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William M. Paul

Covington & Burling LLP
One CityCenter
850 Tenth Street, NW
Washington, DC 20001-4956
T +1 202 662 5300
wpaul@cov.com

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

William J. Wilkins
Chief Counsel
Internal Revenue Service
1111 Constitution Avenue NW
Washington, DC 20224

Emily S. McMahon
Deputy Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue NW
Washington, DC 20220

Steven Musher
Associate Chief Counsel - International
1111 Constitution Avenue NW
Washington, DC 20224

Karl Walli
Senior Counsel (Financial Products)
Department of the Treasury
1500 Pennsylvania Avenue NW
Washington, DC 20220

Marjorie Rollison
Deputy Associate Chief Counsel - International
1111 Constitution Avenue
Washington, DC 20224

Re: Final Section 871(m) Regulations

Ladies and Gentlemen:

This letter addresses certain issues raised by the final section 871(m)[1] regulations issued on September 18, 2015 (the "Regulations"). The letter is submitted on behalf of the U.S. Securities Markets Coalition, the members of which include all of the major options exchanges

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

in the United States and The Options Clearing Corporation ("OCC").[2] Trading in options listed on these exchanges exceeded four billion contracts in 2015.

The Coalition recognizes and appreciates the tremendous effort that has gone into crafting the Regulations. The Regulations are groundbreaking in multiple respects, including most notably their reliance on the theoretical concept of delta to identify options transactions that have a potential for avoiding dividend withholding tax. Given the novelty of this approach, as well as various complex and challenging issues addressed by the Regulations, it is not surprising that some additional fine-tuning of the Regulations is needed.

Understanding that the Regulations have been issued in final form and that there is limited scope for modifying them, the Coalition believes it is nonetheless critical that certain aspects of the Regulations as they relate to listed options be clarified, that certain improvements be adopted to ameliorate the burdens imposed on brokers, and that a regime be established to permit net delta calculations for options strategies that include options with short deltas as well as options with long deltas. In significant part, these clarifications and improvements can be accomplished through revenue procedures or other forms of guidance rather than changes to the Regulations themselves.

The refinements recommended by the Coalition reflect practical approaches that build on existing market mechanisms and practices. As discussed in more detail below, the Coalition's specific recommendations are as follows:

- Permit the deltas of listed options to be determined based on the prior day's closing prices and permit brokers and other parties to use end-of-day deltas generated by OCC.

- Clarify which broker has the obligation to determine whether a listed option transaction is a section 871(m) transaction and to make the other determinations required by Treas. Reg. § 1.871-15(p) with respect to listed options transactions.

- Reduce the burden of the recordkeeping requirements associated with ordinary-course delta calculations.

- Provide additional guidance as to how and when related transactions should be

[2] The options exchange members of the Coalition are: BATS Options, the Boston Options Exchange, the Chicago Board Options Exchange, the International Securities Exchange, NASDAQ Options Market, NASDAQ OMX PHLX, NYSE Arca, and NYSE Amex.

combined for purposes of the delta 80 test.

- Authorize the Commissioner to provide elective regimes reflecting a "net delta" approach for options strategies that include both options with short deltas and options with long deltas.

- Articulate relevant policies that will inform the Commissioner's decision as to the applicability *vel non* of the anti-abuse rule and provide examples.

DISCUSSION

1. Permit Deltas for Listed Options to be Determined Based on Prior Day's Closing Prices. -- Under the Regulations, the delta of a potential section 871(m) transaction is determined when the transaction "is issued."[3] The proposed regulations would have required that delta be determined at the time the long party acquires a potential section 871(m) transaction in the secondary market.[4] The preamble to the Regulations (the "Preamble") acknowledges the burdens associated with that approach and the appropriateness of ameliorating them:

> The Treasury Department and the IRS are persuaded that the difficulties of testing delta each time an NPC or ELI is acquired outweigh the benefit of the increased accuracy of that approach. Accordingly, the final regulations provide that the delta of an ELI or NPC is determined only when the instrument is issued; it is not re-tested when the instrument is purchased or otherwise acquired in the secondary market. Consequently, only an NPC or ELI that has a delta of 0.80 or greater at the time it is issued is a specified NPC or specified ELI.

There has been much discussion, and a bit of confusion, as to when a listed option is considered issued within the meaning of Treas. Reg. § 1-871-15(g)(2). For example, some market participants have suggested that a listed option should be viewed as issued when it is first listed by an exchange as available for trading. Government officials speaking at conferences have stated that listed options are viewed as issued at the time a particular options transaction is entered into. This interpretation is consistent with the manner in which listed options trade.

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[3] *See* Treas. Reg. 1.871-15(g)(2).

[4] *See* Prop. Treas. Reg. § 1.871-15(e).

Unlike most exchange-traded instruments, there is no secondary market trading in listed options. For example, if a person holds a listed call option and wishes to sell it, he or she enters an order to sell an identical call option and tells the broker that it is a closing transaction. The transaction results in a termination of that option contract. The order to sell may be paired with an order from someone else who wishes to buy the identical call option in an opening transaction, which results in the creation of a new contract. Even though these two orders may be matched on the exchange, there is no transfer of the existing call option from the seller to the buyer. From the perspective of market participants, however, this transaction is functionally equivalent to secondary market trading.

The Coalition's prior comments emphasized the enormous burden that the Regulations would impose on brokers with respect to determining deltas for listed options. The Coalition urged simplifying conventions and safe harbors to help ameliorate this burden. The Preamble states that the simplifying proposals put forward by the Coalition and others were rejected because they could result in uncertainty that could make it difficult to determine the status of potential section 871(m) transactions.[5] The Preamble goes on to state that "the changes to the Regulations to require that delta be tested only when a contract is first issued, accompanied by enhanced reporting rules ..., make these alternative tests unnecessary."[6]

Unfortunately, the change in the Regulations to test delta only when a potential section 871(m) transaction is issued does not address the burdens associated with determining deltas for listed options. As noted above, each time a listed options transaction is entered into, there is a new issuance and the delta of the option must be determined at that time. Given the volume of trading in listed options (over 16 million contracts per day), the number of unique options series available for trading (roughly 850,000 on any given day),[7] and the fact that an option's delta changes continuously throughout the course of the day, the burden of determining deltas for listed options at the time of issuance is as great as or greater than the burden of determining deltas for instruments that trade in a secondary market every time the instrument is acquired.[8]

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[5] Preamble at p. 11.

[6] *Id.*

[7] The features of an options series are: (i) whether the option is a call or a put; (ii) the identity of the underlying stock; (iii) the strike price of the option; and (iv) the expiration date of the option. For example, a call option on Intel with a strike price of $35 and an expiration date of March 18, 2016 is an option series. Each option series is given a unique identifying number similar to a CUSIP.

[8] While consistency would support testing delta of a listed option each time a contract is issued (since this is the approach for instruments that trade on the secondary market), the fact that options are issued each time they trade would frustrate the purpose underlying the "test-on-issuance" approach, which was to reduce burdens associated with calculating delta each time an instrument trades.

Accordingly, the Coalition believes it is critical that the Regulations be modified to ameliorate this burden.

Substantial burden reduction, simplification, and increased administrability could be achieved if deltas for listed options were based on the prior day's closing price. (For transactions that take place on the first day an option is available for trading, the closing price on that day would be used.) This approach would admittedly sacrifice some economic accuracy as compared to real-time delta calculations, but the benefits would be very substantial. Moreover, the loss of economic accuracy pales in comparison to the loss of economic accuracy associated with the decision to test instruments with variable deltas that trade in the secondary market -- such as ETNs, convertible debt and exchange-traded warrants -- only on their original issuance. The potential (and likely) change in deltas for such instruments over the entire time they are outstanding -- 20 years or more in some cases -- is huge, and the relevance of their deltas when originally issued to their deltas as they change hands in the secondary market over time can be quite small. Various aspects of the Regulations require striking a balance between economic accuracy and administrability/burden. Compared with the trade-off associated with the decision to test deltas for instruments that trade in the secondary market only on original issuance, the Coalition believes that the loss of economic accuracy from using the prior day's close to determine deltas for listed options should not be a concern.[9]

Basing the delta for a listed option on the prior day's close would be a practical way of achieving some of the burden reduction for listed options that has been achieved for instruments that trade in the secondary market. While deltas for listed options would have to be recomputed once each day, as opposed to only once on initial issuance, this change would still achieve improved administrability and significant burden reduction. For example, closing prices for stocks that underlie listed options, and the closing prices for listed options as well, are readily available to market participants and can be accessed long after the fact.

In addition, OCC currently calculates end-of-day deltas for all options listed on U.S. options exchanges. As noted above, there are approximately 850,000 unique options series available for trading on U.S. options exchanges on any given day. OCC calculates end-of-day deltas for each of these series so that OCC clearing members and members of the options

[9] In prior comments, the Coalition favored the economic accuracy associated with real-time deltas in the context of the Coalition's recommended delta threshold of 90 or 95, along with an "eyeball test" for determining deltas based on an option's extrinsic value and other burden-reducing simplifications. Since these previous recommendations have been rejected in the Regulations and the decision has been made to test instruments that trade in the secondary market only on original issuance, the Coalition believes testing deltas for listed options based on the prior day's close is appropriate.

exchanges can use them for purposes of the "delta-based equity hedge exemption" (the "Delta-Based Hedge Exemption") under exchange rules that limit how many options contracts a market participant can hold on either the long side (long call, short put) or short side (long put, short call) with respect to any particular stock.[10] Under the exemption, long and short delta positions are netted and only the resulting net delta counts for purposes of the rules on position limits. OCC's end-of-day delta calculations are provided to OCC's clearing members who subscribe to OCC's "prices file," which includes, *inter alia*, closing prices for all listed options on U.S. options exchanges in addition to the deltas for those options.[11] OCC clearing members and exchange members are permitted to use either the OCC end-of-day delta or end-of-day deltas calculated using their own proprietary models.[12] The Coalition understands that most clearing members that rely on the Delta-Based Hedge Exemption use their own proprietary models to calculate deltas rather than OCC's deltas.

Permitting deltas of listed options to be calculated based on the prior day's close and permitting the broker required to determine delta to use end-of-day deltas provided by OCC would achieve a significant reduction in burden. Brokers would not need to calculate end-of-day deltas if they choose to use the deltas calculated by OCC. Options would have the same delta throughout the trading day and market participants could readily determine at the time they enter into a listed options transaction whether the delta was above 80 or not for purposes of Section 871(m). And, as noted above, end-of-day price information is widely available and can be retrieved long after the fact.

Permitting deltas for listed options to be based on the prior day's close would also permit simplification and burden reduction with respect to options that may give rise to a dividend equivalent only if a special dividend is declared after the option is acquired. Most listed options contracts have very short terms[13] and do not include a scheduled dividend date, either because the next dividend date falls after the option's expiration date or because the stock does not pay dividends. As a general matter, it is completely unnecessary to determine deltas or make any of the other section 871(m) determinations with respect to these options. However, if, after such an option is entered into, a special dividend on the underlying stock is declared with a dividend date

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[10] The CBOE rule can be found in Interpretations and Policies .04(c) of CBOE Rule 4.11.

[11] Approximately 70% of OCC's members subscribe to this file.

[12] *See, e.g.*, the CBOE rule referenced in fn. 10, *supra*.

[13] For example, roughly 65% of all options volume on the CBOE in 2015 consisted of options with terms of 30 days or less and over 75% of all options volume consisted of options with terms of 60 days or less.

prior to the option's expiration date, the initial delta of the option becomes relevant.[14] If deltas for listed options had to be computed on a real-time basis, the responsible broker would either have to: (i) compute real-time deltas for options with no "in range" dividends because of the possibility that such a special dividend might be declared, or (ii) go back once a special dividend is declared or announced and try to determine what the real-time delta was. Permitting deltas to be based on the closing price on the day before a listed option is entered into will make it much easier to go back and determine the initial delta if a special dividend is later declared on a stock that had no scheduled "in-range" dividend at the time the option was entered into. Given that special dividends are paid on only a tiny fraction of the stocks on which options are traded,[15] adopting an approach that relieves brokers of the need to compute deltas on stocks with no "in-range" dividends merely because of the remote possibility that a special dividend will later be declared and be "in-range" would further reduce the burden of complying with the Regulations.

While the broker responsible for making the required determinations should be permitted to use OCC's deltas, it should also be permitted to use its own proprietary model to determine end-of-day deltas if it chooses. As noted above, for purposes of the Delta-Based Hedge Exemption, clearing members and exchange members are permitted to use their own proprietary models for calculating deltas, and most clearing members that avail themselves of this exemption use their own models to calculate the deltas rather than using OCC's deltas. Brokers should similarly be permitted to use their proprietary models to compute end-of-day deltas for section 871(m) purposes.[16]

2. Clarify the "party" to a listed options transaction that has the obligation to make the determinations required under Treas. Reg. § 1.871-15(p). -- Treas. Reg. § 1.871-15(p) provides rules regarding the "party to the transaction" that is required to determine (i) if a potential section 871(m) transaction is a section 871(m) transaction, (ii) the amount of any dividend equivalents, and (iii) any other information necessary to apply the rules of Treas. Reg. § 1.871-15 (the "Responsible Party"). The Regulations define "party to the transaction" broadly to

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[14] A special dividend of $0.125 or more per share will trigger an adjustment to the terms of an option that is generally treated as a dividend equivalent if the option is a section 871(m) transaction. Special dividends in an amount below that threshold do not result in such an adjustment.

[15] In 2015, some 79 stocks paid special dividends that resulted in an adjustment of the terms of listed options on those stocks. Options are listed on roughly 4,500 stocks, which means that special dividends were paid on fewer than 2% of the stocks on which listed options are traded. Even for these stocks, only options with terms to expiration that included the date for the special dividend would be affected.

[16] Treas. Reg. § 1.871-15(g)(1) provides that if a taxpayer calculates delta for non-tax business purposes, that delta ordinarily is the delta for purposes of Treas. Reg. § 1.871-15(a)(9)(iii).

include not only the long party and the short party, but also brokers, dealers and other intermediaries involved in the transaction.[17]

Unfortunately, Treas. Reg. § 1.871-15(p) does not provide sufficient guidance to identify the Responsible Party in the case of a listed options transaction. It is critically important that there be certainty on this point because if the person who is the Responsible Party fails to make the required determinations, that person may be liable for withholding tax.[18]

Treas. Reg. § 1.871-15(p) provides that if a broker or dealer is a party to a potential section 871(m) transaction with a counterparty that is not a broker or dealer, then the broker or dealer is the Responsible Party. That provision further states that if both parties to a potential section 871(m) transaction are brokers or dealers, or neither party is a broker or dealer, then the short party is the Responsible Party. The Regulations thus make clear that if the parties to a particular transaction include a broker or dealer (as the term "party to the transaction" is broadly defined), then a broker or dealer will be the Responsible Party.

In the case of listed options transactions, there are frequently multiple brokers involved. For example, a foreign person may have a brokerage relationship with a local broker ("introducing broker"); the customer's transactions on a U.S. options exchanges may be executed by a different broker that is a member of the exchange ("executing broker"); [19] and the options transaction may be cleared and settled with OCC by a third broker that is a clearing member of OCC ("clearing broker").[20] Often the same broker will be both the executing broker and the clearing broker. Brokers will typically also be involved on behalf of the short party to the transaction, *i.e.*, the party whose order was matched on the exchange with the order from the long party, but these brokers have no relationship with the long party and do not know the identity of the long party. Accordingly, one of the brokers acting for the long party must be the party responsible for making the determinations required by Treas. Reg. § 1.871-15(p).

The Coalition suggests that the following principles should be used to identify the broker that is the Responsible Party for a listed options transaction:

- The Responsible Party should be a broker who knows that the long party is a non-

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[17] *See* Treas. Reg. § 1.871-15(a)(9)(iii).

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

[19] Only members of an exchange can engage in transactions on the exchange.

[20] All options transactions on U.S. exchanges must be cleared through a firm that is an OCC clearing member.

U.S. person. There is no reason to make the determinations required by Treas. Reg. § 1.871-15(p) if the long party is a U.S. person, and most of the time (roughly 85-90%) the long party to an options transaction on a U.S. exchange is a U.S. person. In this regard, listed options are different from instruments that trade in a secondary market. For such instruments, even though the initial purchaser may be a U.S. person, the instrument may later be sold in the secondary market to a non-U.S. person and thus it is necessary to know the initial delta. As explained above, listed options in the U.S. do not trade in a secondary market and there is thus no reason to calculate delta and make the other determinations required by Treas. Reg. § 1.871-15(p) if the long party in a listed options transaction is a U.S. person.

- The Responsible Party should be a broker that is in a position to see multiple positions that may have to be combined to determine whether they constitute a section 871(m) transaction. Thus, the broker should be able to associate specific transactions with specific customers (as opposed to dealing with transactions in an omnibus customer account of another broker). Essentially, the broker needs to "see" the customer and be able to associate specific transactions with that customer.

- The Responsible Party should be a broker that knows when a transaction is closed out or otherwise terminated. If a section 871(m) transaction is terminated before a dividend date on the underlying stock, there is no dividend equivalent. A broker who "sees" the customer and can associate specific transactions with the customer should be in the position to know if a transaction has been terminated.

Based on these principles, it appears that the broker where the non-U.S. person's assets are held ("custodied") should generally be the Responsible Party. That broker typically "sees" the customer, has tax documentation for the customer, and is in a position to identify potential combinations and to know when a transaction is closed out or otherwise terminated. That broker is also typically the withholding agent. As the Coalition understands things, customer assets are typically held by the clearing broker.[21]

As stated above, the broker required to make the determinations under Treas. Reg. § 1.871-15(p) should be permitted to use end-of-day deltas that OCC calculates. But this is not to

[21] Special considerations may arise if the customer's assets are custodied with a non-U.S. broker that is a nonqualified intermediary (an "NQI"). In these cases, it may make sense for the U.S. broker who receives tax documentation from the NQI and effectuates withholding to be the Responsible Party. Enhancements to the flow of information between the NQI and the withholding agent may be necessary, as well as default rules addressing what the withholding agent should do if the NQI does not provide the necessary information.

say that OCC is the Responsible Party in a listed options transaction (or that OCC is somehow otherwise charged with the requirement to calculate deltas for purposes of section 871(m)). It is clear under the Regulations that OCC is not the party required to make the determinations required by Treas. Reg. § 1.871-15(p). OCC is not a broker or a dealer; it is a clearing organization performing a clearing function similar to NSCC.[22] As such, OCC is a passive market utility and is a party to the transaction only for the limited purpose of carrying out its functions as a clearing organization. OCC is not a party to an options contract at the time the transaction is entered into. OCC becomes a party later in the day when the contract is novated. When novation occurs, OCC is always facing one of its clearing members on the other side, and OCC's clearing members are all broker-dealers. In addition, OCC does not satisfy the principles described above: OCC does not know when a clearing member's customer is a non-U.S. person, and OCC cannot associate specific transactions with any particular customer of the clearing member.

3. **Reduce Recordkeeping Requirements Associated with Calculating Deltas for Listed Options.** -- Under Treas. Reg. § 1.871-15(p)(4), the party with responsibility to determine if a potential transaction is a section 871(m) transaction is required to retain records to support the determinations required under Treas. Reg. § 1.871-15(p)(1). These records include "documentation and work papers supporting the delta calculations." It seems clear that such records must be retained not only for transactions that meet the delta 80 test, but also for out-of-the-money options with very low deltas in order to establish that the options have initial deltas below 80. Such records must be kept only if the long party is a foreign person and, presumably, only if a dividend date occurs while the option is outstanding.

The Coalition believes that these recordkeeping requirements can be greatly simplified if, as recommended above, deltas for listed options can be based on the prior day's close and brokers are permitted to use the deltas that OCC calculates for purposes of the Delta-Based Hedge Exemption. A broker that uses OCC's deltas should be required to retain only the value of the delta (*e.g.*, delta 40) with an indication that it came from OCC. If a broker uses its own proprietary model, it should be sufficient for the broker to retain the value of the delta and an indicator that the delta was calculated pursuant to the model that the broker uses in its business. Given the volume of listed options transactions, and the fact that end-of-day prices are readily retrievable after the fact, it does not seem necessary to require brokers using their proprietary models to retain all of the inputs used to calculate deltas. In this regard, it is worth noting that the

[22] NSCC (National Securities Clearing Corp.) is the clearing organization that clears and settles virtually all broker-to-broker equity securities trading in the United States. Like OCC, NSCC acts as the central counterparty and typically guarantees completion of the transactions.

SEC does not require broker-dealers using proprietary models for purposes of the Delta-Based Hedge Exemption to retain the inputs used in calculating deltas. Nor is OCC required to retain such inputs. It is sufficient that brokers and OCC calculate the deltas pursuant to permitted models as a matter of standard business practice. The same should be true for purposes of section 871(m).[23]

There is another aspect of the recordkeeping rules in Treas. Reg. § 1.871-15(p)(4) that could be improved if deltas for listed options can be computed based on the prior day's close. As noted above, most listed options do not have a scheduled dividend date prior to their expiration date (either because the underlying stock does not pay dividends or because the option will expire before the next scheduled dividend). For these options, there is generally no need to calculate an initial delta except for the possibility that a special dividend will be declared with a dividend date that falls prior to the option's expiration date. Given the fact that only a small percentage of stocks on which listed options are traded will pay a special dividend during any given year (less than 2% in 2015), and if use of end-of-day deltas for listed options is permitted, the Coalition has recommended that brokers with the responsibility to make the determination under Treas. Reg. § 1.871-15(p) not be required to determine the initial delta of options with no in-range dividends unless and until a special dividend is declared with a dividend date prior to the option's expiration. At that point, the broker can retrieve the closing price information for the day prior to the day the option was entered into and compute an initial delta on that basis. Such an approach, however, would not comply with the "substantially contemporaneous" requirement in Treas. Reg. § 1.871-15(p)(4). Accordingly, the Coalition recommends that this requirement not apply in situations in which there are no in-range dividends for an option at the time the option is entered into.

4. **Provide Guidance on Combination Issues.** -- Under Treas. Reg. § 1.871-15(n), two or more potential section 871(m) transactions that are entered into in connection with each other ("Related Transactions") are treated as a single section 871(m) transaction if, on a combined basis, the transactions "replicate the economics of a transaction that would be a section 871(m) transaction if the transactions had been entered into as a single transaction" (the "Combination Rule"). The Regulations provide specific guidance for two fact patterns: First, a purchased call option on 100 shares and a written put option on 100 shares of the same stock should be combined and the resulting delta computed by reference to 100 shares. Second, two purchased at-the-money or out-of-the money call options would not be combined.[24] There are,

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[23] In the case of OCC, retaining inputs would potentially mean retaining input used in calculating deltas for 850,000 unique options series every business day.

[24] *See* Treas. Reg. § 1.871-15(n)(6); Preamble at pp. 30-31.

however, many other fact patterns for which the Regulations do not provide sufficient guidance for brokers or their foreign customers to apply the Combination Rule. As a result, it is not clear how to articulate the logic that is needed in order for brokers to build appropriately robust systems. The Coalition is concerned that if brokers do not know how to apply the Combination Rule, they cannot build the necessary systems and, therefore, may not permit their non-U.S. customers to trade U.S. listed options. In addition, non-US persons making a good faith effort to comply with the Combination Rule will not know how (or whether) it applies. Accordingly, the Coalition urges Treasury and IRS to issue additional guidance on the application of the Combination Rule and to afford brokers adequate time to develop the necessary systems, even if this means delaying the effective date of the Regulations with respect to certain transactions.

The Coalition has two specific recommendations for further guidance. First, applying the Combination Rule to multiple listed options should not result in the creation of complex contracts that must be tested under the substantial equivalence test. Each listed option is a simple contract and potential combinations of individual listed options contracts should be tested under the rule for simple contracts. Applying the Combination Rule to listed options is sufficiently challenging without layering on the need to apply the substantial equivalence test to multiple potential complex contracts that might be created.

We recognize that the Regulations can be read to support the view that the Combination Rule can result in creating complex contracts. The Combination Rule requires that transactions meeting the "in connection with" standard (including, by virtue of the presumptions) are tested as if they had been entered into as a single transaction. If a foreign person bought, say, two at-the-money calls and sold one at-the-money put, applying this standard could mean that the two calls and the put are combined to create a complex contract and that one has to apply the substantial equivalence test to determine if the combined transactions constitute a section 871(m) transaction.

However, the Coalition does not believe that this interpretation was intended. Apart from the extreme complexity that would result, the Regulations themselves support this conclusion. Treas. Reg. § 1.871-15(n)(6) states, in part, as follows:

> If a long party enters into more than two potential section 871(m) transactions that could be combined under this paragraph (n), a short party is required to apply paragraph (n)(1) of this section by combining transactions in a manner that results in the most transactions with a delta of 0.8 or higher with respect to the referenced underlying security. Thus, for example,

> if a taxpayer has sold one at-the-money put and purchased two at-the-money calls, each with respect to 100 shares of the same underlying security, the put and one call are combined. Similarly, a purchased call on 100 shares and a sold put on 200 shares of the same underlying security can be combined for 100 shares with 100 shares of the put remaining separate. The two calls are not combined because they do not provide the long party with economic exposure to depreciation in the underlying security.

If individual options can be combined to create complex contracts, one would need to consider combining both at-the-money calls with the at-the-money put and applying the substantial equivalence test.

We believe that requiring consideration of potential complex contracts in applying the Combination Rule to listed options is unnecessary to implement the policies of section 871(m) and would add an additional layer of extreme complexity to an analysis of multiple positions that is already extremely complex. Accordingly, the Coalition urges that guidance be issued, whether in the form of a revision to the Regulations or otherwise, making clear that in applying the Combination Rule to listed options, potential combinations resulting in complex contracts are not taken into account.[25] Rather, each options transaction is treated as a simple contract and the deltas of two or more options transactions are combined (assuming the Combination Rule applies) to determine if the delta 80 threshold is met.[26]

Second, guidance should be issued making clear that long call options are not combined with one another, without regard to whether they are in the money or out of the money.[27] The Regulations do not expressly address this issue, except in the case of two at-the-money calls, which are not combined because "they do not provide the long party with economic exposure to depreciation in the underlying security."[28] The Coalition believes that the policies underlying section 871(m) and the principles embodied in Treas. Reg. § 1.871-15 support the conclusion that long calls should not be combined without regard to whether they provide downside

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[25] At a minimum, guidance should make clear that the Combination Rule can result in complex contracts only if absolutely necessary to carry out the purposes of section 871(m).

[26] Apart from avoiding additional complexity, this approach should result in a larger number of section 871(m) transactions.

[27] The same is true for written put options.

[28] Treas. Reg. § 1.871-15(n)(6).

exposure (*i.e.*, are in the money).

The validity of this proposition is, perhaps, easiest to see when the call options have the same terms. For example, assume that XYZ stock is trading at $40 per share and foreign person ("FP") buys two call options with a strike price of $35 and initial deltas of 70. Under the Combination Rule, the two calls would be combined if, on a combined basis, "they replicate the economics of a transaction that would be a section 871(m) transaction if the transactions had been entered into as a single transaction."[29] Viewed as a single transaction, FP holds a call option on 200 shares of XYZ with a strike price of $35 and a delta of 70. Thus, on a combined basis the two options would not constitute a section 871(m) transaction.

The analysis is somewhat different when the call options have different strike prices, but the conclusion is the same. The Regulations make clear that a long call option and a short put option are combined. For example, a long at-the-money call and a short at-the-money put are combined and create a delta one instrument (synthetic stock). In this case, it makes sense to add the delta of the call to the delta of the put. All of the delta value of the put relates to a risk that is not present in the long call, *i.e.*, exposure to the stock price below the current price. The short put thus complements the risk associated with the long call in a way that makes the taxpayer's position with respect to 100 shares more like that of owning the stock, including by offsetting the volatility risk in the call. Accordingly, the call option and the put option should be combined and the delta calculated by reference to 100 shares.

The logic of applying a long call and a short put does not apply with respect to two long calls. Assume, for example, that XYZ stock is trading at $49 and FP buys a call with a strike price of $45 and a delta of 70 and a second call option with a strike price of $47 and a delta of 60. Unlike the long call-short put situation, all of the risk exposure to the stock price in the call option with the $47 strike price ("the 47 call") is already present in the call option with the strike price of $45 ("the 45 call"). The 45 call gives FP exposure to the upside above 49 (the current stock price) and the downside from 49 to 45 while the 47 call creates the same upside exposure above 49 and downside exposure from 49 to 47. The 47 call thus does not complement the risk associated with the 45 call in a way that makes the taxpayer's position with respect to 100 shares more like owning the stock. Rather it replicates a portion of the exposure to the stock price inherent in the 45 call with respect to a second block of 100 shares.[30] In addition to the fact that

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[29] Treas. Reg. § 1871-15(n)(1)(iii).

[30] Similarly, adding the 47 call to the 45 call does not increase the likelihood that either the 47 call or the 45 call will finish in the money on a combined basis. The chance that one of the two calls will finish in the money remains equal
(continued...)

all of the exposure to the stock price in the 47 call is already inherent in the 45 call, adding the 47 call increases FP's volatility exposure (as compared to just holding the 45 call) and thus increases a risk that makes the two calls together less like owning stock than the 45 call by itself. Accordingly, the calls should not be combined.

In addition to the two issues discussed above, there are a number of uncertainties relating to the application of the Combination Rule as to which guidance is needed. Here are a few simple examples:

- **Example 1:** Foreign Person (FP) buys a 50 delta call and a 40 delta call and sells a 40 delta put. Which call should the put be combined with?

- **Example 2:** FP buys a call option on Day 1 with a delta of 60. On Day 2, when that call option has a delta of 40, FP writes a put with a delta of 20. Do you use the Day 1 delta of 60 for the call or the Day 2 delta of 40 for purposes of determining if the 80 delta test is met?

- **Example 3:** FP buys a 70 delta call and writes a 50 delta put. It is clear that these transactions should be combined to create a section 871(m) transaction, but it is not clear what the numerator and denominator should be.

- **Example 4:** FP enters into a total return swap on 100 shares and buys a 10 delta call on 100 shares. Are these positions combined? What if the call had a delta of 60?

The Coalition would welcome the opportunity to work with Treasury and the Service to develop the additional guidance that is needed.

Legacy Section 871(m) Transactions

Under the Regulations, if a position is part of a combined transaction that constitutes a section 871(m) transaction, the position remains a section 871(m) transaction even if the other position or positions are closed out or otherwise terminated (the "Legacy Rule"). This rule is uneconomic and is presumably included for administrability reasons.

There are several unanswered questions about what follows from the fact that the retained

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to the chance that the 45 call finishes in the money on a stand-alone basis. In contrast, adding a short put to a long call does increase the likelihood that one of the two options will finish in the money on a combined basis.

position continues to be a section 871(m) transaction:

- Does the retained position carry its own initial delta (which may have been below 80 delta) or the delta for the entire combined transaction for purposes of calculating the amount of any dividend equivalent payments? The answer would appear to be the latter, though this would result in highly uneconomic treatment.

- Is the retained position available to be recombined with other positions or is it walled off?

- Does the Legacy Rule apply if one of the legs in the combined transaction expires by its terms? For example, if FP buys a 50 delta call with three months to expiration and writes a 50 delta put having two months to expiration, and the two transactions are combined, is the call still a section 871(m) transaction after the put expires?

Additional guidance on these issues, whether in the Regulations or through other forms of guidance, would be very helpful.

Time at Which Combination Rule is Applied

There is some uncertainty as to the time or times at which the Combination Rule should be applied. The language in the Regulations could be read to require that the Combination Rule be applied throughout the course of the trading day with the result that positions that are opened and closed on the same day may be combined with other positions on a very transitory basis. Here is an example:

> At 10 a.m. FP buys three 50 delta calls on XYZ stock; at 11 a.m. FP writes two 30 delta puts on XYZ; at noon FP closes the puts; at 1:30 p.m. FP writes one 45 delta put; and at 3 p.m. FP buys a 60 delta call. At the end of the day, FP has three 50 delta calls, one 60 delta call and one 40 delta put. On an end-of-day basis, FP would have one section 871(m) transaction consisting of the 40 delta short put and either the 60 delta call or one of the 50 delta calls (it is not clear which). If the Combination Rule is applied throughout the day, FP created two section 871(m) transactions at 11 a.m. when it wrote the two 30 delta puts. These section 871(m) transactions each consisted of one 50 delta call and one 30 delta put. When FP closed out at the puts at noon, FP continues to have two section 871(m) transactions under the Legacy Rule. The two section 871(m) transactions each consist of a single (delta 50) call. At 1:30 when FP writes the 40 delta put, FP apparently creates

> another section 871(m) transaction consisting of the third 50 delta call acquired at 10 a.m. and the 40 delta put.

The foregoing stylized example, with facts far simpler than those presented by the activity of many options traders, illustrates the radically different results that flow from applying the Combination Rule continuously throughout the day as opposed to applying the rule after the close of trading. Continuous application of the Combination Rule throughout the day, as compared with applying the rule after the close of trading, would result in many more legacy section 871(m) transactions consisting of individual transactions which were briefly combined under the Combination Rule with other positions that were acquired and terminated on the same day.

The Coalition believes that the consequences that follow from applying the Combination Rule throughout the day coupled with the Legacy Rule are inappropriate and unnecessary to carry out the purposes of section 871(m). Continuous application of the Combination Rule would also add significantly to the complexity of applying that rule. Accordingly, the Coalition recommends that the Combination Rule apply only once a day after the close of trading for the day.

5. Permit Elective Approaches for Determining Delta on a Net Basis. -- Many options strategies involve using multiple options, some of which have long deltas and some of which have short deltas. Examples include spreads, straddles,[31] strangles, and butterflies. These strategies have highly non-linear payoffs, *i.e.*, the payoffs do not increase or decrease in synch with changes in the price of the underlying stock, and they are plainly not economic substitutes for owning the underlying stock.

The preamble to the Regulations contains the following discussion of strategies that include long and short delta positions:

> Several comments recommended that a combination rule permit netting of long and short positions. Commenters observed that many standard option strategies involve multiple options positions, often combining positive and negative delta options. As a result, an approach that does not combine these positions would fail to reflect the economics of the

[31] In non-tax options parlance, a straddle consists of either a long call and a long put at the same strike price (a long straddle) or a short call and a short put at the same strike price (a short straddle). The strategy reflects a view on volatility, not the direction of the stock price.

> transactions. Commenters suggested that when a taxpayer modifies an existing combined position that includes both long and short positions, the combined position should continue to be tested based on the net deltas of the component positions rather than test the delta for each position separately. None of the comments, however, proposed an administrable test that could be used to reliably combine long and short positions and net the resulting deltas.[32]

It is extremely important that some mechanism be provided that will permit taxpayers to apply a net delta approach when they use options strategies involving multiple options with both long and short deltas. Failure to address this issue would mean that non-U.S. persons will no longer be able to engage in a number of standard strategies using options over U.S. equities because the withholding tax on dividend equivalents based solely on their long delta options will significantly reduce or eliminate the profit potential of the strategy.

By way of example, consider a fund with foreign investors that pursues a strategy of buying options that are cheap relative to theoretical value and selling options that are expensive relative to theoretical value. The fund is constantly buying and selling calls and puts on a given underlying stock with various strike prices and expiration dates. The fund does not take a directional view on the underlying stock, *i.e.*, it does not seek to be long or short the stock on a net basis. Rather, it seeks to profit from small differences between the market price of an option and the option's theoretical value. The fund hedges away as much risk as possible, including risk associated with changes in the price of the underlying stock. In other words, it seeks to be delta neutral, taking into account all of its positions with respect to an underlying stock, much as an options market-maker or options dealer does. The profit margins for this strategy are quite small and would likely be eliminated by the withholding tax on dividend equivalents if only the long delta positions are taken into account.

The Coalition recognizes the administrability concerns associated with providing an approach for combining long and short delta options. However, we believe that administrable approaches are available. Here are two recommendations:

- Account approach: Permit taxpayers to elect to compute an aggregate net delta for all options and other instruments referencing a particular stock. This approach, which

[32] Preamble at p. 30.

would be similar to the mixed straddle account election in the section 1092 regulations,[33] would presumably require that the aggregate net delta be retested whenever there is a change in the taxpayer's positions referencing the stock. While this obviously deviates from the proposition that one tests delta only at the time of issuance, the account approach would be elective and a taxpayer concerned about the burden of retesting would not be required to use it. Moreover, it is likely that a taxpayer making the election would actually calculate an aggregate net delta every day for its own business or investment purposes (like the fund in the example above). And, if Treasury and IRS permit deltas for listed options to be based on the prior day's close and permit the use of OCC-calculated deltas, the burden of retesting should not be all that great. Indeed, the ability to use deltas based on prior day's close would mean that the Delta-Based Hedging Exemption, which similarly entails calculating an aggregate net delta for all options referencing a particular stock using end-of-day deltas, could be a useful model.

- Identified combination approach: Another approach would be to permit taxpayers to identify specific transactions as related and compute a net delta for the combined transactions. This approach would be comparable to the ability to identify positions that comprise a straddle for purposes of section 1092.[34] Permitting taxpayers to identify related transactions could, for example, provide a viable approach for the appropriate treatment of strategies involving options with positive deltas as well as options with negative deltas (such as spreads) that are entered into as a single transaction pursuant to a "complex order."[35] A taxpayer electing this approach would identify the positions created by a complex order as related and compute a net delta for section 871(m) purposes. Positions entered into pursuant to a complex order are frequently also closed out pursuant to a complex order. When this occurs, there would be no need for retesting of delta after the initial determination. Accommodating other ways in which the initial positions may be terminated (*i.e.*, legging out) would likely require some retesting of delta. However, the approach would be elective and would likely be used only if the taxpayer already calculates delta on an ongoing basis for business or investment purposes. These factors, plus the ability to use end-of-day deltas (including those provided by OCC), should serve to mitigate administrability

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[33] *See* Treas. Reg. § 1.1092-4T.

[34] *See, e.g.*, § 1092(a)(2); Treas. Reg. § 1.1092-3T.

[35] Complex orders represent a significant portion of options exchange volume. For example, in 2013, over 25% of options trading volume on the CBOE was attributable to transactions entered into pursuant to complex orders.

concerns.

The Coalition recognizes that it may well not be feasible to include all the rules needed to implement the above recommendations in the Regulations themselves. However, the Regulations could be modified to provide express authority for the Commissioner to provide these approaches in a revenue procedure or other form of guidance. Such a modification to the Regulations would afford an opportunity for the options industry (and other interested persons) to work with the Service to craft appropriate rules and achieve the goal of having an administrable and economically accurate approach to the tax treatment of strategies involving both long and short positions.

6. Provide Guidance on the Application of the Anti-abuse Rule. -- The Coalition appreciates the need for a broad anti-abuse rule. Notwithstanding the comprehensive and sophisticated nature of the Regulations, it is impossible for Treasury and the Service to envision all the potential ways in which transactions might be structured to avoid the specific rules in the Regulations and achieve results that are inconsistent with the policies underlying section 871(m).

We are concerned, however that the *in terrorem* effect of the broadly worded anti-abuse rule and the associated uncertainty as to when it will be applied will deter non-U.S. persons from entering into transactions that, although informed by a desire not to incur withholding tax on dividend equivalents, are not offensive to the policies underlying section 871(m). We are also concerned that brokers and withholding agents will not permit non-U.S. customers to enter into such transactions (without imposing withholding tax) out of concern that the Commissioner may assert that the broker or withholding agent must have known that the purpose of the transaction was to avoid section 871(m).

Here is a simple example: FP buys an 85 delta call; the call's delta drops to 75; FP closes out the call and immediately replaces it with an identical call. The only reason for FP to close out and replace the call is to avoid section 871(m). Nonetheless, the Coalition believes that this transaction should not be viewed as abusive. While the Regulations call for testing delta only at initial issuance, that rule is one based on administrability concerns associated with retesting delta on later dates. That policy is not fundamental to the purpose of section 871(m), which is to prevent avoidance of dividend withholding tax while holding positions that are economically similar to holding stock. The fact that FP in this example engaged in a section 1001 transaction to come within the rule that delta is tested on initial issuance is not violative of this purpose.

The Coalition recognizes and understands Treasury's and IRS's reluctance to provide detailed guidance regarding the circumstances in which the Commissioner will assert that the anti-abuse rule applies. Nonetheless, the Coalition is concerned that brokers will adopt widely

varying interpretations of what is permissible and what is not and that non-U.S. persons trading listed options over U.S. equities will similarly adopt widely differing views. Thus, the Coalition urges Treasury and IRS to provide some guidance, which need not be in the Regulations themselves, as to the policies and factors that will inform the decision by the Commissioner to invoke the anti-abuse rule, including examples.[36]

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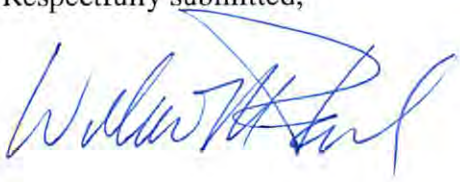
The Coalition appreciates your consideration of these comments and recommendations.

Respectfully submitted,



cc: Mark Erwin
Peter Merkel
Karen Walny

[36] *Cf.* Treas. Reg. § 1.1275-2(g) (OID anti-abuse rule with examples); Treas. Reg. § 1.701-2 (partnership anti-abuse rule with examples).