

September 14, 1998

Internal Revenue Service,
P.O. Box 7604, Ben Franklin Station,
Washington, D.C. 20044.
Attn: CC:DOM:CORP:R (REG-104641-97), Room 5228.

Re: Proposed Guidance on Qualified
Covered Call Options

Dear Sir or Madam:

On behalf of the Securities Industry Association ("SIA"),* this letter responds to the request dated June 25, 1998 by the Internal Revenue Service (the "Service") for comments on whether equity options with flexible terms should be eligible for qualified covered call treatment under Section 1092(c)(4) of the Internal Revenue Code of 1986, as amended (the "Code"), relating to the definition of a qualified covered call option.**

* SIA is the trade organization of the securities industry, representing more than 600 stock brokerage and investment banking firms in the United States and Canada. As a group, these firms account for more than 90 percent of the securities business in North America.

** FI-42-94, published in the Federal Register, at 63 Fed. Reg. 34616, on June 25, 1998.

Summary

SIA commends the Service and the Treasury Department for proposing to clarify that the strike prices of flex options do not affect the lowest qualified benchmarks determined by options with standardized terms.

For the reasons set out below, moreover, SIA believes that flex options should be, and in appropriate cases already are, eligible for treatment as qualified covered call options. Final regulations should state this expressly.

SIA also believes that Treasury has the regulatory authority to extend qualified covered call treatment to over-the-counter options and that Treasury should exercise that authority.

SIA also believes that proposed regulations dealing with flex options should be made effective for all options, rather than solely for options entered into after the date on which the relevant regulations are finalized.

I. Background

Under current law, a straddle consisting of stock and a "qualified covered call option" written against the stock may be exempted from the straddle rules under certain circumstances. A qualified covered call option cannot be a "deep-in-the-money" option, which is defined as an option with a strike price below the "lowest qualified benchmark."* The lowest qualified benchmark is determined by reference to the terms of standardized options that are traded on national securities exchanges and is generally defined (with certain exceptions) as the highest available strike price which is less than the price of the underlying stock at the time the option is granted.

On June 25th, 1998, the Service proposed regulations to clarify that the existence of certain

* Sections 1092(c)(4)(C) and (D) of the Code.

exchange-traded options with flexible terms (so-called "flex options") will not alter or otherwise affect the "lowest qualified benchmark" that is currently based on the terms of standardized exchange-traded options.* The preamble to the proposed regulations (the "Preamble") sought comments, however, on whether flex options themselves should be eligible for qualified covered call treatment.**

II. The Qualified Covered Call Exception

The exception from the straddle rules for qualified covered call options was introduced as part of the Deficit Reduction Act of 1984. The exception replaced a broader exception for all exchange-traded stock options with terms of less than 12 months which had been included as part of the original straddle rules introduced by the Economic Recovery Tax Act in 1981.

The 1981 legislation excepted stock and stock options from the straddle rules on the assumption that they could not be used for abusive tax-motivated deferral and "conversion" transactions in light of the wash sales and short sales provisions that already existed under Sections 1091 and 1233 of the Code.*** The 1984 legislation narrowed the exception, however, out of a concern that stock and stock options were being used to defer gain from one taxable year to the next.**** A typical abusive straddle transaction involved the acquisition of "deep-in-the-money" offsetting option positions. Regardless of whether the value of the underlying stock increased or decreased, one

* Prop. Regs. § 1.1092(c)-1.

** See 63 Fed. Reg. 34616 (June 25, 1998).

*** Hearings on Commodity Straddle Transactions held before the House Ways and Means Committee, 97th Cong., 1st Sess. (April 30, 1981), and before the Senate Finance Committee, 97th Cong., 1st Sess. (June 12, 1981).

**** H.R. Rep. No. 98-432, 98th Cong. 2d Sess. ("House Report") at 1266; S. Rep. No. 98-169, 98th Cong. 2d Sess. ("Senate Report") at 288.

option position resulted in loss that could be realized for tax purposes, while the other option position resulted in gain of approximately equal size that could be deferred until the next year.*

The 1984 legislation exempted, however, the writing of certain call options on stock owned by the taxpayer. These "qualified covered call options" were exempted because "they are undertaken primarily to enhance the taxpayer's investment return on the stock and not to reduce the taxpayer's risk of loss on the stock."** Presumably to ensure that this was the primary purpose of the transactions, and in light of the administrative need to determine a lowest qualified benchmark, the legislation limited the definition of a qualified covered call option to include only options that are (a) traded on a national securities exchange (or other market which the Secretary determines has rules adequate to carry out the purposes of the exception), and (b) not deep-in-the-money. (The legislation introduced other limitations that are not relevant here.)

Congress also granted the Secretary authority to prescribe regulations to carry out the purposes of the exception, including regulations modifying the provisions of the exception as appropriate to take account of changes in the practices of options exchanges.*** The recent introduction of trading in flex options on the Chicago Board Options Exchange (the "CBOE") and the American, Pacific and Philadelphia stock exchanges constitutes such a change. As described in the Preamble, flex options are options with terms, such as strike price and delivery date, which vary from the terms of standardized options that are widely traded on the relevant exchanges. Unlike standardized options, flex options can have European or American-style

* Id.

** House Report at 1266-68; Senate Report at 289-91.

*** Section 1092(c)(4)(H) of the Code.

exercise rights, but they generally cannot have terms of more than 3 years.*

III. Tax Analysis of Flex Options

As a matter of statutory analysis, we think that a flex option on stock can meet the requirements of Section 1092(c)(4)(B) of the Code, and therefore constitute a qualified covered call option, in the absence of any express guidance promulgated by the Secretary. We note, in this regard, that flex options are currently limited to options on stocks on which option are also traded through standardized contracts and that their terms are currently limited to 3 years. (Future regulations might have to deal, however, with any further expansion in the range of stock options which can be traded on a national securities exchange.)

A flex option is, by definition, an option that is traded on a national securities exchange, such as the CBOE, as opposed to over the counter.** Such an option will not be deep-in-the-money, within the meaning of Section 1092(c)(4)(B)(iii) of the Code, if it has a strike price that is equal to, or higher than, the lowest qualified benchmark, as defined in Section 1092(c)(4)(D). Although the lowest qualified benchmark will be determined by reference to relevant standardized options, rather than to the flex option itself (as discussed in the Preamble), this should not prevent the relevant lowest qualified benchmark from applying to the flex option. Whether a straddle involving a flex option meets the other applicable requirements for exception from the straddle rules under Section 1092(c)(4) will depend on the relevant facts and circumstances; none of these requirements needs to be modified, however, to accommodate flex options.

* CBOE Rule 24A.4(a)(4)(ii).

** We assume that "traded" effectively means in this context executed and that this language in the statute is not intended to require that identical contracts be actively traded in substantial volume by other persons.

Neither do we see any policy reasons for promulgating regulations to prevent flex options from being treated as qualified covered call options. Taxpayers may use flex options, as well as standardized options, to increase the yield from their stock investments without seeking primarily to reduce their risk of loss from ownership of the stock. Nothing in the applicable legislative history suggests that Congress intended to limit the qualified covered call option exception to standardized options or provides a rationale for so limiting the exception.

IV. Over-the-Counter Options

Flex options were introduced by options exchanges primarily to compete with similar over-the-counter options. Over-the-counter options cannot, absent the exercise of authority granted by Congress to the Secretary, be treated as qualified covered call options. Congress has granted the Secretary authority, however, to treat options that are traded on markets other than national securities exchanges as qualified covered call options, provided that such markets have rules adequate to carry out the purposes of the qualified covered call option exception.*

We think the Secretary should exercise this authority to extend qualified covered call treatment to over-the-counter options. A failure to extend qualified covered call treatment to over-the-counter options would effectively disadvantage dealers in such options as compared to dealers of substantially identical exchange-traded options.

We see no reason, moreover, to limit qualified covered call treatment to options that are traded on a national securities exchange. Taxpayers who hold significant blocks of stock and seek to enhance their investment returns without diminishing their risk of loss from ownership of the stock can and do accomplish this result by writing options to broker-dealers or other persons

* Section 1092(c)(4)(B)(i) of the Code.

in the over-the-counter market. Congress likely did not extend the qualified covered call option rule to over-the-counter options in 1984 because the over-the-counter market was not sufficiently developed at that time. The over-the-counter market first developed substantial volume in the early 1990's. Today, most major broker-dealers and commercial banks offer over-the-counter options to qualified investors. Information distributed by the securities industry and the business press has resulted in more competitive pricing and increased investor awareness of the over-the-counter market. This information permits investors to find the best price for a particular transaction among the various participants in the over-the-counter market.

Neither are we aware of any abuses which could arise from the extension of qualified covered call treatment to over-the-counter options or of any rules which would be necessary to prevent such abuses. The rules of the Securities and Exchange Commission and the National Association of Securities Dealers regarding margin and position limits for listed options apply equally to over-the-counter options. The extending Treasury Regulations could limit any potential for tax abuse by limiting qualified covered call option treatment to over-the-counter options that are (a) on stocks on which options are also traded through standardized contracts on national securities exchanges, (b) are not deep-in-the-money, based on the lowest qualified benchmarks determined by such standardized contracts, (c) have terms no longer than 3 years, and (d) meet the other applicable requirements for treatment as a qualified covered call option that are set out in Section 1092(c)(4)(B) of the Code.

V. Recommendations

Having raised the issue in the Preamble, we think the Service should promulgate guidance expressly clarifying that flex options will, under appropriate circumstances, be treated as qualified covered call options within the meaning of Section 1092(c)(4)(B) of the Code. We also think that any guidance concerning flex options should be made effective for all options, rather than solely for options entered into after the date regulations are finalized. Such

guidance constitutes clarifying guidance rather than an adoption of new rules.

We also think the Secretary should liberalize the requirements of Section 1092(c)(4) of the Code to permit over-the-counter options to be treated as qualified covered call options where the other relevant requirements of Section 1092(c)(4)(B) and applicable regulations are met. We note that over-the-counter trading in options has greatly increased since Congress enacted Section 1092(c)(4) in 1984. We think such guidance would be within the Secretary's authority to designate other markets with "rules adequate to carry out the purposes of this paragraph," as provided in Section 1092(c)(4)(B)(i), as well as within the Secretary's broader authority under Section 1092(c)(4)(H) to prescribe regulations "to carry out the purposes of this paragraph."

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Questions regarding the foregoing may be directed to the undersigned, Patricia McClanahan (202-326-5324) of SIA, or David Hariton (212-558-4248) of Sullivan & Cromwell.

Yours sincerely,

Anthony J. Cetta
Chairman, Committee on
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