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Invested in America

April 15, 2013

The Honorable Dave Camp
Chairman
U.S. House Committee on Ways & Means
1102 Longworth House Office Building
Washington, DC 20515

The Honorable Sander Levin
Ranking Member
U.S. House Committee on Ways & Means
1106 Longworth House Office Building
Washington, DC 20515

Re: Financial Products Discussion Draft

SIFMA[1] appreciates the opportunity to provide comments and suggestions on the important issues raised in the House Ways and Means financial products discussion draft (the "Draft") released on January 24. We want to commend the Chairman and his staff for initiating an examination of an area of the tax law that is in need of greater consistency and clarity, first by conducting a joint hearing with the Senate Finance Committee on December 6, 2011, and most recently by issuing both suggested legislative language and a draft explanation of relevant reform proposals. In commenting on these proposals, we will cover tax policy issues, administrative issues and, importantly, business-related issues that are of most significance to the financial industry and to individual investors. We believe some of the proposals are sensible but require some tinkering, while other proposals, including the mark-to-market and average basis proposals, raise significant business, policy, and administrative issues that warrant further consideration. In the case of the mark-to-market proposal (the "MTM Proposal"), the definition of a "derivative" that is subject to mark-to-market treatment has been crafted very broadly and in our view needs to be narrowed and further refined so that it is better targeted. We look forward to discussing with Ways and Means staff the intended objectives of the MTM Proposal in order to be able to better assist you in

1 The Securities Industry and Financial Markets Association (SIFMA) brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. 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.

developing the refinements that would narrow its scope and thus ensure that it would not adversely affect routine business transactions and investments, or have other unintended consequences. Until then, please do not hesitate to call our tax counsel, Payson Peabody, at 202-962-9333, or our outside tax counsel, David Hariton, at 212-558-4248, if we can assist you in any way.

I. Proposal to Mark Derivative Financial Positions to Market

As members of the securities industry, we in particular recognize that the development of financial instruments and transactions has outpaced the drafting of the tax rules that are designed to deal with them, and that the current law answers can be improved in many respects. We also recognize how difficult it is to tax financial instruments in a coherent manner that is equitable to investors and other participants and that is consistent with alternative investments that achieve similar economic results. We therefore appreciate the effort to achieve more uniformity in the taxation of financial derivatives.

That said, we believe the MTM Proposal in its current form would have a number of consequences that may not have been fully intended or foreseen and would create a number of practical implementation issues that need to be carefully considered. We are also concerned that the MTM Proposal might not achieve its stated objective of increasing simplicity and consistency in the tax treatment of financial instruments, because it would create new disparities between the tax treatment of certain derivative transactions and economically equivalent underlying securities or alternative transactions. We have no comprehensive alternative to offer to the MTM Proposal, but we look forward to discussing the issues we raise with you further in hopes of helping to better target the MTM Proposal and advance the Chairman's reform agenda. In this regard, we look forward to gaining a better understanding of the Chairman's rationale for concluding that derivative financial positions should be subject to mark-to-market ordinary treatment while their referenced underlying investments should not be, and thus a better understanding of the Chairman's primary objectives in proposing mark-to-market ordinary treatment of the former.

A. Impacted Investments and Transactions

First, and most importantly, we believe the MTM Proposal in its current form would significantly affect the routine investments of Americans seeking to save. All Americans making long term investments expect to obtain the benefit of deferral and capital gains tax treatment of the increase in value of their investments, and they can readily obtain that benefit by investing directly in stocks, securities, commodities, collectibles and real estate. If the MTM Proposal were enacted in its current form, therefore, it would likely discourage Americans from investing in a number of familiar securities that are widely held at the present time, such as structured (or indexed) notes, exchange traded notes, convertible debt, long-term options and listed options, and many stock-or-bond-indexed annuities and other contractual rights. We believe that many investors would reconsider making these investments if deferral and capital gains tax treatment were not available, and we see nothing fundamentally wrong with these investments that might justify their being discouraged.

Similarly, the MTM Proposal in its current form would discourage American individuals and companies from entering into a number of familiar transactions in the ordinary course of business or investment that are widely employed at the present time. This includes hedging downside exposure by acquiring put options, writing qualified covered call options, accepting debt plus warrants (or convertible securities) from start-up ventures or troubled enterprises in exchange for providing them with capital, entering into options and forward contracts for the sale of real property or businesses, taking short positions in stocks and securities, lending out stocks and securities, and investing in mutual funds and exchange traded funds that themselves take derivative positions to make, hedge or manage their investments. It might even discourage financial institutions or parent corporations from guaranteeing indebtedness of customers or affiliates. We are not sure most Americans would go on entering into these transactions if they were required to mark their positions to market, and pay associated taxes at ordinary rates, long before they ever realized any return on their investments, and with the prospect that they might *never* realize any returns on their investments. Imposing mark-to-market ordinary treatment on these derivative transactions would therefore likely discourage investors from engaging in them, a result that seems unwarranted at this time.

Moreover, the potential impact on mutual fund operations could meaningfully diminish the incentives for savings and investment in ways that might not have initially been contemplated by the Committee. Much of the capital invested by Americans outside of tax-advantaged accounts is invested in mutual funds, and many of these funds use interest-rate swaps, equity-swaps, options and other derivatives to actively manage their investment portfolios. Under the MTM Proposal, these derivative transactions would give rise to mark-to-market ordinary gains not only in respect of the derivative transactions themselves, but also in respect of the stocks and securities that those derivatives may serve to hedge. Mutual funds are essentially required to distribute any gains from the sale (or deemed sale) of stock or securities to their shareholders on a current basis, and if the gains do not give rise to cash proceeds, then they must borrow to make these distributions. The shareholders in turn must include these gains in income on a current basis. It is difficult to imagine, therefore, a more potentially far-reaching change in the tax treatment of the savings of most Americans.

The Committee should in any case consider that derivatives are but a way in which certain classes of investors obtain economic exposure to certain kinds of stocks and securities, and the counterparty to the derivative normally hedges by acquiring a position in those stocks and securities. Thus, any proposal that serves in effect to discourage investors from entering into derivative transactions might also serve to decrease demand, and increase volatility, in the market for the underlying stocks and securities. We elaborate on this below with respect to specific cases.

We recognize, of course, that the MTM Proposal will likely be refined to carve some of these investments and transactions out of mark-to-market ordinary treatment, and below we articulate various reasons for doing so. However, each of these exclusions would likely create inconsistencies and line-drawing problems of its own. It is for this reason that we look forward to a better understanding of what the MTM Proposal is designed to accomplish in order to help to more narrowly target it.

B. Valuation and Implementation Issues

Unlike prior mark-to-market proposals, the MTM Proposal in its current form would apply not only to publicly traded positions, or to those and to non-publicly traded positions in publicly traded assets, but also to non-publicly-traded positions in non-publicly-traded stocks, securities and real estate, and even to positions that were deemed to be embedded in other financial positions or instruments. We are concerned that the valuation and reporting problems arising from such a broad approach might lead to inconsistent, unfair and unsatisfying results. Many individuals and small businesses are not required to produce audited financials and would not have any means of independently valuing their positions.

We understand that derivatives clearing organizations and large swaps dealers will soon be required under Dodd-Frank to provide counterparties with valuations of their positions in various swaps, options and other derivatives. This requirement does not extend, however, to many of the securities that might be marked to market under the MTM Proposal, such as structured notes, exchange-traded notes, convertible debt instruments, other "embedded" derivative positions, short stock positions, non-publicly-traded stocks that are part of a "straddle", or stock loans. Neither does it extend to derivative positions that are not entered into with swaps dealers, such as options on real estate or businesses, business-related forward contracts, and other business-related derivative transactions. The valuation positions that investors took when left to their own devices might not be consistent with each other, might not apply the same methodologies, and might vary significantly depending on factors such as perceived counterparty creditworthiness or liquidity discounting, and the resulting inequities could serve to undermine compliance and the respect for the tax system on which it depends.

We therefore think that valuation issues should be carefully considered in deciding what sorts of investments and transactions should be covered by the MTM Proposal. Fundamental to this consideration is the observation that valuation can become enormously complicated and administratively burdensome if prices are not easily observable in a cost effective manner by the taxpayers that need the relevant information. The need for such valuations across a broad spectrum of routine investments and financial activities would presumably increase transaction costs, costs that would ultimately be borne by investors, either directly or indirectly. Moreover, in the absence of easily observable prices, the IRS would likely need to expend considerable time and resources to police and enforce current valuations. The securities industry is also concerned that some taxpayers might seek assistance on valuation matters on audit, which would put market participants in the difficult position of trying to value positions not as a dealer or market maker on a real time basis but rather as a valuation agent on an after-the-fact basis. We therefore urge that consideration be given to the use of valuation safe harbors in order to establish a presumptive baseline valuation methodology for all taxpayers.

Even where the reporting requirements of Dodd-Frank apply, moreover, we are concerned about discrepancies in the valuations of derivative positions that will be reported to taxpayers by market participants. In the case of certain standardized contracts, the relevant transactions will be cleared, and relevant market participants will publicly disclose daily pricing information. Many transactions will not be cleared, however. This would include most non-standardized, or "custom", derivative transactions, as well as derivatives over non-publicly traded property. As noted above, it would include any structured note. Initially, moreover, it will include *most* derivative transactions, because particular kinds of derivative transactions will only become cleared under Dodd-Frank as they are approved on a one-by-one basis by the CFTC or SEC.

Under Dodd-Frank, pricing information with respect to swap transactions that *are* cleared will be stored in a central depositary and made available to market participants. Likewise derivatives exchanges already provide recent sales information and bid/ask spreads to members and introducing brokers. We do not think this information will suffice, however, to produce uniform annual valuations of derivative transactions that are not cleared or traded on an exchange. Many derivative financial positions, like structured notes, are available only over the counter and are not traded at all. Many are occasionally traded, but there can be a very large spread between bid and asked prices, and the prices made available may be based on indicative rather than executable quotes from a very limited pool of market makers, and such quotes are often limited by lot size. There is, in any case, no ready agreement on what the appropriate valuation methodology and metrics might be. For example, while ISDA has endeavored over the years to establish market conventions and default scenarios to resolve pricing matters with regard to contingencies in credit derivatives, such conventions do not exist for other types of contingencies which may be part of a derivative (such as knock-outs, caps, floors, and locks). We therefore think further consideration should be given to how valuation methodologies will apply in practice, and we recommend that mark-to-market taxation be applied only in cases where valuations will be easily observable.

We note that the MTM Proposal might also raise a number of reporting and compliance problems, because the tax treatment of particular financial positions would in some cases turn on specifics relating to the taxpayer's other holdings. Thus, even if a reporting burden was placed on securities dealers, such dealers would not know to report gains and losses from marking to market that was necessitated by the fact that a customer had hedged some of her stocks or securities with a derivative, thereby causing them to be part of a straddle. Rather, the IRS would have to rely on the individual to conclude that the relevant stocks or securities were part of a straddle, value them and report mark-to-market gains accordingly, and where appropriate, to disclose the relevant facts to any person who was preparing a return on the individual's behalf. Thought should be given to how to ensure that individuals would actually do this, and to ensure that those who did would not have the perception that others were not. Thought should also be given to the fact that tax return preparation would become more complex for many individuals, and systems and forms would have to be designed to help implement the new requirements.

Conversely, a reporting of gross proceeds and/or mark-to-market gain with respect to a financial derivative might be misleading to both the IRS and the taxpayer, who might be holding the position as a hedge in the ordinary course of business. Thought should be given to how to ensure that the IRS was equipped to accept a negation of the initial reporting in numerous individual cases outside of audit procedures.

C. Additional Complexity and Inconsistency

We are also concerned that enactment of the MTM Proposal might not serve as anticipated to increase uniformity, consistency, certainty or simplicity in the tax treatment of financial instruments and transactions, because it would introduce yet another "cubbyhole" of instruments that received mark-to-market treatment, as opposed to (a) wait-and-see treatment in the case of actual, rather than derivative, interests in stocks and securities, (b) deemed-accrual treatment in the case of contingent debt instruments subject to the contingent debt regulations, (c) hedge accounting treatment in the case of identified hedges of other positions arising in the ordinary course of business, or (d) some other treatment in the case of instruments that could not reasonably be dealt with under mark-to-market principles and had therefore been carved out of it. To put this differently, much of the confusion, uncertainty and inconsistency in the tax treatment of financial instruments relates to the fact that any given instrument may be similar to numerous permutations of alternative investments that might achieve economically equivalent results. One possible response to this problem might be to provide mark-to-market ordinary treatment of *all* financial positions, or at least of all financial positions entered into by a particular kind of taxpayer. Academics have made such proposals, and such a proposal has effectively been enacted for dealers in securities. But application of such a proposal only to certain derivative financial positions might not serve similarly to reduce inconsistency and uncertainty, because the elimination of differences in the tax treatments of various mark-to-market derivatives might be more than offset by the creation of additional differences between the tax treatment of such positions and other economically similar positions, and in particular between the tax treatment of derivative positions and their underlying economic equivalents.

The hardest and most troubling problems created by such differences in tax treatment are the definitional and line-drawing questions that determine which "cubbyhole" a particular investment or transaction will fall into. We think time should be taken to address these questions in the context of the MTM Proposal, particularly in light of the significant difference in tax treatment that would arise between instruments that were deemed to be financial derivatives and economically similar alternative instruments that were not. Thus, we think the MTM Proposal should elaborate on how an "evidence of an interest" in stocks, securities or commodities would be defined under the MTM Proposal, and how the definition would serve to avoid inconsistency and prevent manipulation or abuse. It is not clear to us, for example, whether an interest in a trust or partnership that holds stocks, securities or commodities would be a derivative under this definition (and therefore be marked to market). The answer might well be yes, in that like any other derivative, an interest in a trust or partnership allows an investor to take a relatively small position in an asset that is too large, illiquid or complex for her to hold directly (or even to take "slices" of exposure to assets that could not be obtained from investment in the asset as a whole). But if the answer is yes, then the MTM Proposal would effectively treat a surprising array of investments as mark-to-market derivatives, including family investment trusts, investment partnerships, business partnerships that hold at least some stock, securities or commodities, and even potentially American Depositary Receipts and other arrangements that allow Americans to hold foreign stocks and securities. It might be difficult, moreover, to draw the line between investments that were, and were not, subject to mark-to-market treatment.

But if the answer is no, then it is not clear how such trust or partnership interests would differ from other derivative interests, like exchange traded notes, that would warrant exempting them from mark-to-market treatment, and a deeper understanding of this difference would be an essential component of any ability to properly characterize financial investments and transactions in the future. It is not clear to us what would happen, for example, when a derivative such as a structured note was documented instead as an interest in the assets that the issuer of the derivative acquired to hedge its position. Or suppose that an interest rate swap was documented as two offsetting loans, one of them fixed and the other floating. In our view, mark-to-market treatment should not turn on easily-manipulated idiosyncrasies of legal form, or it might in effect prove elective.

Similarly, the MTM Proposal would apply the mark-to-market ordinary regime to the ownership of actual stocks and securities as soon as there was a "substantial diminution" of the taxpayer's risk of loss (within the meaning of the straddle rules) by reason of the taxpayer's entering into a derivative position. Under current law, the "substantial diminution" standard is notorious in its ambiguity. It would become a much more important standard, however, under the MTM Proposal, as it would serve to determine whether appreciated stock positions had to be marked to market. We therefore think the MTM Proposal should clarify how the substantial diminution standard would be applied in the context of a significant investment portfolio, and in relation to which criteria. For example, in any diversified portfolio, some positions will appreciate while others will lose value in ways that will correlate to a greater or lesser degree, and it is not always clear how to determine if one position (or a group of positions) substantially diminishes risk of loss with regard to another position.

This is especially important because the MTM Proposal would appear to bypass some important limitations on the straddle rules (as set out in Section 1092 of the Code) for purposes of adapting them to mark-to-market treatment. More specifically, by defining a "position" in a straddle for this purpose to include "any derivative", without reference to Section 1092(d)'s limitations on that definition, the MTM Proposal appears to bypass the rule that stock can only be part of a straddle if it is offset by a derivative position in "substantially similar or related property" (i.e., generally in the same stock or, in the case of a short consisting of a portfolio of stocks, in a portfolio that "substantially overlaps" with the long stock position(s)), as well as the rule that a straddle can only consist of positions in actively traded property. In other words, mark-to-market treatment would appear to apply in any case where a taxpayer's risk of loss from owning property is substantially diminished on account of a derivative. Would a taxpayer therefore "leg into" mark-to-market treatment when she took a short position (or sold a put) in a different stock, or when she shorted the S&P 500 while owning stock representing ten of the index's 500 components, or when she entered into an interest rate swap while holding bonds? If so, how would she know when mark-to-market treatment applied? The only answer would be one that arose out of a subjective interpretation of the substantial diminution standard.

There are also difficult issues to be resolved under the straddle rules with regard to unbalanced straddles (i.e., where one offsetting position is larger than the other). As with valuation, we think consideration should be given to some presumptive safe harbors to promote the administrative efficiency and to reduce the compliance costs and burdens to taxpayers.

We also note that the proposed bifurcation of financial instruments into component parts that include embedded derivatives might add a special degree of complexity and uncertainty to the tax treatment of financial instruments. It is not clear to us what embedded portion of an instrument would be marked to market, and on what basis, using what criteria, this would be done. Likewise, it is not clear if the embedded portion would need to be broken into its smallest derivative components, and how the straddle rules would apply with respect to each component and any potentially offsetting position otherwise held by a taxpayer.

In any case, we think it important that these details be fleshed out in the statute and the legislative history, rather than being left to be worked out in regulations. As the staff is well aware, regulations in this area take a great deal of time, energy and effort to draft, and often go undrafted for very long periods of time. There are, for example, still no regulations governing the treatment of constructive sales as required by Congress when it enacted Section 1259 in 1997,[2] and that statute is fairly simple as compared with the MTM Proposal. Complicated questions are hard to deal with, and they of course don't go away merely because there has been a grant of regulatory authority. What happens in the resulting vacuum of authority is often not what Congress had in mind.

Similarly, we think it is very helpful that the Committee has included an exception for hedging in the ordinary course of business. For the reasons set out below, we think it would be important to also have exclusions for other significant ordinary course of business transactions. We think these exclusions should likewise be fleshed out in subsequent drafts of the MTM Proposal, rather than left to regulations.

D. Liquidity and Other Issues

Finally, we observe that the MTM Proposal would require investors to pay tax in the absence of any realization event and to sell, or borrow against, their positions to pay that tax if they lacked other means to pay it. The resulting forced sales could increase market volatility and also frustrate investors. Alternatively, this might have the effect of restricting the availability of routine investment options to wealthier investors with extra cash or excellent credit. The MTM Proposal would force investors to pay tax at ordinary rates even though their gains had not been adjusted for inflation. Moreover, if the value of the relevant position increased in early years and then

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[2] Unless otherwise specified, all "Section" references are to the Internal Revenue Code of 1986, as amended (the "Code").

decreased in later years, the investor would only be able to carry the later year's losses back two years and so might not be able to offset the earlier year's gains.[3]

No such treatment has yet been proposed by Congress, other than on an elective basis for certain businesses. Current law's limited mark-to-market treatment of individual investors under Section 1256 is bottomed on the notion that the investor's gain has effectively been reduced to cash through the mark-to-market system that applies to margin accounts for futures contracts, so that when the investor realizes a gain in her position, she also realizes a receipt of cash upon which tax may reasonably be imposed.[4] In the absence of such a receipt, the investor would not have any "income", meaning that which "comes in".[5] We think the Committee should take these considerations into account in deciding what sorts of investments and transactions should be covered by the MTM Proposal.

II. Investment Vehicles that would be Discouraged Under the Proposal

A. Stock Loans and Rehypothecation in Brokerage Accounts

Many investors – including many individuals, mutual funds and insurance companies – give their brokers the right to borrow or rehypothecate their stocks and securities. This right is granted either through the boilerplate of a standard agreement they sign when they open their brokerage accounts or through a separately negotiated agreement. This right is an important source of financing for brokers and an important source of share liquidity. Brokers may repo out the relevant shares to obtain additional capital, or they may lend the shares out to accommodate short sales or other business-related transactions. This right is also fundamental to the interplay of market

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3 Section 172(b)(A) provides a two-year NOL carryback and a twenty-year carryforward. Generally, an individual's losses from transactions entered into for profit but not in connection with a trade or business (*i.e.*, most transactions in financial instruments) are not taken into account in calculating an individual's NOL. However, the Proposal would define all mark-to- market losses as trade or business losses (Section 485(b) of the Draft). Thus, the two-year/twenty-year carryback/carryforward would presumably be available for mark-to-market losses.

4 The legislative history of the act noted that as a result of the margin account adjustments, "taxpayers' net gain or loss is approximately equal to the aggregate net amounts which is credited to their margin accounts, or which they had to pay into their accounts, during the year." Committee Reports on P.L. 97-34 (Economic Recovery Tax Act of 1981).

5 We realize, of course, that some academics have defined income to include "increases in wealth". More specifically, the classic Haig-Simons definition of income is personal consumption plus increases in wealth. Academics have been debating the merits of defining the tax base as such for over 70 years. *See, e.g.*, B. Bittker, C. Gavin, R. Musgrave & J. Pechman, A Comprehensive Income Tax Base? A Debate (1968). But a tax on such increases in wealth has never been enacted, partly because it would be exceedingly difficult, as a practical matter, to define such increases in wealth, to determine when they had occurred, and to measure them coherently and consistently.

participants and sources of liquidity (such as the overnight repo markets and money markets) on capital markets, and it is an essential source of funding to routine dealer operations. As demonstrated during the credit crisis, disruption of the overnight money markets can result in immediate and severe adverse consequences to the safety and soundness of all financial markets. The value of this right also reduces the cost of providing brokerage services and so is arguably passed on indirectly to customers. As noted below, Congress itself recognized the importance of a broker's right to borrow or rehypothecate customer securities when it enacted Section 1058 of the Internal Revenue Code in 1978.

When a broker rehypothecates a customer's stock or lends it out to accommodate a short sale, the customer temporarily ceases to own any physical stock and owns instead the broker's obligation to return substantially identical stock at some point in the future, along with the broker's obligation to make "dividend equivalent payments" until the stock is returned. These are of course derivative rights against the broker that, absent an exclusion, would be subject to the MTM Proposal. Partly for this reason, Congress enacted Section 1058 of the Code to clarify then-existing law and ensure that investors would not be required to recognize gain on their appreciated stock positions when they effectively exchanged their stock for derivative rights to receive back substantially identical stock plus dividend equivalent payments.[6] It would be surprising indeed if Congress were now to reverse itself and treat such exchanges not only as taxable events, but ones that subjected the customer to a mark-to-market ordinary regime.

We are hopeful that the Committee intends to exclude such derivative rights against brokers from the ambit of the MTM Proposal. If not, we would be concerned that this effective repeal of Section 1058 of the Code would increase the costs and risks associated with the functioning of capital markets. Nevertheless, we stand ready to help the Committee to minimize or avoid these impacts.

B. Structured Notes

Structured notes (sometimes called "indexed notes") are general obligations of financial institutions the performance of which track, to a greater or lesser extent, the upside or downside performance of one or more equities, equity-related indices, currencies, commodities, commodity-related indices, mutual funds or investment strategies. Structured notes often have limited upside, and some degree of downside protection (but in many cases not the degree of downside protection that would make them debt for tax purposes). They typically have maturities of one to five years, with most at the shorter end of such range. In many cases, their downside protection, albeit limited, makes them a relatively conservative alternative to an outright

6 S. Rep. No 762, 95th Cong., 2d Sess. at 7 (1978).

investment in the assets that they reference. In other cases, the investor accepts greater downside exposure to a particular asset in exchange for higher current income. Approximately $50 billion of new structured note issuances are sold each year to retail investors, and approximately half of these are treated as derivatives (e.g., as prepaid forward contracts), rather than as debt instruments, for tax purposes.

Tax disclosures for structured notes that are treated as derivatives typically state that (although the tax treatment isn't clear) the payments (if any) on the instrument prior to maturity will be reported as ordinary income and that the investor should recognize capital gain or loss on the note's maturity. Because of their finite (and relatively near-term) maturity, structured notes are often less tax efficient than the assets they reference (which might be held indefinitely, and which do not normally generate significant current income).

By imposing a mark-to-market ordinary regime on investors in such structured notes, the MTM Proposal would likely reduce the market for such instruments. It would therefore limit the ability of investors to take limited risk positions in equities or other investment assets. Such investors would have to choose instead between taking riskier positions in the underlying assets themselves or foregoing the investment and making alternative fixed-income investments. Smaller investors would also be limited in their ability to participate on a cost-effective basis in various investment strategies or to make investments in assets that would not otherwise be available to them. And it would limit the ability of investors to obtain greater current income in exchange for downside risk.

C. Exchange Traded Notes

Exchange traded notes" are general obligations of financial institutions that reflect long-term participation in various indices of stocks, currencies and commodities. In contrast to structured notes, they typically (i) are listed and traded on an exchange, (ii) have a fairly long maturity (*e.g.,* fifteen years) and (iii) track on a one-for-one basis the return of a given index or investment strategy. The market, while significant, is meaningfully smaller than that of structured notes, with approximately $17 billion in total issuances outstanding.

While they are issued using debt documentation, exchange traded notes are generally not treated as debt instruments for U.S. tax purposes, because they do not promise any return of principal (*i.e.*, the investor could lose most or all of her money). Investors purchase these notes partly because (unlike investment funds) there are lower (or no) management fees associated with them, and there is also no so-called "tracking error risk" (*i.e.*, investor returns track an abstract index, rather than the values of actual assets). Investors often invest in these notes, however, because there are no available investment funds that invest in the particular asset pools to which they are seeking exposure, and it would not be possible or practical for them to invest in these assets directly. There may, for example, be no fund that takes long and short positions in commodities to express a particular directional view, nor could the investor enter into the relevant commodity positions directly.

Exchange traded notes (and structured notes) can in some cases also be an important source of funding for the banking and securities industry, inasmuch as the issuers of these notes can hedge by entering into swaps, futures and forward contracts that require no up-front cash, rather than by investing the proceeds of issuance of the notes in the underlying assets. As such, the issuance of exchange traded notes contributes to the financial health and stability of the banking and securities industries.

We recognize that in some cases, exchange-traded notes compete as investment alternatives with mutual, exchange-traded and other funds that offer long-term exposure to diversified investment classes. We presume that the MTM Proposal was not designed to encourage investment in one over the other, but clearly it would have that incidental effect, inasmuch as taxable long-term investors would be deterred from investing in exchange-traded notes if they lost the tax benefits of deferral and capital gains treatment that are normally associated with such investment and that would continue to be associated with investment in mutual, exchange-traded and other funds. We would for this reason be glad to meet with you to further discuss the constructive role played by exchange-traded notes (and structured notes) in capital markets.

D. Convertible Debt Instruments

Convertible debt instruments are hybrid investments that allow an investor to earn interest from a loan to a corporation while also participating in the appreciation of the value of the borrower's equity above a specified price by converting the loan into equity (without any tax realization event). These instruments also allow corporate borrowers to obtain lower costs of capital by offering lenders upside participation. The opportunity to keep interest rates down by offering lenders such participation is particularly important to young corporations, and to older corporations that are financially troubled. Indeed, convertible debt instruments have played an important role in maintaining the financial health and vigor of the American economy. Approximately $30 to $50 billion of convertible debt is issued in any given year, much of which is purchased by individuals or mutual funds.

Investors would likely be discouraged from investing in these instruments if any appreciation in their embedded equity positions had to be marked to market annually and treated as ordinary income, rather than as capital gain. They would likely invest instead in underlying common stock, so that they retained the deferral and long-term capital gains that they have come to expect for appreciated long-term investments. Indeed, in cases where the relevant underlying stock had appreciated substantially, it would be hard to distinguish (as an economic matter) the ownership of convertible debt from the ownership of the relevant underlying common stock, except that the former, but not the latter, would be taxed on a mark-to-market ordinary basis.

Because convertible debt instruments have been a mainstay of our economic system for more than a hundred years, there are numerous statutes, regulations, rulings and cases dealing with them.[7] Convertible debt instruments were carved out of the definition of "contingent debt" when the contingent debt regulations were finalized in 1996,[8] because it was at that time deemed inappropriate to disturb the time-honored treatment of convertible debt and require investors to accrue interest income at a rate higher than the coupon rate on the instrument. We see no reason for Congress to now move in the opposite direction, and far beyond requiring investors to accrue such phantom interest in income, require investors to annually mark-to-market all of the unrealized gain associated with their conversion options and treat it as ordinary income. As noted above, investors would likely be discouraged from purchasing a convertible debt instrument under these circumstances.

E. Exchange-Traded and Over-the-Counter Long-term Options

Long-term options, such as "LEAPS",[9] are listed on a number of national exchanges (*e.g.*, the Chicago Board of Exchange, the NYSE MKT LLC (formally the American Stock Exchange), the NASDAQ OMX PHLX (formally the Philadelphia Stock Exchange), and the NYSE Arca) and are entered into in substantial volume by retail investors. LEAPS generally have terms of two or three years. In 2012, investors bought and sold over 4 billion options,[10] and it is estimated that approximately 10% of the options market consists of long-term options.[11] LEAPS are currently offered on over 2,000 common stocks and over 25 indices.

In effect, such options allow investors to take a leveraged view on the direction of an equity—*e.g.*, an investor who believes that Facebook stock will be worth more in the future could borrow \$80x and purchase \$100x of Facebook stock (using \$20x of her own equity). Alternatively, she could spend \$20x to purchase a long-term

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7 *See, e.g.*, Section 249 (limiting deductions for repurchase premium in the repurchase of convertible debt); Treas. Reg. Section 1.1273-2(j) (definition of issue price for convertible debt); Treas. Reg. Section 1.1275-4(a)(4) (specifically exempting convertible debt from the contingent payment debt rules); *Chock Full O'Nuts Corp v. United States*, 453 F.2d 300 (2d Cir. 1971); Rev. Rul. 2002-31, 2002-1 C.B. 1023 (May 6, 2002) (addressing contingent convertible debt).

8 T.D. 8674 (June 11, 1996).

9 "LEAPS" stands for long-term equity anticipation securities.

10 Source: The Options Clearing Corporation: http://www.optionsclearing.com/webapps/historical-volume-query.

11 Source: Etrade.com ("LEAPS® account for approximately 10% of all options listed). https://us.etrade.com/e/t/kc/oic?id=50004#availability

option on the stock of Facebook. These are, as it turns out, economically similar financial positions, as more fully and accurately expressed by the so-called Black-Scholes option pricing equation. In light of margin rules and other constraints, however, the option may be the only alternative at the investor's disposal. An investor can also acquire a long-term put option to take the view that the value of a stock is likely to decline, or she can acquire such an option in order to hedge against the risk of loss from this happening in connection with stocks that she already owns.

The above exchange-traded options have been in existence since 1990, and there has to date been no suggestion that there is anything problematic about their existence. As noted above, however, the MTM Proposal, if enacted, would likely discourage investment in these options, because a taxable investor would not readily invest for long term appreciation in assets giving rise to unrealized gains that are subject to mark-to-market ordinary treatment. Similarly, if the MTM Proposal were enacted, an investor would probably not use such options to hedge against risk of loss from an appreciated stock position, since doing so would cause the appreciated stock position to be treated as sold and then subsequently marked to market. Although Congress enacted Section 1259 to require investors to recognize gain when they eliminate substantially *all* of their risk of loss *and* opportunity for gain from an appreciated stock position, nothing in the legislative history of Section 1259 suggests that Congress thought it appropriate to require an investor to recognize gain merely because she reduced or eliminated any portion of her risk of loss. To the contrary, the legislative history of Section 1259 makes it clear that Congress did not think mere acquisition of a put should result in gain recognition.[12]

We note that the securities industry also issues over-the-counter options to investors, to some extent in competition with the exchanges. Nothing in the law suggests that Congress or the Secretary have ever viewed this as problematic. In fact, during the period between 1998 and 2002, Treasury extended the qualified covered call option exception from the straddle rules to qualified over-the-counter options and to so-called "flex" options that do not have standardized terms.[13]

F. Qualified Covered Call Options

"Covered calls" are call options sold by many individual investors and mutual funds who own the stock referenced by the call. A "qualified covered call"

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12 "[I]t is not intended that a taxpayer who holds an appreciated financial position in stock will be treated as having made a constructive sale when the taxpayer enters into a put option with an exercise price equal to the current market price (as "at the money" option). Because such option reduces only the taxpayer's risk of loss, and not the opportunity for gain, the above standard would not be met." Committee Reports on P.L. 105-34 (Taxpayer Relief Act of 1997).

13 Treas. Reg. Sec. 1.1092(c)-2 and 3.

(QCC) is a covered call that meets the requirements of Section 1092(c)(4) of the Code, typically because its exercise price is at or above the trading price of the stock at the time it is sold. Because it meets those requirements it – and the stock position which it references – are largely exempt from the straddle rules. QCCs are widely used by both mutual funds and individuals who are fundamentally long investors - after all, a QCC seller (except for the call option premium received) retains the full downside exposure on the stock. They also constitute a significant portion of both the listed and the over-the-counter options markets.

The MTM Proposal would repeal Section 1092(c)(4) of the Code. We assume that this proposed repeal is intended to subject investors who sell what are today QCCs to the MTM Proposal's mixed straddle rule – that is, the sale of a QCC would trigger any gain on the "covered" long position and thereafter the long position and the call would be marked to market and taxed at ordinary income rates. If this assumption is correct, the MTM Proposal would likely discourage taxable investors from issuing QCCs on appreciated stock, and even on unappreciated stock, since investors would not want to impose a mark-to-market ordinary tax regime on the future appreciation of their stock positions.

Obviously, one consequence is that investors would be disincentivized to increase their current income from the ownership of stocks by writing calls against them. Given that Congress has already specifically enacted a statute to accommodate this activity, and Treasury has written numerous sets of regulations to further accommodate it, we'd like to better understand the rationale for such a change in law. Moreover, we believe that the anticipated resulting drop in option volume would cause bid/offer spreads to widen on both calls and (because of "put-call parity")[14] on puts, adversely affecting all investors seeking to hedge. The decrease in options market volume would, in turn, likely result in a decrease in liquidity and an increase in volatility in the underlying physical market.[15]

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[14] For an explanation of put-call parity, see http://www.investopedia.com/terms/p/putcallparity.asp#axzz2NHjnn1eB.

[15] These impacts arise partly because when an investor sells call options – and written call options (both the qualified cover variety and otherwise) represent the majority of all listed options – the financial institution that is its ultimate counterparty will typically sell short a number of the referenced shares that corresponds to the delta of that option. If the stock price drops, (i) the delta drops and therefore (ii) that institution will go into a falling market to buy back some of the shares it sold short. Conversely, if the stock price rises, (i) the delta rises and therefore (ii) that institution will sell more shares short into a rising market. In all of these cases – the initial hedging and the subsequent adjustments to the delta – the financial institution's actions create liquidity and dampen volatility – activities that benefit all investors, and that would be reduced if the MTM Proposal became law.

G. Put Options

The mixed-straddle rule in the MTM Proposal would similarly discourage investors from purchasing protection, in the form of a put option, from a decline in the value of their appreciated (or unappreciated) stock positions. Moreover, the broad expansion of the straddle rules through the removal of the "personal property" requirement might discourage the purchase of protection against general market downturns, even if the protection did not overlap with any of the long positions held by the investor.[16]

Put options are commonly acquired by investors, including many taxable investors, who are worried about the direction that a particular stock price, or the market as a whole, might take in the short or medium term, but who are not yet ready to dispose of their stock altogether. As noted above, Congress was careful not to discourage this activity in enacting Section 1259 of the Code. Nor do we see any policy rationale for a rule that effectively requires investors to sell their appreciated stock positions if they are worried about a decline in future prices, rather than hedge against them. Indeed, for reasons similar to that noted above, preventing investors who hold appreciated stock from acquiring puts would adversely affect not only them, but arguably *all* investors – whether taxable or tax-indifferent, and whether or not they use derivatives – by removing liquidity and increasing volatility in the underlying physical market.

H. Short Sales

A taxpayer who borrows stock and sells it short has a derivative position because she doesn't own any stock, but rather has an obligation to buy stock in the future and return it to the stock lender. The Technical Explanation of the Proposal makes it clear that the intent of the Proposal is to treat short positions as derivative positions subject to mark-to-market ordinary treatment.

Given that a taxpayer who has a long position in stock does not need to mark her position to market at year's end under the MTM Proposal, we are not clear what the policy rationale is for requiring a taxpayer who has a short position in the stock to do so. In this regard it would assist us in helping the Committee to target the MTM Proposal to have a better understanding of why the Committee believes mark-to-market would be the right answer for short positions.

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16 See further discussion of this point in "III C. Business Straddles."

I. Derivative Positions of Mutual Funds and Exchange-traded Funds

Many Americans save by investing in mutual funds and exchange-traded funds ("ETFs"). These funds help them to diversify their investments and avoid the risk of having too much exposure to any particular company. Americans investing in these funds expect to be taxed only when they ultimately dispose of their investments and then, if the holding period is met, to obtain long term capital gain treatment As discussed below, because these funds regularly make use of derivatives, the MTM Proposal would fundamentally change the tax treatment of these investments at the investor level. Alternatively, the MTM Proposal might effectively discourage these funds from making constructive use of swaps, options and other derivatives.

Diversified mutual funds normally qualify as "regulated investment companies" ("RICs") for tax purposes, which treatment generally allows them to deduct from their otherwise taxable income their dividend distributions and, thereby, pay no tax at the corporate level. RICs must generally distribute most of their income and gains to shareholders on a current basis.[17] ETFs, which likewise invest in diversified pools of assets, usually either qualify as RICs, or as partnerships or other pass-through entities that pass their income and gains through to their shareholders.[18] Americans currently invest enormous amounts of their savings in RICs and ETFs. As of the end of 2011, U.S. mutual funds had approximately $11.6 trillion in assets under management[19] and ETFs had approximately $1.048 trillion in net assets.[20]

Under the MTM Proposal, mutual funds and ETFs would generally be required to mark their derivative positions to market. They would also be required to mark to market any stocks or securities that were partially hedged with puts, calls, or other derivative positions, because the latter would form a straddle with the former. They would similarly be required to mark to market any stocks against which covered calls or other derivatives were written in order to increase income. In the case of ETFs treated as partnerships or trusts, these mark-to-market gains would be passed through to investors (*i.e.*, to partners or trust certificate holders) on a current basis, and they would likewise be treated as ordinary income in the hands of investors. Mutual funds and ETFs that are treated as RICs would similarly be required to make distributions to shareholders substantially equal to these mark-to-market gains (possibly in the absence of any realized cash), and shareholders would presumably be required to treat these distributions as ordinary income. RICs would not be entitled, moreover, to carry any net mark-to-market ordinary losses forward to reduce taxable distributions to

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17 Section 852(a)(1).

18 ETFs are also often organized as partnerships or trusts.

19 Source: Investment Company Institute 2012 Investment Company Fact Book: http://www.icifactbook.org/fb_ch2.html

20 Source: Investment Company Institute 2012 Investment Company Fact Book: http://www.icifactbook.org/fb_ch3.html

shareholders in subsequent taxable years, because current law does not allow any such carryforward. [21]

As noted above, Americans invest their savings in RICs and ETFs primarily to obtain long-term appreciation, so that their savings keep pace with inflation and hopefully offer a positive return. A lot of such investment is made through taxable accounts, as opposed to 401(k), IRA and other tax-exempt accounts. We believe that Americans might be discouraged from investing their capital in RICs and ETFs if the law required them to treat that appreciation as mark-to-market and ordinary. In response, we suspect that RICs and ETFs might avoid using derivative transactions to achieve their investment objectives.

We are not aware of any reason, however, to discourage RICs and ETFs from making use of these important financial tools. To the contrary, we believe that RICs and ETFs are making valuable use of these tools, and they employ them for reasons that have nothing to do with taxation.

J. Access Products

The term "access product" refers to a "delta one" instrument: that is, an instrument that tracks on a one-for-one basis the physical security it references. Mutual funds – especially international funds – frequently acquire such instruments as the only way to access securities (equities or debt) in a number of significant overseas markets, such as China and India. Direct investment by non-locals in those markets is either prohibited or very limited, and thus those markets can only be accessed by acquiring a derivative from a financial intermediary who is licensed to deal in those markets. That financial intermediary, in turn, will typically hedge by buying the local-market security referenced by the derivative it has issued. We understand that such hedging represents a significant portion of local market purchases.

Thus, under the MTM Proposal, an investor who followed the conventional wisdom of seeking to diversify her long-term holdings through worldwide equity exposure (typically through a mutual fund) might be subject to a mark-to-market/ordinary regime with respect to a significant portion of her portfolio. Conversely, U.S. investors (or mutual funds acting on their behalf) might be discouraged from entering those markets in the only manner practicable, and might be encouraged to withdraw from positions already acquired.

In this regard, as in the case of options, we wish to highlight the interdependency and interchangeability of derivative and underlying physical markets. In this case, the derivative is used to the same extent as are parallel physical holdings to

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21 Section 852(b)(2)(B).

achieve long-term capital appreciation, and as noted there is typically a physical investment that corresponds to the derivative. Thus, the same policy considerations used to justify deferral and capital gain in the case of physical investments would seem to be present here as well. In any case, as noted earlier, we look forward to obtaining a better understanding of the Committee's objectives so that we can help to better target the MTM Proposal.

K. Variable Whole Life and Other Insurance Products

Insurance companies offer a wide variety of investment contracts with returns that vary with the performance of various stock indexes, mutual funds, commodities or currencies. In the case of variable whole life insurance, the increase in the value of the policy is not subject to current tax, may be borrowed against, and may ultimately pass tax-free to the heirs of the insured. Other special rules apply to variable annuities.

These contracts represent derivative contractual rights of investors against the insurance company, rather than the ownership of underlying property. We hope that the MTM Proposal was not intended to require that these rights be marked to market. It may be difficult, however, to draw a clear line between these and other derivative financial transactions other than by reference to the classification of the issuer.

III. Business Arrangements and Transactions

There are a number of common business arrangements and transactions that would constitute derivatives subject to mark-to-market treatment under a literal reading of the MTM Proposal. In at least some of these cases, we assume that this result was not intended, although their inclusion for now hints at the line-drawing problems inherent in the breadth of the current definition of derivative under the MTM Proposal. As noted above, we believe that any intended exclusions should be expressly set out in the MTM Proposal, rather than left for regulatory guidance.

A. Business Options and Forward Contracts

Options and forward contracts are fundamental aspects of many sales of business-related property, from real estate, to book, film and music rights, to oil, gas or mineral rights, to whole-sale businesses. Normally such business-related property is held through corporations or partnerships, and relevant options or forward contracts would therefore be over the stock, partnership or other equity interests in these entities. Moreover, the MTM Proposal would define a derivative to include any option or forward contract on "real property" (other than a single tract or property). These option and forward contracts would, therefore, have to be marked to market under a literal reading of the MTM Proposal.

It is difficult, however, to envision a system that routinely required such options and forward contracts to be marked to market for tax purposes. Often the parties to these agreements would not be large enough to account for these transactions on an accrual basis. Even those that did, however, might employ methods of accounting that did not value these agreements or rights, or did not do so on an annual basis. And even where they did, these businesses might not have the cash needed to pay large amounts of taxes well in advance of any realization of income or gain.

Furthermore, options and forward contracts are widely used in mergers and acquisitions, included in transactions that Congress clearly intends to treat as tax-free reorganizations. Consider, for example, a simple agreement whereby the shareholders of Corporation A agree to exchange their A stock for stock of Corporation B. The agreement, which must necessarily be binding as a tentative matter prior to approval and closing of the transaction, would appear under a literal reading of the MTM Proposal to be a derivative that would force the shareholders of Corporation A to recognize all of their gain under the MTM Proposal's mixed straddle rule. Other routine business acquisition agreements, such as rights of first refusal, or collars for agreed-upon purchase prices, could likewise be treated as derivatives subject to mark-to-market under a literal reading of the MTM Proposal.

B. Incentive Compensation and Deferred Compensation

Many employees receive part of their compensation in the form of options to acquire stock of their employers. Employees also receive other forms of derivative compensation, such as "phantom stock" and other rights to receive amounts in the future that vary with the value of the employer's stock. This form of compensation is thought to help align the interests of employees with those of their shareholders and give them a longer range view of the company's performance. It also allows employees to view themselves as part owners of the corporations for which they work. Numerous statutory, regulatory and case law rules govern the tax treatment of this kind of compensation. As a general matter, however, employees do not recognize income or gain in respect of their ownership of employee stock options until they acquire and sell the underlying stock.

As a technical matter, employees receiving this kind of compensation have derivative positions in the stock of their employers, because they do not own the underlying stock in their employers. We hope it is not intended that the unrealized gain inherent in such compensation be marked to market on an annual basis and that this form of employee compensation will accordingly be carved out of the MTM Proposal, as we do not see how current law's carefully thought out regime for taxing incentive compensation of employees could profitably be replaced by such a mark-to-market system. How, for example, would employees get the money to pay the relevant taxes?

Likewise, employees often receive deferred compensation consisting of rights to receive amounts from an employer in the future in exchange for work done today. These future amounts are generally determined by the performance of certain phantom "investments" chosen by the employees, such as mutual funds, bond funds or stock indexes. While the employer often hedges its financial position by making the relevant underlying investments themselves, the employees do not own these investments and do not have a secured claim in them in the event of the employer's bankruptcy. The employees therefore do not own these assets for tax purposes, and these rights are therefore likewise derivatives rights.

We likewise hope that it is not intended that these rights be subject to mark-to-market ordinary treatment and that the MTM Proposal will likewise be clarified to exclude this form of compensation. Numerous statutory, regulatory and case law rules likewise govern the tax treatment of deferred compensation. In general, provided that the deferral terms cannot be altered following grant (other than for statutorily allowable reasons), the employee need not include the compensation in income until the employee can receive the compensation in question.[22] It is similarly difficult to see how current law's carefully thought out regime for taxing deferred compensation could profitably be replaced by a system that would effectively require such employees to include the increases in value of their deferred compensation in income on a current basis.

C. Business Straddles

The MTM Proposal expands the definition of a "straddle" to include cases where the taxpayer's offsetting position is not with respect to "personal property." Given the drastic tax consequences of being within the scope of the MTM Proposal, this change would likely discourage ordinary-course transactions, to the economic detriment of taxpayers. Two examples illustrate this point:

As a first example, U.S. parent companies often hedge foreign currency risk by shorting the functional currency in which a given foreign subsidiary does business (a so-called "Hoover hedge"). If the fx short and the equity of the foreign subsidiary are "offsetting positions," the U.S. parent would have to mark the equity of the subsidiary to market under the MTM Proposal, even though the latter is not

[22] Section 409A.

"personal property." The cost and complexity of such a result would effectively limit the ability of a U.S. parent to hedge its currency exposure.

As a second example, as noted in Part I. C above, it is common for a manager of a mutual fund to acquire, say, fifteen stocks and to simultaneously take a short position in the benchmark she is seeking to outperform, say the S&P 500. Today, there is a reasonably bright line test (under Treas. Reg. Section 1.246-5) that allows taxpayers to know whether or not the S&P 500 short is "personal property" – and thus a straddle – with respect to a long stock position. In the absence of these rules, the fund will be left with a question of whether a straddle has been created, the answer to which will be far more important (since a conclusion that a straddle exists will trigger gain on the long positions and put them on a mark-to-market/ordinary income regime) and far less clear than it is today.

D. Debt Guarantees

Banks and other financial institutions routinely provide guarantees of outstanding indebtedness in the ordinary course of business. Likewise, parent corporations routinely guarantee the outstanding indebtedness of their subsidiaries. Under the MTM Proposal, mark-to-market ordinary treatment applies to "any derivative financial instrument with respect to any note, bond, debenture, or other evidence of indebtedness". While we would not view this as appropriate, a written guarantee might conceivably be treated as a "financial instrument" for this purpose, in which case it might be subject to mark-to-market ordinary treatment because it "referenced" outstanding indebtedness.

We note in particular that the technical explanation of the MTM Proposal describes a credit default swap as "a contractual arrangement in which one party buys from another party protection against default by a particular obligor with respect to a particular obligation", and it goes on to clarify that it is intended that a credit default swap be subject to mark-to-market treatment because it "represents an option [presumably a put option] with respect to a debt instrument". The same might arguably be said of a guarantee, and the drafters of this language might conceivably have been concerned about the ability of taxpayers to document transactions that are similar to credit default swaps as guarantees.

Nevertheless, we believe that guarantees should be expressly carved out of the definition of a derivative under the MTM Proposal. If a guarantee was treated as a derivative in the cases described above, then it would presumably form a straddle with the indebtedness it referenced, and thus the indebtedness itself would have to be marked to market. We do not see any policy reason for requiring holders or issuers of guaranteed indebtedness to mark their indebtedness to market or to treat any gains arising from the sale of such debt as ordinary. Such debt does not differ meaningfully from other debt as an economic matter. Moreover, coherent application of such mark-to-market ordinary treatment would rely on application of the MTM Proposal's mixed straddle rule, as holders could not reasonably be required to recognize ordinary income from a guarantee merely because the issuer's credit had deteriorated, and then later be allowed only a mismatched capital loss if the issuer ultimately defaulted. As noted above, however, there are significant problems with application of the mixed straddle rule.

IV. Issue Price of Debt in Connection with Debt Modifications

Under current law, when outstanding publicly traded debt is modified, the issue price of the new modified debt is generally equal to its fair market value. If, therefore, the debt has declined in value (*e.g.*, because of a rise in interest rates, or a decline in the issuer's credit quality), the issuer will recognize cancellation of indebtedness income even though the principal amount of the modified debt remains the same. The Draft includes a proposal that in such a case would generally cause the issue price of the new modified debt to equal the issue price of the old debt, provided that such issue price is not less than the modified debt's stated principal amount and the modified debt provides for adequate stated interest. This proposal would effectively reintroduce the language of old Section 1275(a)(4), which was repealed in 1990.

We view this as a helpful proposal, because we believe it will make it easier for corporations to finance their operations and modify outstanding issuances to suit their and the market's changing circumstances. We note, however, that some modifications might not qualify as tax-free recapitalizations for holders, because the remaining term of the relevant debt instrument might be too short for the instrument to qualify as a "security". We believe that some form of relief should be provided to ensure that secondary holders (i.e., holders who purchased the relevant debt after it had declined in value) do not recognize artificial tax gain (i.e., taxable gain in the absence of any economic gain) because the issue price of the new modified debt substantially exceeds its fair market value.

V. Limitation on the Accrual of Market Discount

We support the Draft's proposed limitation on the amount of the accrual of market discount. However, we believe that the limit is too high and so deserves further consideration. The need for such a limitation would be heightened, moreover, by the accompanying proposal, discussed below, to require that market discount be included in income on a current basis.

The basis for requiring holders to include original issue discount in income on a current basis is that the discount (i.e., the excess of principal amount over issue price) is certain to be received at maturity and is equivalent to interest income that accrues and is reinvested.[23] By contrast, market discount arguably doesn't reflect anticipated interest income when it arises from a deterioration in the credit quality of the issuer occurring after original issuance, because it is not certain to be received (rather the issuer may default or become bankrupt), and it is not economically equivalent to interest income that accrues and is reinvested. Interest has been defined by the Supreme Court as an amount received for the use or forbearance of money,[24] and it is true that original lenders receive some part of their compensation in exchange for their willingness to bear the risk that the borrower may never repay its borrowing.[25] But an investor who purchases a bond at a deep discount in the secondary market after the borrower has experienced serious financial difficulties is not really anticipating compensation for the advancement of funds. Rather, she is hoping to realize gains from the investor's financial recovery. And unlike the case of *United States v. Midland-Ross*, the investor's recovery of principal at maturity is by no means certain and so cannot support the accrual of interest income.

Thus, suppose the applicable federal rate of interest is 4% per annum, and a 30-year $1,000 bond originally promising 6% per annum plunges in value, because the issuer is likely to declare bankruptcy. An investor purchases this bond for its $200 fair market value (*i.e.*, 20 cents on the dollar), hoping that the issuer will unexpectedly recover and that she will therefore realize a gain of $800 (*i.e.*, a 5 to 1 return on her investment). Under current law, the investor would technically have $800 of "market discount" that would be treated as ordinary income, rather than capital gain, an arguably incorrect result. To make matters worse, the investor would have to include the full amount of the $60 per annum coupons in income as ordinary interest income, even though her investment was only $200. In effect, she would be accruing interest income at a rate of 30% per annum. As noted above, moreover, the Draft would exacerbate these problems by requiring the investor to accrue the market discount and include it in income currently over the life of the bond, well before there was any knowledge of whether the $800 gain would be realized, and notwithstanding that the gain might never be realized.

The Draft would address this in part by limiting the accrual of market discount to the greater of 10 percentage points above the applicable federal rate or five percentage points above the bond's original yield. This is certainly better than current law, but we believe the limit is too high to accomplish its intended purpose. If an investor purchases a bond for 20 cents on the dollar in light of the risk of the issuer's impending bankruptcy and the issuer then recovers, the bond's "double" yield thereafter

23 *See, e.g., United States v. Midland-Ross Corp.*, 381 U.S. 54 (1965).
24 *Deputy v. du Pont*, 308 U.S. 488 (1940).
25 *See generally* R. Merton, On the Pricing of Corporate Debt: The Risk Structure of Interest Rates, 29 J. Fin. 449 (May 1974).

from the investor's perspective does not reflect the fact that it is thereafter appropriate for the issuer to pay interest at a rate of 12% per annum, rather than 6% per annum. It merely reflects the bond's 5-fold increase in value owing to the issuer's recovery. In other words, the investor's additional 6% per annum return is not an amount received for the use or forbearance of money. Yet the Draft's limitation will not prevent the gain from being treated as market discount, because a 12% yield is still below 14% (the 4% applicable federal rate plus 10 percentage points). And as noted above, the problem would now be exacerbated by the Draft's requirement that this "market discount" be included in income on a current basis.

VI. Current Inclusion of Market Discount

Under current law, investors who acquire bonds at a discount in the secondary market are not required to include such discount in income on a current basis (unless they elect to do so). The proposal would require investors to include such market discount in income currently, as if they had acquired the relevant bond at original issuance.

The original issue discount accrual rules have not historically been extended to market discount partly because it might be difficult to measure and report such income currently.[26] In the case of bonds originally issued at a discount, the rate of interest and discount accrual over the life of the bond can be determined by the issuer and then communicated to various chains of reporting agents, who can then use this information to report the investor's discount income as required on Form 1099. By contrast, market discount is unique to each individual investor, based on the price for which he or she acquired a bond in the secondary market. A broker-dealer might not necessarily know the price for which an investor acquired the bonds that she holds in her account, as she may have acquired them elsewhere. In any case, broker-dealers do not currently have systems in place that would enable them to compute accrued market discount for each individual investor, based on the price for which he or she acquired a bond. We also note that the current inclusion rule would apply to municipal bonds that were otherwise tax-exempt and so would require current inclusions in income in respect of portfolios that did not otherwise generate interest income subject to tax.

These problems would be exacerbated if, as the Technical Explanation of the Draft suggests, the Draft might eliminate the de minimis rule for market discount.[27]

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26 See Senate Finance Committee Report to the Tax Reform Act of 1984, S. Rep. No. 98-169, at 155 (1984) (noting that such an approach "would involve administrative complexity").

27 The Technical Explanation provides an example that would require a holder to include an amount of market discount even though the market discount is de minimis within the meaning of Section 1278(a)(2)(C).

Half of the bonds purchased in the secondary market would in that case be market discount bonds requiring the routine bond-specific computation of relatively small amounts of market discount. In many cases, moreover, corporate debt is sold to the public at a range of different prices that vary slightly from the original sales price, and numerous holders therefore have de minimis amounts of market discount.

While we applaud the associated proposal to limit the amount of market discount as discussed above, we do not think (as noted above) that this limitation would be sufficient to prevent a very substantial portion of market discount from being attributable to anticipated gains from the hoped-for financial recovery of an issuer, rather than to the anticipated earning of interest income from an advancement of funds to that issuer. A current accrual requirement would therefore exacerbate the consequences of a mischaracterization under current law, by requiring investors not only to treat such gains as ordinary income rather than as capital gains, but also to include them in income currently well in advance of their realization, and indeed, well in advance of any knowledge that the hoped-for gains will ever materialize. We note, in this regard, that investors often acquire portfolios of such bonds, in hopes of mitigating their risk of loss from default through diversification. Under a current accrual regime, however, gains from issuer survival would be currently included in income while losses from further deterioration of the issuer would not be deductible until the bonds were deemed worthless.

VII. Average Cost-Basis of Specified Securities.

The Draft includes a proposal that when an individual sells shares of stock, she be treated as if she had sold a pro-rata portion of all the shares of stock of that type that she held in her account, rather than the particular shares that she identified. This requirement would also extend to sales of "specified securities", which is defined to include, in addition to stock, any note, bond, debenture, or other evidence of indebtedness, and any commodity, or contract or derivative with respect to such commodity.

We hope to gain a better understanding of the rationale behind this proposal. As a policy matter, we are not certain that it reaches the right result. We recognize that there are times when individuals or businesses may reasonably be treated as subject to pro-rata rules. For example, money is fungible, and it is therefore reasonable in some cases to treat an individual as applying funds pro-rata to various purposes. It is not clear to us, however, that such a rule is appropriate in this case, or that similar reasoning applies. Blocks of stock are *not* fungible if they have indeed been purchased at different times for different prices.

For example, consider two individuals, one of which already owns 100 shares of Stock X, and the other of which does not. Both individuals are considering a purchase of 50 shares of Stock X, which has risen in value lately. Under the Draft, the first individual would be disadvantaged as regards the prospective purchase as compared to the second individual, because if the first individual then sold the 50 shares she purchased, she would be forced to realize her unrealized gain in one third of her old shares. The second individual would have no such problem. The first individual would therefore be better advised not to purchase more shares of Stock X. It's not clear to us that this is the right answer, as a matter of logic or policy.

The answer seems worse, moreover, when considered in light of the limits of the proposal. Thus, if the first individual purchases her new shares of Stock X using a different broker, she has no such problem. Indeed, if the first individual places her new shares of Stock X in a different account with the same broker, she has no such problem, because the proposal merely averages the basis of shares sold out of the same account. Thus, the proposal effectively reduces to a requirement that an individual purchase more shares of an appreciated stock with another broker, or at least open a new account with the same broker to do so.

In other words, the ability to identify the shares sold is not a "loophole" or a tax benefit conferred upon investors. Rather, it arises directly from the fact that the individual has in fact purchased shares at different times and can therefore sell the shares separately. An individual cannot reasonably be deprived of that ability without disadvantaging her as compared with any individual who purchases shares only once. And in our view, enactment of an artificial rule in this regard would only lead to correspondingly artificial behavior in the marketplace, such as the needless opening of multiple accounts.

Moreover, enactment of such a rule would complicate such simple procedures as grants of employer stock to employees as compensation. Many such employees already hold some "old and cold" shares of the stock of their employers, but they don't want to hold more, so they immediately sell any new shares they receive. We see no basis for treating such sales as sales of the old and cold stock that they hold from many years prior, nor do we see much sense in introducing artificial requirements, such as the creation of separate employee accounts, in order to ensure that employees avoid such a result.

In addition, it is not clear to us that this proposal would raise revenue or otherwise benefit the fisc. More specifically, in the absence of a specific identification, the law generally requires taxpayers to treat identical shares of stock as sold on a first-in-first out basis.[28] We understand that most customers do not identify the shares of stock sold and therefore fall under this rule.

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28 Treas. Reg. Sec. 1.1012-1(c)

It is also important to note that this proposal would likely introduce a number of difficult reporting and compliance issues. The Emergency Economic Stabilization Act of 2008 requires securities dealers to report the basis of shares of stock disposed of by their customers. The proposal would require securities dealers to determine this by reference to the average basis of shares of stock in an account. This would require implementation of a new systems methodology that computed such average basis based on purchase history and inputs. Every time a shareholder purchased a share of stock, the basis of the other substantially similar shares of stock in her account would have to be recomputed. Nevertheless, securities dealers would still be required to maintain parallel systems that allowed investors to identify the blocks of stock they were selling, because that identification would serve to determine the holding period of the block of stock sold and therefore whether the relevant gain or loss was long-term of short-term.

In addition, securities dealers would have to maintain separate basis calculations for shares of stock acquired prior to January 1, 2014, the effective date of the average cost basis proposal. This would require brokers to be able to bifurcate cost method for a single CUSIP within the same account. Unfortunately, this is not currently possible within the same system. Either a parallel system would have to be built, or clients would have to be asked to open a second account to hold their newly purchased shares. This would increase maintenance costs and burden system capacity.

We note also that it might prove difficult to communicate information relating to these three different regimes for accounting for cost basis to individual investors, and for individual investors to understand and apply them. This is true not only with respect to their decisions to buy and sell securities, but also with respect to their ability properly account for their gains on relevant tax returns. Consideration should be given to how reported basis under the various methodologies would be reported to investors and employed by them on revised forms, so as to limit the risk of confusion and misreporting.

Furthermore, the proposed extension of this requirement to debt instruments would greatly increase the costs of compliance, reporting and opportunities for confusion and misreporting as described above. Moreover, the potential benefit would appear to be minimal, as debt instruments do not generally vary in value like shares of common stock.

Finally, we note that members of the securities industry have already invested a considerable amount of time, effort and capital in the development and implementation of new compliance systems designed to deliver cost-basis reporting as required by The Emergency Economic Stabilization Act of 2008. In the case of larger securities dealers, the capital outlays for each dealer has been in the tens of millions of dollars. An average cost-basis requirement would negate much of this work and introduce new compliance costs and burdens.