U.S. Securities Markets Coalition

December 19, 2014

By Electronic Delivery and First Class Mail

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

Re: Application of Mark-to-Market Proposals to Exchange-Traded Equity Options

Dear Mr. Mazur:

On behalf of the members of the U.S. Securities Markets Coalition[1] and the millions of individuals and other taxpayers who use exchange-traded options as part of their investment strategies, we write to express our serious concerns regarding tax legislative proposals that would treat all options as sold at the end of the year and treat appreciated stock as sold if a taxpayer enters into an option to manage the risk associated with owning the stock. Proposals having this effect, such as the uniform mark-to-market proposal for derivatives included in Chairman Camp's tax reform bill (H.R. 1) and in prior Administration budgets, would adversely affect taxpayers using exchange-traded options to manage risk, including many individuals using basic options strategies; distort rational economic decision-making; and replace the well-established and relatively simple tax rules for exchange-traded options with a harsh, burdensome and overly complicated regime. Accordingly, we urge the Administration not to advance or support the

[1] The members of the Coalition include all of the major options exchanges in the United States as well as The Options Clearing Corporation ("OCC"), which provides central counterparty clearing for all U.S. exchange-traded options. The exchange members of the Coalition are BATS Options, BOX Options Exchange, Chicago Board Options Exchange, International Securities Exchange, NASDAQ Options Market, NASDAQ OMX PHLX, NYSE Arca, and NYSE Amex. In 2013, these exchanges accounted for over 98 percent of all exchange-traded options volume in the United States.

application of such proposals to exchange-traded options (also known as listed options), whether in the context of the Administration's budget, tax reform or otherwise.

Equity options have been traded on U.S. securities exchanges for over 40 years. The U.S. options exchanges currently offer options on roughly 3,700 individual stocks, exchange-traded funds ("ETFs"), and equity-related indices. In 2013, some 3.7 billion options contracts on individual equities were traded on U.S. options exchanges, with each contract covering 100 shares of the underlying stock. Individual taxpayers are significant participants in the listed options markets. While precise statistics are not available, it is estimated that approximately one-fourth of the volume on U.S. options exchanges is attributable to individuals, with millions more individuals participating indirectly through mutual funds and other investment vehicles.

Our concerns regarding the application of the mark-to-market proposals to listed options include the following:

- The proposals would effectively impose a tax penalty on individuals and other taxpayers who use listed options to manage the risk associated with owning stock. A taxpayer who hedges appreciated stock with a listed option is treated as having sold the stock for its fair market value even though the taxpayer has not sold the stock and may continue to hold the stock for many years. For example, many individuals holding stock buy put options in times of market uncertainty to limit their downside exposure in the stock. Under the proposals, these individuals would have to recognize any gain in the stock at that time. While such deemed sale treatment may make sense as a matter of tax policy if the taxpayer eliminates substantially all of the economics of owning the stock, the mere fact that a taxpayer has reduced risk is not a sound basis for treating the taxpayer as having sold the stock. The fact that the proposals do not similarly treat any loss as currently recognized compounds the unfairness of this approach.

- Complex tax accounting rules would be needed to coordinate changes in the value of the stock while the offsetting option position is in place. The Treasury "Green Book" describing the Administration's uniform mark-to-market proposal for the 2015 budget states that Treasury would be given regulatory authority to promulgate rules coordinating the timing and character of gain or loss on stock and an offsetting option (or other derivative). Chairman Camp's version of the mark-to-market proposal included such rules and those rules illustrate the complexity and burdens taxpayers would face, including (i) marking to market of the stock when the option is closed out or expires (as well as at year-end when the option is marked to market); (ii) gains and

losses on the stock switching from capital to ordinary and then back to capital again, and (iii) interim basis adjustments to the stock to reflect changes in value while the offsetting option position was in place. There is no simple way to achieve the coordination envisioned by the proposals. Whatever approach Treasury might settle upon would, among other things: (i) change the time at which gain/loss on the stock or gain/loss on the option is taken into account, (ii) require basis adjustments or suspension of recognized gain/loss, and (iii) require recording and retaining (often for many years) data points that are not necessary to record or retain under current law, such as the value of the underlying stock at the time the offsetting option is entered into and at the time the option is closed out or expires.

- The "substantial diminution" standard is vague and creates significant uncertainties. The mark-to-market proposal in the Administration's 2015 Budget would apply these rules to stock if the option substantially diminishes the risk of loss in the stock. The "substantial diminution" concept is borrowed from the straddle rules in Code section 1092. It is often extremely difficult to determine if this standard is met. For example, if a taxpayer owns 100 shares of stock trading at $50 a share and buys a 30-day put option with a strike price of $40, has the taxpayer substantially diminished his or her risk of loss on the stock? When a straddle does exist, it can often be difficult to determine which positions are part of the straddle. For example, if a taxpayer owns 200 shares of stock and buys a put option on 100 shares, does the straddle include all 200 shares of stock or just 100 shares? Does the volatility of the stock need to be taken into account in answering these types of questions? If only 100 shares are part of the straddle, which 100 shares? The existence of these and other ambiguities may be acceptable in the context of anti-abuse rules, such as the straddle rules, but it is unreasonable to have such uncertainties in a regime that will treat a taxpayer as having sold appreciated stock merely as a result of hedging activity. In addition, whether a straddle exists is often a moot point under current law (*e.g.*, where the positions are all disposed of in the same year or the disposition of a position does not result in a loss), but that would not be the case under the proposals.

- The proposals would exacerbate the existing disparity between the tax treatment of business hedges and investment hedges. Unlike business hedges, which are taxed in an economically rational way, investment hedges are already taxed uneconomically due to the punitive aspects of straddle rules. Treating appreciated stock as sold merely because a taxpayer has hedged the risk of loss on the stock would make the disparity between the treatment of business hedges and investment hedges even greater.

- Treating gain and loss on listed options as ordinary would lead to character whipsaws. Taxpayers using equity options as part of an investment strategy could end up with ordinary income from their options activity and capital losses on their stock transactions (where the options relate to other stocks or otherwise do not substantially diminish risk of loss on stocks held by the taxpayer). A taxpayer who hedges general market risk associated with a portfolio of stocks by entering into an index option could also end up with capital losses in the stock portfolio that could not be used to offset ordinary income from the option.

- The tax treatment of listed equity options not held in combination with the underlying stock is governed by well-established rules that are relatively simple, straightforward and easy to understand. These rules are set forth in Rev. Rul. 78-182, which was issued not long after options first started trading on a national securities exchange. The fact that these rules were adopted a number of year ago is not an argument for replacing them. Not only do they continue to work well, but the listed options to which they apply are essentially the same as they were 35 years ago. Moreover, the vast majority of listed equity options traded have very short terms. Based on analysis by the Chicago Board Options Exchange ("CBOE"), approximately 76 percent of options contracts traded in 2013 had terms of two months or less and some 83 percent had terms of three months or less. The average time these contracts were outstanding is even shorter since most option contracts (roughly 70 percent) are closed out prior to their expiration date. Thus, listed options typically do not involve the type of long-term deferral associated with certain other instruments. Marking these options to market at year-end, and the associated complexities and burdens, thus seem unwarranted.

The principal policy objective of proposals to mark all derivatives to market appears to be to apply uniform tax treatment to all derivatives. The concept of uniformity, however, can be applied in different ways. For example, one uniform approach to financial products would be to tax financial products with similar economics according to similar tax rules regardless of the particular "cubbyhole" a particular financial product might fall into. This approach would increase efficiency because a taxpayer would not select a particular financial product over another financial product with similar economics in order to obtain more favorable tax treatment. The uniform mark-to-market proposals would not achieve uniform tax treatment in this sense. They would apply a single mark-to-market approach to all derivatives even if they have very dissimilar economics and without regard to whether they are governed by clear and sensible rules under current law. In this regard, the proposals paint with too broad a brush.

Moreover, uniformity is not an ultimate tax policy goal in itself. Rather, it is an intermediate goal that in some contexts furthers the ultimate tax policy goals of simplicity, fairness, efficiency, and administrability. As applied to listed options, however, the uniform mark-to-market approach in the proposals, and the associated rules that would apply when a taxpayer hedges stock with an option, do not further these important goals:

- Simplicity -- The proposals would introduce great complexity in the tax treatment of exchange-traded options and stock as compared with the well-established rules of current law.

- Efficiency -- The proposals would distort economic behavior and discourage individuals and other taxpayers from using listed equity options to reduce risk or generate income in economically rational ways.

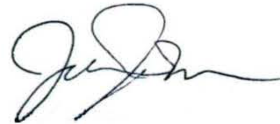
- Fairness -- The proposals would trigger gains -- but not losses -- in stock when a related option position is established. Taxpayers would need to come up with cash to pay the tax on unrealized gains.

- Adminstratibility -- The rules that would be needed to coordinate the treatment of stock and an offsetting option position -- including deemed sales of stock, basis adjustments, suspended gains and losses, and character conversion rules (with stock moving from capital gain or loss to ordinary income or loss and back again) -- would require extensive recordkeeping to capture and retain data that is completely unnecessary under current law and that would not be retained for any non-tax purpose.

Based on these tax policy considerations, and the other concerns expressed above, we urge the Administration not to advance or support the application of mark-to-market proposals to exchange-traded options.

Sincerely,

Craig Donohue
Executive Chairman, Options Clearing Corporation



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