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November 20, 2012

Delivered Electronically

Manal Corwin
Deputy Assistant Secretary (International Tax Affairs)
United States Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Re: ISDA Comments on Grandfathering Provisions of Announcement 2012-42

Dear Ms. Corwin:

I am writing on behalf of the North American Tax Committee (the "NATC") of the International Swaps and Derivatives Association ("ISDA") with comments on the grandfathering provisions included in Section VI of Announcement 2012-42 (the "Announcement") issued on October 24, 2012, by the Treasury Department related 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.

ISDA has previously submitted comments proposing the extension of the grandfathering provisions of FATCA in order to allow for the capital markets to operate in an efficient manner. Following the provisions in the Announcement, we believe that the grandfathering provisions require additional modifications in order to ensure that FATCA does not have a negative impact on the US derivatives markets. Below we discuss the issues with grandfathering still remaining after the Announcement and proposed changes that would address those issues.

Issues with the Grandfathering Relief Provided in Announcement 2012-42

Announcement 2012-42 was generally helpful to the industry, but by choosing to only extend grandfathering in limited circumstances some real timing problems remain. In particular, by choosing not to extend general grandfathering past December 31, 2012, financial institutions will be forced to make impossible decisions either to take unknown withholding risk beginning in

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

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2013 or cut client trading lines if clients do not amend documents for FATCA before January 1, 2013. The reason for the impossible choice is mainly because of "gross up" provisions that exist in most types of master agreements, many of which were executed well before FATCA was even proposed legislation. Under these gross up provisions, compliant US and foreign financial institutions may bear the FATCA tax on behalf of clients that are not FATCA compliant and that are not willing to eliminate the FATCA gross up provisions from their agreements.

- *Example*: Assume a non-US counterparty receives during 2014 a $100 payment that is subject to 30% FATCA withholding tax.
  - If the financial institution is required to gross up the payment under the agreement, the financial institution would be required to make an outlay of $142.86 in order to cover the withholding tax due to the IRS ($100/.70)

ISDA members and financial institutions at large have been working for over a year to remediate these tax gross up provisions; however, attempts to convince counterparties to amend documents in absence of executed Intergovernmental Agreements (IGAs) and final regulations have been poorly received by counterparties and have very limited effect on the overall risk of financial institutions. Given the recent announcement by Treasury of all the countries engaged in discussions to conclude IGAs, neither taking unknowable risk nor cutting clients off at the end of 2012 makes sense for the financial markets. Similar to the delay for the new account procedures provided in the Announcement, there are real benefits to being able to wait to make these business decisions until better information about participation is available in the market.

In addition, it is also important that the collateral grandfathering rules provided in the Announcement be expanded to accommodate more of the common forms of collateral posting arrangements present in the financial markets. Also, there are some technical issues with the language in the Announcement that need to be corrected in the Final Regulations in order for the provisions to provide the relief we believe IRS/Treasury intended to provide in the Announcement. Fixes to the language of the Announcement for incorporation in the Final Regulations are outlined below.

Proposed Changes to the Grandfathered Obligation Provisions

1. Move the US Obligation Grandfather date to December 31, 2013

The simplest and most cost effective solution to the concerns raised by the proposed grandfathered obligation rule is a wholesale extension of US obligation grandfathering until the end of 2013. This solution ensures there is no confusion in the market over what is subject to the grandfathering provisions. There is concern that, even if the more targeted fix for master agreements proposed below is adopted, items could slip through the cracks. For example, there are US securities in cross-collateral / cross-margin arrangements in place for clients that would not qualify for the extended collateral grandfathering. Allowing an extension of all US obligation grandfathering until the end of 2013 allows institutions to unwind these relationships, if necessary, while preserving the intended grandfathering on collateral.

Moreover, master agreements are not the exclusive legal form of contracts used in the marketplace for transactions or under which client collateral is maintained. While many of these agreements generally do not include a gross-up for FATCA withholding, FATCA withholding may be required with regard to payments because the client's FATCA status will not be clear by January 1, 2013. If withholding agents end up with large volumes of transactions that are subject to FATCA withholding, the systems build out will be very costly and will need to include all types of agreements (which increases systems complexity and build out time). A number of firms are hoping that they will not have to build these automated withholding systems, based on an expectation that Treasury's IGA program will be broadly implemented allowing institutions the practical option of transacting only with counterparties that are FATCA compliant. However, even based on the timing in the Treasury press release on IGA process, the FATCA status of most counterparties will not be clear until later in 2013. The expectation is that clients will be more willing to document their FATCA status after the marketplace has had a chance to absorb the final regulations and more IGA agreements are made final. If Treasury does not provide the general December 31, 2013 grandfather relief, the fear is that firms will have no choice but to build these extraordinarily expensive withholding systems. This result also incentivizes firms to continue to transact freely with counterparties that are not FATCA compliant since the funds have been spent on the withholding system.

Although we acknowledge full grandfathering creates additional grandfathered debt obligations, we believe the benefit of a clear end of 2013 rule and the relief it potentially provides firms from not having to build FATCA withholding systems outweighs any incremental abuse risk. Moreover, this additional time should not negatively impact a FFI's willingness to promptly participate with FATCA as counterparties will still be reaching out to each other relatively early in 2013 after the regulations are published and the IGA landscape is better known to confirm their participation with FATCA.

2. Under all circumstances provide additional grandfathering relief for master agreements

Short of a full extension of grandfathering till the end of 2013 as discussed above, it is critical that additional relief be provided for transactions executed under the framework of a master agreement. There are numerous master agreement types and a change in market standard language for all of them will require time to be absorbed both in substance and administratively. As noted in the discussion of the issues, until the market has digested Final Regulations and critical masses of IGAs are signed many counterparties may refuse to assume the risk of FATCA withholding, even into 2013. The ISDA protocol that has been outstanding for several months has an adherence rate of only a fraction of 1% of all swap market participants.

In addition, as important as grandfathering transactions under master agreements themselves, it is critically important to grandfather the collateral that supports these transactions. As a result, we would propose if grandfathering is not wholly extended until the end of 2013, the following provision be added to grandfathering in the Final Regulations:

- The term "grandfathered obligation" includes any transaction entered into before January 1, 2014 under a "Master Agreement".

- For purposes of this provision, a "Master Agreement" is any agreement, whether or not governed by US law, in respect of transactions (including, but not limited to, any swap or options transactions, derivatives transactions (whether exchange traded or otherwise), securities borrowing and securities lending transactions, repurchase transactions and reverse repurchase transactions, futures contracts, or any purchase or sale of a security, including a forward purchase or sale of a security) entered into between the parties where the parties separately agree upon the specific economic terms of each transaction entered into under such master agreement (e.g., specific transaction type, asset underlier, term and pricing), including, without limitation, for purposes of clearing such transactions with a central clearing counterparty.

- Examples of a Master Agreement include, but are not limited to any master agreement for derivatives published by International Swaps and Derivatives Association ("ISDA"), any Master Repurchase Agreement, Master Securities Loan Agreement, or Master Securities Forward Transaction Agreement published by the Securities Industry and Financial Markets Association ("SIFMA"), any Global Master Repurchase Agreement published by International Capital Market Association ("ICMA"), and any Global Master Securities Loan Agreement published by International Securities Lending Association ("ISLA"), any agreement governing clearing of derivatives transactions with a central clearing counterparty, any similar agreement whether or not published under US law and any agreement that has been agreed between the parties outside of a particular industry published template.

3. Provide additional relief for collateral

Under either relief approach, general grandfathering to the end of 2013 or just the extended grandfathering till the end of 2013 for master agreements, there is also a need to provide grandfathering for collateral. Both approaches assume that a firm can stop trading with a noncompliant client before January 1, 2014. However, firms still need to be able to obtain collateral after January 1, 2014 for their historical transactions. In addition, it is important that the collateral provisions in the grandfathering rule cover all common collateral arrangements. Based on these considerations, we propose a critical change to the collateral grandfathering rule described in the Announcement:

The term "grandfathered obligation" will include any obligation to make a payment with respect to, or to repay, collateral posted to secure any transaction or any combination of transactions entered into before January 1, 2014.

4. Proposed Technical Corrections to the Grandfathering Provisions in the Announcement

Even with the additional grandfathering for obligations and for collateral addressed as proposed above there are a couple of technical corrections needed to the rules in the Announcement in order for them to work as intended. As a result, we would propose clarifying

and adding to the definition of grandfathered obligations as follows (shown blacklined against the text in the Announcement):

- The rule set forth in Prop. Reg. §1.1471-2(b)(2) will be amended to provide that the term "grandfathered obligation" includes any obligation that ~~produces or could produce a foreign passthru payment and that cannot~~ does not produce a withholdable payment, provided that the obligation is ~~outstanding as of~~ entered into no later than the date that is six months after the date on which final regulations defining the term "foreign passthru payment" are filed with the Federal Register. For purposes of this [section], a withholdable payment shall not include a payment made to a United States person (as defined in section 7701(a)(30)).[2]

- The term "grandfathered obligation" will include any instrument that gives rise to a withholdable payment solely because the instrument is treated as giving rise to a dividend equivalent pursuant to ~~section 871(m) and the regulations thereunder~~ the final regulations issued under section 871(m) (and did not give rise to a dividend equivalent pursuant to section 871(m) prior to the effective date of such regulations), provided that the instrument is ~~outstanding on the~~ entered into no later than the date that is six months after the date on which instruments of its type first become subject to such treatment.

We thank you for the opportunity to provide these comments on the Announcement 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 S. Prevost

[2] This change makes clear that swaps between US financial institutions and FFI as well as NFFE would be grandfathered. Although payments to NFFEs would not give rise to FATCA withholding because they would not give rise to either US source income or passthru payments, grandfathering these swaps remains important because if they are not grandfathered, payments made on collateral underlying such swaps would not be grandfathered.

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