ISDA Safe, Efficient Markets

September 4, 2012

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Deputy International Tax Counsel
United States Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Michael Danilack
Deputy Commissioner (International)
Large Business and International Division
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: ISDA Comments on Proposed FATCA Regulations

Dear Ms. Rolfes and Mr. Danilack:

I am writing on behalf of the North American Tax Committee (the "NATC") of the International Swaps and Derivatives Association ("ISDA") with comments on selected issues relating to proposed regulations (the "Proposed Regulations") issued on February 15, 2012, by the Treasury Department pursuant to Sections 1471-1474 of the Internal Revenue Code of 1986, as amended (the "Code")[1], commonly referred to as "FATCA".

ISDA's mission is to foster safe and efficient derivatives markets to facilitate effective risk management for all users of derivative products. ISDA has more than 800 members from 58 countries on six continents. These members include a broad range of OTC derivatives market participants: global, international and regional banks, asset managers, energy and commodities firms, government and supranational entities, insurers and diversified financial institutions, corporations, law firms, exchanges, clearinghouses and other service providers. For more information, please visit: www.isda.org.

Although a number of ISDA members have commented on the proposed regulations either directly or through participating in other trade associations, we felt it important to provide specific comments on how FATCA affects transactions documented under ISDA Master Agreements and their related schedules and annexes. We note these comments may also have applicability to other industry standard contractual relationships

[1] Unless otherwise specified, section references are to the Code. References to regulations are to the Treasury regulations promulgated thereunder.

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that provide for tax gross-ups such as securities lending and repos, but our comments will be focused on ISDA Master Agreements.

Executive Summary of Issues Discussed

- Existing ISDA Master Agreements provide for a tax gross-up of the Payee, even if the Payee does not comply with FATCA.
- The expiration of grandfathered obligations on January 1, 2013 creates significant issues for derivatives.
- The application of withholding to all US source FDAP beginning in 2014 creates additional complexities for derivatives.
- The lack of grandfathering for collateral arrangements raises significant issues for derivatives, even for trades executed before 2013.
- The confusion in the market over whether IGAs will create situations where a home country collects tax on behalf of the US under a domestic law has made amending agreements extremely challenging.

Background

Under all versions of the ISDA Master Agreement that have been published to date[2], if a Payor is required to withhold tax on a payment made to a Payee, the Payor is required to pay additional amounts that will ensure that the Payee receives 100% of the agreed-upon amount (i.e. "gross up the payment"). Historically, derivative transactions documented under an ISDA Master Agreement have not generally been subject to withholding taxes. In the event there has been withholding, this is usually as a result of the local laws of the Payor's jurisdiction. Because such a withholding tax is known to the Payor prior to entering into the contract and its application is not within the control of the Payee, the gross-up is typically an appropriate allocation of tax risk. Under FATCA, however, withholding will generally only occur where the Payee refuses to sign a foreign financial institution ("FFI") agreement with the IRS, something that is completely outside the control of the Payor. Given this risk paradigm, Payors should not be required to accept the risk that a counterparty will fail to comply with FATCA and must now amend their existing ISDA Master Agreements in order to prevent being required to gross up non-participating FFIs for FATCA withholding.

Amending existing agreements is a daunting task as large financial institutions can have thousands, if not tens of thousands, of agreements and each counterparty must agree in writing to any amendment of the ISDA Master Agreement. Although ISDA has published a Protocol that would facilitate the process of amending ISDA Master Agreements for FATCA, this Protocol requires each counterparty to consent to the amendment by executing and sending an adherence letter to ISDA. This leaves counterparties to FFIs with the risk that an FFI might not adhere to the Protocol, causing

[2] Although the 2002 Master Agreement is the latest form, some 1987 and 1992 forms of the Master Agreement remain in use.

significant concern about a potential financial impact of FATCA through no fault of their own.

Whether or not counterparties adhere to the Protocol, Payors are, as further described below, at risk of underwithholding for FATCA in respect of trades with non-FATCA compliant counterparties with respect to a significant number of derivative transactions where there is lack of clarity as to how or whether FATCA applies, and for which Payors may be reluctant to affirmatively withhold under FATCA.

Critical FATCA Dates

We do appreciate the Proposed Regulations provide some relief for transactions confirmed under an ISDA Master Agreement by specifying that transactions entered into prior to January 1, 2013, are not subject to FATCA withholding. However, there remain significant issues surrounding FATCA and derivatives transactions. Concerns about withholding being due under ISDA-documented transactions currently have 4 critical dates:

1. January 1, 2013, from which any new transaction documented under an ISDA Master Agreement may be subject to withholding at some future date.
2. January 1, 2014, withholding on any US source FDAP payments begins. In particular focus are specified notional principal contracts under section 871(m) ("SNPCs"). Discussed further below, withholding in 2014 also includes withholding on any US source collateral posted to collateralize credit exposure resulting from grandfathered transactions.
3. January 1, 2015, withholding on any gross proceeds that can produce interest or dividends that are U.S. source FDAP income. In focus is the termination of SNPCs.
4. January 1, 2017 or later date, withholding on passthru payments, which may be applicable to a transaction entered into on or after January 1, 2013.

End of Grandfathering of Existing Obligations on January 1, 2013

With respect to the January 1, 2013 grandfathering date, particularly with respect to SNPCs, passthru payments on other derivatives and swaps which may be considered to have significant non-periodic payments, the grandfathering date needs to be extended sufficiently past the date when payees will become FATCA compliant in order for counterparties to then have sufficient time to amend their existing ISDA Master Agreements. Many equity, interest rate and credit derivatives transactions executed in January, 2013 will have terms that extend into 2014 and beyond. A number of interest rate and credit derivatives have 5 year terms and would be expected to last well into 2017. With the lack of coordination between the grandfathering date and the earliest possible withholding dates for these types of payments, and the requirements for passthru payments being still largely unknown, counterparties may be taking unknown risk if they confirm a new transaction on or after January 1, 2013 without having amended their

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ISDA Master Agreement to eliminate the gross up requirement for FATCA withholding. This uncertainty as to the future tax treatment of current transactions has the potential to be very disruptive to derivative and capital markets around the world.

To present one very real example, although payments on a swap entered into by a US financial institution would generally not be subject to FATCA, if a non-US swap counterparty enters into a swap under which it could be considered to have made a significant non-periodic payment to the US counterparty, any amounts treated as interest, and any gross proceeds on the swap, would become subject to FATCA. For any counterparty that does not adhere to the ISDA protocol prior to January 1, 2013 (in practice it will be nearly impossible to ensure that every counterparty does adhere by this date), the US financial institution will bear the risk that it would be liable to gross-up for FATCA withholding. Moreover, in many cases it will be unclear whether a swap should be treated as in part a loan for US federal income tax purposes. In these cases, in order to avoid potentially being at risk for not withholding on payments under the swap, the US financial institution will need to ensure that its counterparties not only adhere to the Protocol, but are indeed FATCA compliant, which is not possible on January 1, 2013 given FFI registration will not open until that date. Given these constraints, providing additional grandfathering to allow the market to settle makes logical sense.

FDAP Withholding in 2014

Many of our members understood that the intent of limiting withholding in 2014 was to focus on a subset of withholdable payments that the financial industry already withholds on under Chapter 3. Although comments requested a specific limitation to only US source dividends and interest, the proposed regulations require withholding on all US source FDAP, with the exception of vendor payments. As a result, 2014 withholding applies to a number of situations in addition to straight dividends and interest including: collateral arrangements, deemed loans under swaps (see example above), dividend equivalents covered by 871(m), interest that is treated as US source due to a permanent establishment in the US and swaps where the long party may be treated as the owner of the underlying assets. Many of these additional categories create significant uncertainty in the derivatives markets as alternative characterizations under Chapter 3 did not result in withholding, but can under Chapter 4.

In particular, there are significant concerns related to collateral posted for new and grandfathered transactions. Collateral arrangements for derivatives documented under an ISDA Master Agreement are typically governed by an ISDA Credit Support Annex ("CSA"). Generally, under a CSA, a party will post collateral to cover the net exposure of all transactions confirmed under the relevant ISDA Master Agreement. Collateral may be in cash or in securities, and is typically very strictly defined in the CSA. Cash paid by a US Payor will generate US source interest subject to FATCA withholding. In addition, one of the most commonly permitted security types are US Treasury bonds. As US Treasuries produce US source interest it is very likely that these collateral obligations will give rise to withholdable payments in 2014. This is true whether or not a pledged

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Treasury would have itself been grandfathered (i.e., issued before 2013) as most pledged securities are treated as securities loans for federal income tax purposes and would therefore (if pledged after 12/31/2012) be treated as new - non-grandfathered - transactions. It appears that because the CSA has no definitive term, the Agreement itself is not eligible for "grandfathering". In addition, most collateral obligations will not be eligible under the grandfathered obligation rules. While it may appear that this issue could be solved by simply grandfathering collateral posted for transactions that were entered into prior to January 1, 2013, the amounts required to be posted under the CSA are determined by netting all the various derivatives positions executed under the applicable ISDA Master Agreement. Some of these derivative positions will be grandfathered, and some will not. Because the collateral posted is fungible, the only way to know for a certainty that cash or other assets held as collateral are associated with a grandfathered obligation would to be stop trading prior to January 1, 2013.

The reason the treatment of collateral is so critical is that it is has been argued by some parties in the market that the tax gross-up provision previously discussed would also require the Payor to gross up any payments on collateral that may be subject to withholding tax under FATCA. If this is the case, the withholding tax again becomes the economic risk of the FATCA compliant counterparty, which must gross up when required to withhold on a non-FATCA compliant counterparty absent an amendment to the ISDA Master Agreement. It clearly does not progress the policy objectives under FATCA to require a compliant FFI to bear the FATCA withholding tax risk, especially when that risk that cannot be mitigated in the future because the trade and collateral type have previously been agreed and executed. The only remedy under the current regulations is to amend the ISDA Master Agreement prior to withholding commencing on January 1, 2014. If a non-compliant FFI counterparty refuses such an amendment, the compliant FFI will be required to bear the cost of non-compliance. This uncertainty over the ability to mitigate the risk has produced a great amount of anxiety in the market. Moreover, this risk is exacerbated by the fact that in the approximately $700 trillion OTC derivative market, cash and US Treasuries as well as European Government Securities have become by far the most popular forms of eligible collateral or eligible credit support[3]. Based upon the ISDA Margin Survey from May 2012[4], out of $2,459 billion of collateral received and delivered by respondents against non-cleared OTC derivative transactions in 2011, $139.9 billion (5.7%) represented US Treasuries and $1,901.3 billion (77.3%) represented cash collateral, of which $1331.1 billion was received by US Payors[5]. Out of the $139.9 billion of US Treasuries posted as collateral, $32.2 billion represented US Treasuries delivered by non-US Payors to US or non-US Payees. Even if it is assumed that only one quarter of the $133.1 billion of the cash collateral received by

[3] Although any type of collateral or credit support could be eligible to be posted by the parties under the CSA, parties usually insist on designating only collateral that is highly liquid, easily valued and easily transferred.
[4] ISDA Margin Survey 2012, available at www.isda.org.
[5] *Id.* Table 2.1

US Payors was delivered by non-US Payees to such US Payors, these numbers represent an enormous FATCA withholding tax exposure[6].

Gross Proceeds Withholding in 2015 – Expanded Application of 871(m) for Chapter 4

Many of the items discussed in the sections above may have applicable gross proceeds withholding in 2015, which is a matter of great concern. In addition, under section 1.1473-1(a)(3)(ii)(B) of the proposed regulations, gross proceeds from the termination of a NPC are subject to FATCA withholding if the NPC is of a type that "can" produce dividend equivalent payments as defined under 871(m). That means that FATCA withholding could apply to a termination payment on an NPC even where 871(m) does not make any portion of the payment U.S. source. To illustrate, a contract that is generally only "price only", but provides for adjustments in the event of extraordinary dividends would be a contract that can produce dividend equivalent payments if one of the 7 factors are present, even if there is never an extraordinary dividend. Given the uncertainties as to how FATCA should apply in this case (or what it means to withhold on "gross proceeds" in this context), financial counterparties may be unwilling to withhold on gross proceeds, and would be at risk to the extent any counterparty is not FATCA compliant.

Difficulties Amending Current ISDA Agreements due to Uncertainty over How IGAs Will Affect the Landscape

In addition to the time constraints involved in amending ISDAs and the uncertainty over the ability to mitigate the tax risk of counterparty non-compliance with FATCA, the fast moving landscape on Intergovernmental Agreements ("IGAs") has made it challenging to draft a standard provision for ISDA Master Agreements to address FATCA risk that will withstand the test of time. In particular, many of our members have raised concerns that the IGAs could change the way FATCA withholding operates in the future. Although the Model 1 IGA helps to address local law concerns and provides that the FFIs in a number of countries will all be compliant, uncertainty over the final FATCA landscape makes it more difficult to get counterparties to agree to FATCA language. Many counterparties may wish to wait until Final Regulations and the next round of announced FATCA Partner Countries prior to agreeing to amend their ISDA

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[6] The numbers presented in the text are conservative and the amount of collateral that gives rise to US source FDAP payments is likely larger in reality. While the ISDA Survey acknowledges that some of the numbers quoted in the survey include double counting (see Appendix 2 therein), the survey also provides an "estimated total amount of collateral in circulation in the uncleared OTC derivatives market", which includes an estimate of the additional collateral delivered to or received from non-respondents. This figure was approximately $3.6 trillion in this survey, which is significantly larger than the $2,459 billion of total ***reported*** collateral in this year that is cited in the text (see Chart 2.1 therein). Moreover, the numbers that are cited in the text do not take into account collateral that is posted by non-US persons in the form of US municipal bonds and US corporate securities that also produce US source FDAP payments.

Master Agreements. Given we are already in August and a mass contract remediation project can take an average sized institution at least 6-12 months to complete, clearly there is a need for more time to allow proper transition in the capital markets.

Recommendations

In light of the current state of the Proposed Regulations and the IGAs, ISDA would recommend the following:

- **Grandfathering of derivatives transactions until January 1, 2015:** Given the complexity of amending existing ISDA Master Agreements and the complications of trying to withhold on payment types
- **In combination with the grandfathering of derivatives transactions, all collateral posted under grandfathered transactions should also be grandfathered**: The posting of collateral is merely an extension of the derivatives transaction. Collateral related to a derivative should benefit from the same grandfathering as the underlying trade.
- **Grandfathering of obligations that produce foreign passthru payments should also be extended beyond December 31, 2012:** In addition, ISDA would recommend that, with respect to obligations that can produce foreign passthru payments the grandfathered obligation date be extended to a date no earlier than January 1, 2015, but at least 12 months after Final Regulations defining foreign passthru payments are issued.

We thank you for the opportunity to comment on the Proposed Regulations and would be happy to discuss with you further either via phone or in person the issues presented in this comment letter.

With best regards,

Sincerely yours,

Thomas Prevost

Thomas S. Prevost

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