April 6, 2012

Karl Walli, Esq.
Senior Counsel – Financial Products
United States Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, DC 20220

Re: ISDA Recommendations - Proposed Regulations Under Section 871(m)

Dear Karl:

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 January 20, 2012, by the Treasury Department pursuant to Section 871(m) of the Internal Revenue Code of 1986, as amended (the "Code").[1] The selected issues represent those that NATC members believe have the potential to have the most significant practical impact on the market for equity derivatives. In particular, we make a number of recommendations regarding modifications to the Proposed Regulations that we believe should be reflected in the final regulations (the "Final Regulations") under Section 871(m).

Summary of Recommendations

Our recommendations can be summarized as follows. Detailed explanations of the recommendations and the rationale for each are provided below.

- Delay the effective date of the Final Regulations, and permanently grandfather certain transactions.
- Limit application of the Final Regulations to transactions that create "delta one" or nearly delta one exposure for the long party.
- Add an "in connection with" standard to most of the criteria for identifying an SNPC.
- Permit a withholding agent to rely on contractual representations of a long party.
- Modify the definition of customized index and clarify the application of certain rules relating to contracts that refer to indices.

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

- Eliminate the criterion that refers to "average daily trading volume." Clarify the application of the public float test and, if it is not eliminated, the ADTV test.
- Reduce the minimum term from 90 to 15 days and clarify the rules for matching offsetting positions to other positions for purposes of determining the actual term of a position.
- Modify and clarify the definition of "special dividend."
- Create an effective exception for non-U.S. dealers who become long parties to an SNPC and for hedges by issuers of structured notes.
- Make various technical and miscellaneous modifications and clarifications.

Detailed Recommendations

1. Grandfathering/Effective Date

Recommendation

Subject to considerations arising from the exact provisions of the Final Regulations, discussed further below, we recommend that the Final Regulations delay implementation of the date on which withholding on dividend equivalent amounts ("DEAs") is required to coincide with the date on which withholding under FATCA becomes required (currently January 1, 2014), or if later, one year after publication of the Final Regulations. We also recommend that the Final Regulations permanently grandfather all "new SNPCs" issued before the date 90 days after Final Regulations are issued. By "new SNPCs," we mean those contracts that would not have been treated as SNPCs under the terms of the statute or the temporary regulations issued contemporaneously with the Proposed Regulations, but that would be treated as SNPCs under the Proposed Regulations (or ultimately, the Final Regulations).

Rationale

In general

Our effective date recommendation is based on the assumption that the Final Regulations will limit significantly, based on the proposals below, the extent of systems modifications and operational adjustments that market participants will need to implement to comply with the Final Regulations. We should note, however, that a number of our members have meaningful reservations about their ability to adapt their systems in the time frame we propose, even if all of our substantive proposals are adopted.

If our substantive proposals are not adopted, and counterparties are required to monitor all of their U.S. equity trading platforms (options, structured notes, swaps, other derivatives, etc.) globally to determine whether the long party has violated any of the tests (or just whether they have reason to know that there is a violation), which seems to be required under the Proposed Regulations, we are concerned that many members will not be able to make these modifications and adjustments for a very long time, *if at all*. In order to provide a more meaningful recommendation on the effective date if our proposals are not implemented in the Final Regulations, it is critical that our members understand better what the actual requirements are expected to be. Only then can we provide a more accurate estimate of how long it will take the industry to comply with the new requirements. Once you have had a chance to review our recommendations, we would appreciate an opportunity to discuss the effective date issue in more detail.

Systems challenges

Even in the "best case scenario," of the Treasury Department accepting all of our recommendations, the challenges facing the industry are daunting. Given the global appetite for investing in U.S. equities, many dealers have multiple locations that trade or sell products where at least part of the value is linked to U.S. equities or equity indices. Even if one assumes that all of ISDA's recommendations are implemented in the Final Regulations, dealers and other market participants still would need to build significant systems in multiple legal entities to capture the information necessary to determine if withholding tax is due and to pay over the withholding tax. Given that most dealers' trading and payment systems are a patchwork of systems that have been put together over the years as mergers, acquisitions, internal growth and reorganizations have occurred, and new regulatory requirements have been imposed, development of systems to identify contracts on which withholding is required and to implement withholding on those contracts is a difficult, time consuming and expensive undertaking. Assuming all of our recommendations are accepted, the *best case* scenario for systems implementation costs and timing for each dealer is several million dollars and at least one year of build time.

The costs are high and the lead time long because this undertaking will have far reaching effects for each dealer. First, dealers would need to capture and process information from several entities and disparate systems for each dealer group, including a number of foreign entities. Many of these entities will become withholding agents for the first time, and possibly on a large scale.

Second, the work will need to capture multiple product lines (such as swaps, forwards, collars, structured notes, and other contracts). Each product line, which can represent thousands of trades per year, will need to be assessed for potential withholding requirements. In the case of existing transactions, we cannot even be certain that unlimited time to perform diligence will enable dealers to determine if withholding is required after the effective date, given the

extraordinary volume of transactions and the fact that current systems do not capture most of the information that would be necessary to make that determination.

Third, multiple trading areas will need to be trained. It is not sufficient simply to build computer systems. A significant human resources effort will be required to train numerous individuals, worldwide, on the operation of the new systems and the new "rules of the road" for trading desks.

Fourth, multiple trading and payment systems across legal entities and product lines will have to be modified and coordinated. Added to the build out for FATCA withholding and reporting, this type of work is unprecedented.

Fifth, entirely new custody processes and systems will need to be built or modified. In effect, a new system will be required for each different situation where an instrument or contract "sits" with a withholding agent who did not participate in creating the underlying transaction. For example, if an equity linked note ("ELN") is held in a prime brokerage account, the broker that receives a payment on behalf of a non-U.S. client will not know whether all or a portion of that payment is a DEA, even if the broker for some reason knew that the ELN was an SNPC.[2] In this case, the issuer would need to provide information to the broker about any DEA that is paid, and the broker would have to incorporate that information into its withholding system. Clearing members who are withholding agents with respect to listed derivatives would have the same issue, and different systems would have to be built for different platforms such as cleared options, swaps, futures and other products.

Sixth, the fact that numerous entities that previously were not withholding agents would become withholding agents, means that new withholding systems will need to be built, mostly from scratch.

Seventh, in addition to systems for capturing information, processing payments and remitting withholding taxes, brand new reporting systems will need to be created for many entities, and in other cases will need to be heavily modified.

And eighth, virtually all systems will need to be modified to capture data that has never needed to be collected. For example, systems will need to start tracking the declaration date and ex-dividend date of all dividends and determine whether a contract is entered into between those dates.

Building new systems is time consuming because it requires much more than simply writing new code. First, the scope of the project must be determined by surveying existing

[2] Unless the broker or an affiliate was involved in the structuring and sale of the ELN, it would not necessarily have access to sufficient information regarding the computation of payments on the ELN to determine the DEA.

systems to determine which systems contain the relevant information and which systems will be affected by any changes. Once new systems are designed, they must be repeatedly tested to determine that the new systems will function properly with existing systems to accomplish the desired goal and not disrupt the existing functions of the systems. Due to the variety of systems involved and the interrelated nature of their functions, testing to ensure that each existing function will continue to operate correctly is labor intensive and time consuming. As errors are discovered, systems must be modified and iteratively re-tested. This process can take months once the scope of a project is identified and the system is built. Since the financial industry relies so heavily upon systems, the cost of errors resulting from the integration of new systems is very high, and this careful testing phase is absolutely critical.

Compounding the difficulties described above, there are a number of different transactions in which the amount and timing of withholding that would be required under the Proposed Regulations is not clear. For example, the amount and timing of DEA withholding attributable to dividend-based strike price adjustments on options is not specified in the Proposed Regulations (this would remain an issue even if our recommendations with respect to non-delta one transactions below are adopted). It's also not clear in the case of an ELN whether any portion of a final payment that otherwise would be treated as a return of principal could be treated as a DEA. In addition, we have suggested an important revision to the rule contained in the Proposed Regulations for a contract that is not initially an SNPC, but at some future point becomes one. Our recommendation would change the rule that requires withholding for all DEAs paid at any time under the contract and instead require withholding only for payments that are made after the contract becomes an SNPC, with reporting of the prior DEAs. In each of these cases, it would be at best inefficient to begin adapting systems before there is clarity regarding the specific rules.

We also note that the burden of building operating systems to cater to the provisions of the Proposed Regulations would not just fall on the community of dealers. The typical non dealer counterparties for many of these products are hedge funds, and these entities usually don't have the same level of resources or expertise that a dealer has. The Proposed Regulations provide a number of instances where a long party would be liable for a withholding tax under Section 871(m) without any withholding agent being required to withhold. This could be the case where a long party purchases the underlying security at the same time as its equity swap is terminated in a manner that causes the swap to become an SNPC. The short party to the swap may have no withholding liability if it received appropriate representations (see our discussion of representations below) and no reason to know that the long party was making the purchase. Self reporting of the tax would be required, and the long party would have to construct appropriate systems to be able to do so.

Additional potential systems challenges

If our recommendations are not largely adopted, the systems challenges described above would be magnified exponentially, primarily due to what would become a global due diligence requirement for dealers. If the Treasury Department were to reject all of our recommendations, the systems work necessary would require tens of millions of dollars and multiple years to complete, and it is not at all certain that the end result would be entirely adequate to accurately and thoroughly administer the Proposed Regulations.

As mentioned previously, most dealers have multiple trading and payment systems that have been developed over the years as mergers, acquisitions, internal growth and reorganizations have occurred. The biggest hurdle for dealers under the Proposed Regulations would be the due diligence requirements to identify all other equity linked products with the same or cash trading activity in the underlying security across all dealer related parties and various systems. For example, one ISDA member has 20 different systems across numerous client facing entities globally that have equity linked products.

After identifying what equity linked products need to be captured on the new system, and which legal entities need to be included (including continuous monitoring for potential additions), each system's client and product reference data would need to be refined and enhanced to ensure that the dealer could look across all the equity linked positions that a particular client may have on the various systems. Ironically, a task as seemingly simple as identifying a single customer cannot be taken for granted. Since there has never been the need for detailed coordination of customer positions across business units or legal entities, many dealers cannot reliably identify whether a single client has accounts on more than one of its legal entities and systems, because there is no global account identifier. The only way to identify multiple client accounts would be to search for a client account name, but the precise client account name may be different across various legal entities and systems. For example, a client account name could be Hedge Fund, Ltd. on one system and Hedge Fund, Limited on another.

Many dealers also would have similar issues with product reference data. For some products, dealers may keep track of trade details in Excel spreadsheets, from which data would be extremely difficult to extract. While there is an increased focus in the industry on synthesizing and automating client and product reference data across these multiple systems, this project alone will take multiple years for many dealers to complete, even before ensuring that the systems have all of the specific reference data fields required for testing products under the Proposed Regulations.

In addition to the client and product data, various detailed market data about the contract being tested (e.g., notional amount, actual term, pricing date) and the underlying security (e.g., public float, 30 day daily trading volume, special dividends, actual vs. estimated dividends,

announcement and ex-dividend dates) must be gathered and stored to apply the tests. Much of this data is not currently tracked in dealer systems.

Once all client, product and market reference data is both reasonably accessible across the dealer's global group, and the collected information synthesized in the manner made necessary by the Proposed Regulations, considerably more work still would be required. New systems would then need to track the following simply to test a single U.S. equity linked contract:

(a) all of the client's cash trading activity in the underlying security for the entire day at the outset and termination of the contract;
(b) all equity linked products with the same underlying security that the client has in place at the time the client enters into the contract being tested;
(c) all equity linked products with the same underlying security that the client enters into in the first 90 days of the contract, including whatever information is required to determine whether the contract is offsetting (such as delta or Section 1259/1260 test information); and
(d) all underlying securities posted as collateral to the dealer by the client if the dealer is a foreign short party or from the dealer to the client, if the client is a foreign short party.[3]

The steps detailed above are daunting, expensive and time consuming to say the least. Adding to the time and expense, extensive global employee training would be required. Moreover, assuming that the tasks can be accomplished at all, there would be additional challenges, expense and time needed to address custodied and cleared products as well. The foregoing should demonstrate that relief not just on the effective date, but the substantive provisions of the Proposed Regulations is imperative.

Other considerations – effective date and grandfathering

We have made the general recommendation of tying the effective date of the Final Regulations to the effective date of FATCA withholding because there is substantial overlap between the systems work that is required for Section 871(m) and that required for the implementation of FATCA. Moreover, DEA payments that could be subject to withholding under Section 871(m) also could be subject to FATCA withholding and reporting starting on January 1, 2014. Although the specific requirements differ, there are substantial efficiencies to be gained by allowing Section 871(m) systems work to proceed "side by side" with FATCA systems work. For example, it is likely that the same project team and IT staff will work on both implementations.

[3] The number of systems referenced earlier may increase if this step (d) were required in order to capture other unrelated activity, such as sale and repurchase agreements, that a dealer may have with the client.

We feel strongly that grandfathering is the only fair approach with respect to "new SNPCs." We believe these contracts should be grandfathered because it will take considerable time for counterparties to implement processes simply to start capturing the data required to address withholding once the Final Regulations are issued. Without those processes in place, parties will simply be unable to enter into transactions with confidence about whether any particular transaction will be an SNPC.

We have described in considerable detail the operational challenges in applying the various tests going forward. It will be even more difficult to apply the various tests to a large number of existing contracts retroactively, even where good faith efforts to prepare operational systems are currently proceeding apace, but this is exactly what would be required without grandfathering. Given the scope and complexity of the Proposed Regulations, we anticipate that the Final Regulations will have multiple tests that will need to be applied to every transaction in scope to determine whether DEA withholding is required. Even within a single product line, we would expect a very large number of U.S. equity linked transactions to be outstanding on a single day, each of which - assuming our recommendations are accepted - would need to be tested for one or more of the following:

(1) whether the transaction is a delta one product;
(2) whether the transaction has a dividend equivalent; and
(3) whether the transaction fails any one of the seven factors.

Further, much of the information that will be required will need to be provided by the counterparty through representations, which obviously would need to be done in a "manual" as opposed to automated manner. It goes without saying that information relevant to testing such contracts simply will be more difficult for dealers and their counterparties to obtain.

Long dated contracts will pose additional fairness issues. Many of these contracts were entered into long before required DEA withholding could in any way have been foreseen. Market practice with respect to the risk of withholding tax on these instruments is not entirely uniform. In some cases, the risk of any U.S. withholding tax being imposed is borne by the long party (where the documentation permits the short party to withhold as may be required), and in others, the withholding tax risk is borne by the short party (where the documentation requires the short party to "gross up" the long party for any amounts withheld). In either case, the burdened party may, or may not, be entitled to terminate the contract. If withholding is required, the reasonable expectations of one of the parties – depending on which party bears the economic cost of the withholding - would be unfairly compromised.

Delay of the effective date also serves a fairness objective with regard to contracts that are not grandfathered (whether or not our grandfathering recommendation is accepted). A dealer that has entered into perhaps thousands of transactions would need to diligence every single

transaction to determine if withholding is required under the Final Regulations. Depending on the nature of a particular dealer's systems and the frequency with which the dealer entered into such long dated contracts, completing diligence in the time allotted and implementing withholding with respect to those contracts may not be a viable practical possibility. The additional time allows for a reasonable period to negotiate the unwinding of these transactions in an orderly way before withholding is required.

2. Non-delta one instruments

Recommendation

We recommend that Final Regulations apply only to instruments that bear a sufficient economic relationship to a long position in the underlying equity for any amount that is paid to the long party to be treated as a DEA. There are two alternative approaches that we can suggest. The first suggestion is to limit the transactions subject to Section 871(m) to those that provide delta one or near delta one exposure. Because certainty is important for withholding agents, we recommend using a bright line test. One possibility is using a test that is itself based on "delta."[4] Another is applying the NYSBA proposal referring to a retained ownership percentage based on options pricing methodology for purposes of the constructive ownership/constructive sales rules (sections 1259, 1260).[5] The need for certainty for withholding agents is so compelling that even a less universal and economically sensitive approach, like identifying specific types of transactions that are not subject to the rules of Section 871(m) would be preferable to having no bright line rule. Those transactions could include options that are not "deep in the money" by some specified amount, equity collars that have a sufficiently wide band, instruments that are at least 80% principal protected, instruments treated as debt for income tax purposes, and "reverse convertible" bonds.

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[4] In basic terms, "delta" is a measure of how likely an option is ultimately to be exercised. The delta of an instrument relative to a particular underlying security will be between 100% and -100% and reflects the change in the value of the instrument relative to the change in the value of the underlying security, with a delta of 100% indicating a virtually perfect correlation. For example, if an equity linked instrument has a delta of 100%, the price of the instrument will change by $1.00 if the price of the underlying stock changes by $1.00. There will be 100% price correlation between the instrument and the stock. The price of an instrument with a delta of 70% will change by $0.70 if the underlying stock price changes by $1.00. An instrument with a delta of 100% is referred to as a "delta one" instrument. The delta of a non-delta one instrument will change over time and will be sensitive (due to the option price inputs) to time value of the option and volatility of the underlying stock. We would be happy to discuss with you the appropriate percentage of delta to use as well as how best to define and apply an administrable test based on delta.

[5] Under the recommended test, the sum of the price of options that replicated the transaction to be tested would be divided by the sum of the prices of an at the money put option and an at the money call option on the relevant equity security. As applied to a determination under Section 871(m), the transaction would be excluded from being an SNPC if the quotient is less than a specified percentage. Adopting the NYSBA proposal in the context of Section 1259, that percentage would be 90%. *See* New York State Bar Association Tax Section, *Comments on H.R. 846* (May 21, 1997), p.19.

If no bright line test is feasible, an alternative is to treat a transaction as subject to Section 871(m) only if that transaction that would give rise alternatively to constructive ownership under Section 1260 or a constructive sale under Section 1259 if the referenced section were applicable, but without elaborating further on the standards applicable to either section. Although the lack of certainty in this approach may make the judgment that a withholding agent has to make more difficult in certain close cases, this approach would at least leave the market participants with experience in transactions invoking the potential application of those sections to apply relatively familiar principles.[6]

An important issue for clarification is the time at which the test, whatever it may be, is applied. We believe the test should be applied only when the transaction is entered into, and should not be "retested." Thus, for example, say a test based on delta is adopted, and an option when entered into does not meet the relevant standard to be an SNPC whether or not any of the seven specified criteria are met. If the stock were to rise in value so that the option at a later point had a delta of nearly 100%, that option should not become an SNPC (say because the long party was in the market when it purchased the option) solely by reason of the delta having changed over time.

Rationale

The legislative history of Section 871(m) makes it clear that Congress intended to prevent the avoidance of taxation on dividends with respect to certain equity derivative transactions. The common theme of the derivative transactions identified by Congress as problematic is that they all have indicia of being substitutes for what otherwise would have been physical ownership of the underlying security (and not the mere fact that a counterparty had a partial long exposure to the underlying security). The avoidance that Congress was concerned with can only take place when a non-U.S. person gains economic exposure that is comparable to owning the underlying equity. If the economic exposure is not sufficiently comparable to owning the underlying equity, the dividend-related return achieved from that economic exposure cannot be fairly said to resemble a true dividend received due to physical ownership of the underlying security.

Simply put, if the resemblance between a party's economic exposure and physical ownership of the underlying security is sufficiently weak, no aspect of the return to that party can be said to be a substitute for a dividend. If the return to that party is not a substitute for a dividend, tax avoidance on dividends is not taking place. For example, the adjustment in the strike price of an option on account of a dividend payment can no more be said to cause any

[6] As discussed in Part 11., below, we recommend clarification to the term "offsetting position." Although alternatives exist, we would view it as logical to apply the analog of the test adopted to address sufficient similarity to a delta one position for the rules of Section 871(m) to apply. Thus for example, if a 90% delta test is adopted, an offsetting position could be defined as one that has at least an 90% delta relationship with the original transaction.

portion of a payment on settlement of the option to be a substitute for a dividend payment to a non-U.S. person than would be the case if a U.S. person had received the same payment on the option (and who would not be treated as receiving a dividend payment for any U.S. tax purpose).

We understand that if the concept of delta is introduced into the administration of the tax law, that there must be mechanisms for audit and verification. In the case of listed options, a standardized computation of delta is available on Bloomberg. For transactions where a published delta is not available, the parties can be required to reconstruct an accurate calculation of delta.

The concept of testing the tax treatment of a transaction only at the time a transaction is entered into is a familiar one. Whether an instrument is treated as debt or equity, a sale or lease, or an option or current sale all are determined only at the time the transaction is entered into, even though a test at a later time when economic conditions have changed in some respect would have yielded a different result. Constant monitoring of a position to determine its delta or other metrics is simply impractical, as is the possibility of administering withholding with respect to an instrument that fluctuates in and out of being treated as a potential SNPC.

3. "In the market"/addition of "in connection with" requirement

Recommendation

We recommend that the Final Regulations change the standard for several of the SNPC criteria to include an "in connection with" the relevant transaction standard. The specific criteria that our recommendation would apply to are (1) "in the market," (2) "entering into offsetting position," (3) "have more than 5% exposure to public float" and "maximum percentage ADTV," and (4) "short party posting underlying to the long party."

We recognize that an "in connection with" standard for each of these tests might be difficult to administer in some cases. Accordingly, it is necessary to specify clear principles for application of an in connection with test, and ideally Final Regulations would provide a number of realistic examples. Our suggestion is that a transaction meets the in connection with standard if the long party takes the relevant action as part of an investment plan along with the subject swap or other transaction, or would not have taken the action (at the same price) but for having entered into the subject transaction. In addition, to meet the standard, there must be actual knowledge of the "responsible person" at the long party. We would define the "responsible person" as the person who made the investment decision. This person could be a trader if the trader is authorized to make investment decisions (as opposed to merely execute the decisions of others), or the investment manager (or similarly titled person) of the long party who directed a

trader to execute the transaction.[7] Two or more officers or employees of the long party who are acting in concert will be treated as a single person for this purpose, even if they are employed by different entities within an affiliated group.

For example, under this standard, if the responsible person at a long party decided to sell stock and enters into a long position under a swap to replace its physical exposure on the same day as the sale of the stock, the sale would be treated as in connection with entering into the swap. Similarly if within the relevant term, the responsible person who had entered into a swap that was not an SNPC at inception decided to enter into a short physical position with respect to the same underlying security to hedge its synthetic exposure, the swap would become an SNPC. On the other hand, if after one responsible person enters into a long position under a swap that otherwise is not an SNPC, and a different person, who was unaware of the original long position, entered into the offsetting position within the relevant term, that offsetting position would not be treated as having been entered into in connection with the swap.[8]

Rationale

Two or more unrelated positions that an investment fund may happen to establish without knowledge or coordination among those acting for the fund, cannot by their very nature be employed to achieve any tax avoidance. (One can't engage in tax avoidance accidentally.) Nonetheless, the Proposed Regulations appear to allow unrelated and uncoordinated transactions to result in the adverse consequences of becoming SNPCs. This is a far cry from the intentional, coordinated transactions in which a foreign person briefly substituted synthetic long positions for physical ownership of U.S. equity securities – the core transactions that instigated the enactment of Section 871(m).

Moreover, the criteria contained in the Proposed Regulations for a swap to be an SNPC would make it impossible for a very broad segment of the market to determine whether even the most unobjectionable of transactions is not an SNPC. As a practical matter, investment funds will have separate business units, executing different trading strategies, on an entirely uncoordinated basis. Traders or investment managers in one business unit will not confer or coordinate with traders or investment managers in another business unit before executing a trade.

[7] At some firms, the trader doesn't actually make investment decisions. Instead, the firm uses traders to execute the transactions given to them by multiple investment managers. In this situation, it is the investment manager who would know about all of the transactions being executed that are relevant to their potential SNPC transaction.

[8] It should be noted that funds will generally have records reflecting their trading positions by strategy. As a result, IRS Agents should be able to figure out fairly easily what positions were entered into or closed out in a given day. They should also be able to determine if other offsetting transactions in the relevant underlying security were entered into subsequent to the original trade. Moreover, funds will have to keep documentation to prove to their external auditors that they are not running afoul of the withholding rules, which should help the IRS in their determination. As a practical matter, we do not believe that our recommendations will result in marketplace abuses. The IRS also has an anti-abuse rule it can apply.

Accordingly, a trader or investment manager who wishes to execute an unobjectionable long equity swap, and even transacts an entire strategy solely in derivative transactions, simply will not know whether another trader in the same firm is "in the market" that day, and a trader who is selling stock will not know that another trader entered into an otherwise unobjectionable long equity swap on the same day.

Without a relatively constrained "in connection with" test, most market participants will not be able to know whether they are in compliance with the various proposed tests. Even if a fund were able to monitor all positions real time, the fund as a practical matter would need to create systems that assigns the cost of a withholding tax incurred under Section 871(m). It is unclear how a fund would choose to assign that cost, but the end result would be to impose uncertainty on the results on any particular trader or business unit that is pursuing its own trading strategy without any tax avoidance motive. This would hinder the legitimate business of an investment fund without serving to prevent the activities that Congress sought to address with Section 871(m). Perversely, the result would be to favor smaller investment funds over larger ones and single strategy funds over multi-strategy funds, for no good policy reason.

4. **Reliance on customer representations/covenants**

Recommendation

We have three recommendations in this area. First, we recommend that withholding agents should be permitted to rely on counterparty representations and covenants made in the relevant agreement and be insulated from withholding liability absent actual knowledge or "reason to know" that the representation is inaccurate or covenant has been breached. Second, as a critical adjunct to this recommendation, withholding agents should not be treated as having reason to know unless information about other potentially relevant transactions between the entities is readily available in the ordinary course of business to the "responsible person" at the withholding agent entity (i.e., the person who makes the investment decision to enter into the transaction that generates a DEA).

Third, we recommend that the Final Regulations clarify that the withholding agent's liability for withholding should begin only with respect to DEAs relating to SNPC payment dates after such time that the withholding agent has knowledge under the applicable standard. To protect the Treasury's interest with respect to DEAs relating to earlier payment dates, the withholding agent should be required to report to the IRS those amounts along with the name of the payee. At a minimum, it should be clarified that a withholding agent does not have exposure to interest and penalties for having failed to withhold on amounts with respect to payments on an SNPC before at least 30 days after the withholding agent had the requisite knowledge to trigger its responsibility to withhold.

Rationale

Reliance on representations and covenants[9] is critical because the withholding agent will in many cases not have access to information regarding circumstances that could cause a transaction to be an SNPC. For example, the withholding agent would not necessarily know whether a long party was in the market or entered into an offsetting position within the relevant term, where the long party's other transactions took place with a party unrelated to the withholding agent, or even with a different desk at the withholding agent. Clearly it would be improper to impose liability on a withholding agent who did not have actual knowledge or reason to know of those transactions. In a large organization, for example, the equity swaps desk generally doesn't know what transactions the cash desk or options desk are entering into, unless another desk's transaction affects their transaction, pricing or is otherwise related. Moreover, we don't think it is feasible for dealers to build comprehensive monitoring systems across products and across legal entities, particularly entities in different jurisdictions.

Imposing constraints on the reason to know standard is a necessary adjunct to both the recommendation to adopt an "in connection with" standard and generally permitting the withholding agent to rely on representations and covenants. The common reason for both of those recommendations is that the withholding agent cannot reasonably be held responsible for facts that it does not have access to.[10] In applying this principle, it must be recognized that as a practical matter, there may be any number of transactions that are conducted between the two counterparties (and related entities) for which monitoring in real time is not realistic. For example, say that a withholding agent generally is permitted to rely on representations and covenants, but that withholding agent could have potential liability based on a "reason to know" standard where the withholding agent might as a theoretical matter have access to information (e.g., the execution of an offsetting position within the relevant term requirement) within its own or affiliated institutions, all with multiple regions and trading desks whose activities are not coordinated. If this were the case, much of the purpose of permitting reliance on representations and covenants is defeated because accessing and analyzing that information is not practical. If a withholding agent could be considered to have reason to know based only on theoretically available information and not reasonably constrained readily available information, the in

[9] In practice, we would anticipate that market participants would use a combination of representations and covenants. Representations would relate to relevant facts that are known as of the time a contract is entered into and covenants would relate to relevant facts that would not be known until a time in the future. For example, upon entering into a swap, the long party might represent that it is not in the market in connection with entering into the swap, and covenant that it will immediately notify the short party if it enters into an offsetting position that is treated as terminating the swap within the minimum term requirement or is in the market in connection with the termination of the swap.

[10] Guidance under the so-called FATCA rules in Sections 1471-1474 reflect the need of withholding agents for certainty as well as a recognition that the party making representations will not always have complete or perfect information. For example, the proposed FATCA regulations allow FFIs to document existing individual accounts based on criteria designed to address the burdens of an overly broad "reason to know" standard.

connection standard itself becomes theoretical because the withholding agent would have no choice but to withhold. Since intent is a key element to the in connection with standard, the mere fact that there may be other transactions involving the same parties and information relating to those other transactions is theoretically available in the withholding agent's operational systems should not be sufficient to deem a withholding agent to have reason to know and to impose liability on the withholding agent.[11]

With regard to "retroactive withholding liability," if withholding liability is imposed on a withholding agent for amounts attributable to DEAs associated with payments prior to the time that the withholding agent knew of its withholding responsibility, the credit analysis and practices associated with all derivative transactions would need to change dramatically. Even for transactions, such as swaps, for which dealer counterparties provide credit support in the normal course, collateral systems will need to be substantially modified to account for the credit risk associated with respect to a retroactive application of withholding. Instead of creating a potential credit problem for withholding agents and requiring a change in industry practices, we believe it would suffice if the withholding agent were simply required to report to the IRS the amount of withholding for prior payments that otherwise would have been required. Finally, if our recommendation regarding retroactive withholding liability is not adopted, it is obviously unfair to subject a withholding agent to interest and penalties for failing to have withheld before a point in time when the withholding agent knew or had reason to know of its obligation to withhold. Our recommendation that withholding agents should be allowed at least 30 days after determining that a contract is a SNPC to do the withholding without suffering interest or penalties is based on the fact that knowledge of a contract becoming an SNPC after it is entered into often will come from outside of the withholding agent's computer systems. Hence "transfer" of that knowledge to the systems for generating withholding cannot be assumed to be instantaneous. Again, reporting of the prior amounts should be sufficient to address legitimate concerns.

[11] It is important to note that the "reason to know" issue is considerably different for the withholding agent in the context of potential withholding under Section 871(m) than in any other situation. In all other situations, the withholding agent must make a determination based on the status of the recipient of a payment and in most cases has had the opportunity to collect documentation about the payee's status before the payment is to be made. The withholding agent can be deemed to have "reason to know" if on review of the documentation a reasonable person would see some irregularity in the information collected relative to the status the payee is claiming (such as a United States address for a person claiming to be foreign). In contrast, withholding liability under Section 871(m) would be imposed not based on the status of the payee, but on a potentially complex analysis of voluminous transactions entered into by varying business units and different legal entities.

5. Indices

Recommendation

Alternative definitions of "customized index"

We ask that you modify the definition of "customized index" so that fewer indices would be treated as customized indices. There are several reasonable possibilities for doing so, all of which are consistent with the underlying policy of Section 871(m). One possibility is to reconsider the recommendation in our March 25, 2011 letter to you. In the context of the Final Regulations, that would mean defining a customized index to be an index that is a narrow based index or is not a "qualified index." The definition of qualified index would have two components. First is the definition of "index." We recommend defining an index as (i) a measure of a portfolio of stocks that are chosen to reflect the changing value of a certain market, industry, market sector, geographical sector, combination thereof, or similar segment of the market, (ii) the value of which is determined by reference to the prices of its constituent shares (calculated by reference only to the share value or also taking into account actual dividends paid on those shares), and (iii) that is modified or rebalanced at set intervals according to predefined objective rules (except, in customary limited circumstances, where adjustments must be made to eliminate ambiguities or to preserve the integrity of the index) to most accurately reflect the changing landscape of the particular market, industry, market sector, geographical sector, combination thereof, or similar segment of the market. The NATC believes an index should include not only the well known indices, but also proprietary indices established by market participants that are intended to achieve the same goals as the widely used indices, and the recommended definition would include both types. The second part of the definition is what makes an index "qualified." We recommend defining a qualified index as any index (i) the value of which is published and publicly available, whether freely or by any license or similar arrangement, or which is made available for use by multiple unrelated parties, and (ii) satisfies appropriate size and concentration tests (except as discussed below).

Using the recommended definition, examples of common indices that would be qualified indices are:

- S & P sector indices
- Dow Jones sector indices
- various MSCI indices
- Russell 3000 total return and other Russell indices
- Proprietary indices that meet the criteria described above

A second possibility is for the Final Regulations to define a "customized index" as an index that is either (1) a narrow-based index or (2) not published by a recognized independent index publisher. A "recognized independent index publisher" means an organization that publishes indices that are created, calculated and compiled by a group of employees that have no

duties other than those related to the publication of the indices, offered for license to all third parties on similar terms, and actually licensed by multiple third party industry participants. The definition includes without limitation, Standard & Poors, Dow Jones, Russell and MSCI.

A third possibility is to maintain the definition of customized index in its current form, but add to those non-narrow based indices that are not treated as customized, any index for which there exists an exchange traded fund ("ETF') that tracks such index.

Regardless of what definition of customized index is adopted in the Final Regulations, we recommend elimination of the concentration tests contained in the definition of a narrow-based index in the Proposed Regulations, provided that the index is (i) an index on which a futures or options contract is traded on a qualified board or exchange, (ii) created and maintained by a third party unrelated to parties to the particular transaction, or (iii) traded in the form of an ETF.

Technical points

There are a number of technical points on which we would recommend clarifications. First, the Final Regulations should explicitly state that transactions linked to "good" indices are not SNPCs regardless of whether any of the seven criteria are met. Second, the Final Regulations should clarify that the relevant testing date of whether an index is customized is the date that the transaction is priced. Third, the Final Regulations should clarify that a transaction that is linked to some combination of good indices or a good index and other measures is not an SNPC as it relates to payments linked to the good index or indices. Examples would be (1) an index consisting of equal parts S & P 500 and DJIA is not a customized index, (2) an index consisting of equal parts S & P 500 and an oil price index is not a customized index, and (3) an index consisting of a long position in the S & P 500 and a short position in the S & P 100 is not a customized index.[12]

Fourth, an index that is substantially similar to a non-customized index should not be treated as a customized index (e.g., a price only vs. total return index). For example, in the event the current definition of non-customized index is generally adopted, Final Regulations should clarify that an index that has the same components as a price return index that is a non-customized index but is total return also qualifies as a non-customized index. As another example, we understand that it is common for swaps desk to execute transactions on a price return index providing for dividends to be paid currently (instead of referencing the total return version of such index which generally would provide for reinvestment of dividends). Thus, Final Regulations should clarify that a swap on a non-customized index with this "current pay" feature also would be exempt.

[12] We would assume that a transaction that involved a combination of one or more customized indices combined with one or more "good" indices would be treated as separate transactions, and DEA withholding would be required on DEAs attributable to the customized indices in the transaction.

Fifth, should the Final Regulations make no change to the definition of customized index contained in the Proposed Regulations, or adopt either of the first two alternatives above, the Final Regulations should clarify that an ETF that tracks a non-customized index should be treated as a non-customized index. Thus, for example, if a long party enters into a swap on an ETF that tracks the S & P 500, and on the same day sells one or more securities that are included in the S & P 500, no portion of any DEA on the swap referencing the ETF should be subject to withholding under Section 871(m).[13]

Sixth, a basket or index often will include a rebalancing mechanic where the exposure to a given underlying security may be increased or decreased. Where the rebalancing is not within the control of the long party, we recommend that the final regulations be clarified that, in such a case, withholding would not apply by mere reason of such a rebalancing.

Finally, the definition of customized index should exclude an index less than 20% of the notional value of which is composed of U.S. equities.

Rationale

An index generally is meant to reflect a market sector or segment, and components of the index (including additions and deletions of those components) are not within the control of the investor wishing to gain exposure to such sector or segment. As such, market participants enter into index swaps primarily for the economic exposure to the index, and also for credit, leverage and other significant non-tax reasons. This is evidenced by the large number of index swaps effected with tax indifferent long parties, such as pension funds. An index swap used for sector trading does not facilitate tax avoidance. Moreover, we note that if an index swap were considered to be an SNPC, withholding tax administration could become exceedingly complex, particularly for indices with large numbers of dividend paying securities.

Our recommendation regarding elimination of the concentration test (or its limitation to proprietary indices) stems from research by some of our members indicating that many commonly used sector indices either would fail the test or are close to failing (and with market movements could fail).[14] Whether an index meets the concentration test on a particular day

[13] A contract relating to that ETF should be an SNPC, however, if any of the criteria that otherwise would make a contract on a single underlying equity were met (e.g., the long party is in the market with respect to the ETF shares in connection with the entering into of the derivative contract).

[14] Some examples, among many, include the: (1) S & P 500 Energy, which has 43 components, with the top 5 comprising 60%; (2) S & P 500 Diversified Financials, which has 27 components, with the top 5 comprising 61%; (3) S&P 500 Info Tech, which has 71 components with the top 5 comprising 52%; (4) S&P 500 Oil and Gas E&P, which has 16 components with the top 5 comprising 59%; (5) S&P 500 Retail, which has 16 components with the top 5 comprising 59%; (6) Dow Jones Semiconductors, which has 45 components with the top 5 comprising 59%; (7) CBOE Oil Index, which has 11 components with the top 5 comprising 57%; (8) CBOE Oil Index, which has 11

generally is not determined for any other purpose. Thus, information regarding whether the concentration test is satisfied is not necessarily readily available, and can be difficult to calculate. If an index meets any of the three criteria we recommend above, there cannot be any serious question that its composition can be manipulated or otherwise used to avoid Section 871(m).[15]

We believe that each of our technical recommendations is self explanatory. All are consistent with the reasoning behind exempting certain indices generally and do not offer opportunities for abuse. Three points merit some further explanation. First, a requirement to re-test an index after a transaction is entered into would be extraordinarily burdensome, and the very nature of an index, however it may be defined, makes continuous redeterminations unnecessary to prevent any manipulation. Second, it is not entirely clear under the Proposed Regulations whether withholding would be imposed where a position in a particular underlying security contained in a customized index was not referenced for the requisite holding period, which may happen because of routine periodic rebalancing. Where the long party does not control the composition of the index, subjecting a long party to withholding tax (on what in practice may be de minimis DEAs) serves no policy rationale, and would require yet additional complex systems adaptation. And third, the clarification relating to ETFs is something we believe to be in the nature of a conforming change. The rationale for excepting certain indices applies equally to ETFs. In the example cited above, there would be no withholding on a swap referencing the S & P 500 itself, if the long party happened to sell one or more of its components on the day the swap was entered into and there is no reason to distinguish that case from one involving swap on an ETF that tracks the S & P 500.[16]

6. Trading volume / public float tests

Recommendation

We recommend elimination of the ADTV test. If a volume limit is viewed as necessary, the ADTV test should not apply to non-delta one transactions (if our recommendation regarding non-delta one transactions is not adopted).[17] The ADTV threshold should then be increased to

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components with the top 5 comprising 57%; (9) S&P 1500 banks, which has 82 components with the top 5 comprising 65 %; and (10) S&P 1500 Software, which has 110 components (!) with the top 5 comprising 63%.

[15] We recognize that our March, 2011 letter recommended using the concentration tests that are contained in the Proposed Regulations. We were unaware at the time we submitted that letter of the difficulties that the concentration test would engender. We believe the alternative criteria we now propose are more than adequate to address any potential abuse of the recommended narrowing of the definition of customized index, however.

[16] Indeed, it is debatable whether the technical rules of the Proposed Regulations would capture any portion of the dividend on the swap referencing the ETF in the hypothetical case. We raise this suggested clarification out of caution over an interpretation of the Proposed Regulations that would in fact impose withholding in this case.

[17] Our remaining recommendations in this section are premised on the Final Regulations adopting our recommendation regarding the exclusion of non-delta one transactions. It is not uncommon for non-delta one

30%. Furthermore, if the ADTV test is retained, only transactions executed by a long party in a single day should be aggregated, and for a transaction that is executed in tranches over multiple days, each day's volume should be tested separately. In addition, the time for determining the relevant ADTV amount should be the day before the initial price of the contract is determined, rather than the "first day of the term of the swap." Another refinement we would suggest for the ADTV test is to base the test on the greater of the trailing ADTV as of the pricing date or the trading volume on the day on which the transaction is executed. Finally, the public float test in the Proposed Regulations is not stated to be as of any particular time and appears therefore to be a maintenance test. To the extent the public float test is retained, the test should be applied only at the time a transaction is entered into.[18]

Rationale

The ADTV test seeks to prevent the execution of a trade of sufficient size where it may be more likely that there has been some kind of direct or indirect "cross" without the knowledge of the dealer counterparty. Given the "not in the market" requirement, the ADTV test is unnecessary to police this crossing concern and would only serve to further complicate the administration of the rules under Section 871(m). Accordingly, our first suggestion would be to relax the test by raising the threshold to 30%. At a minimum, the broad aggregation test is entirely unnecessary. If two parties execute a series of swap transactions on different days that are all relatively small, and the notional of each transaction is below the maximum ADTV, none of the individual transactions is likely to have resulted in a direct or indirect cross. However, the total notional amount of all of the transactions may exceed the maximum ADTV and subject some of the transaction to withholding. Indeed, one can easily envision an example where a swap over 100 shares on a day when ten million shares were traded could be an SNPC for no other reason than the same two parties previously entered into a swap on the same shares (which prior swap is not treated as an SNPC).

In addition, if the ADTV test is retained, it is only practical to measure the ADTV against the notional amount of the contract on the date the contract is priced. Since the ADTV can change between the pricing date and the date that the term contract begins, generally three business days later, a contract that does not run afoul of the ADTV limit on the pricing date,

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transactions to reference more than 5% of the public float or 20% of ADTV. Because the delta is less than 100%, by definition, the short party hedge would be expected to be some number of shares less than the full notional amount of the transaction. The number of shares traded to hedge the instrument could then be less than the ADTV or public float limit even if the instrument's notional number of shares is higher than the limit. For example, the number of shares over which an out of the money option is written will be substantially greater than the number of shares actually required to hedge that position (and by varying amounts depending on the exact delta of the option). Adapting the ADTV or public float tests to non-delta one instruments would need careful consideration if our recommendation regarding these instruments is not adopted, and could add further complexity to the Final Regulations.

[18] Some of our members would recommend elimination of the public float test entirely.

which is the date on which the parties bind themselves, can through no fault of the parties become an SNPC under the Proposed Regulations due to reductions in trading volume in the short period between pricing and the beginning of the term of a contract. On the other hand, if trading levels were to rise sharply and the parties wanted to transact on days of significantly increased volume, we see no harm in allowing them to do so based on that increased volume level.

Regardless of the purpose of the public float test, we do not see the utility of testing a transaction other than at the time it is entered into (and introducing yet additional complexity and administrative burden if continuous testing is required).

7. Term

Recommendation

We recommend that the minimum term should be 15 rather than 90 days.

Rationale

In our March, 2011 letter, we recommended that the term of a contract generally should not be treated as a criterion for treating the contract as an SNPC. We continue to hold that view. We will not here repeat our entire reasoning for the recommendation in the prior letter, but there are two points that we would like to highlight.

First, unlike other types of transactions identified in the Code as having tax avoidance potential based on a specified time period, swaps or other equity derivatives cannot be used as techniques to reduce tax liability. There is no arbitrage inherent in an equity swap like there is in the case of the receipt of a dividend eligible for the dividends received deduction and recognition of a corresponding capital loss that may produce a tax benefit at a significantly higher rate. Similarly, there can be no tax credit generated in an amount disproportionate to the amount of income earned in a short period. This is illustrated by a simple example. Two parties enter into a total return swap over a single share of a U.S. equity security at an initial price of $100. The security pays a dividend of $1 the very next day, and the swap is terminated on the following day. If price of the security is not otherwise affected by changes in the market, the ending price of the swap would be $99, and the settlement of the swap would involve a small payment from the long party to the short party in respect to the interest accrual on the notional amount of the swap (i.e., short party pays dividend ($1); long party pays depreciation ($1) plus interest). It is obvious that the long party achieves nothing from this transaction in the way of economic gain or tax reduction. Thus, the long party's motivation for entering into the transaction is the desire to benefit from appreciation in the stock (net of the reduction attributable to the dividend) in excess of the accrued interest amount – regardless of the term of the swap. Put another way, no one

would enter into a synthetic long position for the sole reason of reducing tax without changing its economic position.

Second, it is clear that Congress did not consider the choice to enter into a long synthetic position instead of buying a physical equity to pose a case of tax avoidance unless other factors were present. Thus, for example, giving effect to Congress's intent, we recognize that a synthetic long position may appear to give rise to potential tax avoidance when the long party in some way substitutes the synthetic position for a physical position that the party otherwise actually would hold over an ex-dividend date. However, so long as there is no such substitution (which is already policed by the "in the market" criterion) the short term of the transaction is a reflection of the long party having accomplished its trading goal in that period and not of tax avoidance. In identifying transactions that have the potential for tax avoidance, some have looked to a short term as an indication of tax avoidance, but we believe it to be the case only where some other indication of tax avoidance (like crossing) is present.

Assuming that a term requirement is considered necessary, we believe 90 days is far too long, given the other protections provided by the Proposed Regulations. Fifteen days[19] is more than sufficient to eliminate transactions that Congress would have identified as improperly avoiding dividend withholding, where the long party cannot be "in the market" or take advantage of short term trade to avoid tax on a special dividend. We also note that many funds offer 30 day liquidity. If a 90 day term is imposed, there is a significant likelihood that withholding tax will be allocated to fund investors admitted after the dividend equivalent payment date and before the termination date, splitting up the benefit of benefit of the dividend equivalent from the burden of the related withholding tax between two different parties. This issue would be significantly mitigated if a 15 day term is used.

8. <u>Estimated / Expected / Special dividends</u>

Recommendations

We recommend generally defining "special dividend" in a manner similar to "extraordinary dividend" under Section 1059, with an appropriate percentage referencing the value of the stock instead of its basis. We suggest 5%.

Although we believe the 5% rule should apply generally, a different rule should be used for listed options (assuming these options are not excluded as non-delta one products). To maintain consistency with the likely terms of the option transaction and avoid potentially serious market disruption, we recommend using the standard applied in the Options Clearing Corporation policy. The standard applied by the OCC is that an "ordinary dividend" is a

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[19] *Cf*. Sections 901(l) and 901(k) (fifteen day holding period required to claim foreign tax credit for withholding on interest or dividend payments).

dividend "paid pursuant to a policy or practice of paying such dividend on a quarterly or other regular basis" (subject to a de minimis rule of $0.125 per share, which we understand virtually never applies). Although the OCC makes a determination of whether the standard is met in each case where a strike price adjustment might follow, we would not expect the IRS to be bound by the OCC's determination (although we would anticipate the tax law and OCC conclusions to differ at most rarely). Further, we understand that most OTC options as a matter of market practice incorporate the OCC rules for strike price adjustments for special dividends. Given the similarity in language and purpose between the definition in the Proposed Regulations and the OCC definition, we also recommend extending use of the OCC definition to all other option contracts whose terms incorporate the OCC definition.[20]

In addition, the definition of a dividend equivalent should exclude (or the definition of estimated dividend should include) any payment or price adjustment for an unannounced "special dividend" (as redefined per our recommendation). Finally, we recommend that Final Regulations clarify that the "implicit" price adjustment for ordinary dividends that are declared before a contract and went ex-dividend after the contract was entered into is not treated as a dividend equivalent, so long as the dividend is not a special dividend.

Rationale

The potential for tax avoidance is heightened when a dividend is higher in amount. Therefore we believe that the main criterion for identifying a special dividend should be its size.

It would be extremely burdensome to effectively require dual calculations of what constitutes a special dividend for a listed option (or OTC option that incorporates the OCC special dividend criteria). Thus, our recommendation is to use the OCC rule where it is used by the parties, and the 5% standard otherwise. Whereas we believe the 5% standard is the most appropriate standard as a general matter, applying the OCC standard solely to option transactions is something we believe is necessary to avoid a burdensome intrusion on the options markets overall. Our recommendation to use the OCC standard for these transactions also is based on the greater clarity of the language used by the OCC, relative to the special dividend definition in the Proposed Regulations. The definition of special dividend in the Proposed Regulation is somewhat vague and overbroad. For example, the definition would capture any first time dividend that a corporation may pay even if it is de minimis in amount and intended to be recurring. The definition also may capture a regular dividend that a corporation reinstates after some hiatus. The OCC language is more readily applied to produce certain and sensible results in these cases.

[20] If the recommendation to use a 5% standard generally is not adopted, we believe the language used by the OCC to define a special dividend should replace the definition used by the Proposed Regulations. The OCC definition provides greater clarity, and would result in fewer interpretive issues.

9. Offshore dealers offering synthetic short exposure (i.e., dealer becomes long party)

Recommendation

We recommend integration of the stock lending and SNPC regimes into a single QSL regime, along with a robust credit forward mechanism that integrates credits for withholding on actual dividends, substitute dividends and DEAs, as contemplated by the statute.

A less preferable solution to the issues arising from a non-U.S. dealer becoming the long party to a transaction referencing a U.S. underlying security would be to exclude from treatment as an SNPC, transactions in which a non-U.S. dealer is the long party, provided the transaction is entered into in the normal course of the dealer's business, i.e., with clients. In the alternative, a QSL-like rule mechanism could be provided for dealers who are long parties. If the foregoing recommendations are not adopted, we would at least ask that the definition of SNPC exclude any transaction between a U.S. and non-U.S. related party, provided the transaction directly or indirectly hedges a transaction between the non-U.S. party and an unrelated party, so long as the transaction between the two related parties was within the scope of their trades or businesses as a dealers in securities or commodities.

Rationale

There is no issue of tax avoidance for a transaction that is executed with a non-U.S. dealer that would have attracted no U.S. tax if executed with a U.S. dealer. Accordingly, the Proposed Regulations favor U.S. dealers over non-U.S. dealers, which causes concerns in the marketplace. Many EU and multinational counterparties have good business reasons (including collateral netting and potentially Dodd-Frank) for wanting to transact with a single EU domiciled dealer.

Section 871(m)(6) authorizes the Treasury Department to create a comprehensive QSL regime for both substitute dividends under stock loans as well as all other amounts that are DEAs under Section 871(m)(2), since the definition of dividend equivalent amount includes substitute dividends. The imposition of cascading withholding taxes clearly is undesirable. Accordingly, the implementation of a comprehensive QSL regime along with a robust credit forward mechanism as described above is logical and would address what we regard as an unintended application of Section 871(m) to the situations identified. Implementation of such a regime is squarely within the mandate of Code Section 871(m)(6). The alternatives described above would not fully remedy unintended and unnecessary cascading withholding taxes, but would at least prevent a number of common and unobjectionable transactions from becoming subject to such cascading taxes.

10. Offshore Issuers of Structured Notes

Recommendation

If our primary recommendation in the preceding section – implementation of a comprehensive QSL regime - is not adopted, we recommend that Section 871(m) not apply to hedges of structured notes issued by foreign entities, whether or not the issuer hedges the structured note issuance with a related or unrelated counterparty.

Rationale

Entities that issue structured notes may or may not be dealers for U.S. tax purposes depending on the instruments they issue and/or the activities they otherwise undertake. Moreover, many dealers contract with unrelated entities to issue structured notes, and those unrelated entities for the same reasons may or may not be dealers. In either such case, the structured note issuer frequently will enter into a derivative transaction with a dealer as a hedge of the structured note. Although the Proposed Regulations contain an exception for transactions between related dealers, the exception would not apply to a transaction between a dealer and a non-dealer structured note issuer, whether related or unrelated, to hedge the exposure on a structured note.[21]

11. Miscellaneous Recommendations / Observations.

We recommend that the Final Regulations do not treat gross up payments as dividend equivalents. We do not see the need to impose withholding on an amount greater than the actual dividend on the underlying security (especially if the issuer of the stock on which the dividend is paid would not have had to pay any gross up amount). If the Final Regulations do not adopt this suggestion, then the relevant gross up payments should be treated as dividend equivalents only for contracts entered into more than 30 days after publication of the Final Regulations.

We recommend exempting equity collars, variable delivery forwards, and other non-delta one contracts (if not otherwise exempted) where the underlying stock is traditionally posted as collateral from the "collateral" criteria rule unless another criterion is also satisfied. Absent the

[21] Moreover, we understand that structured note issuers frequently hedge with physical positions as opposed to derivative positions. This fact pattern also raises the specter of cascading withholding taxes, and is a powerful illustration of why our primary recommendation in Section 9 above, a QSL regime that fully integrates actual dividends and DEAs, should be adopted.

satisfaction of one or more of the other criteria, no potential dividend tax avoidance is implicated in any of these cases.

We recommend clarifying that a payment based on a dividend declared prior to January 1, 2013 (or the relevant later date per our recommendation) when the instrument is not an SNPC is not to be withheld against even if paid on or after January 1, 2013 (or the relevant later date).

We recommend clarifying that for an instrument that references a special dividend on which withholding is required, withholding is not required on any other DEAs unless the instrument is an SNPC for reasons other than referencing the special dividend.

Listed, cleared and custodied instruments (including structured notes) present special challenges in applying the rules of Section 871(m) under the Proposed Regulations, even if all of our recommendations are adopted. For example, since there is no contractual privity between the economic participants to the transaction, delivery and reliance on representations and covenants becomes problematic. We are considering a number of other issues that would arise in connection with these instruments and would appreciate the opportunity to discuss those issues with you.

We recommend removal of the reference to "payments pursuant to a redemption of stock that gives rise to a dividend under section 301" in the definition of dividend equivalent, because the determination of whether this payment constitutes a taxable dividend is made at the recipient/shareholder level and not at the issuer level, and in many instances is not taxed as a dividend. The IRS has not yet issued final regulations under section 302 that would allow withholding agents to rely on certain certifications from shareholders as to whether certain redemption payments constitute withholdable dividends.

We recommend clarification of the meaning of "offsetting positions." The apparent intention of the deemed termination rule is to prevent avoidance of the term requirement, by allowing a long party put itself in the same economic position as it would be in if it had terminated a swap by the simple technique of entering into an identical, but opposite derivative position. Thus, it is apparent that it would be inappropriate for example to use the definition of "offsetting position" contained in Section 1092, which only requires substantial diminution of the risk of loss for a position to be considered offsetting.[22] A more appropriate standard to apply for this purpose is that a position must offset substantially all the economic consequences of the position to which it is being compared. A clear and administrable standard is extremely important, since this test will be applied by non-U.S. taxpayers – both institutional and retail – with respect to each U.S. equity linked instrument during each day of the relevant holding period against any other equity linked instruments that the non-U.S. taxpayer may enter into.

[22] Although the Proposed Regulations use the term "offsetting position" we infer from the absence of a cross reference to Section 1092 definition, that a different meaning in fact was intended.

As an alternative for defining "offsetting position," we would suggest using a standard that reflects the approach taken to define delta one or nearly delta one instruments. Thus if a mathematically based test such as a 90% delta is adopted, then the same standard should apply for determining whether a position is considered to be offsetting. If the standard applied is made to be the standard under Section 1259 or Section 1260, the same standard could be applied in this context.

Furthermore, in addressing offsetting positions, we would appreciate clarification that the increase or decrease in the notional amount of a position is not treated as an entirely new transaction for purposes of applying the SNPC tests. Rather, any increase in notional amount should be treated as a new transaction and likewise any decrease in notional amount should be treated as a terminated transaction. In addition, an "ordering rule" is necessary to apply an offsetting transaction against existing positions. Thus for example, where a party has established multiple long positions in a particular underlying security, and that party enters into an offsetting position, the taxpayer should be permitted to choose any reasonable method to determine which long position should be deemed terminated by the offsetting position (e.g., FIFO or LIFO) and communicate such method to its withholding agent.

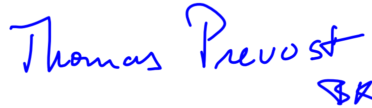
Some practitioners have expressed concern that the payment of a dividend on an underlying equity security triggers the obligation of the short party to an SNPC to withhold and remit tax in respect of the associated DEA, without regard to when payment dates under the SNPC might be. Accordingly we recommend further clarification that the event that triggers the obligation of a withholding agent to withhold an amount pursuant to Section 871(m) is a payment date under the SNPC that reflects a DEA on an underlying equity security. The withholding agent would then remit the required withholding in accordance with normal periodic withholding deposit schedule.

Finally, we recommend clarifying "announcement date" by cross-reference to section 1059(d)(5).

We appreciate your consideration of these issues. We would be pleased to discuss the issues further with you, or provide you with any additional input as you may wish.

With best regards.

Sincerely yours,



Thomas S. Prevost

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