



Futures Industry Association

2001 Pennsylvania Ave. NW
Suite 600
Washington, DC 20006-1823

202.466.5460
202.296.3184 fax
www.futuresindustry.org

December 15, 2011

Via Electronic Submission

Internal Revenue Service
1111 Constitution Avenue, NW.
Washington, DC
Attention: K. Scott Brown

Re: Swaps Exclusion for Section 1256 Contracts, 76 FR 57684 (September 16, 2011), RIN 1545-BK22

Dear Mr. Brown:

The Futures Industry Association (“FIA”)¹ appreciates the opportunity to provide the Internal Revenue Service (“IRS”) with comments on the proposed amendments to Income Tax Regulations under Sections 1256 and 446 of the Internal Revenue Code (“Proposed Regulations”).² The Proposed Regulations purport to implement the amendment made to Section 1256 (“Swap Exclusion”) by the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”).³

FIA believes that the Proposed Regulations go beyond Congress’ intent in enacting the Swap Exclusion and would establish unwise and detrimental tax policy. The Proposed Regulations expand the definition of a “payment” to include “deemed payments” for purposes of defining a notional principal contract (“NPC”) and then provide that if a regulated futures contract (“RFC”) falls within the definition of an NPC it is not a Section 1256 contract. As a consequence of these

¹ FIA is the leading trade organization for the futures, options and OTC cleared derivatives markets. It is the only association representative of all organizations that have an interest in the listed derivatives markets. Its membership includes the world’s largest derivatives clearing firms as well as leading derivatives exchanges from more than 20 countries. As the principal members of the derivatives clearinghouses, our member firms play a critical role in the reduction of systemic risk in the financial markets. They provide the majority of the funds that support these clearinghouses and commit a substantial amount of their own capital to guarantee customer transactions.

FIA’s core constituency consists of futures commission merchants, and the primary focus of the association is the global use of exchanges, trading systems and clearinghouses for derivatives transactions. FIA’s regular members, who act as the majority clearing members of the U.S. exchanges, handle more than 90% of the customer funds held for trading on U.S. futures exchanges.

² Unless otherwise indicated, all references herein to “Section” or “§” are to the Internal Revenue Code of 1986, as amended (the “Code”), or the Treasury Regulations promulgated thereunder.

³ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

changes, the IRS would effectively remove from Section 1256 treatment a large number of traditional futures contracts that are now and have always been taxed as Section 1256 contracts. Furthermore, by providing that an option on an NPC cannot be a Section 1256 contract, the IRS would also remove such options from Section 1256 treatment.

In our view, a far better approach to implementing the Swap Exclusion would be to simply exclude from Section 1256 treatment those futures contracts that have cash flow payments prior to maturity separate and apart from variation margin payments. Under this approach, traditional futures contracts and options on these contracts would continue to receive Section 1256 treatment, but futures contracts that are structurally equivalent to OTC swaps would be excluded from Section 1256.

BACKGROUND

Dodd-Frank amended Section 1256 by adding the Swap Exclusion to the definition of a Section 1256 contract. This exclusion provides that the following products are not and cannot be Section 1256 contracts: “any interest rate swap, currency swap, basis swap, interest rate cap, interest rate floor, commodity swap, equity swap, equity index swap, credit default swap, or similar agreement.”⁴ The Swap Exclusion was added by the Conference Committee to preserve Section 1256 treatment for existing Section 1256 contracts and to prevent centrally cleared OTC swap transactions from migrating into Section 1256.

Contrary to what we believe to have been Congress’ intent in adding the Swap Exclusion to Section 1256, the Proposed Regulations use the Swap Exclusion to justify excluding from Section 1256 all § 1.446-3 NPCs. The IRS claims that this approach is appropriate because the wording of the Swap Exclusion “suggests that Congress was attempting to harmonize the category of swaps excluded under Section 1256(b)(2)(B) with swaps that qualify as notional principal contracts under § 1.446-3(c), rather than with the contracts defined as ‘swaps’ under section 721 of the Dodd-Frank Act.”⁵ In other words, the IRS is arguing that because the products listed in the Swap Exclusion are similar to the products included in the definition of an NPC (with the addition of credit default swaps), Congress intended to exclude from Section 1256(b)(2)(B) all products that are NPCs under § 1.446-3(c). While we disagree with the approach, it might be more workable were it not for the IRS’ further proposal to expand the existing definition of an NPC through the “Deemed Payment Rule,” discussed below.

Under the IRS’ proposed amendment to the definition of NPC, any futures contract that has as part of its terminal value more than one computation relating to a “specified index” that is made prior to expiration would be treated as an NPC and hence excluded from Section 1256 treatment. In addition, options on such futures contracts would no longer be classified as nonequity options under Section 1256(g)(3) and would lose Section 1256 treatment.

⁴ Dodd-Frank at Section 1601.

⁵ 76 FR at 57685.

PROPOSED NEW DEFINITION OF AN NPC

The IRS has proposed that an RFC could be a Section 1256 contract only *if it met all* of the following conditions:

1. It is subject to a system of marking to market;
2. It is traded on or subject to the rules of a qualified board or exchange;
3. It is not required to be reported as a swap under the Commodity Exchange Act (the “CEA”); and
4. It is not an NPC.

The first two of these conditions are required by Section 1256 itself. The third and fourth requirements would be added by the Proposed Regulations. The third condition is not a statutory requirement but appears entirely appropriate given Congress’ intention to avoid the migration of centrally cleared OTC swaps into Section 1256. The fourth requirement, however, is without statutory justification or authorization and in our view exceeds the IRS’ authority.

The proposed revised definition of an NPC provides that if at least one party to a financial instrument has an obligation to make “two or more” payments to the other party “calculated by reference to a specified index” then the financial instrument is an NPC. This is essentially similar to the existing definition.⁶ If this were the only change to the definition of an NPC, traditional futures would continue to not be NPCs because they do not involve “two or more” payment calculations by reference to an index. On the other hand, given the requirement that an NPC cannot be a Section 1256 contract, futures contracts that provide, in addition to variation margin payments on a mark to market basis, periodic payments from contract counterparties based on an index (that is, replicated payments made between OTC swap counterparties), would be excluded from Section 1256 treatment. This makes sense because these nontraditional futures contracts are designed to be the structural equivalent of OTC swaps. For example, the interest rate swap future contract listed by the International Derivatives Clearing Group (“IDCG Swap Futures”)⁷ has both variation margin and periodic payments.

The IRS proposes to go further and expand the definition of an NPC so as to sweep traditional futures contracts into the NPC definition. This would be accomplished in the Proposed Regulations by redefining a “payment”⁸ for purposes of the NPC rules to include an amount that

⁶ See Andrea S. Kramer, *Financial Products: Taxation, Regulation and Design*, §§ 78.02[A][2] and 78.10 (3d ed. CCH 2011 supplement).

⁷ <http://idcg.com/idch/index.html#contract>.

⁸ 26 C.F.R. § 1.446-3. Section (c)(1)(i) of this Regulation currently states, in part:
A notional principal contract is a financial instrument that provides for the payment of amounts by one party to another at specified intervals calculated by reference to a specified index upon a notional principal amount in exchange for specified consideration or a promise to pay similar

is “fixed on one date and paid or otherwise taken into account on a later date” (the “Deemed Payment Rule”).⁹ The Deemed Payment Rule would force the reclassification of many traditional futures contracts as NPCs and hence out of Section 1256.

Perhaps the best way to illustrate why and how this would occur is to give examples of existing traditional RFCs that would fall within the expanded definition of an NPC and thus outside of Section 1256. One long established futures contract that would be reclassified as an NPC under the Proposed Regulations is the 30-Day Federal Funds Futures contract (“Fed Funds Futures”). Fed Funds Futures have traded at the Chicago Board of Trade (“CBOT”) since 1988, and options on them have traded since 2003. Under current law, Fed Funds Futures are RFCs and options on these futures are nonequity options, both of which are Section 1256 contracts. Fed Funds Futures are cash-settled interest rate contracts, the value of which is based on the average daily effective Federal Funds rate during the delivery month as released each business day by the Federal Reserve Bank of New York.¹⁰ Under the Proposed Regulations, Fed Funds Futures would be recharacterized as NPCs and thus excluded from Section 1256 treatment because their final (or terminal) value is determined based on a series of amounts “fixed on one date and paid or otherwise taken into account on a later date.”¹¹ A substantial number of other RFCs would also be reclassified as NPCs for analogous reasons. These include the following:

- The 3-Month Overnight Index Swap Futures (“OIS Futures”) listed on the Chicago Mercantile Exchange (“CME”)¹²
- Realized Volatility Futures listed on the CME¹³

amounts...Notional principal contracts governed by this section include interest rate swaps, currency swaps, basis swaps, interest rate caps, interest rate floors, commodity swaps, equity swaps, equity index swaps, and similar agreements.

⁹ 76 FR at 57686.

¹⁰ A complete summary of the specifications of CBOT’s Fed Funds Futures contract can be found at http://www.cmegroup.com/trading/interest-rates/stir/30-day-federal-fund_contract_specifications.html.

¹¹ Attached to this Comment Letter as Appendix I is a detailed explanation that involves a buyer and seller that enter into 100 November 2011 Fed Funds Futures contracts on November 1, 2011, at a price of 98.89 and hold them to expiration.

¹² See http://www.cmegroup.com/trading/interest-rates/stir/3-month-ois_contract_specifications.html. This contract reflects the Federal Funds rate compounded over a three month period that ends on the expiration date of the contract. The final settlement of an OIS Futures is based on the interest that would have been earned on a \$1,000,000 notional principal amount during a 3-month period with daily compounding referencing, on a daily basis, the effective overnight Federal Funds rate. Like the Fed Funds Futures contract, the final settlement on the OIS Futures contract is based on a series of payment obligations tied to a specific index. See http://www.cmegroup.com/trading/interest-rates/stir/3-month-ois_contract_specifications.html.

¹³ See http://www.cmegroup.com/trading/fx/realized-fx-volatilities/eur-usd-1-month-realized-volatility_contract_specifications.html.

- Certain electricity futures contracts listed on the New York Mercantile Exchange (such as PYM Western Hub Peak Calendar-Month Real-Time LAMP Swap Futures¹⁴ and the Henry Hub Natural Gas Index (Platts Gas Daily/Platts FIERCE) Futures¹⁵
- CME Seasonal Strip Degree Days Index Futures¹⁶
- Hurricane Seasonal Futures¹⁷
- S&P/Case-Shiller Home Price Index Futures¹⁸
- Interest Rate Swap Futures listed on the Eris Exchange¹⁹
- Mini MSCI EAFE Net Total Return Index Futures listed on NYSE LIFFE US²⁰
- Mini MSCI Emerging Markets Net Total Return Index Futures listed on NYSE LIFFE US²¹

All of these contracts are now taxed as RFCs and options on these contracts are taxed as nonequity options. Nothing in Dodd-Frank or its legislative history suggests that Congress intended to reclassify any of these contracts or to have any of them taxed other than as Section 1256 contracts.

¹⁴ See http://www.cmegroup.com/trading/energy/electricity/pjm-western-hub-peak-calendar-month-real-time-lmp_contract_specifications.html.

¹⁵ See http://www.cmegroup.com/trading/energy/natural-gas/henry-hub-natural-gas-index-swap-futures-platts-gas-daily-platts-iferc_contract_specifications.html.

¹⁶ See <http://www.cmegroup.com/rulebook/CME/IV/400/405/405.pdf>.

¹⁷ See http://www.cmegroup.com/trading/weather/hurricanes/hurricane-seasonal_contract_specifications.html.

¹⁸ See http://www.cmegroup.com/trading/real-estate/residential/SandP-case-shiller-home-price-index_contract_specifications.html.

¹⁹ The Eris Exchange is a CFTC designated contract market. The interest rate swap futures contract (“Eris Futures”) is cleared by the CME Clearing. Eris Futures are traditional futures contracts and are currently taxed as RFCs. The final settlement value is based on a calculation of price alignment, interest adjustments, and coupon payments of the underlining swap over the life of the contract. The only interim payments are those associated with the variation margin standard for all RTCs.

²⁰ See <http://www.nyseliffeus.com/sites/liffeus.nyx.com/files/minieafentr.pdf>.

²¹ See <http://www.nyseliffeus.com/sites/liffeus.nyx.com/files/miniemntr.pdf>.

ALTERNATIVE APPROACH

As we noted above, if the IRS were simply to drop the Deemed Payment Rule, nontraditional futures contracts such as the IDCG Swap Futures contracts would be excluded from Section 1256 because of their actual periodic payments while traditional futures contracts would remain as Section 1256 contracts. This suggests to us that the better approach to the implementation of the Swap Exclusion would be to draw a clear distinction between traditional RFCs, such as those mentioned above, and nontraditional futures contracts that replicate those OTC swaps that Congress may have sought to keep out of Section 1256.

This would be an appropriate and straight forward approach. If an RFC provides for cash flow payments that replicate periodic swap payments, those RFCs should be reclassified as NPCs. However, traditional futures contracts (including Fed Funds Futures, OIS Futures, Eris Futures and the like) that do not have a payment structure that differs in any way from other futures contracts (such as corn, petroleum, and gold), and the options on these futures contracts, would continue to receive Section 1256 treatment. The rationale for this direct and far less convoluted approach is that futures contracts traditionally have been distinguished from OTC swaps by reason of the absence of periodic cash flows (unrelated to mark to market movements). Traditional futures contracts do involve daily mark to market margin payments but no periodic payments based on “an index.”²² Swaps, on the other hand, involve periodic payments.

In passing the Swap Exclusion, Congress sought to prevent swaps that become subject to central clearing from becoming Section 1256 contracts. We have no argument with that objective. Indeed, we believe that futures contracts that are purposely structured to replicate the pattern of a swap’s periodic payments should not be entitled to Section 1256 treatment. What we object to is the IRS’ proposal to reclassify traditional RFCs as NPCs on the entirely artificial ground that they involve “deemed payments.” Calculation methods vary from futures contract to futures contract, and to suggest that one calculation method but not another should result in a futures contract losing Section 1256 treatment is arbitrary in the extreme.

SIMILAR ECONOMICS IS NOT THE TEST

We understand that IRS personnel are of the view that a futures contract with “the same economics” as an OTC instrument should be taxed as an OTC instrument and not as a Section 1256 contract. This notion is misguided for a variety of reasons. First, it is and always has been possible to use futures contracts to replicate the economics (if not the costs or cash flows) of OTC products. For example, a properly constructed strip of Eurodollar futures would replicate the economics of an OTC interest rate swap.²³ Second, the “same economics” is not a criterion for tax treatment. As the IRS is well aware, many economically similar financial

²² Collateral may also flow between counterparties to provide security for performance, and acts in many respects like variation margin for futures contracts in that it flows based on the value of a party’s open position. The primary difference is that variation margin becomes the property of the recipient, while collateral remains the property of the party posting it.

²³ See http://www.cmegroup.com/trading/interest-rates/stir/eurodollar_contract_specifications.html.

products are taxed differently. And third, the criteria for a particular product's classification under Section 1256 is not economic equivalence or nonequivalence to some other product but rather the structure and regulatory treatment of the particular financial product in question.²⁴

CONCLUSION

We again emphasize the radical and unauthorized change in the status of many existing futures and option contracts that would result from adoption of the Proposed Regulations. Continuing to treat traditional futures contracts as RFCs and their options as non-equity options, while excluding nontraditional contracts structured as OTC swaps from such treatment, would fully implement the Congressional objective in passing the Swap Exclusion without unnecessarily and inappropriately disrupting the existing tax status of traditional futures contracts.

We would be pleased to meet with you to discuss our comments further.

Respectfully yours,



John M. Damgard
President

²⁴ See Joint Committee of Taxation Report (JCX-56). See also testimony of Thomas Barthold, Chief of Staff for the Joint Committee on Taxation at House Ways and Means Committee and Senate Finance Committee Joint Hearing on the Tax Treatment of Financial Products (Dec. 6, 2011) "But the bottom line result is that while the underlying economics -- often anyway -- the bottom line result is that while the underlying economics of two different financial [products] may be identical, the tax treatment under present law may not be equal." See also testimony of Chairman of the Joint Committee of Taxation, David Camp, "[T]oday's marketplace features a wide array of products that can result in different tax or financial accounting treatment of economically similar products. ..."

APPENDIX I

Fed Fund Futures Example

Inputs		
	\$ 5,000,000.0	
Notional Principal/Contract	0	
Value of a Tick (one full increment)	\$ 41.67	= Notional (5,000,000) / # of possible ticks (10,000) / frequency (12 months)
Quantity Traded	100	Assumed
Price Traded	99.89	Assumed
Date Traded	11/1/1011	Assumed
Terminal Settlement Price (expiry - 11/30)	99.919	= 100 - average Fed Effective Rates for the month rounded to 3 decimal places
	99.9193333	
Terminal Value -- no rounding	3	
Profit by the Buyer	\$ 12,083.33	= (Final Settlement - Price Paid) * Quantity Traded * Value of a Tick
Loss by Seller	\$ (12,083.33)	= (Price Sold - Final Settlement) * Quantity Traded * Value of a Tick

The example includes the actual daily Fed Effective Rates for the month of November 2011 released by the New York Fed. It also includes the daily settlement prices for the November 2011 Fed Funds Futures contract from November 1st through November 30th (i.e., the averaging period for the November 2011 contract). In the example, the buyer profits (and the seller loses) \$12,083.33. This result can be calculated in three different ways.

- (1) Determine the number of ticks in the difference between the price traded and the terminal value. (This is shown above in the lines "Profit by Buyer" and "Loss by Seller.")
- (2) Determine the aggregate net amount of variation margin that flowed between the parties. (This is shown under the "Analysis" below in the column entitled "Variation Margin.")
- (3) Determine the aggregate net value of the constructive payments made between the buyer to seller based on the daily Fed Effective rate. In other words, determine the daily constructive payments, the sum of which at the end of the month will equal the profit and loss. (This is shown under the "Analysis" below in the column entitled "Constructive Daily Accrued Payment.")

APPENDIX I (continued)

Analysis

<u>Date</u>	<u>FF Effective</u>	<u>Futures Equiv</u>	<u>Constructive Daily Accrued Payment (Seller to Buyer)*</u>	<u>Futures Settlement Actual**</u>	<u>Variation Margin (Seller to Buyer)</u>
11/1/2011	0.08%	99.92	\$ 416.67	99.9200	\$ 12,500.00
11/2/2011	0.08%	99.92	\$ 416.67	99.9200	\$ -
11/3/2011	0.08%	99.92	\$ 416.67	99.9200	\$ -
11/4/2011	0.08%	99.92	\$ 416.67	99.9200	\$ -
11/5/2011	0.08%	99.92	\$ 416.67	99.9200	\$ -
11/6/2011	0.08%	99.92	\$ 416.67	99.9200	\$ -
11/7/2011	0.08%	99.92	\$ 416.67	99.9175	\$ (1,041.67)
11/8/2011	0.08%	99.92	\$ 416.67	99.9175	\$ -
11/9/2011	0.08%	99.92	\$ 416.67	99.9175	\$ -
11/10/2011	0.08%	99.92	\$ 416.67	99.9175	\$ -
11/11/2011	0.08%	99.92	\$ 416.67	99.9175	\$ -
11/12/2011	0.08%	99.92	\$ 416.67	99.9175	\$ -
11/13/2011	0.08%	99.92	\$ 416.67	99.9175	\$ -
11/14/2011	0.08%	99.92	\$ 416.67	99.9175	\$ -
11/15/2011	0.09%	99.91	\$ 277.78	99.9175	\$ -
11/16/2011	0.08%	99.92	\$ 416.67	99.9175	\$ -
11/17/2011	0.08%	99.92	\$ 416.67	99.9150	\$ (1,041.67)
11/18/2011	0.08%	99.92	\$ 416.67	99.9150	\$ -
11/19/2011	0.08%	99.92	\$ 416.67	99.9150	\$ -
11/20/2011	0.08%	99.92	\$ 416.67	99.9150	\$ -
11/21/2011	0.08%	99.92	\$ 416.67	99.9150	\$ -
11/22/2011	0.08%	99.92	\$ 416.67	99.9150	\$ -
11/23/2011	0.09%	99.91	\$ 277.78	99.9150	\$ -
11/24/2011	0.09%	99.91	\$ 277.78	99.9150	\$ -
11/25/2011	0.07%	99.93	\$ 555.56	99.9150	\$ -
11/26/2011	0.07%	99.93	\$ 555.56	99.9150	\$ -
11/27/2011	0.07%	99.93	\$ 555.56	99.9150	\$ -
11/28/2011	0.08%	99.92	\$ 416.67	99.9175	\$ 1,041.67
11/29/2011	0.08%	99.92	\$ 416.67	99.9175	\$ -
11/30/2011	0.10%	99.90	\$ 0.00	99.9190	\$ 625.00
Totals			\$ 12,083.33		\$ 12,083.33

* A terminal value adjustment is made on November 30 to account for the fact that the CBOT takes the monthly Fed Funds average to 3 decimal places.

** November 30 is marked to terminal value, not exchange settlement on 11/30. This happens normally on the next business day. The result, however, is the same.