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Executive Vice President
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July 15, 2014

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
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The Honorable William J. Wilkins
Chief Counsel
Internal Revenue Service
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Washington, DC 20224

Re: Proposed Regulations Under Code Section 871(m) (REG-120282-10)

Gentlemen:

This letter sets forth the comments of The Options Clearing Corporation ("OCC") on the revised set of proposed regulations issued last December under section 871(m)[1] relating to the imposition of withholding tax on dividend equivalents (the "New Proposed Regulations"). OCC provides central counterparty clearing and settlement services to all U.S. options exchanges[2] as well

[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 12 options exchanges in the United States.

as to several futures exchanges that trade single stock futures contracts and futures contracts on equity-based indexes. 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 Wall Street Reform and Consumer Protection Act,[3] OCC has been designated as a systemically important financial market utility ("SIFMU").

OCC is a member of the U.S. Securities Markets Coalition (the "Coalition") and fully supports the Coalition's March 5, 2014, comments on the New Proposed Regulations. As is evident from the comments that have been filed by the Coalition and other groups, there is widespread concern about (i) the disruptive effects the New Proposed Regulations would have on the markets for listed options and other exchange-traded derivatives, and (ii) the extraordinary burdens that would be placed on broker/dealers and other market participants.[4] We recognize that IRS and Treasury face a daunting task in developing sensible rules to prevent avoidance of dividend withholding tax through the use of derivatives referencing U.S. stocks. We believe, however, that at least as applied to listed options, the New Proposed Regulations paint with too broad a brush and unnecessarily exacerbate the disruptive effects on the markets and the burdens on various market participants. Accordingly, we urge IRS and Treasury to target potential avoidance transactions more narrowly in order to reduce the burdens that would be placed on various market participants and to reduce the potential for confusion and disruption of the listed options markets. Given the unusually challenging nature of this task and the novel and complex administrative issues involved, we recommend that IRS and Treasury convene

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[3] P.L. 111-203, 124 Stat. 1376 (2010).

[4] *See, e.g.*, Coalition comment letter dated March 5, 2014 (the "2013 Proposed Regulations would unnecessarily disrupt trading on U.S. options exchanges"); SIFMA comment letter dated May 2, 2014 (describing the proposed regulations as "operationally unadministerable" and expressing "serious concerns about how to implement section 871(m) withholding in the context of exchange-traded ... products" even if SIFMA's recommended changes are adopted); ISDA comment letter dated May 16, 2014 ("the Proposed Regulations impose massive operational and administrative burdens on broker-dealers ... and the complexity of the rules may result in substantial confusion ..."); and New York State Bar Tax Section comment letter dated May 20, 2014 ("potentially enormous complexity involved in applying delta test to exchange-traded instruments").

a roundtable of interested market participants to discuss the costs, burdens and adverse consequences of the New Proposed Regulations and to identify more practical approaches to meeting the policy objectives underlying section 871(m).[5] If you decide not to follow this course, we strongly recommend that the next iteration of the regulations be issued in proposed form so that market participants have an opportunity to comment before the revised regulations are issued in final form.

The balance of this letter focuses on aspects of the New Proposed Regulations that could directly affect OCC's ability to function efficiently in its critical role as the clearing organization for all U.S. options exchanges as well as several U.S. futures exchanges. These aspects include: (i) identifying the market participants who have the obligation to determine if a transaction is a section 871(m) transaction and, if so, the amount of any dividend equivalents, (ii) OCC's potential withholding and reporting obligations when it is facing one of its non-U.S. clearing members acting either for its own account or for a customer, and (iii) OCC's potential withholding and reporting obligations when it is facing one of its U.S. clearing members that is acting directly or indirectly for a non-U.S. customer. Our recommendations may be summarized as follows: (i) clarify which market participant will have the obligation to determine if a transaction is subject to section 871(m) and the amount of any dividend equivalents, and impose those obligations on someone who knows that the long party is a non-U.S. person; (ii) expand the qualified dealer exception to include proprietary (non-dealer) transactions; and (iii) make clear that the established rules relating to dividend withholding apply with respect to dividend equivalents and amend the definition of financial institution in Treas. Reg. § 1.1441-1(b)(2)(ii) to include registered broker/dealers.

OCC and the Clearance and Settlement Process

As a central counter-party clearing organization, OCC is a passive intermediary and its primary function is to minimize credit risk. OCC clears options on over 3,700 different stocks and equity-based indexes. In 2013, OCC cleared 3.7 billion options contracts on individual equities, with

[5] We note that the U.S. Chamber of Commerce has made a similar recommendation.

each contract representing 100 shares of the underlying stock. When index options are included, OCC cleared 4.1 billion options contracts in 2013, or an average of 16.3 million contracts every trading day. In 2013, the total gross premiums for options cleared and settled by OCC was $1.2 trillion or roughly $4.8 billion per trading day. The average notional value for options contracts cleared by OCC in 2013 based on month-end data was $3.8 trillion. OCC also clears single stock futures contracts and futures contracts on equity-based indexes. This is a much smaller part of OCC's activity. In 2013, OCC cleared 59.6 million futures contracts, of which 9.5 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.

On a daily basis, OCC receives "matched trade" reports from each options exchange identifying the clearing members involved in each options transaction during the day.[6] Among other things, this information includes whether the transaction is an opening or closing transaction and whether the transaction is for the clearing member's proprietary account or for its omnibus customer account. In the case of customer transactions, the report does not identify the specific customer and OCC does not otherwise have that information.[7] Similarly, while OCC knows if a closing transaction is for a clearing member's proprietary account or its omnibus customer account, OCC does not know which specific option contract is closed out. For example, if a clearing member has 5,000 Intel call options with identical terms and closes 50 of them, OCC does not know which 50 of the 5,000

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[6] All transactions on an exchange must be between members of the exchange, and all exchange members must either be clearing members of OCC or have an account with a clearing member of OCC through which their trades are cleared.

[7] The matched trade report includes an "optional data" field in which clearing members may record additional data for their own internal purposes. OCC understands that some clearing members include a number in this data field to identify the particular customer for whom they acted. OCC does not know the identity of any specific customer that may correspond to such a number.

contracts were closed. As far as OCC is concerned, all the contracts are fungible. For transactions in a clearing member's customer account, OCC also does not know which specific customer's contracts were closed, nor does OCC know whether the customer is a direct customer of the clearing member or a customer of an intermediate broker that uses the clearing member to clear its trades.

Based on the information in the matched trade reports, OCC determines the net premiums payable by or to each clearing member for the day taking into account all of the member's trades with all other clearing members. Based on the open positions of each clearing member at the close of the day (including both newly created positions during the day and continuing positions entered into previously), OCC computes the daily margin requirement for each clearing member. By 9:00 am (Central Time) the next morning, OCC debits the clearing bank account of each clearing member with a net amount payable and by 1:00 pm (Central Time) (but often much earlier) credits the clearing bank account of each clearing member with a net amount receivable. In 2013, OCC processed an average of $1.0 billion in daily changes in initial and variation margin payments, and the peak daily initial and variation margin payment processed by OCC was $7.8 billion on June 20, 2013.

Issues Raised for OCC Under the New Proposed Regulations

1. Identifying the market participants who have the obligation to determine whether listed options transactions are section 871(m) transactions and to determine the amount of any dividend equivalents

The New Proposed Regulations require certain parties to a transaction that may be subject to section 871(m) to determine whether the transaction is a section 871(m) transaction, and if so, the amount of any dividend equivalents. The determination of whether an options contract is a section 871(m) transaction requires a determination of the initial delta of the option. Similarly, the determination of the amount of a dividend equivalent requires a determination of the option's delta on the dividend date, or for contracts with terms of one year or less, on the day the option is closed out, exercised or expires.

Under Prop. Treas. Reg. § 1.871-15(o)(1), if a broker or dealer is a party to a transaction with a counterparty or customer who is not a broker or a dealer, then the broker or dealer must make these determinations. If both parties to the transaction are brokers or dealers, or neither party is a broker or dealer, then the "short party" must make these determinations. The party required to make these determinations must report to the counterparty or customer (and to certain other persons on request) the timing and amount of any dividend equivalents.[8] If the party required to make the determination and to provide the information fails to provide it in a timely manner, the person who would normally be the withholding agent is relieved of withholding responsibility and the party failing to provide the information becomes liable for the withholding tax.[9] Given these consequences, it is critically important that there be no ambiguity as to the identity of the party that has these obligations.

All of OCC's clearing members are brokers and/or dealers; OCC is not a broker or a dealer.[10] Thus, clearing members rather than OCC will have the obligations described above if they and OCC are "parties to the transaction" for these purposes. For trades in their proprietary account, the clearing member is obviously a party to the options contract. For trades in their customer account, it is unclear whether the clearing member is a party to the transaction for purposes of Prop. Treas. Reg. § 1.871-15(o). When a clearing member's (direct or indirect) foreign customer holds a long call or has written a put, OCC would appear to be the "short party" to the transaction.[11] As a result, if the clearing member acting (directly or indirectly) for the foreign customer is not considered a party to the transaction for purposes of Prop. Treas. Reg. § 1.871-15(o)(1), OCC would appear to have the obligations described above (unless the customer happens to be a dealer or a broker).

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[8] *See* Prop. Treas. Reg. § 1.871-15(o)(3).

[9] *See* Prop. Treas. Reg. § 1.1441-3(h)(2).

[10] *Cf.* Treas. Reg. § 1.6045-1(a)(1) and -1(b)(Example 2(vii)) (clearing organization is not a broker for information reporting purposes).

[11] Once a listed options contract is novated, OCC becomes the counterparty to the option seller and the counterparty to the option buyer.

The New Proposed Regulations define the term "party to a transaction" to mean any person that is a long party or a short party to the transaction.[12] The "long party" is defined to mean the party entitled to a dividend equivalent and the "short party" is defined to mean the party liable for a dividend equivalent.[13] The terms "long party" and "short party" would seem to mean the principals to the contract, rather than intermediaries acting as agents.

However, it is not clear if this definition is intended to apply for purposes of Prop. Treas. Reg. § 1.871-15(o)(1). First, the preamble to the New Proposed Regulations contains the following discussion of the thinking that underlies the proposed approach:

> "Most equity-linked transactions involve a financial institution acting as a broker, dealer, or intermediary. A financial institution is usually in the best position to undertake the responsibility to report the tax consequences of a potential section 871(m) transaction. Accordingly, §1.871-15(o) of the 2013 proposed regulations provides that when a broker or dealer is a party to a potential section 871(m) transaction, the broker or dealer is required to determine whether the transaction is a section 871(m) transaction, and if so, the amounts of the dividend equivalents."

This rationale is difficult to square with a rule providing that even though a broker is involved in a transaction on behalf of a customer, the obligation is not imposed on the broker because it is not a "party" as defined in Prop. Treas. Reg. 1.871-15(a)(7).

> **Example:** Acting through a broker, a foreign person (FP) enters into a transaction that may be a section 871(m) transaction. The party on the other side (OP), who is not itself a broker or dealer, also acts through a broker. Although the discussion in the preamble suggests that the

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[12] *See* Prop. Treas. Reg. § 1.871-15(a)(7).

[13] *See Id.*

> obligation should be imposed on one of the brokers involved in the transaction, a narrow reading of the term "party" in this context would put the obligation on OP.

Second, the list of persons in Prop. Treas. Reg. § 1.871-15(o)(3) who can request the information regarding dividend equivalents includes the phrase "any party to the transaction" three times and each time the phrase is followed by "as described in paragraph (a)(7) of this section." In contrast, Prop. Treas. Reg. § 1.871-15(o)(1) uses the phrase "party to the transaction" without any reference to the definition in paragraph (a)(7). Third, Prop. Treas. Reg. § 1.871-15(o)(1) speaks in terms of a broker or dealer that "is a party to a potential section 871(m) transaction with a counterparty or a customer that is not a broker or dealer."[14] Since the parties to the transaction as defined in Prop. Treas. Reg. § 1.871-15(a)(7) are counterparties, it is not clear what is contemplated by referring to a broker (or dealer) that is a party to a transaction with a "customer" who is not a counterparty. Finally, the example in the New Proposed Regulations indicating that a clearing organization is a withholding agent for purposes of section 871(m) when facing a non-U.S. clearing member acting for a foreign customer states that the clearing organization is "the counterparty" to the foreign clearing member.[15] This language appears to indicate that OCC and the clearing member acting as agent are the counterparties to the contract for these purposes.

Regardless of what was intended, there are strong practical reasons why an approach that focuses on the parties to the transaction, as defined in Prop. Treas. Reg. § 1.871-1(a)(7), does not make sense for listed options. If the "party to the transaction" is a customer of the clearing member (or of an intermediate broker down the chain), OCC does not know if that customer is itself a broker or dealer, and if the customer is a broker, whether the broker is acting for its own account or for one of its customers. More importantly, OCC does not know if the customer is a U.S. or foreign person. Most of the time, it is a U.S. person, in which event section 871(m) has no application and there is no

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[14] Emphasis supplied.

[15] *See* Prop. Treas. Reg. § 1.1441-7(a)(3), Example 7.

need to determine whether the transaction otherwise falls within section 871(m). Assigning responsibility for determining if a transaction is subject to section 871(m) and the amount of any dividend equivalents based on the status of the parties cannot work properly if one party to the transaction does not know who the other party is. More fundamentally, such responsibility should arise only if a non-U.S. person is a long party to the transaction. Thus, the obligation to determine if section 871(m) applies and the amount of any dividend equivalents should be imposed on a person with knowledge that a non-U.S. person is a long party to the transaction.

It would not be feasible for OCC to establish and maintain the systems necessary to determine the tax status of the ultimate customer for all listed options transactions, determine whether that customer is a broker or dealer, determine the initial delta for a transaction that meets these two filters, and determine the amount of dividend equivalents associated with the transaction. OCC does not receive documentation on the tax status of such ultimate customers and, given the volume of transactions and the demands associated with clearing and settling those transactions quickly, accurately and efficiently on a daily basis, we cannot envision a feasible way for OCC to obtain that information and incorporate it into its systems in a timely manner. Imposing such an obligation on OCC would increase operational risk in ways that are at odds with its responsibilities as a central counter-party clearing organization and a SIFMU. It is clear that the broker with the direct relationship with the customer (or a broker that receives appropriate documentation from that broker) is in the best position to know the tax status of the customer. This broker is also in the best position to know if multiple transactions are related. It makes sense for this broker to be given the responsibility to determine if a customer transaction is a section 871(m) transaction and the amount of any dividend equivalents.

2. Withholding and reporting obligations with respect to listed options transactions entered into by OCC's Canadian clearing members

The New Proposed Regulations would make clear that OCC is a withholding agent when it faces a Canadian clearing member.[16] As a withholding agent, OCC will also be obligated to report dividend equivalent amounts annually to its Canadian clearing members and to the IRS. There is a limited exception to the withholding requirement for certain dividend equivalents received (or deemed to be received) by "qualified dealers" acting in their capacity as dealers.[17] A qualified dealer is defined as any dealer (i) that is subject to regulatory supervision by a governmental authority in its home country, and (ii) that furnishes a written certification to the counterparty that it is a qualified dealer acting in its capacity as a dealer and that it will withhold and deposit the tax due on any dividend equivalent payment that it makes (or is deemed to make) as a short party in a section 871(m) transaction. This exception does not apply to proprietary (i.e., non-dealer) positions held by a qualified dealer.

Different issues are presented depending on whether the Canadian clearing member is engaging in a transaction for its own account or for a customer account.

Customer Account Transactions: OCC is planning to modify its rules to require all of its non-U.S. clearing members to be qualified intermediaries assuming primary withholding responsibility ("Withholding QIs"). As a result, OCC will not be required to withhold on any dividend equivalent with respect to section 871(m) transactions in a Canadian clearing member's customer account. OCC will still be required to report the amount of any such dividend equivalent. However, if our recommendation above is adopted, the Canadian clearing member will provide OCC with the information it needs to comply with its reporting obligations.

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

[17] *See* Prop. Treas. Reg. § 1.871-15(j).

Proprietary Account Transactions: The qualified dealer exception, as proposed, would relieve OCC of withholding responsibility when a Canadian clearing member is acting in a dealer capacity, but it would not apply to non-dealer proprietary transactions. The qualified dealer exception should be expanded to include proprietary (i.e., non-dealer) transactions entered into by a qualified dealer. This expanded approach would track the rules in Notice 2010-46 for substitute dividend payments made to "qualified securities lenders" ("QSLs"). If a QSL is obligated to make an offsetting substitute dividend payment on identical securities it has borrowed, the QSL must withhold and remit the tax with respect to that payment. If the QSL does not have to make an offsetting payment (*e.g.*, because it lent securities that it owned), then the QSL must remit the tax due on the substitute dividend payment it receives. This latter context -- where a QSL remits the tax it owes and that normally would have been withheld from the payment it receives -- is analogous to applying the qualified dealer exception to dividend equivalents received by a clearing member with respect to proprietary (non-dealer) transactions. In both situations, the QSL or qualified dealer is paying the tax for which it is liable.[18]

OCC will still be required to report dividend equivalents associated with transactions in its Canadian clearing members' proprietary accounts. However, if the Canadian clearing member is required to determine if a listed options transaction is a section 871(m) transaction and to tell OCC the amounts of any dividend equivalents, OCC will have the information it needs to comply with its reporting obligations.

Even though OCC has relatively few Canadian clearing members, OCC is not in a position to identify those transactions that are section 871(m) transactions, calculate associated dividend equivalents, and withhold and remit the appropriate withholding tax. Accordingly, we strongly urge that: (i) the qualified dealer exception be expanded to include proprietary non-dealer

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[18] SIFMA and the New York State Bar Tax Section have similarly recommended expanding the qualified dealer exception along these lines.

transactions, and (ii) that non-U.S. clearing members be required to provide OCC with information necessary for OCC to report required information on Forms 1042 and 1042-S.

3. Withholding and reporting obligations with respect to listed options transactions entered into by OCC's U.S. clearing members when they are acting, directly or indirectly, for a foreign customer

When OCC is facing a U.S. clearing member acting directly or indirectly for a foreign customer, OCC may be viewed as the short party if the transaction is a section 871(m) transaction. As a result, OCC may be a withholding agent because it is deemed to have control and custody of any dividend equivalent.[19] OCC will not, however, have an obligation to withhold if it can treat the U.S. clearing member as the "payee" of the dividend equivalent. Under Treas. Reg. § 1.1441-1(b)(2), a payee is generally the person to whom a payment is made regardless of whether that person is the beneficial owner of the payment. However, if a withholding agent makes a payment to a U.S. person and has actual knowledge that the U.S. person is receiving the payment as an agent of a foreign person, the withholding agent must (generally) treat the payment as made to the foreign person. Significantly, this latter rule does not apply if the withholding agent is making the payment to a "financial institution" and the withholding agent has no reason to believe that the financial institution will not comply with its withholding obligations.[20] If the withholding agent is relieved of withholding under this rule, the withholding agent also has no obligation to report the payment to the IRS.

If the rules described above apply to dividend equivalents under section 871(m), then OCC would have no withholding or reporting obligations when it is facing a U.S. clearing member acting, directly or indirectly, for a foreign customer. When OCC is facing a U.S. clearing member, OCC does not have actual knowledge that the beneficial owner of any deemed dividend equivalent is

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[19] *See* Treas. Reg. § 1.441-7(a)(2).

[20] *See* Treas. Reg. § 1.1441-1(b)(2)(ii).

a foreign person. OCC will know that the trade is in the clearing member's omnibus customer account, but that is all.

Even if OCC were to have actual knowledge that the beneficial owner is a foreign person, OCC does not have to withhold as long as the U.S. clearing member is a financial institution for purposes of these rules and OCC has no reason to believe that the clearing member will not comply with its withholding obligations. Under the prior regulations, a financial institution was defined for this purpose to include a broker or dealer in securities. It thus clearly encompassed all of OCC's U.S. clearing members. In February, however, Treasury amended the definition as part of a large-scale revision of definitions and rules in Chapter 3 to make them consistent with various definitions and rules adopted in the FATCA regulations.[21] As a result, the new definition of financial institution for Chapter 3 purposes is the same as the definition in the FATCA regulations.[22] That definition does not by its terms provide that a broker or dealer in securities is a financial institution. The part of the new definition that would most likely 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."[23]

In the FATCA context, the definition of financial institution is generally self-applied, *e.g.*, a foreign entity needs to determine if it is itself a financial institution. The entity obviously

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[21] *See* T.D. 9658.

[22] *See* Treas. Reg. § 1.1441-1T(c)(5), providing that the term "financial institution" means a person described in Treas. Reg. § 1.1471-5(c).

[23] The phrase "income from holding financial assets and related financial services" is defined to mean:

> "custody, account maintenance, and transfer fees; commissions and fees earned from executing and pricing securities transactions; income earned from extending credit to customers with respect to financial assets held in custody by the entity (or acquired through such extension of credit); income earned on the bid-ask spread of financial assets; fees for providing financial advice with respect to financial assets held in (or potentially to be held in) custody by the entity; and fees for clearance and settlement services."

knows what its sources of gross income have been over the prior three years. In the Chapter 3 context, and specifically in the context of the rule providing that a withholding agent need not withhold if it makes a payment to a U.S. financial institution acting for a foreign person, this definition poses significant problems. How is a withholding agent supposed to know if the person to whom it is making a payment meets the 20% of gross income test? If the clearing member is a disregarded entity owned by another U.S. entity, the challenge becomes even greater. It may well be that all of OCC's U.S. clearing members meet this test but the test still does not make sense in this context. Accordingly, we recommend that the definition of financial institution in this context be amended to include registered broker/dealers.[24]

We also recommend that the New Proposed Regulations be modified to make clear that the rules described above apply with respect to dividend equivalents. Unfortunately, the New Proposed Regulations create some ambiguity in this regard. The rules described above contemplate that a payment is actually being made. In contrast, dividend equivalents with respect to options (and other derivatives) will not involve actual payments. The short party is deemed to control the dividend equivalent and therefore could conceivably be obligated to withhold and remit the tax due even if there is a U.S. financial institution between the short party and the foreign customer, although it is hard to understand how this would work if the short party does not have tax documentation establishing that the customer is a foreign person and the identity of that person.

We believe that the person required to withhold on dividend equivalents should be determined using the same rules that apply to actual payments of dividends. Apart from avoiding confusion and disruption, this approach will tend to place withholding responsibility on a broker or other withholding agent with information as to the foreign person's tax status and with assets of the foreign person against which to withhold. Accordingly, we ask that the New Proposed Regulations

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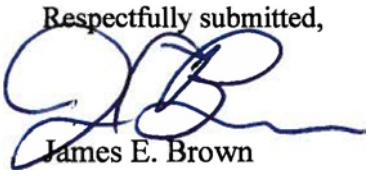
[24] All of OCC's U.S. clearing members are broker/dealers registered with the SEC.

be modified to make clear that the rules for withholding on actual dividends apply for purposes of determining who has withholding responsibility with respect to dividend equivalents.

Respectfully submitted,



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