November 10, 1998

Lon B. Smith
Assistant Chief Counsel
Financial Institutions & Products
Michael S. Novey
Counsel to the Assistant
Chief Counsel
Alvin J. Kraft
Assistant to Branch Chief
Richard Hoge
Attorney
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, D.C. 20224

Jeffrey W. Maddrey
Attorney Advisor
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, D.C. 20220

Gentlemen:

We are writing in response to the recent submission of the Ad Hoc Coalition on Intermarket Coordination (the "Coalition") concerning guidance on constructive sales under Section 1259 of the Code (the "Submission"). We are grateful to the Coalition for its careful reflections and for its efforts to assist the Treasury and IRS in developing effective and workable guidance. We also think the Submission provides a good start for thinking about the relevant issues.

Nevertheless, we disagree with the conclusions reached by the Submission in several important respects. The Securities Industry Association ("SIA") represents, as you know, more than 800 securities firms accounting for more than 90 percent of the securities business done in the United States. These firms hedge the stock and securities positions of their customers in the ordinary course of business, and their activities in this regard play a legitimate and important role in our economy. Hedging has, for example, served to spread some of the losses that have arisen from the recent volatility in the stock market and therefore served to mitigate the impact of this volatility on both the stock market itself and the economy as a whole.

In summary of what is discussed more fully below, we think that Treasury and the IRS should establish reasonable "spread" safe harbors to accommodate most of the hedging transactions entered into by taxpayers at this time. These safe harbors should be designed to assure retention of significant risk of loss and/or opportunity for gain for most hedges of appreciated stocks in most economic periods, taking account of all of the relevant factors, including volatility. Our specific recommendations for reasonable and administrable spread safe harbors are set out further below.

We therefore do not agree with the Submission that spread safe harbors should only be made available for hedges with terms of one year or less. We likewise do not agree that the spreads for such safe harbors should be wide enough to assure retention of significant risk and opportunity on hedges of the <u>most</u> volatile stocks in the most volatile economic periods (at the cost of being unduly restrictive for average stocks or in average economic periods). We likewise do not agree that there should be a single safe harbor for all in-the-money options with terms of more than one year (which is unduly restrictive when applied to longer-term options).

We also do not agree that the determination of whether a hedging transaction results in a constructive sale should be based on the specific volatility of the hedged stock. We likewise do not agree that a hedging transaction should result in a constructive sale if a taxpayer cannot provide "clear and convincing evidence" of the significance of the retained risk and opportunity based on such stock-specific volatility. We likewise do not agree that Congress has required the Secretary to include the specific volatility of the hedged stock among the standards which determine whether a hedging transaction results in a constructive sale.

We in any case think the approaches proposed by the Submission are somewhat misleading in theory, burdensome in practice and unnecessarily restrictive. We also think they would favor hedging through listed options over hedging in the over-the-counter markets.

Our conclusions are based on the following considerations:

First, we think it important not to lose sight of the fundamental purpose of the guidance in question. Congress has directed the Secretary to determine which transactions will result in constructive sales because they have “substantially the same effect” as completely offsetting derivative transactions. The legislative history anticipates that transactions will result in constructive sales if they have the effect of eliminating “substantially all” of the taxpayer’s risk of loss and opportunity for gain from the relevant financial position. Obviously the significance of the retained risk or opportunity must be considered in relation to the value of the position itself. Congress has not directed the Secretary, however, to compare the retained risk and opportunity to the risk and opportunity of an unhedged position. If the retained risk or opportunity is significant, and the hedge therefore does not have substantially the same effect as a completely offsetting derivative transaction, the risk and opportunity of an unhedged position is arguably irrelevant.

We think it important to consider, moreover, that the portion of the taxpayer’s risk and opportunity from changes in price around the current stock price is disproportionately significant. Thus, if a taxpayer who owns stock worth $100 purchases a put struck at $95, it would not be reasonable to assert that the taxpayer had eliminated 95% (and thus “substantially all”) of her risk of loss (as compared, for example, to the case where a corporate taxpayer which disposes of 95% of its assets is deemed to have disposed of “substantially all” of its assets). The risk of $5 of loss from a decline in the stock price from $100 to $95 may be as significant as the risk of $95 of additional loss from a subsequent decline in the stock price from $95 to zero, because the former loss is much more likely to occur.

We therefore do not agree with the Submission's assertion that the determination of whether a hedging transaction eliminates "substantially all" of the taxpayer's risk and opportunity should be based primarily on a consideration of the specific volatility of the underlying stock. We think it should be based primarily on (a) the relation between the amounts which the taxpayer stands to gain and/or lose and the current stock price, and (b) whether the gains or losses will arise from increases or decreases in value near the current stock price. We recognize that the applicable legislative history states with respect to collar transactions that "it is anticipated that Treasury regulations will provide specific standards that take into account various factors with respect to the appreciated financial position, including its volatility." The drafters of the legislative history merely "anticipated", however, the standards which the Secretary would take into account. They did not direct the Secretary to take certain standards into account. As noted above, the important point is that the statute directs the Secretary to determine when a transaction has "substantially the same effect" as a completely offsetting derivative transaction, and the drafters of the legislative history think this occurs when a transaction eliminates "substantially all" of the taxpayer's opportunity for gain and risk of loss. They purposefully left which specific standards would determine when this occurs to be decided by the Secretary under regulations, however, because they were in no position, given their limited time frame, to consider the complex questions of logic and practical administration that were obviously relevant. We therefore think the Secretary will be following the relevant statutory and legislative directives if he provides specific standards which take into account such factors as the term of the hedge, the size of the gap between the put and call strike prices (the so-called "spread") and its relation to the value of the stock itself and merely considers the impact of volatility in providing those standards.

Neither is it true, as the Submission suggests, that the New York State Bar Association recommended the adoption of a comparative valuation approach. The New York State Bar Association recommended a spread approach for hedges with terms of five years or less and then went on to consider a comparative valuation approach as an alternative possibility, recognizing at the same time its complexity and expressing concern about the associated administrative burden.[1/] Nor is it true, as the Submission suggests, that the legislative history endorses the comparative valuation approach. The relevant House and Senate reports merely state that one approach that Treasury might take in issuing regulations is to rely on option prices and option pricing models. They also state, however, that it may be appropriate for Treasury to establish spread safe harbors.

We recognize, of course, that a taxpayer who owns $100 worth of Volatile.com has an opportunity for greater gains or losses than a taxpayer who owns $100 worth of Utility Co. If both taxpayers write calls struck at $110 and buy puts struck at $90, however, both taxpayers still stand to gain or lose amounts equal to 10% of the value of their investment if the stock price moves at all. Indeed, the investor in Volatile.com is more likely to gain or lose a significant amount than is the investor in Utility Co. We think it obvious that neither taxpayer has eliminated substantially all of her opportunity for gain and risk of loss and that the transaction therefore does not have “substantially the same effect” as a completely offsetting

---

[1/] See NYSBA Report on Proposed Constructive Sale Legislation dated May 21, 1997 (printed in Tax Notes Today, May 29, 1997) at p. 17: “Accordingly, as in our Prior Report, we recommend such a [spread] safe harbor or presumption for any collar or similar hedge that has: (i) a relatively short term (e.g., not exceeding three or, alternatively, five years); (ii) a total “spread” of at least 20% of the current trading price of the hedged security, and (iii) a spread that includes the current trading price of the hedged security” . . . . “Second, as in our Prior Report, we recommend allowing a presumption based on options pricing, which is more accurate but less easily administrable than the “gross spread” approach.” See also NYSBA Report on prior legislation dated March 1, 1996 (printed in Tax Notes Today, March 6, 1996): “Using option prices to calculate retained risk of loss and opportunity for gain has several limitations.”

derivative transaction. We in any case think it makes little practical sense to assert that the investor in Volatile.com has eliminated all of her risk and opportunity while the investor in Utility Co. has not. As noted above, the investor's ability to profit or lose money from the first 10% of the appreciation or depreciation in the value of the stock gives her far more than 10% of the risk and opportunity. We think this may be enough to render the significance of volatility de minimis, or at least not significant enough to justify the promulgation of complex and administratively burdensome regulations.

In this regard, we think the methods proposed by the Submission for determining the significance of retained risk of loss and opportunity for gain are poorly suited to the retail market (i.e., the options exchange market) to which they are directed. We have difficulty envisioning less sophisticated taxpayers applying a formula set out in applicable Treasury regulations to the closing prices of the relevant stocks for the past 90 or 365 days to compute the historic 90-day or one-year volatilities of those stocks, let alone going on to use a formula such as the one set out in Exhibit 1 of the Submission--which has 10 variables and involves natural logarithms and cumulative normal density functions--to compute the values of each of four hypothetical options on each relevant stock and insert them into a fraction. We think that such regulations would significantly disadvantage less sophisticated taxpayers who were not in a position to hire bankers to evaluate these complex mathematical expressions.

Equally important, we do not think these methods serve their purported function in a reliable manner. For example, the Submission proposes a "probability approach" under which a taxpayer would be deemed to have retained less than 10% of the risk of loss and opportunity for gain if the probability that either a relevant put or a relevant call would wind up in the money was greater than 90%. Consider again, however, the taxpayer who owns a share of Volatile.com worth $100. Suppose she buys a put struck at $80 and a call struck at $120, but a share of Volatile.com is expected to be worth either $0 or $200 when the put and call expire and the probability of its being worth between $80 and $120 (i.e., of neither the put nor call winding up in the money) is 0. We think it obvious that the taxpayer has nevertheless retained the opportunity for substantial profit (i.e., $20) and risk of loss (i.e., $20) from her $100 investment. Any other conclusion would not be implementing the will of Congress, which clearly did not intend to treat so-called collar transactions as resulting in constructive sales.

Likewise, the Submission proposes a comparative valuation approach which compares the value of the relevant put and call option to the value of an at-the-money put and call option, on the theory that (a) the difference between the two values represents the value of the retained risk, and (b) the value of the at-the-money put and call options represents the value of the total amount of risk. The derivatives experts we have asked, however, maintain that there is no such thing as the value of the retained risk or the total risk, or if there is, that the comparative valuation approach does not measure them. The relevant values of puts and calls are derived from put-call parity and reflect the values of the cost of carrying the underlying stock. The comparable valuation approach may serve, therefore, to value the right to receive an amount equal to the difference between the strike prices of the relevant put and call, but this does not equate with the amount or significance of the retained risk. The results under this approach are determined, moreover, by “historic” volatility, which can diverge substantially from implied volatility (i.e., the volatility which investors actually perceive, based on the prices they are willing to pay for options). For example, the value of an option on a stock which has recently been very volatile is lower than the value derived from historic volatility, because investors anticipate “regression to the mean” (i.e., the unusual volatility was partly an historical anomaly which is not likely to be repeated).

We in any case urge the Treasury and IRS to consider the very important point that volatility changes over time. It is at precisely those times when stocks are most volatile that taxpayers are desirous of hedging their positions, for perfectly legitimate business reasons. And it is at precisely those times that taxpayer protection against risk of loss is most important to the economy as a whole. The volatility-based approaches proposed by the Submission would force taxpayers to substantially widen their collars whenever volatility increased. We doubt that this is a result desired by Congress. If Congress effectively concluded that a three-year put struck at $90 and a three-year call struck at $110 should not result in a constructive sale because it is not substantially equivalent to a completely offsetting derivative transaction, we doubt it would reach a different conclusion merely because the underlying stock had become more (or less) volatile. The approaches proposed by the Submission would profoundly limit the ability of taxpayers to enter into hedging transactions at precisely the time when they were most needed.

Second, we are greatly concerned by the fact that the Submission proposes to limit "spread" safe harbors to hedges with terms of one year or less. Like the New York State Bar Association, we endorse the use of spread safe harbors as a simple and practical approach, and as an approach which may be as technically accurate as any alternative that has been proposed to date. We think that any safe harbors based on a spread approach should be extended, however, to cover hedges for a long enough period of time (e.g., up to 10 years) to be relevant for hedging in the over-the-counter markets, rather than solely for hedging through options listed on options and securities exchanges. This is partly because, in light of the difficulties and complexities associated with the application of guidance based on stock-specific volatility, we think the spread safe harbors may be the only guidance which taxpayers and auditors use as a practical matter.

We are also concerned that such safe harbors not (as the Submission suggests) be made wide enough to ensure that taxpayers retain significant risk and opportunity when they hedge even the most volatile stocks. We think they should be designed with a view to accommodating the average stock, or at least a broad range of stocks. Most of the hedging that is done in over-the-counter market is of higher capitalization, lower volatility stocks which trade in sufficient volume to permit securities dealers to hedge their clients on a cost-effective basis. The spread safe harbors proposed by the Submission are designed to ensure retention of at least 10% of the risk of loss and opportunity for gain (based on the “comparative valuation” and “probability” approaches proposed by the Submission) for stocks in the 99th percentile of volatility (i.e., small capitalization stocks of “start-up” companies that are almost never hedged in the over-the-counter market). Moreover, the Submission uses 90-day historic volatility for this purpose, which is much higher than one-year historic volatility (i.e., stocks are less volatile in the long term).

As a result, the approach suggested by the Submission would effectively require a spread equal to 40% of the current stock price (e.g., for a stock worth $100, a put struck at no more than $80 and a call struck at no less than $120) for a four-year hedge.[2/] We think this is far too wide. It is quite clear, for example, that Congress did not think a typical over-the-counter collar transaction with a three-year term and a 20% spread would result in a constructive sale. In fact, that is similar to the economics of many “DECS”-type transactions wherein a shareholder transfers to public securities holders all of the risk of loss (other than the risk of a decline in dividends) and the opportunity for gain in excess of 120% of the current stock price on 5/6ths of her shares (retaining all of the opportunity for gain on the remaining 1/6th of her shares). Such a collar is not “substantially equivalent” to a completely offsetting derivative transaction, and all of the individuals who participated in the drafting of the relevant legislation confirmed this fact when the legislation was drafted.

We are similarly concerned that the Submission proposes a spread safe harbor for deep-in-the-money options with terms of more than one year which is (as the Submission itself suggests) far too restrictive for options with terms of substantially more than one year. Thus, a three-year put option could not qualify for the safe harbor if it was more than 20% in the money. Corporations have been issuing so-called “PERQs” securities for years, however, and these

---

[2/] This is based on the Submission’s assumption that the required spread should increase with the square root of the term of the hedge. See p. 22 of the Submission.

securities have the economics of three-year put options that are anywhere from 30% to 50% in the money. As set out in Exhibit B (<u>see</u> examples 14A-15C), even a three-year 50%-in-the-money put option on the <u>least</u> volatile stock (unlike the case of collars, the <u>less</u> volatile stock results in less risk retention) retains more than 15% of the risk of loss and opportunity for gain, using the comparative valuation approach suggested by the Submission. We in any case do not believe that Congress viewed the issuance of a PERQs as resulting in a constructive sale.

In light of the above, we recommend that the Secretary provide for the following spread safe harbors for collar-type hedges with terms of 10 years or less and that these safe harbors apply to hedges of all stocks:

For hedges with terms of 3 months or less, we recommend a minimum spread of 5% of the current stock price; for hedges with terms of 1 year or less, we recommend a minimum spread of 10% of the current stock price (<u>e</u>.<u>g</u>., a put struck at $95 plus a call struck at $105 would qualify); for hedges with terms of 3 years or less, we recommend a minimum spread of 15% of the current stock price; for hedges with terms of 5 years or less, we (like the New York State Bar Association-–see fn.1, above) recommend a minimum spread of 20% (<u>e</u>.<u>g</u>., a put struck at $90 plus a call struck at $110 would qualify); and for hedges with terms of 10 years or less, we recommend a minimum spread of 30% of the current stock price. In order for a hedge to qualify for these “collar” safe harbors, the current stock price at the time of the hedge would have to be less than, or equal to, the strike of the call and greater than, or equal to, the strike of the put. Swaps and other derivative hedges would have to have substantially similar economics.

Likewise, we recommend the following safe harbors for in-the-money put options: for puts with terms of 1 year to 2 years, in the money by an amount that is no greater than 20% of the stock price; for puts with terms of 2 to 3 years, in the money by an amount that is no greater than 40% of the stock price; for puts with terms of 3 to 5 years, in the money by an amount that is no greater than 60% of the stock price; and for puts with terms of 5 to 10 years, in the money by an amount that is no greater than 90% of the stock price (i.e., the strike price of the put cannot be greater than 1.9 times the current price of the stock).

The permissible in-the-money amounts must be smaller for in-the-money call options for two reasons: first, the total amount by which a call option can be in the money is not unlimited (as in the case of a put option) but rather is limited to the stock price; second, because stock prices are generally expected to rise over time, the retained risk becomes less, rather than more, significant as the term of the option increases beyond several years. We therefore recommend the following safe harbors for in-the-money call options: for call options with terms of up to 2 years, in the money by an amount that is no greater than 10% of the current stock price; for call options with terms of 2 to 10 years, in the money by an amount that is no greater than 15% of the current stock price.

As set out in the attached Exhibit B, even using the comparative valuation approach proposed by the Submission, these safe harbors would effectively require the taxpayer to retain between 15% and 20% of the risk of loss and opportunity for gain for hedges of stocks of average volatility and at least 10% of the risk of loss and opportunity for gain for hedges of stocks of exceptionally high volatility (or for hedges of unusually stable stock in the case of in-the-money options).[3/] In any case, these

---

[3/] This assumes that the volatility of the average stock that is hedged by taxpayers is 30%, that the volatility of an exceptionally volatile stock is 50% and that the volatility of an unusually stable stock is 20%. For the following reasons, we think these assumptions are conservative:

Over the past 13 years, the implied volatility of the average stock in the S&P 100 index has been 25.3%. Historic volatility has been approximately the same. See Exhibit C attached. The average volatility of smaller capitalization stocks is higher, but the amount of hedging which occurs in respect of these stocks is (continued...)

safe harbors would assure retention of significant risk and opportunity for the vast majority of stocks in most economic periods. We think this is as far as Congress intended the Secretary to go, and we think it would be reasonable, and within the directive of Congress, for the Secretary to provide for significantly narrower spreads.

Finally, we are greatly concerned by the Submission's suggestion that there be a presumption of a constructive sale in any case where a taxpayer cannot provide clear and convincing evidence of retention of more than 10% of the risk of loss and opportunity for gain based on one of the volatility approaches proposed by the Submission. No safe harbor devised by Treasury and the IRS could possibly cover all of the transactions that are likely to arise over the course of the coming decades. We cannot vouchsafe that there will even be a recognizable "put

---

[3/](...continued)
far smaller, both because the value of the outstanding stock positions is lower and because the positions themselves are more costly to hedge. Thus, the average volatility of the stocks comprising the Russell 3000 Index in the year 1997 (weighted for market capitalization) was 33%, the median volatility was 30.3%, the 75th percentile of volatility was 36.1%, the 90th percentile of volatility was 46.8%, and the average volatility of stocks in the most volatile quintile of stocks was 49.3%. Active hedging in the over-the-counter markets only occurs, however, in connection with stocks of the largest 1,000 companies in the Russell 3000 (i.e., the stocks that are in the Russell 3000 but not in the Russell 2000). The average volatility of these stocks in 1997 was 32.1%, the median volatility was 29.5%, the 75th percentile was 35.5%, and the 90th percentile was 42.7%. Without any weighting for market capitalization, moreover, the median volatility was 30%, the 75th percentile was 38%, and the 90th percentile was 52%. The chart attached as Exhibit A shows these unweighted volatilities. Our volatility assumptions are also discussed in Exhibit B.

strike" and "call strike" of hedging transactions which taxpayers enter into in the year 2010. We think the determination of whether transactions which do not qualify for a safe harbor devised in 1998 have substantially the same effect as completely offsetting derivate transactions (because they effectively eliminate substantially all of the taxpayer's risk and opportunity) must be based on the relevant facts and circumstances taking account of the specific standards that are set forth by the Secretary in regulations. The legislative history urges that the Secretary issue guidance which includes "safe harbors", not exclusionary rules, and we think this means a subset of transactions which are automatically safe, not a presumption that transactions which do not qualify are automatically disallowed. We therefore urge the Secretary to (a) clarify that the mere fact that a hedging transaction does not qualify for a safe harbor does not create a presumption that the transaction results in a constructive sale, and (b) set forth the factors to be considered in such a case in determining whether the transaction does result in a constructive sale.

Thank you for your consideration.

Very truly yours,

Anthony J. Cetta
Chairman, Committee
on the Federal
Taxation of the
Securities Industry