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Re: Section 871(m) 2016 Grandfather Date

Dear Ladies and Gentlemen:

The Securities Industry and Financial Markets Association (SIFMA)¹ is submitting this letter with respect to the January 1, 2016 effective date (the “early effective date”) that applies to longer-term financial instruments under the recently issued final and temporary regulations promulgated under Section 871(m) of the Internal Revenue Code (the “Regulations”). We appreciate and acknowledge the significant effort that went into the drafting of the Regulations

¹ SIFMA is the voice of the U.S. securities industry, representing the broker-dealers, banks and asset managers whose 889,000 employees provide access to the capital markets, raising over \$2.4 trillion for businesses and municipalities in the U.S., serving retail clients with over \$16 trillion in assets and managing more than \$62 trillion in assets for individual and institutional clients including mutual funds and retirement plans. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit <http://www.sifma.org>.



and the consideration that the government gave to the issues that were raised by the securities industry, and we are committed to working with the government to implement the Regulations. While this letter is limited to the early effective date issue, we look forward to working with the government with respect to other areas in the Regulations where guidance is needed, particularly with respect to listed instruments, and instruments, such as structured notes, that are held through intermediary financial institutions.² In addition, we will be devoting a tremendous amount of work and resources to implement the Regulations, including, over the next two months, with respect to OTC delta-one instruments (as detailed below) that are entered into after the early effective date.

For the reasons set forth below, however, SIFMA believes strongly that it is commercially unreasonable to implement the early effective date with respect to other types of financial instruments, and it is essential that this date be deferred to January 1, 2017 for all such instruments other than (a) over-the-counter (“OTC”) delta-one financial instruments with respect to U.S. corporations that are not held through financial intermediaries (such delta-one instruments are hereinafter referred to as “OTC delta-one instruments”), and (b) single stock futures contracts.³ The financial instruments for which we are requesting deferral of the early effective date include OTC non-delta-one financial instruments, structured notes, exchange traded notes, listed options and index futures, and derivatives with respect to partnerships.

As discussed in more detail below, we are concerned that a failure to defer the early effective date with respect to such instruments will cause a significant disruption to the equity derivatives markets that we do not believe was intended by the drafters of the Regulations. In addition, we urge the government to issue the additional guidance described below with respect to OTC delta-one instruments and single stock futures contracts that are entered into in 2016.

We understand that the government is aware of some of the problems that arise from the early effective date but believes that these problems will be mitigated by the delayed implementation (until after 2017) of withholding in respect of deemed dividend payments. As

² Specifically, we believe that in the absence of future guidance regarding the application of the Regulations to listed instruments and structured notes, we are unsure whether the Regulations can be applied to such instruments even if the early effective date is deferred until January 1, 2017. In addition, the application of the Regulations to financial instruments with respect to partnership interests raise numerous issues for which guidance is needed, including the methodology for determining whether a partnership is a “covered partnership” and the process for transmitting the dividend equivalent amount that is attributable to a partnership. We expect to address these issues (as well as other issues) in a future submission.

³ For purposes of the discussion below, when we refer to financial instruments, we are only referring to instruments that are not OTC delta-one instruments.

discussed below, the delayed implementation of withholding will not address many of these issues because (a) there will be many thousands of financial instruments that will have a term beyond 2017 and that could potentially be subject to Section 871(m) and (b) in most cases, it will be essential to *know, at the time a financial instrument is entered into*, whether or not the instrument will be subject to withholding after 2017. In many cases, moreover, it will also be essential to know, at the time a financial instrument is entered into, how such withholding will be effected so that intermediaries know how and whether they can comply with their withholding obligations and so that the relevant documentation can be negotiated. Otherwise, as discussed in more detail below, we anticipate that many foreign investors will not purchase such instruments, and many issuers and intermediaries will refuse to participate in the market for such instruments.

More specifically, the securities industry will be unable to properly implement the Regulations unless all of the following objectives are accomplished *prior* to the early effective date.

First, the securities industry must develop entirely new and complex systems to (a) identify contracts that could be subject to the Regulations, (b) distinguish between complex and simple contracts, (c) compute and retain delta, (d) apply the substantial equivalence test to complex contracts, and (e) apply the delta to the dividend equivalent with respect to a contract that is subject to the Section 871(m) withholding tax. This will involve not only the design, programming and testing of the relevant IT systems, but also the creation, vetting and implementation of internal compliance and certification procedures. This cannot be done on a manual basis because there will be many thousands of instruments that are subject to these rules. Moreover, the industry will have to coordinate to ensure that they are applying such rules in a consistent manner so that equivalent instruments in the market are not subject to different tax consequences. These systems will be much more complex and will require much more development time than the systems necessary to implement Section 871(m) with respect to the OTC delta-one instruments referenced above.

Second, the combination rules will require financial institutions to set up entirely new and very sophisticated systems to identify transactions that are entered into within two business days of each other in the same account, and to then exercise “reasonable diligence” to determine whether any combination of such transactions should be combined into a single instrument that is subject to Section 871(m). As discussed below, this cannot be done on a retroactive basis. In addition, there is significant uncertainty as to how the combination rules apply in certain cases and the IRS has asked for comments regarding the combination rules. There is accordingly a significant likelihood that additional guidance will be issued with respect to such rules, which would effectively require taxpayers to retroactively change their systems.

Third, the government must issue guidance as to who is responsible for calculating and transmitting the delta and dividend equivalent amounts for listed options and futures because the Regulations do not adequately address this issue. This is further complicated by (a) the manner in which such instruments are sold and traded, which includes standardized contracts, exchanges, clearing houses, clearing brokers and execution brokers and (b) the potential that such instruments will be treated as newly issued each time they are sold which will require a new delta computation in respect of each sale. Furthermore, once guidance is issued regarding these matters, industry-wide systems will need to be created for transmitting delta and dividend equivalent information among market participants. We are concerned that, in the absence of such guidance and systems, many market participants will refuse to participate in these markets after the early effective date because of an understandable concern that future guidance could cause them to be responsible for Section 871(m) withholding taxes for which they may not be reimbursed or could cause them to be responsible for complex delta computations.

Fourth, the government must similarly issue guidance as to how delta and dividend equivalent amounts will be transmitted in the case of financial instruments, such as structured notes, that are held through intermediary institutions. Industry-wide systems would then need to be developed to implement such guidance. Furthermore, guidance must be issued as to how withholding taxes will be imposed upon a sale of such instruments in the secondary market. If the issuer is the withholding agent, the issuer will have no payments upon which to withhold and in any case generally will have no knowledge of the sale. In the absence of such guidance, we fear that many market participants will refuse to participate in these markets after the early effective date due to a concern that future guidance could cause them to be responsible for Section 871(m) withholding taxes for which they may not be reimbursed. In particular, we understand from personnel at Euroclear and Clearstream, which generally act as the intermediary for foreign investors in structured notes, that they may no longer act as intermediaries for any structured notes that could be subject to Section 871(m) until guidance is issued with respect to the issues described above and systems are developed to implement such guidance.

Fifth, SIFMA members and their clients and counterparties must develop and agree on changes to the transaction documentation for financial instruments that reference U.S. equities to ensure that (a) there is no gross-up for any Section 871(m) withholding taxes and (b) withholding agents are indemnified for any Section 871(m) tax liabilities that they incur with respect to such instruments. This is particularly important because most financial instruments that are subject to the Regulations will be subject to the risk that the withholding tax could exceed the amount that the withholding agent will actually pay to the holder of the instrument.

Sixth, the securities industry must educate employees in numerous offices around the globe, many of whom are non-U.S. individuals with minimal experience with U.S. tax rules, regarding the very complex and detailed rules in the Regulations. These employees will in turn have to ensure that the new withholding rules are properly disclosed to clients and counterparties. Whether and how these withholding rules will apply to investors will have to be disclosed to investors before they enter into a transaction because otherwise presumably they will refuse to enter into the transaction.

Seventh, the securities industry must determine how to apply the novel and complex substantial equivalence test to a broad range of financial instruments. While the concept underlying this test originated from within the securities industry, many market participants are unfamiliar with it, and the securities industry in general is not sure how it applies to many instruments. The government is still seeking comments on the test, and further guidance may be issued with respect to the test that cannot be anticipated as of the early effective date.

It is commercially unreasonable to expect the securities industry to accomplish these objectives in two months, particularly given the number of stakeholders, clients, legal agreements and systems that exist worldwide. This is the first time that a broad-based withholding regime will be applied to “phantom” income inclusions that do not correspond to any payments under the instruments themselves. Industry members are still digesting the details and implications of the Regulations which could not have been fully anticipated prior to their issuance.

We note that most of these issues are not equally applicable to OTC delta-one instruments for which we are not seeking a deferral of the early effective date, and even where they do apply to such instruments, they do not apply to the same extent. More specifically, OTC delta-one instruments are bilateral contracts that are not listed and are not held through intermediaries. In addition, (a) no computation of delta is necessary for such instruments, (b) withholding is applied to dividend equivalent amounts, with no adjustment for delta, (c) the delta and withholding can be more readily explained to clients, (d) the substantial equivalence test does not apply to such instruments, and (e) they are less likely to involve cashless withholding than in the case of options and other non-delta-one instruments. In addition, it will be much easier to set up the systems to impose the Section 871(m) withholding tax with respect to such instruments than with respect to the financial instruments for which we are seeking a deferral of the early effective date. Finally, the delta-one trading desks of our member firms have long expected that Section 871(m) would apply to OTC delta-one instruments and they had a general understanding of how it would do so, and they accordingly have had time to prepare for the application of the Regulations to such instruments. By contrast, there was significant uncertainty



prior to the issuance of the Final Regulations as to whether and how Section 871(m) would apply to non-delta-one financial instruments, and therefore traders in such instruments have not had the necessary time to prepare for the implementation of Section 871(m) withholding with respect to such instruments.

In light of the issues set forth above, we want to make sure that you are aware that, based on past practice, members of the securities industry expect that they will collectively enter into tens of thousands of financial instruments in 2016 that relate to U.S. equities and that will have a term that will extend beyond December 31, 2017. These include many different classes of instruments, including options, index futures, and structured notes.

We are aware of speculation that the issues set forth above could be alleviated if the contemporaneous identification requirements set forth in the Regulations temporarily are relaxed so that they would be satisfied if a transaction is identified at the end of 2016 (at which time the necessary guidance described above presumably will have been issued). This approach incorrectly assumes that market participants would be willing to enter into transactions without knowing whether and how Section 871(m) withholding might apply to the transaction. As noted above, we expect that clients, counterparties and intermediaries will not enter into transactions on that basis. For example, it would likely be impossible to market a structured note to foreign investors, or to find to any intermediaries that would hold such a note on behalf of foreign investors, if the offering document for the notes states that the issuer is unsure whether payments and sales proceeds in respect of the notes will be subject to withholding tax, and, if such withholding applies, it is unclear who would be responsible for collecting and paying the withholding tax. Furthermore, such a “look back” approach effectively would require financial institutions to develop a second set of systems for 2016, thereby introducing additional technological and quantitative complexities at a time when firms will be dedicating all available resources to preparing for the January 1, 2017 effective date. In addition, in many cases, particularly in the case of instruments that are subject to the combination rule, financial institutions will not have the necessary quantitative information to retroactively determine the delta of an instrument that was issued earlier in 2016.

We also note that it will not be possible to terminate most of these transactions prior to 2018 so that withholding never occurs. Most of the financial instruments that could potentially be subject to Section 871(m) do not grant the financial institution that will be the withholding agent the right to unilaterally terminate the transaction. The addition of termination provisions for such instruments would be commercially unreasonable because it would require the entire industry to incorporate these provisions in the documentation for a broad range of derivatives across multiple geographic jurisdictions within the next two months. Moreover, investors and



counterparties that enter into options and other derivatives generally will not grant the broker dealer a unilateral right to terminate a transaction without requiring significant financial concessions. In addition, even if such a termination provision theoretically could be included for such instruments, the termination of all such contracts immediately prior to January 1, 2018 could create significant turmoil in the equity derivatives markets.

As a policy matter, we believe that new and complicated tax rules should not be effective before taxpayers have a chance to fully understand the rules and to implement the proper systems that are necessary to comply with the law. This is particularly the case in respect of new rules, such as the Regulations, which are extremely novel and complex, will be the subject of comments and possible further revisions, and are expected to significantly impact the financial markets. Finally, the failure to defer the early effective date will not only adversely affect the derivatives markets but it would also impair the ability of financial institutions to raise much needed financing via the issuance of structured notes and similar derivatives.

As discussed above, we are not seeking a deferral of the early effective date with respect to OTC delta-one financial instruments and single stock futures contracts. We believe, however, that it is critical that the government issue the following three items of guidance before January 1, 2016 regarding the application of the Regulations to such instruments.

First, many such instruments will relate to a "qualified index." However, the Regulations provide that an index that otherwise is a qualified index will not qualify as such if the holder of the long position with respect to the index enters into a short position with respect to more than five percent of the components of the index. The Regulations do not provide for any presumptions or other rules that would enable a withholding agent to determine whether a counterparty has entered into any short positions with respect to the components of the index. Accordingly, in the absence of any guidance, withholding agents will have no way of knowing whether an index is a qualified index with respect to any particular investor, and may therefore impose the Section 871(m) withholding tax with respect to derivatives on an index that would be a qualified index in the absence of the short position rule described above. Therefore, we urge the government to issue guidance before the early effective date to the effect that withholding agents may presume that a particular investor has not entered into any short positions with respect to the components of an index unless it has actual knowledge that the investor has entered into any such positions.

Second, we urge the government to issue guidance to the effect that the contemporaneous identification rules will be satisfied for OTC delta-one instruments and single stock futures contracts that are entered into in 2016 if the relevant information is identified and recorded no

later than the end of 2016 (as opposed to the ten-day period under the Regulations). That is because, while we expect to be able to determine the delta for such instruments at the time of issuance, we may not be able to fully implement the systems by the early effective date that would record all of the information that is required by the contemporaneous identification rules.

Third, we urge the government to issue guidance that would provide that withholding agents will not be required to combine two or more instruments that are entered into in 2016 into a single OTC delta-one instrument or a single stock futures contract under the combination rules, unless either (a) such instruments are marketed, priced, or sold as part of a single transaction or (b) the withholding agent has actual knowledge that the transactions are entered into “in connection with” each other. That is necessary because, as noted above, it would be commercially unreasonable for financial institutions to set up, within the next two months, the very sophisticated systems that would be necessary to identify transactions within the same account that are subject to the combination rule.

Accordingly, in light of the issues discussed above, we strongly urge the government to issue guidance as soon as possible that would (a) defer the early effective date for all financial instruments other than OTC delta-one instruments and single stock futures contracts to January 1, 2017 and (b) provide the guidance described above with respect to OTC delta-one instruments that are entered into in 2016.



Thank you for your consideration of these issues. Please do not hesitate to contact me at (202) 962-7300 or ppeabody@sifma.org, or our outside counsel David Hariton and Jeffrey Hochberg at Sullivan & Cromwell LLP. David can be reached at (212) 558-4248 or haritond@sullcrom.com, and Jeffrey can be reached at 212-558-3266 or hochbergj@sullcrom.com.

Respectfully submitted,

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