC shares with a strike price of \$55 that expire in approximately 10 weeks, then the investor is probably best off in terms of price and liquidity by selling 10 standardized, listed call options (each covering 100 shares) expiring on March 20, 2004.

If, however, the investor determines that the optimum call option to sell for his or her covered call writing strategy would be a 90-day American-style option with a strike price of \$52.25 (which will generate a higher premium than the option described above), that investor will not find a listed option with that optimum strike price and maturity. In fact, the listed option with

the closest terms is the one described in the previous paragraph, and for purposes of a covered call writing strategy, that listed option is no substitute for the optimum option. Moreover, the investor may sometimes prefer to sell a European-style call option, because it is less likely to be exercised than an American-style option (all other factors being equal). There are, however, no standardized, listed European-style options available.

As an analogous situation, imagine that stock exchanges quoted prices for stocks only in \$5 increments (as opposed to today's quotes in penny increments), and an investor wanted to buy or sell shares for \$17.25 — the investor could not transact at that price and could not execute his or her investment strategy. The investor could trade only if he or she were willing to accept a price of either \$15 or \$20 a share, which is a large deviation from the desired price of \$17.25.

As described in the flex options discussion, above, selling a flex option with the optimum terms generally is not a viable solution for covered call writing strategies, because a flex option is considerably more “expensive” (that is, the bid-offer spread is substantially higher) than a listed or OTC option. In the end, the only market that the investor can turn to is the OTC options market, where the investor will find many OTC options dealers willing to bid for the exact call option he or she would like to sell to optimize his or her covered call writing strategy. The proposed amendment to the QCC rules, under which only OTC options would not be eligible for QCC treatment (whereas listed options, including flex options) would continue to be eligible), would effectively close the door to the OTC options market for investors pursuing covered call writing strategies.

To continue the analogy described above, imagine that several competing equity dealers were eager to trade directly with an investor off the exchange at \$17.25 a share, but such a private trade is taxed at higher rates than trades executed on the exchange. Should tax rules discriminate against that private trade, even though it is the economically efficient trade?

Treasury Regulations Making OTC Options Eligible for QCC Treatment

The options markets (both listed and OTC) have grown and evolved considerably since the enactment of the QCC rules by Congress in 1984. With accurate foresight, Congress in 1984 granted Treasury broad authority to issue regulations that could even modify the statutory QCC provisions to the extent appropriate to reflect changes in the practices of options exchanges. One such change was the creation of listed flex options (described above), which the options exchanges developed as a competitive response to the rise of the OTC options market.⁵

To take into account the development of listed flex options, Treasury first proposed regulations in 1998 that addressed only a technical QCC issue raised by flex options and not the issue of whether they would be eligible for QCC treatment.⁶ In response to taxpayer comments, Treasury proposed a more comprehensive set of regulations in 2001 that, among other provisions, explicitly provided that listed flex options and OTC options would be eligible for QCC treatment

⁵ “To compete with this growing OTC market in customized equity options, the [options exchanges] propose to expand their FLEX Options rules to permit trading in FLEX Options on specific equity securities . . .”. Securities and Exchange Commission Release No. 34-36841, 61 Fed. Reg. 6666 (Feb. 14, 1996).

⁶ Notice of Proposed Rulemaking (REG–104641-97), 1998-2 C.B. 75.

(if certain additional requirements were met).⁷ Treasury recognized that as a matter of fairness, OTC options had to be eligible for QCC treatment if flex options were.⁸

In 2002, Treasury issued final regulations that adopted, among other rules, the provision in the 2001 proposed regulations that permitted QCC treatment for both flex and OTC options.⁹ The 2002 QCC regulations set forth carefully crafted requirements for OTC options to be eligible for QCC treatment. In the first place, an OTC option must meet all of the general QCC requirements that apply to listed options, such as term limitations and the requirement that the option not be deep-in-the-money (as precisely defined by the QCC rules). In addition to the general requirements, an OTC option is required to be entered into with an SEC registered broker-dealer or other person such as a bank that meets certain federal securities law requirements (or a trading system that meets certain federal securities law requirements). An OTC option must also provide for prompt payment of a single fixed premium and a single fixed strike price (if exercised). Finally, an OTC option on a particular stock can qualify as a QCC only if there is an outstanding listed option on that stock, so the QCC treatment of OTC options applies in respect of the same group of stocks as listed options. These requirements ensure that OTC options that are eligible for QCC treatment do not lend themselves to tax abuse.

In light of the foregoing, we are at a loss as to why Treasury and the IRS should be overruled and the 2002 QCC regulations repealed. We are not aware of any tax authority supporting the proposition that using OTC options for covered call writing is abusive.

⁷ Notice of Proposed Rulemaking (REG-115560-99), 2001-1 C.B. 993.

⁸ “The proposed regulations also provide that certain OTC options may be QCC options so that OTC options that are economically similar to equity options with flexible terms [*i.e.*, flex options] may enjoy the same tax benefits as equity options with flexible terms.” Notice of Proposed Rulemaking (REG-115560-99), 2001-1 C.B. 993, 994.

⁹ Treasury regulation sections 1.1092(c)-3 and -4 (effective as of July 29, 2002).