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August 16, 2016

Re: Final Section 871(m) Regulations Effective Date

Ladies and Gentleman:

On behalf of the U.S. Securities Markets Coalition ("Coalition"),[1] The Options Clearing Corporation ("OCC") appreciates the opportunity to comment further on the final and temporary regulations issued under section 871(m) and related provisions (the "Regulations"). For the reasons discussed below, we request a postponement of the effective date of the Regulations, from January 1, 2017, to January 1, 2018.

OCC provides central counterparty clearing and settlement services to all U.S. options exchanges, as well as to several futures exchanges that trade single-stock futures contracts and futures contracts on equity-based indices.[2] In this capacity, OCC clears options on over 3,700 different stocks and equity-based indices. In 2015, some 3.7 billion listed options on individual equities were traded on U.S. options exchanges. When

[1] The members of the Coalition (together with OCC) are BATS Options, BOX Options Exchange, Chicago Board Options Exchange, International Securities Exchange, NASDAQ Options Market, NASDAQ OMX PHLX, NYSE Arca, and NYSE Amex.

[2] OCC is the world's largest equity derivative clearing organization. It is regulated by the Securities and Exchange Commission, the Commodities Futures Trading Commission, and the Federal Reserve Board.

listed options on securities indices are included, some 4.1 billion listed options were traded on U.S. options exchanges, or an average of approximately 16.4 million contracts every trading day. OCC has approximately 120 clearing members, consisting of the largest broker-dealers, securities firms and futures commission merchants in the world. Eight of OCC's clearing members are Canadian firms operating through Canadian offices.

Since the promulgation of the Regulations 10 months ago, OCC's clearing members have been working to make the changes to their systems necessary to implement the Regulations. This is a very daunting task because of the sheer magnitude of the approximately 850,000 unique options series that are available for trading and that would need to be reviewed each trading day to determine whether they are in-scope, as well as the cooperation that the Regulations require among a wide range of market participants. As the January 1, 2017, deadline rapidly approaches, we do not expect that our members' systems will be operational by that date. The Coalition therefore joins with other organizations in requesting a temporary, one-year postponement of the effective date of the regulations.[3]

We write separately to provide some additional context regarding the types of operational issues our members are encountering as they try to write the required software, to obtain the necessary data, and to make the other changes required to implement the regulatory scheme as it currently stands, as well as how it might change between now and the end of the year. The issues below are not the only challenges our members face, but they may serve to illustrate why we believe a postponement of the effective date is truly necessary and not simply convenient or desirable.

The Combination Rule

The single biggest implementation challenge for our clearing members is the combination rule. In five months' time, section 1.871-15(n) will require our members to combine multiple equity options transactions and treat each as a section 871(m) transaction subject to withholding if, among other criteria, combining them would replicate the economics of a section 871(m) transaction. The software logic necessary to combine deltas from different options, to reconcile their trade dates, and to track continually each customer's transactions and positions during the two-day-presumption window provided by the Regulations is very difficult to design and has not yet been developed, due to remaining ambiguities in the Regulations. Many firms have hoped that third parties would develop systems to make the computations required by the Regulations, but no such systems have been developed to date.

The complexity of designing, writing, and testing the relevant software code and other systems has been compounded by the absence of key data, as well as uncertainty on some of the input variables. For example, many brokers use an omnibus account at a clearing member, such that the member has no visibility whether the same person is

[3] *See, e.g.*, Letter of Payson Peabody, Securities Industry and Financial Markets Association, to IRS and Treasury, June 24, 2016.

holding positions that might be subject to the combination rule. Even assuming the clearing member could require the broker to identify its customer (and that the broker could or would comply), the broker itself is unlikely to have available to it the information required to determine whether two customers trading through the omnibus account are related through attribution under section 267(b) or section 707(b) (*e.g.*, both are fiduciaries of trusts that share the same grantor).

To take another example, if one clearing member pairs two transactions effected on the same day under the combination rule from a customer who has other transactions on that same day and then transfers the those positions to another clearing member, there is currently no mechanism to transfer data regarding the relevant deltas. It is unclear from the Regulations whether the receiving member can (or should) "re-pair" the transaction when it receives the two positions, and if so whether it should rely on the transferring member's pairing logic when it receives the two positions or use its own pairing logic.

Still more complexity arises if one of the combined transactions is closed out. For example, assume that a 0.5 delta call option and a 0.4 delta put option are combined at one clearing member into a single delta 0.9 transaction subject to section 871(m); the put option is closed out; and the call option is then transferred to a different clearing member. The receiving member's systems must determine—in the absence of any information from the transferring member—that the call option continues to give rise to section 871(m) withholding, the amount of required withholding (*viz.*, based on a 0.9 delta or a 0.5 delta), whether the call option should be re-paired as a result of the transfer, if so whether it should be re-paired only with transactions entered into after the transfer or potentially unknown transactions before the transfer, and which deltas to use. Whatever systems could be created during the next few months to address the relevant computations involving such scenarios—in the absence of clarifying guidance—are likely to produce a wide array of incompatible outcomes among market participants on January 1, 2017.

For these reasons, a postponement of the effective date of the combination rule would be particularly welcome.

Other Missing Data

There are several other situations, apart from the combination rule, in which the Regulations require calculations based on missing or incomplete data. For example, when a clearing member on-boards a customer who is transferring their account from another broker, the industry-standard customer account transfer file that the member receives now contains only a customer's positions.[4] It does not include data necessary for section 871(m) computations, such as the delta of those positions on their entry date. Until the transferring institution can populate those fields, the receiving clearing members

[4] The Automated Customer Account Transfer Service (ACATS) is a system that automates and standardizes procedures for the transfer of assets in a customer account from one brokerage firm and/or bank to another. ACATS is operated by The Depository Trust Clearing Corporation.

will not be able to ascertain which positions are subject to withholding and reporting. One might argue that clearing members simply should insist that all incoming accounts provide such information, but making changes to ACATS so that it can transfer deltas on options positions held in a customer account is itself a significant undertaking and to our knowledge has not yet been accomplished.

A similar issue arises in prime brokerage arrangements, in which a client custodies its assets at a clearing member but uses other brokers to execute its options trades. The clearing member in such a situation will not automatically receive delta information from the executing broker, and there is no established format or protocol for the executing or clearing broker to transmit that information upstream. Such scenarios become even more complicated when one considers situations like the ones discussed above, in which paired transitions are transferred between brokers or a paired trade is closed out and then transferred to another broker. Assuming systems could be put in place by the end of the year for all relevant market participants to address such issues, the Regulations still do not specify *which* delta they may use, such as the end-of-day delta requested in prior comments. It is difficult to design systems around unspecified variables that may change in subsequent guidance.

As others have pointed out, our clearing members also must receive or provide new withholding documentation by the end of the year—documentation which is not yet available. The QI agreement for QDDs has not yet been finalized, and foreign market participants thus cannot enter into QI agreements as QDDs, even assuming that they have assured themselves that they could comply with the relevant terms of those agreements. The administrative challenge of gathering new documentation from all relevant counterparties on short notice cannot be overstated. At this point in time, the absence of final guidance that would allow foreign market participants to commence their documentation process makes it unlikely that they can complete that process by January 1, 2017.

Novel Systems

Several aspects of the Regulations also require novel systems and untested links between systems to be developed. For example, clearing members' systems at present do not link dividends on underlying stock to listed options trades. This linkage now must be established for each trade with a delta equal to or greater than 0.8. No current process exists to link corporate actions, such as mergers and stock splits, to contracts within the scope of the Regulations. Systems do not currently exist to impose withholding unconnected to a payment from which the funds could be withheld.[5] All of these systems must be completed and tested in the next few months, based upon the current effective date. It is unlikely that a sufficient number of market participants will be able to accomplish this task for the Regulations to reach a "critical mass" of compliance.

[5] *See* T.D. 9734, 80 Fed. Reg. 56,866, 56,875 (Sept. 18, 2015) ("[I]f an option that is a section 871(m) transaction lapses, the short party is nonetheless required to withhold on any dividend equivalent associated with the option.").

The Preamble to the Regulations also recognizes that "[p]arties may need to modify contractual arrangements to ensure that there are sufficient funds available to satisfy withholding obligations."[6] This statement, while certainly true, does not capture the full extent of the systems and other changes required to accomplish, in effect, a margin requirement of varying amount upon entry into a contract that could result in cashless withholding. Additional amounts would need to be gathered from customers even if a given transaction is not a section 871(m) transaction because it could become one under the combination rule.

Very much to their credit, the Regulations recognize in several other places as well the administrative burden and complexity generally imposed by section 871(m) on both taxpayers and the IRS.[7] From an implementation perspective, it is a time-consuming task to design software logic with unknown variables and incomplete information. We believe our members would be ill-served if they are required to "go live" on January 1, 2017 without fully testing even a finished system in the context of a market that processes approximately 16.4 million contracts each trading day.

* * *

For the foregoing reasons, and others, we support the request to extend the effective date of the Regulations by one year, to January 1, 2018.

Respectfully submitted,

Craig S. Donohue
Executive Chairman
The Options Clearing Corporation

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6 *Id.*

7 *See, e.g.*, 80 Fed. Reg. at 56,871 (eliminating the one-year exception because "[a]ny benefit from the rule is outweighed by the complexity of creating systems to track contracts that differ only in term."); *id.* at 56,873 ("The Treasury Department and the IRS recognize the challenges that short parties could face in identifying transactions to be combined.").