December 17, 2015

The Honorable John Koskinen
Commissioner
Internal Revenue Service
1111 Constitution Avenue NW
Washington, DC 20224

The Honorable Mark Mazur
Assistant Secretary for Tax Policy
Department of the Treasury
1500 Pennsylvania Avenue NW
Washington, DC 20220

The Honorable William J. Wilkins
Chief Counsel
Internal Revenue Service
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Re: Proposed Regulations Under Code Sections 871(m) and 1441 Relating to Qualified Derivatives Dealers (REG-127895-14)

Gentlemen:

This letter sets forth the comments of The Options Clearing Corporation ("OCC") on the proposed regulations issued under Code sections 871(m) and 1441[1] relating to the exemption from withholding tax for dividend equivalents paid to "qualified derivatives dealers" (the "Proposed Regulations"). We understand that additional details relating to this exemption will be provided when the Internal Revenue Service (the "IRS") issues proposed amendments to the qualified intermediary ("QI") agreement relating to qualified derivatives dealers. We may have additional comments when these proposed amendments are released.

OCC provides central counterparty clearing and settlement services to all U.S. options exchanges[2] as well as to several futures exchanges that trade single stock futures contracts and futures contracts on equity-based indices. OCC is the world's largest equity derivatives clearing organization. It is regulated by the Securities and Exchange Commission, the Commodity Futures Trading Commission, and the Federal Reserve. Pursuant to regulatory reforms mandated by the Dodd-Frank

[1] Unless otherwise indicated, all references to sections are to sections of the Internal Revenue Code of 1986, as amended, or to the regulations thereunder.

[2] There are currently 13 options exchanges in the United States.

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Wall Street Reform and Consumer Protection Act, OCC has been designated as a systemically important financial market utility ("SIFMU").

As a central counter-party clearing organization, OCC is a passive intermediary and it acts to minimize credit risk. OCC clears options on over 3,700 different stocks and equity-based indices. In 2014, OCC cleared over 3.8 billion options contracts on individual equities, with each contract representing 100 shares of the underlying stock. When index options are included, OCC cleared over 4.2 billion options contracts in 2014, or an average of 17 million contracts every trading day. In 2014, the total gross premiums for options cleared and settled by OCC was $1.2 trillion or roughly $4.8 billion per trading day. OCC also clears single stock futures contracts and futures contracts on equity-based indices. This is a much smaller part of OCC's activity. In 2014, OCC cleared 67.6 million futures contracts, of which 10.9 million were single stock futures contracts.

OCC has approximately 120 clearing members, consisting of the largest broker- dealers, securities firms and futures commission merchants in the world. The vast majority of OCC's clearing members are U.S. firms (or U.S. subsidiaries of foreign firms), but seven of OCC's clearing members are Canadian firms operating through Canadian offices.

The final regulations issued in September make clear that OCC is a withholding agent for purposes of section 871(m) when it faces a Canadian clearing member whether the member is acting for a customer or for its own account.[3] In addition to withholding tax obligations, OCC will also be obligated to report dividend equivalent amounts annually to its Canadian clearing members and to the IRS. Given the volume of transactions cleared by OCC on a daily basis and OCC's overall responsibilities as a clearing organization, OCC is not a positon to withhold tax on dividend equivalents received by its non-U.S. clearing members. Accordingly, OCC plans to amend its rules to ensure that its Canadian clearing members assume primary withholding responsibilities with respect to dividend equivalents.

With respect to transactions in their customer accounts, OCC's rule amendments will require that all non-U.S. clearing members be qualified intermediaries assuming primary withholding responsibility ("Withholding QIs"). As a result, OCC will not be required to withhold on any dividend equivalents with respect to section 871(m) transactions in a Canadian clearing member's customer account with OCC.[4]

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[3] *See* Treas. Reg. § 1.1471-7(a)(3) (Example 7).

[4] OCC will, however, still be required to report the amount of any such dividend equivalents to its Canadian clearing members and to the IRS. As we understand the rules of Treas. Reg. § 1.871-15(p), the Canadian clearing members will be required to provide OCC with the information it needs to comply with its reporting obligations. The application of Treas. Reg. § 871-15(p) with respect to listed options transactions is, however, ambiguous in a number of respects and will be addressed in subsequent comments.

OCC also needs to ensure that it does not have withholding responsibility with respect to transactions in which a Canadian clearing member is acting as principal rather than for a customer. Under the Proposed Regulations, there is an exemption from the withholding requirements for certain dividend equivalents paid to "qualified derivatives dealers" ("QDDs") acting in their capacity as dealers.[5] Under the Proposed Regulations, a QDD is defined in relevant part, as a qualified intermediary ("QI") that (i) is a dealer in securities subject to regulatory supervision as a dealer by a governmental authority in the jurisdiction in which it was organized or operates, and (ii) furnishes a written certification to the counterparty that it is a QDD acting in its capacity as a dealer and that it assumes primary withholding and reporting responsibilities with respect to any dividend equivalent payment that it receives and makes in its dealer capacity.[6] This exception does not apply to a QDD's proprietary (i.e., non-dealer) positions.

Accordingly, OCC's amended rules will require non-U.S. clearing members to be QDDs with respect to transactions that they enter into as principal (*i.e.*, transactions in their proprietary account with OCC). Unfortunately, the QDD exemption, as proposed, would not relieve OCC of withholding responsibility to the extent a Canadian clearing member engages in non-dealer proprietary transactions. As OCC and others have previously recommended, the QDD regime should be expanded to include proprietary (i.e., non-dealer) transactions entered into by a QDD.[7] The preamble to the Proposed Regulations does not discuss these earlier recommendations and does not explain why they were rejected. Just as a QDD acting in its dealer capacity will be liable for tax on a dividend equivalent payment it receives when an offsetting dividend equivalent payment the QDD is required to make is less than such payment (or if there is no offsetting dividend equivalent), the QDD would similarly be liable for tax on dividend equivalent payments it receives in its proprietary (non-dealer) capacity. We are not aware of any reason why compliance by a QDD with its QI agreement with respect to proprietary transactions (as distinct from its dealer transactions) should be of any particular concern to the IRS.

Expanding the QDD exception in this way would (i) be consistent with the fact that clearing members of OCC have a single proprietary account with OCC that includes all transactions the clearing member enters into as principal (as distinct from transactions entered on behalf of customers), (ii) be consistent with non-tax regulatory concepts of dealer activity, which include a dealer's proprietary trading,[8] (iii) greatly simplify the withholding process when a QDD engages in dealer activity and proprietary trading with the same counterparty, and (iv) most importantly to OCC, permit OCC to continue to allow Canadian firms to be OCC clearing members. If the final regulations require OCC to withhold on a Canadian clearing member's proprietary trading transactions even though the

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[5] *See* Prop. Treas. Reg.§§ 1.871-15(q), 1.1441-1(b)(4)(xxii).

[6] *See* Prop. Treas. Reg. § 1.1441-1(e)(6).

[7] *See* OCC comment letter dated July 15, 2014, at pp. 11-12; SIFMA comment letter dated May 1, 2014, at pp. 29-30.

[8] In the securities regulatory context, dealer activity includes both principal trading to facilitate customer activity as well as principal trading solely on behalf of the firm.

Canadian clearing member is a QDD, Canadian clearing members will no longer be able to engage in proprietary trading of U.S. listed options as they currently do. Accordingly, we strongly urge that the QDD exception be expanded to include proprietary non-dealer transactions.

We note that the requirement that a QDD be a QI may be unduly restrictive given the current definition of the term QI in Treas. Reg. § 1.1441-1T(e)(5)(ii). In relevant part, the definition is limited to financial institutions, which are defined in Treas. Reg. § 1.1441-1T(e)(5) by cross-reference to Treas. Reg. § 1.1471-5(c). While the prior definition of financial institution for section 1441 purposes included brokers and dealers in securities, the current definition (as revised to conform to the FATCA definition) does not by its terms include brokers and dealers. The part of the new definition that would be most likely to include broker/dealers applies to an entity if at least 20% of its gross income for the prior three years consists of "income attributable to holding financial assets and related financial services." While this definition would seem to cover brokers, it may well not encompass a dealer that does not also provide brokerage, custody or similar services for customers.

We have previously recommended that the definition of financial institution be revised to once again expressly include brokers and dealers in securities.[9] In the absence of restoring such entities to the definition of financial institution, it may be appropriate to revise the definition of a QI in Treas. Reg. § 1.1441-1T(e)(5)(ii) to expressly include a dealer in securities.

Cascading or Excessive Withholding Tax

As IRS and Treasury have recognized, there is a potential for cascading or excessive withholding tax when a QDD (or other dealer) acts as intermediary with respect to section 871(m) transactions. The Proposed Regulations would address this concern by providing that to the extent a QDD receives a dividend equivalent as the long party to a section 871(m) transaction and also pays a dividend equivalent as the short party to a section 871(m) transaction referencing the same underlying security, the QDD is not liable for tax under section 871 or 881 on the dividend equivalent it receives and would withhold tax on the dividend equivalent it pays. This approach is similar to the approach in the qualified securities lender ("QSL") regime established by Notice 2010-46.

There is, however, one significant difference between how the approach works in the QSL context and how it may work in the broader section 871(m) context encompassing specified notional principal contracts ("specified NPCs") and specified equity linked instruments ("specified ELIs"). In the QSL context, a substitute dividend is treated as a substitute dividend regardless of whether the payee is a U.S. person or a non-U.S. person. In contrast, dividend equivalents with respect to specified NPCs and specified ELIs appear to exist only if the payee is a non-U.S. person. Based on the language in the Proposed Regulations,[10] it appears that if a QDD is the long party to a specified NPC or

[9] *See* OCC comment letter dated July 15, 2014, at pp. 13-14.

[10] *See* Prop. Treas. Reg. § 1.871-15(q)(1).

specified ELI and enters into an offsetting specified NPC or specified ELI with a U.S. counterparty, the QDD will be liable for tax under section 871 or 881 on the dividend equivalent it receives -- even though it is acting as an intermediary -- because the QDD is not treated as making a dividend equivalent payment to the U.S. counterparty. Under section 871(m)(6), Treasury and the IRS have authority to reduce the tax otherwise due with respect to a section 871(m) transaction to address the role of intermediaries. Exercising that authority to address this concern would eliminate the distortion in economic behavior that will result if a QDD has to hedge with a non-U.S. person in order to avoid having to satisfy U.S. tax liability from its own funds (as opposed to withholding the dividend equivalent payment it makes on an offsetting section 871(m) transaction entered into with a non-U.S. person).

A similar issue can arise in connection with the transition from the limited scope of section 871(m) currently in effect to the expanded scope that will exist for transactions entered into on or after January 1, 2017. Specifically, a QDD might hedge a short grandfathered position, *i.e.*, a short position that would be a specified NPC or specified ELI except that it was entered into before January 1, 2017, with a long specified NPC or specified ELI entered into on or after January 1, 2017. The QDD would receive a dividend equivalent payment with respect to the long specified NPC or specified ELI, but would not be treated as paying a dividend equivalent with respect to the short grandfathered position. As a result, the QDD would apparently be liable for tax under section 871 or 881 even though it is acting as an intermediary. Again, we urge Treasury and IRS to exercise their authority under section 871(m)(6) to ameliorate this problem.

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We appreciate the extensive effort that the IRS and Treasury have expended in attempting to craft a workable set of rules for implementing the Congressional policies embodied in section 871(m). We believe that adopting the recommendations set forth in this letter would further that objective.

Respectfully submitted

Joseph P. Corcoran
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